A Way Out of California's Public Finance Nightmare?

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Introduction

The need for an overhaul of California's tax system did not arise overnight; the state's fiscal troubles have been brewing for decades. The changing fiscal landscape was jump-started by a property tax revolt in the 1970s, essentially putting a freeze on property tax revenue. That, in conjunction with a shift in consumption patterns, overspending during the good years, fueled most recently by the booming real estate market, followed by the recent housing crash and a nationwide economic slump, have left California's finances in a woeful state. In the face of these grim circumstances, Gov. Arnold Schwarzenegger (R) created the Commission on the 21st Century Economy to research and propose changes to the state's tax system to get the state back on sound fiscal footing. The commission's report is the culmination of a yearlong effort.

Background

The fiscal situation began to deteriorate after the passage in 1978 of Proposition 13, which essentially froze property taxes at 1970s levels. Residential and commercial properties are subject to reassessment on sale. However, commercial properties rarely exchange hands. As a result, the property taxes of many commercial properties are artificially low, undercutting the state's ability to raise sufficient revenue.

Sales tax revenue has also seen a decline over the last couple of decades as consumption shifted toward services and away from the purchase of tangible goods. When the sales tax was implemented in the first half of the 20th century, tangible goods comprised the majority of consumer spending. However, as of 2007, nearly 60 percent of personal consumption consisted of services.[1] In California, most services are not subject to sales tax and this shift is eroding the sales tax base.

The state has become increasingly reliant on the income tax, followed by the sales tax. Approximately half of California's general fund revenue comes from the income tax.[2] The state's second largest source of revenue is the sales tax, which constitutes over a quarter of general fund revenue.[3] Dependence on those two revenue sources, as opposed to the property tax, is problematic because they may fluctuate wildly with the rise and fall of the economy, exacerbating the budget problems in tough years. When people need state services the most, the state faces record budget shortfalls.

The Commission on the 21st Century Economy

The commission's purpose was to find ways to stabilize state revenue through a fair and equitable tax structure that follows the principles of sound tax policy, including simplicity, efficiency, predictability, and ease of administration.[4] Proposed changes to the tax system should also promote the long-term economic prosperity of the state and its citizens and improve California's competitiveness with fellow states and other nations as regards jobs and investments.[5]

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[1]Institute on Taxation and Economic Policy, "Should Sales Taxes Apply to Services?" Policy Brief #3 (2008), *available at* http://www. itepnet.org/pb3serv.pdf.

[2]The California Budget Project, "California's Tax System" (February 2009), a*vailable at* http://www.cbp.org/pdfs/2009/0902_Californias_Tax_System.pdf.

[3]Legislative Analyst's Office, "California's Fiscal Outlook: LAO Projections 2008-09 Through 2013-14," (Nov. 2008) at 23, *available at* http://www.lao.ca.gov/2008/fiscal_outlook/fiscal_outlook_112008.pdf.

[4]Commission on the 21st Century Economy (COTCE), Report, *available at* http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf. *Supra* note 2, at *iii*.

[5]*Id.*

The commission, which began its work in January 2009, comprised 14 members, 7 appointed by Schwarzenegger and the remaining 7 appointed by the State Legislature.[6] Not surprisingly, the Republican governor's choices highlighted his pro-business stance: two members are fellows with the Hoover Institution, a conservative think tank, two represent statewide business associations, one is a Republican city mayor, and one is the CEO of an investment firm; the sole member who does not represent the interests of business is president of a nonprofit focusing on youth, education, and stewardship.[7] The members appointed by the Democrat-controlled Legislature are a more diverse group: a president of an investment bank, a law school dean and civil rights activist, a CEO of a healthcare business, a director of a social and economic justice nonprofit organization, a county treasurer, a CEO of a Spanish-language newspaper, and a law professor who is a state and local tax expert.[8] Although more diverse than the representatives of business interests appointed by the governor, it is not clear whether the Legislature's appointees have knowledge of or expertise in state taxation, with one exception. This is the team that took on the challenge of restructuring California's state tax system.

Tax Policy

There are five generally agreed on broad principles of sound tax policy: ability to raise adequate revenue, neutrality, fairness, ease of administration and compliance, and accountability.[9] The American Institute of Certified Public Accountants upped the ante and settled on 10 principles; however, most of those principles can be condensed to fall under one or more of the principles listed above.[10] Inevitably, those five principles often conflict with one another. For example, an expansion of the tax base to lower-income earners to generate adequate revenue may violate the principle of fairness.

The commission's goal was to comport with "principles of good taxation."[11] It appears that the commission focused on four of the five principles of sound tax policy: economic efficiency (that is, neutrality), fairness and equity, administrative ease, and revenue generation.[12]

Overview of California's Tax System

State Tax Revenue

There are four major sources of revenue for the state's general fund: personal income tax, sales and use tax, corporate tax, and property tax.[13] In the current fiscal year, California's personal income tax accounted for roughly 54 percent of the state's general fund revenue.[14] The rate ranges from 1 percent to 9.3 percent, with an additional 1 percent levied on individuals earning over $1 million.[15] The sales and use tax, levied on nonexempt tangible goods and set at a 7.25 percent base statewide rate, brought in over 27 percent of state revenue.[16] In general, services are not subject to the sales and use tax. Purchases by individuals account for roughly two-thirds of the sales tax revenue; business purchases account for about one-third.[17] The corporate tax accounts for roughly 13 percent of the state's general fund revenue.[18] That tax includes the corporate franchise tax, the corporate income tax, and the bank tax, and is imposed on corporations (at a rate of 8.84 percent for regular corporations), financial corporations (10.84 percent), subchapter S corporations (1.5 percent), and other business entities.[19]

State Tax Expenditures

Because of many tax expenditure programs (TEPs), California's taxpayers often pay far less in state taxes than the base tax rates would suggest. TEPs are intended to remove perceived inequities in the basic tax structure, to advance specific policy goals, or to bring California tax law into conformity

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[6]*Id.*

[7]*Id.* at *v.*; Morgan Family Foundation, *available at* www.morganfamilyfoundation.org (last visited Oct. 4, 2009).

[8]COTCE Report, *supra* note 4; SCOPE Strategic Concepts in Organizing and Policy Education, *available at* http://www.scopela.org (last visited Oct. 4, 2009).

[9]David Brunori, *State Tax Policy: A Political Perspective* 13-23 (The Urban Institute Press, 2005).

[10]American Institute of Certified Public Accountants, "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals 9-10: (2001), *available at* http://www.aicpa.org/download/members/div/tax/Tax_ Policy_stmt1.pdf. AICPA's 10 principles: equity and fairness, certainty, convenience of payment, economy of collection, simplicity, neutrality, economic growth and efficiency, transparency and visibility, minimum tax gap, and appropriate government revenue.

[11]COTCE Report, *supra* note 4, at 27.

[12]*Id.* at 29.

[13]Legislative Analyst's Office, "2009-10 Budget Analysis Series: Revenues," (February 2009) at 6, *available at* http://www.lao.ca.gov/2009/tax/revenues_0209/revenues_020609.pdf. Although the property tax is a local tax, local property tax revenues going to school and community college districts are used to fund education as mandated by Proposition 98, a ballot initiative passed in 1988 that committed the state to spending 40 percent of the general fund on schools.

[14]*Id.* at 18.

[15]*Id.*

[16]*Id.* California imposed an additional temporary 1 percent sales and use tax increase effective April 1, 2009, and set to expire July 1, 2011; cities and counties may add up to an additional 2 percent to the statewide sales and use tax with voter approval.

[17]COTCE Report, *supra* note 4.

[18]LAO, *supra* note 13.

[19]*Id.*

with federal provisions.[20] Reports from the State Board of Equalization and the Franchise Tax Board identify over $50 billion in annual TEPs.[21]

Income Tax Expenditures

The standard deduction, personal exemption, and exemption for each dependent are not classified as tax expenditures.[22] TEPs resulted in a loss of fiscal 2008-2009 personal income tax revenue of approximately $36 billion. In fiscal 2007-2008, the mortgage interest deduction cost the state roughly $5 billion, the exemption from tax of capital gains on inherited property cost $4 billion, and the combined deductions by employers for contributions to employees' pensions and accident/health plans cost the state $8.3 billion. Additional TEPs include, for example, exclusions from income of scholarship and fellowship income, employee childcare benefits, and unemployment benefits, as well as deductions for student loan interest, charitable contributions, contributions to IRAs, and medical expenses.[23]

Sales Tax Expenditures

Sales tax expenditures cost the state about $9 billion in fiscal 2008-2009. That came almost entirely from the exemptions for the sales and use tax of food ($5 billion); gas, electricity, water, and steam ($2.3 billion); and prescription medicines ($1.8 billion).[24]

Demographics of Taxpayers — Who Pays Taxes in California?

California is a state with a large number of high-income individuals. In 2007 more than 690,000 tax returns filed in California reported adjusted gross incomes of $200,000 or more.[25] That represents only 4 percent of tax returns filed, but accounts for 37 percent of the total AGI reported for the state. Sixty-six percent of all returns filed in 2007 showed an AGI of less than $50,000.

Because of the progressive nature of California's income tax system, higher-income households pay a greater share of their income in income taxes. The state's sales and use taxes, however, are regressive; that is, lower-income households pay a larger share of their income in sales and use taxes. Taxpayers in the bottom quintile pay 11.7 percent of their income in state and local taxes; taxpayers in the top 1 percent pay 7.1 percent.[26]

Legislative Environment/Governance

Proposition 13 has had far-reaching effects. In addition to rolling back property tax levels and placing a fairly inflexible cap on the maximum annual property tax increase, the measure included the more troubling requirement that any tax increase must gain the support of two-thirds of the Legislature. As of 2008, California was 1 of only 13 states to require a supermajority vote of the Legislature to raise any tax.[27] Also, Proposition 98, passed by voters in 1988, committed the state to spending 40 percent of its general fund revenue on schools. Those are just some of the restrictions placed on state government officials, and as a result, state officials have only a few ways to adjust to budget shortfalls and the increased need for government services.

Table 1.
State and Local Revenue as a Percentage of Personal Income, 2006*

State	Percent of Personal Income	Rank
U.S. Total	11.6%	—
New York	15.7%	2
New Jersey	12.5%	10
California	12.1%	14
Pennsylvania	11.4%	26
Massachusetts	10.9%	36
Texas	10.0%	46

**Source:* Tax Policy Center, "Tax, Facts," *available at* http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=531.

State Comparisons

Although California has a reputation as a high-tax state, it barely ranks in the top third of states — at 14th — in state and local tax collections as a percentage of personal income (see Table 1). When comparing own-source revenue as a percent of personal income, California ranks even lower, at 18th.[28]

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[20]Department of Finance, "Tax Expenditure Report 2008-09" (2008) at 2, *available at* http://www.dof.ca.gov/research/documents/Tax_Expenditure_Rpt_08-09-w.pdf. Franchise Tax Board, "California Income Tax Expenditures: Compendium of Individual Provisions" (December 2008), at 1, *available at* http://www.ftb.ca.gov/aboutftb/taxExp08.pdf.

[21]LAO, *supra* note 13, at 7-8. The LAO thinks that the cost is much higher than $50 billion because many agencies lacked sufficient data to estimate the cost of a significant proportion of the tax exemptions.

[22]FTB, *supra* note 20, at 1.

[23]Department of Finance, *supra* note 20, at 6-7.

[24]LAO, *supra* note 13, at 8.

[25]IRS, SOI Tax Stats — Individual Income Tax Return (Form 1040) Statistics, *available at* http://www.irs.gov/taxstats/index.html (last visited Nov. 25, 2009).

[26]The California Budget Project, *supra* note 2 at 1. Fiscal 2007 taxes as a percentage of 2004 household income.

[27]National Conference of State Legislatures, "Legislative Supermajority to Raise Taxes," (2008), *available at* http://www.ncsl.org/ default.aspx?tabid=17421.

[28]Tax Policy Center, "Tax Facts," *available at* http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=531; American Institute of Certified Public Accountants, "Statement No. 44 of the Governmental Accounting Standards Board," 8-04 J.A. 92, 96 (2004).

Table 2. Current Tax System — Single Filer (Tax Year 2008) *							
Bracket	Taxable Income			Flat Tax		Percent	Of the Amount Over
1	$0	-	$7,168	$0.00	+	1.0%	$0.00
2	$7,168	-	$16.994	$71.68	+	2.0%	$7,168
3	$16,994	-	$26,821	$268.20	+	4.0%	$16,994
4	$26,821	-	$37,233	$661.28	+	6.0%	$26,821
5	$37,233	-	$47,055	$1,286.00	+	8.0%	$37,233
6	$47,055	+	& Over	$2,071.76	+	9.3%	$47,055
*Source: Franchise Tax Board, "Personal Income Tax Booklet 2008" at 26, available at http://www.ftb.ca.gov/forms/2008/08_540tt.pdf.							

Table 3. Proposed Tax System — Single Filer (Tax Year 2009)*							
Bracket	Taxable Income			Flat Tax		Percent	Of the Amount Over
1	$0	-	$27,500	$0.00	+	2.75%	$0.00
2	$27,500	-	& Over	$756	+	6.50%	$27,500
*Source: COTCE Report, *supra* note 4, at 43, App. 30-31.							

On average, California taxpayers devote 12.1 percent of personal income to state and local taxes, which is only slightly higher than the national average of 11.6 percent.[29] Wyoming is ranked first, with 16.6 percent, and South Dakota is lowest, with 9.1 percent.

States differ on whether they subject the purchase of services to the sales tax. California exempts most services from taxation, levying sales tax on just 21 services. Hawaii taxes 160 services, barely edging out Washington and New Mexico as the state that taxes the most services. Only eight states tax fewer services than California does. Oregon, which has no sales tax, is the only state that does not tax any services.[30] The average across all states is taxation of roughly 57 services. The services that California taxes include automotive services, gift packaging and wrapping, tuxedo rental, photocopying, printing, commercial art and graphic design, videotape rental, and short-term leases (of automobiles, airplanes, and other personal property).[31]

Summary of the Commission's Proposals

The commission focused on California's three main tax components of state-level revenue: the personal income tax, the sales and use tax, and the corporation tax, which together account for the 95 percent of the state's general fund revenue. At the conclusion of the study, the commission set forth six recommendations:

- reduce and restructure the personal income tax;
- eliminate the corporation tax and the minimum franchise tax;
- eliminate the state general purpose sales tax;
- establish a business net receipts tax;
- create an independent tax forum; and
- establish a new rainy day reserve fund.

This report focuses on the first and third recommendations. Together, those two revenue sources account for over 80 percent of the state's general fund revenue.

Personal Income Tax

The commission's first recommendation proposes several changes to the personal income tax: modify the standard deduction and curtail the number of itemized deductions available to taxpayers, reduce the number of tax brackets from six (see Table 2) to two (see Table 3), and eliminate credits (excepting the credit for other states' taxes). The revised standard deduction for a single filer would be $22,500 ($45,000 for joint filers). In other words, the first $22,500 ($45,000) of AGI would be exempt from personal income taxation. AGI above the exempted amount and up to $27,500 would be taxed at a rate of 2.75 percent; all income above $27,500 would be taxed at 6.5 percent. Itemized deductions would be

[29]Tax Policy Center, *id.*

[30]Federation of Tax Administrators, "Sales Taxation of Services Survey — 2007 Update," *available at* http://www.taxadmin.org/fta/pub/services/services.

[31]*Id.*

Table 4.
Application of Proposed Tax Brackets and Rates*

2007 AGI Tiers	Percent of All Filers	Average Taxable Income (All Filers)	Single Filer		Joint Filers	
			Current Tax Brackets	COTCE Tax Brackets	Current Tax Brackets	COTCE Tax Brackets
< $50K	66%	$13,400	2%	2.75%	1%	2.75%
$50K - $75K	12%	$37,600	6%, 8%	6.5%	4%	2.75%
$75K - $100K	8%	$55,500	9.3%	6.5%	6%	2.75%, 6.5%
$100K - $200K	10%	$92,500	9.3%	6.5%	8%	6.5%
$200K +	4%	$488,900	9.3%	6.5%	9.3%	6.5%

*[*Source:*] Internal Revenue Service, *supra* note 13; calculations by author, see Appendix (p. 49).

limited to mortgage interest, property taxes, and charitable contributions.[32]

Sales and Use Tax

The commission's third recommendation proposes phasing out the 5 percent general fund portion of the sales and use tax, keeping in place the temporary 1 percent increase and the portions of the sales tax on gas and diesel fuels. The phaseout would reduce the general statewide portion of the sales and use tax by 1 percentage point each year over five years.[33]

Analysis of Commission Proposals and Rationales

Personal Income Tax

The commission's many recommendations concerning the personal income tax would affect the state's tax brackets, tax rates, standard deduction, credits, and itemized deductions.[34]

Tax Brackets, Standard Deduction, and Tax Rates

Tax Brackets. For the 2008 tax year, there were six tax brackets for single filers. The commission proposes to reduce those to two.

For joint filers, the six brackets would also be reduced to two; the two brackets would be split at $55,000. Also, the commission proposes a standard deduction of $22,500 for single filers and $45,000 for joint filers.[35] The rationale provided by the commission for condensing the brackets was partly because it wanted to reduce taxpayer confusion created by the multiple brackets, which results in taxpayers being unable to estimate what their tax burden will be. The idea that most taxpayers are unable to do that is based primarily on anecdotal evidence; taxpayers who engage in serious tax planning are likely to use tax accountants, who are capable determining which bracket applies to the taxpayer.

Table 4 provides a rough comparison of how average taxpayers would likely fair under the proposed versus the current tax brackets. The table reflects only changes to the tax brackets, without taking into consideration the proposed changes to the standard deduction.

There are some inherent weaknesses in using the above calculations:

- AGI is federal AGI, not state;
- average taxable income is likely overstated for single filers and understated for joint filers;
- single filers and joint filers are compared against the average across all filers; and
- the calculations do not account for filers who itemize.

Despite those limitations, the data do provide a rough sketch of the effects of the commission's proposals.

It is apparent from Table 4 that the biggest benefit of the new tax bracket structure would go to taxpayers currently in the highest tax bracket. Taxpayers in the top two or three tiers could look forward to a nearly 3 percentage point reduction in their marginal tax rate, while those in the lowest tax brackets would be hit with a tax increase. Most of the benefit of this restructuring is captured by a fourth of the population — the fourth that is most well-off.

The Standard Deduction. The commission recommends greatly increasing the standard deduction. For single filers, the standard deduction would be increased to $22,500; for joint filers, the standard deduction would be $45,000. The results of a comparison of the current structure versus the proposed structure do not improve markedly when the increased standard deduction is factored in (see Table 5, p. 48).

The same limitations that applied to the tax bracket calculations apply to standard deduction calculations, but some effects are discernable. The increased standard deduction would exempt California's poorest citizens from paying the income tax. Singles with AGI less than $22,500 would have no income tax, and joint filers with AGI less than

[32]COTCE Report, *supra* note 4, at 43.
[33]*Id.* at 44.
[34]*Id.* at 43.
[35]*Id.*

$45,000 would avoid income tax. In 2007, 66 percent of tax returns in California reported an AGI of less than $50,000, so almost all those filers would be exempt from the income tax. The commission voiced concern about overreliance on high-income taxpayers, but its proposed tax regime levies an income tax only on roughly the top third of taxpayers. Exempting two-thirds of taxpayers from income taxes is hardly fair to the remaining third and is liable to cause justifiable resentment. Single persons with an AGI of $22,500 and couples with an AGI of $45,000 are not poor by any government definition: $22,500 is twice the poverty level for a single person; $45,000 is three times the poverty level for a family of two.[36]

Tax Rates. The commission criticizes California's personal income tax for its "very high marginal rates."[37] But the entire tax burden must be analyzed, not just one component of the tax burden. Nevertheless, it is true that California, after February's budget deal, now has one of the highest marginal rates, even when excluding the special bracket for taxpayers earning over $1 million, in which taxpayers are hit with an additional 1 percent tax. For 2009 California's top bracket imposes a marginal tax rate of 9.55 percent on incomes over $47,055.[38] But states' marginal tax rates involve a lot of moving parts, and simply comparing states' top rates is meaningless. For example, Vermont has a top rate of 9.4 percent, roughly the same as California's top rate, but that does not kick in until income exceeds $372,000. However, Missouri's top marginal tax rate, while only 6 percent, affects all income over $9,000.[39]

Credits and Deductions

The commission proposes eliminating all credits except the credit for other states' taxes and limiting itemized deductions to mortgage interest, property taxes, and charitable contributions. These tax expenditure serve important policy objectives. The objectives could be achieved by means other than tax provisions. Rather than reducing beneficiaries' taxes, the Legislature could, for example, establish direct expenditure programs to allocate money toward its policy goals. The two primary policy motivations for tax expenditures are to facilitate a more equitable tax system by providing relief to some taxpayers and to encourage or discourage taxpayer behavior.[40]

Tax expenditures take a big bite out of the state's annual revenue. In fiscal 2008-2009, all tax expenditures cost the state roughly $50 billion.[41] Of that amount, roughly $36 billion was attributable to tax expenditures that reduce personal income tax revenue.[42] Less than $10 billion of those tax expenditures resulted from itemized deductions.[43] The home mortgage interest deduction was the largest tax expenditure, at approximately $5.12 billion. The charitable contribution deduction was the sixth most costly, at $1.83 billion. At $1.45 billion, the real estate deduction, which includes the deduction for property taxes, amounted to $1.45 billion in tax expenditures. Together, those three itemized deductions — the only ones that the commission does not want to eliminate — account for approximately 84 percent of all itemized deductions. For purposes of figuring federal taxes owed, a taxpayer is allowed to deduct state and local real estate taxes paid even if the taxpayer does not itemize; California is not as generous, allowing only itemizers to take the deduction.[44] The proposed changes to itemized deductions would affect roughly 40 percent of California tax returns.[45]

The commission would eliminate all credits except the credit for other states' taxes. It is reasonable to allow a credit for other states' taxes because without that credit, California residents would potentially be taxed twice on some income earned or purchases made in other states. This credit is most valuable to high-income earners, who are more likely to work and travel outside the state. California also permits the following credits: joint custody head of household credit, dependent parent credit, senior exemption credit, senior head of household credit, blind exemption credit, child- and dependent-care expenses credit, a credit for child adoption

[36]Federal Poverty Guidelines, *Federal Register*, vol. 74, no. 14 (Jan. 29, 2009), *available at* http://aspe.hhs.gov/poverty/09fedreg.pdf.

[37]COTCE Report, *supra* note 4, at 7.

[38]Tax Foundation, "State Individual Income Tax Rates 2009," *available at* http://www.taxfoundation.org/taxdata/show/228.html.

[39]*Id.*

[40]FTB, *supra* note 20, at 2.

[41]Department of Finance, *supra* note 20, at 4.

[42]*Id.*

[43]Includes the home mortgage interest deduction, charitable contributions deduction, real estate deduction, employee business and miscellaneous expenses deduction, medical and dental expenses deduction, and casualty loss deduction.

[44]FTB "Personal Income Tax Booklet" 2008, at 11, http://www.ftb.ca.gov/forms/2008/08_540a_540ins.pdf.

[45]Gerald Prante, Tax Foundation, "Most Americans Don't Itemize on Their Tax Returns" (July 23, 2007), *available at* http://www.taxfoundation.org/research/show/22499.html (for tax year 2005).

costs, and the nonrefundable renter's credit.[46] With the exception of the last three, those credits are all aimed at assisting California's residents who are faced with additional burdens and may be struggling to make ends meet. Also, the renter's credit is available only to those who had AGI of less than $35,000 (for single filers).[47] The commission would do away with all those credits aimed at helping out California's less fortunate residents.

The commission wants to eliminate all credits but leave in place allowable deductions, with the exception of the minor changes proposed for itemized deductions. Credits are usually more valuable to low-income taxpayers than deductions. A credit results in a dollar-for-dollar reduction in tax liability until one's entire tax liability is extinguished. In the case of refundable credits, the taxpayer may get a tax refund even if he has not paid any taxes, that is, has no tax liability. Alternatively, the value of any deduction depends on a taxpayer's income tax bracket, and a deduction has no value to a taxpayer if he has no tax liability. The higher the tax bracket one is in, the more valuable the deduction. For example, in the proposed system, there are only two tax brackets, 2.75 percent and 6.5 percent. If taxpayer A (2.75 percent bracket) and taxpayer B (6.5 percent bracket) both have a $1,000 deduction, the deduction will reduce taxpayer A's tax liability by $27.50, but will reduce taxpayer B's tax liability by $67.50.

If the state were to adopt the commission's recommendation to eliminate almost all tax expenditures that affect the personal income tax, the state would no doubt bring in tens of billions of additional revenue each year. However, tax expenditures are more than just costs to the state: They serve the dual purposes of achieving equity and furthering state goals without direct intervention by the government. The sales tax is one of the most regressive taxes, meaning that it is most burdensome on low-income earners. One rationale for exempting groceries from the sales tax is that such necessities constitute a larger share of income for poorer taxpayers, and to levy a tax on those items would therefore disproportionately affect low-wage families. Also, the state can use tax expenditures to provide incentives to modify personal behavior. For example, employees are allowed to exclude qualified employer-provided transportation benefits from income. Those benefits include transit passes and ride share subsidies. Here, the legislative intent was to promote the use of public transit and ride share programs.[48] Or take for example the exclusion of income earned on section 529 education savings accounts. That tax expenditure aims to encourage taxpayers to invest for future higher education expenses, with the goal of making higher education attainable for more of California's citizens.[49]

There are often well-reasoned justifications for the existence of tax expenditures, and the commission has either adopted a rather cavalier attitude toward favored public policies or is being disingenuous in recommending that all but four of them be eliminated. The Legislature is unlikely to give up on its public policy objectives and would instead fund programs that would bring about the same result through direct government intervention. Undoubtedly, there are many tax expenditures that could be eliminated, but the commission's radical approach goes too far. Presumably, the commission has significantly raised the standard deduction to offset the near-total elimination of credits and the reduction in allowable itemized deductions, but such a broad stroke approach is poorly conceived.

Sound Tax Policy?

The only principles of tax policy that are implicated by the proposals to overhaul the personal income tax are adequacy, fairness, and compliance. There is no evidence that one's personal tax rate affects personal decisionmaking, which implicates neutrality. The more than 36 million population of California suggests that high personal income tax rates are not leading residents to flee the state. The proposals do not change the status quo as regards to ease of administration and accountability. From the perspective of adequacy and fairness, taken together, the proposals for reforming the personal income tax are poor tax policy.

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The commission proposes consolidating the current six tax brackets into two brackets, with corresponding changes to the income tax rates. Taxpayers in the top tax brackets would see their rate slashed to a maximum of 6.5 percent, the same rate as applied to all taxpayers reporting taxable income above $27,500 (for single taxpayers). That would be a huge blow to the progressive nature of California's tax system. The idea behind vertical equity, as

[46]FTB, *supra* note 44, at 13-14.

[47]FTB, "What Is and How Do I Qualify for the Nonrefundable Renter's Credit?" *available at* http://www.ftb.ca.gov/individuals/faq/ivr/203.shtml (last visited Nov. 10, 2009).

[48]Department of Finance, *supra* note 20, at 22.

[49]Department of Finance, *supra* note 20, at 30.

exemplified by such progressivity, is that a resident's tax burden is representative of the taxpayer's ability to pay. The proposed rates would tax a person with taxable income of $30,000 at the same rate as a person who earns $300,000. Taxing high-income earners at a rate nearly 3 percentage points lower than the 2008 marginal rate of 9.3 percent would also put a sizable dent in state revenue derived from income taxes.

The proposed standard deduction giving each taxpayer a $22,500 deduction (for a single filer) in lieu of various credits treats dissimilarly situated taxpayers the same, which bucks the notion of horizontal equity. Two taxpayers with AGI of $30,000 are both given a standard deduction of $22,500. They are similar in all ways with two exceptions — one taxpayer is blind and is taking care of a dependent parent. Under the current system, the state allows a credit for those two situations. The proposed system ignores those differences, giving both taxpayers the same deduction amount. Vertical equity — which reflects a taxpayer's ability to pay — is also implicated. The proposal gives the full benefit of $22,500 or $45,000 to taxpayers at all income levels, whereas credits are typically phased out for those with the highest incomes.

Eliminating the multitude of credits available to taxpayers would simplify the tax regime, reducing the time and money necessary for taxpayers to comply with the tax law. Also, doing away with those tax expenditures could result in more general fund revenue, although that would arguably be offset by the increased standard deduction amounts. Those modest benefits of this proposal, despite the proposed changes to the personal income tax, are overshadowed by the effect that the elimination of credits has on the tax system's fairness.

Sales and Use Tax

The commission recommends that California eliminate the general fund portion of the sales and use tax, which is currently set at 5 percent.[50] However, the state would continue to collect the state portion of the sales and use tax levied on gas and diesel fuels.[51] In reaching its recommendation, the commission highlighted three concerns: the high rate structure, the narrowing of the tax base, and the possible double taxation of goods. Because this report does not address business taxes, only the first two concerns are addressed here.

The commission voices concern regarding the basic statewide rate of 8.5 percent.[52] Citing 8.5 percent as the average rate is somewhat disingenuous. The total statewide base sales and use tax rate during the first quarter of 2009 was 7.25 percent before the imposition of the temporary 1 percent increase, effective as of April 2009 and set to expire in July 2011.[53] That was an emergency measure in response to the state's budget shortfalls. Nevertheless, even the 7.25 percent statewide tax rate is the highest nationally, a quarter percentage rate higher than Mississippi's, the state with the next highest statewide sales tax rate.[54] But that takes into account only the *state* tax rate in other jurisdictions. Before the imposition of the extra 1 percentage point, the average sales tax rate across California's more than 1,700 municipalities was 7.79 percent.[55] Since 2.5 percent of the base sales and use tax rate goes either directly or indirectly to those municipalities, municipalities do not tack on much in the way of additional sales tax — just over 0.5 percent on average. Compare that with New York City's. The New York state tax rate is only 4 percent, much lower than the statewide rate in California. But with the addition of a transportation district tax of 0.375 percent and a New York City local tax of 4.5 percent, the total sales tax rate is 8.875 percent.[56] That phenomenon is not limited to large cities. Although the statewide sales tax rate in Texas is only 6.25 percent, in the city of Georgetown, the total sales tax rate is 8.25 percent because the city tacks on an additional 2 percent.[57]

The commission need not be concerned that California's sales tax rate puts the state at a competitive disadvantage. Even if the sales tax rate was high compared with other jurisdictions', it is just one piece of the tax system: The whole tax burden has to be analyzed to really compare one state with another. As discussed above, California barely ranks in the top one-third of the states in total tax burden.

The commission also expresses concern that the tax base is shrinking as more consumer purchases

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[50]COTCE Report, *supra* note 4, at 44. Excluding the temporary 1 percent increase.

[51]*Id.* Revenue would be used for transportation improvements as mandated by Proposition 42 (passed in 2002).

[52]*Id.* at 19.

[53]Board of Equalization, Historical Tax Rates 1/1/09 through 3/31/09, *available at* http://www.boe.ca.gov/sutax/archive_rates.htm.

[54]FTA, State Sales Tax Rates Jan. 1, 2008, *available at* http://www.taxadmin.org/fta/rate/sales.html.

[55]BOE, California City and County Sales and Use Tax Rates, *available at* http://www.boe.ca.gov/sutax/files/city_rates.xls. Adjusted by author to exclude temporary, 1 percent tax rate increase.

[56]New York State Department of Taxation and Finance, "Sales Tax Law Changes in New York City — Effective August 1, 2009," *available at* http://www.tax.state.ny.us/pdf/notices/n09_12.pdf (last visited Nov. 21, 2009).

[57]Georgetown, Texas Finance & Administration, *available at* http://finance.georgetown.org/tax-information/ (last visited Nov. 21, 2009).

consist of services rather than tangible, taxable goods. According to the report, that change is problematic because it has exacerbated the inconsistent treatment of the purchases of the two types of goods.[58] Instead of choosing to expand the sales tax to cover more or most services, the commission opts instead to address the disparity by recommending elimination of the 5 percent statewide sales tax. Over the last three decades, the sales tax base has been eroded — Californians purchase a greater percentage of services than goods and those services are mostly exempt from the sales tax. According to the report, in 2008, spending on taxable goods accounted for 34.6 percent of personal income; in 1980, spending on taxable goods accounted for 55.4 percent of personal income.[59] If the state's aim is to raise sufficient revenue, California should expand the sales tax to include more services. Spreading the sales tax across more services would increase the stability of the sales tax as a revenue source, although the tax would still be subject to the vagaries of the economy. Selectively choosing the services to which to expand the sales tax could improve equity and fairness, another of the commission's stated goals. For example, targeting services used primarily by wealthier citizens would reduce the overall regressivity of the sales tax.

Sound Tax Policy?

The commission's proposal to eliminate the state's general fund portion of the sales tax defies all logic. State sales taxes constitute over a quarter of all of the state's general fund revenue. That alone is evidence of its adequacy. The sales tax is sufficient in that it raises plenty of revenue and certain in that the tax rate does not vary widely from year to year, if at all. The only factor that would challenge the tax's adequacy is its stability. When the economy is suffering, people naturally cut back on their spending, resulting in a decline in sales tax revenue. For that reason, the state should not rely heavily on sales tax revenue, but that is hardly sufficient reason to scrap the tax altogether.

> ***The commission's proposal to eliminate the state's general fund portion of the sales tax defies all logic.***

For most purchases, the sales tax is a relatively neutral tax. For example, it is unlikely that a consumer will be influenced to purchase a $100 item in one jurisdiction versus another because of a 1 percent difference in sales tax; the difference amounts to $1. For much more expensive items and larger disparities in the applicable sales tax rate, that assumption may not hold as true. There is disagreement among researchers regarding the neutrality of the retail sales tax. Some studies have shown that "no conclusion can be made that sales tax affects consumer purchase intentions."[60] Whereas other studies do find that the sales tax affects the choice of vendor, although many of those studies focused on more drastic scenarios, such as purchases from bricks-and-mortar stores versus over the Internet.[61]

Although the sales tax is arguably neutral, its fairness is debatable. The sales tax is regressive, falling disproportionately on lower-income earners. In that sense, the tax does not have vertical equity, and groups that look after the interests of America's less fortunate citizens would challenge any claim that the sales tax is fair.[62] However, the tax does have horizontal equity, affecting similarly situated people more or less the same. Two families, both with two adults, two children, and gross income of $30,000, will pay roughly similar percentages of their income in sales tax.

The commission's recommendation eliminates one of the most efficient taxes in terms of ease of administration and compliance. Vendors collect the tax and remit the revenue to the state. Since merchants automatically calculate and collect the sales tax, it is usually difficult for a purchaser to avoid paying the sales tax, resulting in a high level of compliance. Granted, off-the-book cash transactions can be used to avoid evidence of a sale, and thus the need for collection of sales tax. Also, California residents can avoid paying sales tax by making purchases online from out-of-state vendors. However, not all those purchases go untaxed. Simply because there are loopholes to be exploited does not justify giving up on the sales tax. The sales tax has a high level of accountability. It is transparent, and no one is claiming that the BOE, the entity that administers the state's sales tax program, is run unethically.

[58]COTCE Report, *supra* note 4, at 21.
[59]*Id.* at 19.

[60]Kimberly G. Key and Lisa L. Scribner, "Sales Tax and Consumer Purchase Decisions," *Journal of Applied Business Research*, vol. 20, no. 1 (2004), *available at* http://www.cluteinstitute-onlinejournals.com/PDFs/2004141.pdf.

[61]Austan Goolsbee, "In a World Without Borders: The Impact of Taxes on Internet Commerce," *The Quarterly Journal of Economics* (May 2000), *available at* http://www.mitpressjournals.org/doi/pdf/10.1162/003355300554854?cookieSet=1 (Nov. 22, 2009); Charles L. Ballard and Jaimin Lee, "Internet Purchases, Cross-Border Shopping, and Sales Taxes," *National Tax Journal*, vol. LX, no. 4 (Dec. 2007).

[62]*See* Center on Budget and Policy Priorities at http://www.cbpp.org and California Budget Project at http://www.cbp.org.

Table 5.
Calculations Taking Into Account Proposed Standard Deduction *

2007 AGI Tiers	Average AGI (All Filers)	Single Filers			Married Filers		
		Standard Deduction	Average Taxable Income	COTCE Tax Bracket	Standard Deduction	Average Taxable Income	COTCE Tax Bracket
< $50K	$17,500	$22,500	$0	0%	$45,000	$0	0%
$50K - $75K	$61,400	$22,500	$38,900	6.5%	$45,000	$16,400	2.75%
$75K - $100K	$86,500	$22,500	$64,000	6.5%	$45,000	$41,500	2.75%
$100K - $200K	$135,300	$22,500	$112,800	6.5%	$45,000	$90,300	6.5%
$200K +	$593,000	$22,500	$570,500	6.5%	$45,000	$548,000	6.5%

**Source:* Internal Revenue Service, *supra* note 13; calculations by author, see Appendix (next page).

The recommendation to eliminate the statewide portion of the sales tax flies in the face of sound tax policy. As a well-established, essentially neutral tax, with a high level of compliance, that results in substantial revenue to the state, the sales tax has earned a permanent place in California's tax system.

Alternative Proposals

Although the commission's proposals for personal income tax and sales tax reform are uninspired and do not comport with sound tax policy, there are many sensible alternatives, a few of which are discussed here.

Amend Proposition 13

No state tax overhaul is complete without trying to ameliorate the damage wrought by Proposition 13. The property tax is a stable tax. California's homeowners have become attached to the annual caps on their property tax assessments. Because constitutional tax provisions enacted by a vote of the public can be modified only through a subsequent vote of the people, the chances of persuading residents to repeal Proposition 13 are slim to none.[63] Rates of homeownership increase with age; the same is true for rates of voter participation.[64] Even if property owners would likely kill any attempt to make changes to the current property tax regime, voters may be open to overturning or modifying the two-thirds vote requirement for the raising of taxes. Giving legislators the ability to effectively govern is imperative.

Sales and Use Taxes

Instead of eliminating the state portion of the sales tax, the sales tax should be expanded to include services, the use tax regime should be overhauled, and the state may want to consider revamping the sales tax exemption for necessities.

It is time for California to expand the sales tax to encompass services, especially discretionary services. Services that should be taxed include: pet grooming; auto and personal goods storage; dating services; hair, nail, skin, massage, and other beauty services; dry cleaning and laundry services; admissions to and use of amusements such as movies, bowling alleys, miniature golf, and amusement parks; and limousine services. As purchases have shifted away from tangible goods to intangible goods and services, it is only appropriate that the tax regime adapt to the new economy.

As sales move away from bricks-and-mortar stores to online vendors, sales tax collection is undermined. Only vendors with a physical presence in the state can be required to collect and remit sales tax.[65] Internet purchases, whether coincidentally or intentionally, undermine not only state revenue collection but also taxpayer accountability. Those transactions also foster contempt for tax collection. California's tax forms have a line item for self-reporting of purchases subject to the use tax. No one reports purchases there and the line item is considered a joke. At a minimum, the state should do away with the use tax line item for single purchases under some significant amount, perhaps $500. Ideally,

[63] LAO, "California's Tax System: A Primer," at 12, *available at* http://www.lao.ca.gov/2007/tax_primer/tax_primer_040907.pdf.

[64] U.S. Census Bureau, "Housing Vacancies and Homeownership (CPS/HVS)," Table 17, *available at* http://www.census.gov/hhes/www/housing/hvs/annual08/ann08ind.html. (Roughly 68 percent of Americans are homeowners; only 41 percent of those under 35 years old are homeowners, whereas over 80 percent of persons over 55 years of age are homeowners); U.S. Census Bureau, "Voting & Registration," Table 5, *available at* http://www.census.gov/hhes/www/socdemo/voting/publications/p20/2006/tables.html (22 percent of citizens between 18 and 24 reported voting in the November 2006 election, 40 percent of voters between 25 and 44, 58 percent of voters between 45 and 64, and 64 percent of voters between 65 and 74).

[65] *Quill v. North Dakota*, 504 U.S. 298 (1992).

Congress will eventually take action to impose a national sales tax on Internet sales, with remittance to go to the state where the item is shipped. To minimize the burdens on vendors, items could simply be taxed at the state rate, without having to take into account variations at the county and city levels. That partial collection of the total sales tax due is far superior to the current system.

The commission acknowledged the policy behind exempting necessities from the sales tax, but pointed out that purchases of those goods rise with income, thereby conferring the most benefits on those with higher incomes.[66] If that truly is a concern, the state should consider allowing a credit based on family size to account for yearly expenditures on groceries, medications, and other necessities in lieu of exempting those purchases from sales tax. That would simplify the sales tax regime and continue to protect low-income earners if the credit is refundable. Also, higher-income families would not benefit more from the exemption than the low-income families those exemptions are trying to help.

What Now?

Every several years California conducts or commissions yet another study on the state's tax system. In 2000, State Controller Kathleen Connell released a report from a "tax simplification" task force that focused on conformity and competitiveness.[67] The commission proposed, for example, that the Legislature draft a user-friendly state tax code and conform California's tax code to federal law.[68] The 2000 task force also recommended lowering the top personal income tax rate.[69] The task force made many proposals, most of which were summarily ignored. In 2003 the California Commission on Tax Policy in the New Economy presented Schwarzenegger with the results of its two-year study.[70] Originally commissioned in 2000 in response to the last economic downturn, the 2003 commission report proposed expanding the sales tax base to include some services and simultaneously lowering the state sales tax rate.[71] The advice was evidently not heeded.

It is unlikely that the proposals of the latest commission will gain any more traction than those of the last few commissions. Even if the commission had proposed reasonable and worthy changes to California's tax system, a notoriously divided Legislature would have to take steps to enact such proposals. This proposal, like the others, will be filed away and forgotten.

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[66]COTCE Report, *supra* note 4, at 20.

[67]California State Controller's Office, Tax Simplification Task Force 2000, "Conformity, Simplicity, Fairness, Investment (May 2000)," *available at* http://www.sco.ca.gov/pubs_taxforce2000.html.

[68]*Id.* at 1.

[69]*Id.* at 17.

[70]COTCE Report, *supra* note 4.

[71]*Id.* at 4.

Appendix.
Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2007

Tax Year 2007: Historical Table 2 (SOI Bulletin) (http://www.irs.gov/taxstats/article/0,,id=171535,00.html)

	Item	**All Returns**	**Size of Adjusted Gross Income**				
			Under $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 or more
California							
A	Number of Returns	17,601,109	11,561,096	2,186,100	1,338,397	1,824,003	691,513
B	Percent of All Returns		65.7%	12.4%	7.6%	10.4%	3.9%
C	Adjusted Gross Income*	1,109,534,361	$202,501,806	$134,334,307	$115,792,522	$246,809,578	$410,096,149
D	Average AGI (D = C/A x 1,000)		$17,516	$61,449	$86,516	$135,312	$593,042
E	Taxable Income (TI): Amount*	748,218,862	$90,243,369	$79,780,985	$73,404,079	$167,885,761	$336,904,666
F	Average TI: Number	12,683,536	6,735,606	2,120,106	1,323,147	1,815,602	689,075
G	Average TI (G = E/F x 1,000)		$13,398	$37,631	$55,477	$92,468	$488,923

*Amounts are in thousands of dollars.