TAX REFORM IN AN ERA OF BUDGET "CRISES": AN OVERVIEW OF ISSUES AND ALTERNATIVES

Mark A. Ibele, Assembly Committee on Budget, California Legislature

BACKGROUND

IN THE FALL OF 2008, GOVERNOR SCHWARZENEGGER convened a state commission assigned the responsibility of examining and making recommendations to improve California's tax system. While the official title excluded any references to either "taxes" or "reform," the *Commission on the 21st Century Economy* was explicitly assigned the task, through an executive order, to develop proposals for laws that would:

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

In an effort to encourage a bipartisan solution to perceived problems of California's tax structure, the Commission's 14 members were split, with half appointed by the Democratic Legislature and half by the Republican Administration. The Commission's goals were sufficiently broad and non-controversial to elicit support and endorsement from across the political spectrum. The absence of any ranking in importance, their subjective nature, and the potential for internal contradiction allowed for a wide range of interpretation of the goals. As a consequence, the goals allowed for a broad-based "buy-in" and a helpful framework, but did not provide commonly-shared reference points.[1]

CONTEXT OF TAX REFORM EFFORTS

Established and its membership appointed in late 2008, the Commission held 10 meetings throughout 2009 and issued a final report in September of that year.[2] The Commission was established during a period of severe economic and budgetary stress in California, with challenging economic, fiscal, and budgetary conditions that continued throughout its existence. This context provides an informative backdrop for interpreting the recommendations of the Commission as well as the response to its report.

Four characteristics of the prevailing economic and fiscal conditions in California are of particular importance for this discussion. These characteristics are not unique to the state, but because of California's dynamic social and economic environment their effect may be more pronounced here than elsewhere.

- **Consumption Patterns:** Reflecting national and global changes, California's economy has shifted from the production and consumption of tangible goods toward the production and consumption of intangible goods and services.
- **Income Distribution:** Nationally, the last two decades have seen an increasing share of income going to top earners compared to other income groups. California's income distribution has been more stratified that that of the nation.
- **Compensation Structure:** Means of compensation for employees and owners has diversified, with increasing amounts of compensation provided through stock options and capital gains and less by way of wages and salaries.
- **Revenue Volatility:** Changes in the economic structure and income distribution within the state have had effects on the overall performance of California's revenue structure, with an increasing frequency of boom and bust revenue cycles.

As I noted, the Commission's consideration of structural tax changes occurred in the context of

a budget "crisis." California's ongoing structural budget imbalance was — and continues to be — severely exacerbated by the sharp economic decline and subsequent anemic (or non-existent) economic growth since 2008. The direction given to the Commission was to step back from this crisis, and focus its energies on policy changes that would result in an improved tax system over the long term. Despite this explicit directive, immediate economic and fiscal conditions had an important impact on the framing of the proposals and the ensuing discussion.

CALIFORNIA'S DYNAMIC REVENUE STRUCTURE

The basic framework of California's tax system is similar to that of many industrial states. At the state level, the major sources of revenue for the 2010-11 General Fund are:

- Personal Income Tax (PIT)—$47.8 billion (52 percent);
- Sales and Use Tax (SUT)—$26.7 billion (29 percent);
- Corporation Tax (CT)—$11.5 billion (12 percent).

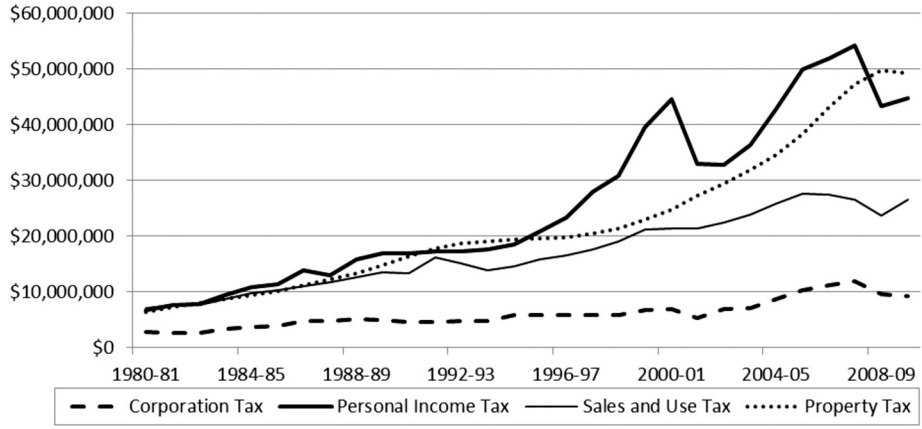
The state's three largest taxes thus constitute about 93 percent of annual revenues. The remainder of revenues comprises a variety of minor taxes and fees. In addition, the state imposes a property tax (PT) levied at the local level which — while not technically a state revenue source — is partially used to support local school districts, the minimum funding of which is mandated by law. As a consequence, a large portion of the $50 billion raised by the PT goes to schools and affects the amount of state support.

Tax System Has Changed Over Time

Growth in California's major taxes, as shown in figure 1, reflect changes in the state's underlying economic structure as well as various policy changes. A few characteristics stand out. Clearly displayed is the rapid growth in PT revenue despite the tax rate limit and assessment constraints imposed by Proposition 13. SUT revenue, on the other hand, rose slowly despite increases in the rate during this period. The overall but uneven rise in PIT revenue and almost static CT revenues are also apparent. Note that the data do not represent state's tax revenues in real terms, but how revenues have changed over time.

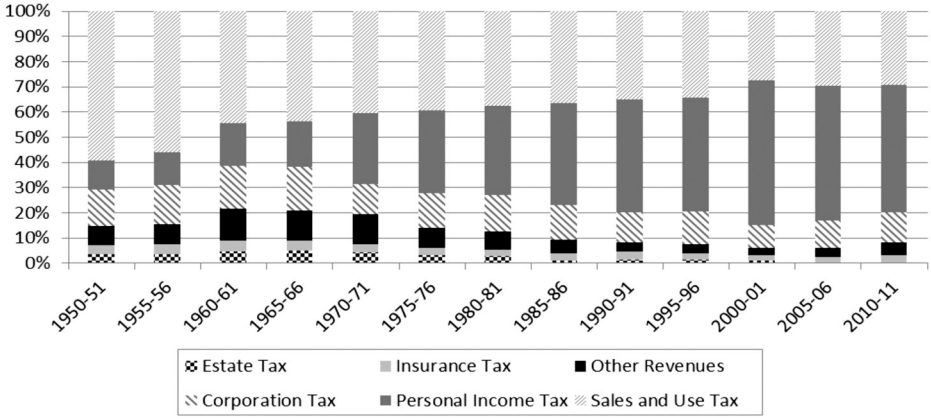
Not surprisingly, differences in growth rates had an impact on the share of the state revenues contributed by the state's major taxes, as shown in figure 2 below. For 2010-11, PIT revenues accounted for about 50 percent of the total. This revenue profile is dramatically different that which prevailed just two decades ago. In 1980-81, the PIT and SUT each contributed roughly one third of total General Fund revenues. Even more striking, 1950-51 data

Figure 1: **Growth in California's Taxes (in Thousands)**



Source: 2011-12 Governor's Budget and Board of Equalization.

Figure 2: **Share of California's Revenues (percent of total)**



Source: Governor's Budget, Various Years.

reveals that the SUT contributed 60 percent of total revenues and the PIT over 11 percent. Clearly, the state's tax portfolio has shifted significantly.

Economic Shifts Have Affected the Tax System

Economic and social changes that have occurred in the decades since California's tax system was established in the 1930s have had a profound effect on the state's revenue profile, as well as on the performance of revenues upon which the state relies. The shift in the tax revenue profile has been dramatic. The biggest changes have been the erosion of the SUT as the major component of state revenue portfolio and complimentary increase in the importance of the PIT. These, in turn, have had secondary impacts on the system in terms of burden distribution and volatility.

Sales and Use Tax Undermined by Consumption Changes

As shown in figure 2, the proportion of revenues raised by the SUT dropped from 60 percent to about 30 percent over the 60-year period shown, while over the same period revenues from the PIT increased from 10 percent of the total to roughly 50 percent. The shift in performance is all the more notable given that SUT rates actually increased during this period.

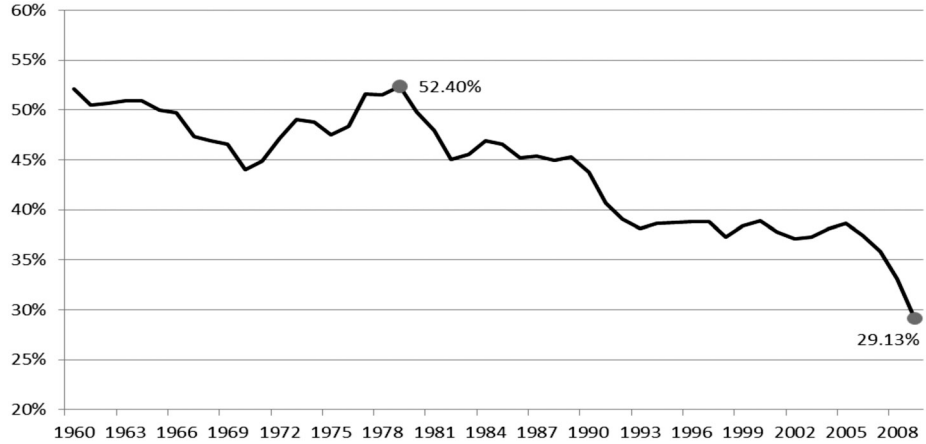
What is the reason for the relative shifts of these two taxes? The explanation, in large part, lies in economic transformation and resulting changes in consumption. As the economy has shifted from activities based on tangible goods production to intangible goods and services, so too has there been a change in consumption patterns. As shown in figure 3, the impact on taxable sales in California has been significant, with the ratio of taxable sales to personal income dropping from a post-1960s peak of 52 percent to less than 30 percent currently.[3]

Compounding this shift away from consumption of tangible goods to intangible goods and services, is that sectors unaffected by this transformation had no countervailing impact on SUT base erosion. For example, food consumption and medication are not in the SUT base, and thus had no ameliorative effect on the underlying trend in base erosion. In addition, the continuing expansion of remote sales has undercut the SUT base since these purchases typically escape tax collection efforts.

Personal Income Tax Surges and Changes

As the SUT has weakened over time, the PIT has taken on an increased importance for the state. Some of the increase in the PIT revenues has been by design, specifically changes in the tax rate. Imposed in 1935 with a top rate of 15 percent, the rate dropped to 6 percent from 1943 to 1967 and then increased to the 9.3 to 10 percent range. Except for relatively short periods where additional 10 percent and 11 percent brackets were introduced (during the early 1990s, for example) or other temporary add-ons (such as the recently-expired 0.25 percent temporary rate) the top rate has remained at 9.3 percent.[4]

Figure 3: **Ratio of Taxable Sales to Personal Income**



Source: California Board of Equalization and Bureau of Economic Analysis.

In addition to explicit policy decisions, growth in the PIT occurred as a result of underlying changes in the economy, trends in income distribution, and an increase in pass-through income. Nationally, income has grown more rapidly in recent years at the upper end of the income range than in the middle and lower ranges; this trend is somewhat stronger in California than nationally. As shown in figure 4, income has shifted upwards in California, increasing the AGI concentration of the top 1 percent from about 13 percent in 1993 to 25 percent or above during the expansionary periods of 2000-2001 and 2005-2008.

As a result of this shift, more income is now subject to the top marginal rate of tax than formerly.[5] As shown in figure 4, the proportion of the tax paid has shifted up dramatically, increasing the tax concentration of the top 1 percent from about 33 percent in 1993 to about 50 percent during the expansionary periods of 2000-2001 and 2005-2008. The corresponding shift in reliance to the PIT is particularly apparent during these growth years. In 2000-01, the PIT share was 58 percent but had dropped back to about 50 percent by 2010-11. Thus, the general trend increase in reliance on the PIT has been coupled with periodic spikes in this revenue source and increased revenue volatility.

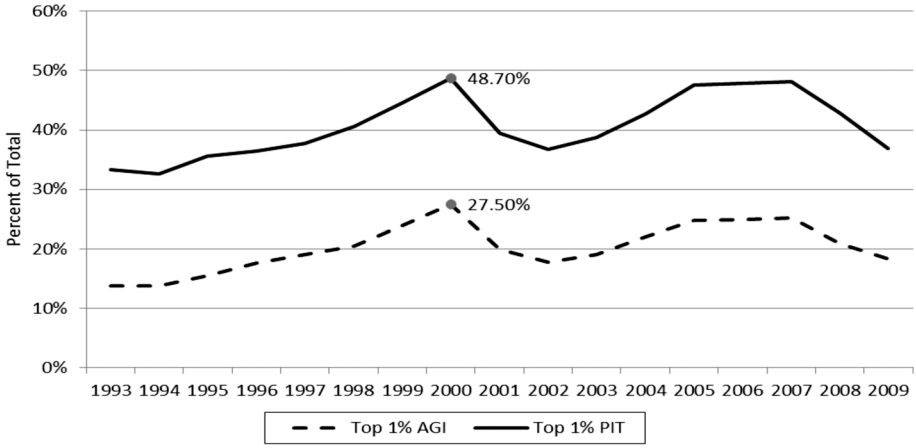
The means by which compensation is received by individuals has also changed, with a much greater proportion of compensation realized through capital gains and stock options. Between tax years 1988 and 2009, there was an overall shift in the composition of personal income toward capital gains. The trend was by no means monotonic (due to the uneven performance of this income source) but it was undeniably in an upwards direction. Figure 5 below shows the percentage of total AGI represented by capital gains for all taxpayers and for the top five percent. Similar shifts occurred with respect to stock options and dividends. The performance of the PIT has also changed as a result, reflecting the characteristics of these types of compensation.

Volatility Increases Amidst Economic Shifts

The volatility of the tax system has also changed over time. California's tax system generates revenues that are more volatile than the underlying economy. This has remained a consistent characteristic over time, as vividly displayed in figure 6 below. The state benefits from this high elasticity during periods of economic expansion but pays the price during economic downturns, with steep corresponding declines in revenues. Figure 6 also suggests that short-term elasticity has increased over the last three decades. In fact, short-term (annual) elasticity increased from about 1.0 in the 1980s to 1.5 in the 1990s to 3.5 in the 2000s.

The reason for this increase in volatility is related partially to the shift from the SUT to the PIT. In figure 7, below, I show volatility of the major taxes and revenues in aggregate based on the coefficient

Figure 4: **Income and Tax Concentration**



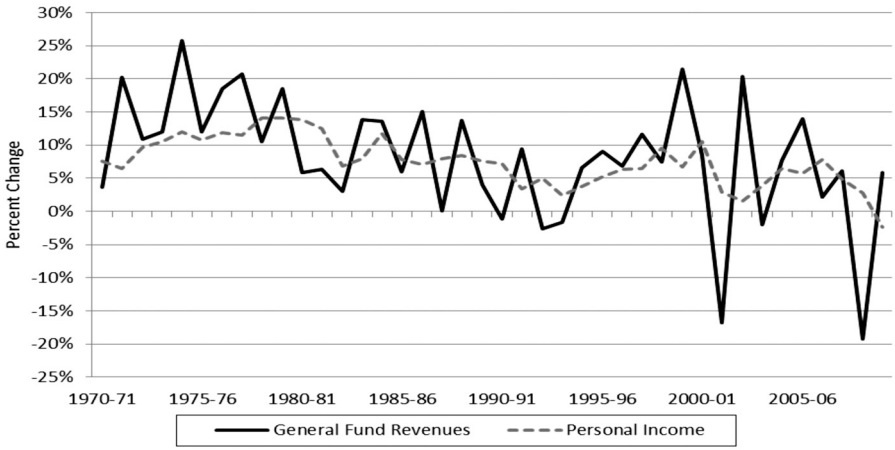
Source: California Franchise Tax Board.

Figure 5: **Capital Gains as Percent of Adjusted Gross Income**

Five-Year Periods	*All Tax Returns*	*Top 5 Percent of Tax Returns*
1989-1993	4.4	11.9
1994-1998	6.5	16.9
1999-2003	8.9	21.8
2004-2008	9.9	23.6

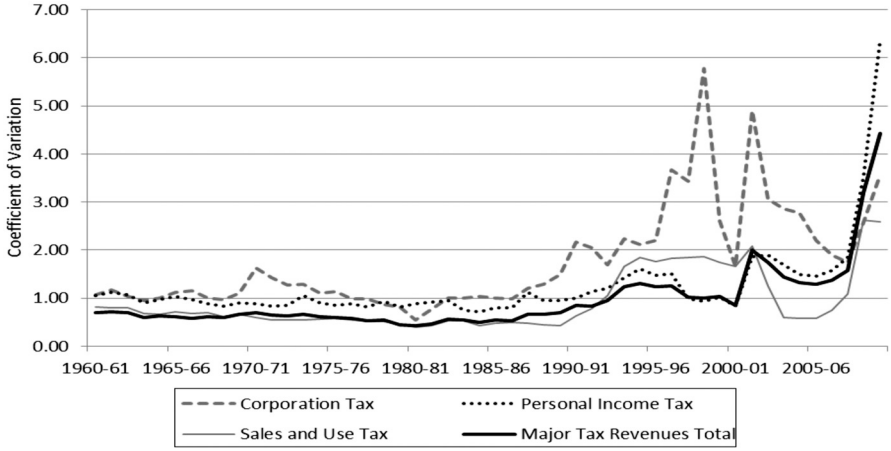
Source: Franchise Tax Board.

Figure 6: **Revenue and Personal Income**



Source: Governor's Budget, Various Years and Bureau of Economic Analysis.

Figure 7: **Tax Revenue Volatility**



Source: Governor's Budget, Various Years.

of variation.[6] The figure indicates that the PIT has historically been somewhat more volatile than the SUT. Thus, even before taking into account any change in the nature of the PIT itself, the shift by the state away from the SUT and towards the PIT, resulted in an increase in the volatility of aggregate revenues.[7]

In addition to a shift in reliance on a historically more volatile revenue source in the PIT, the PIT itself has become more volatile. This phenomenon is clearly depicted in figure 7, where the post-1990 period shows substantially greater degree of variability than the earlier time period. As noted earlier, this variability is the result of increasing amounts of revenue generated by highly variable sources of income, including capital gains, stock options and dividends.

As shown in figure 5, these types of income disproportionately accrue to high-earners. For the 2009 tax year, almost 77 percent of capital gains went to taxpayers with AGI of $500,000 or greater, and almost 90 percent to taxpayers with AGI of $200,000 or greater. Because of the concentration of this income source by high-earners, the unweighted percentage of this source (5.7 percent) is much less than the tax-weighted distribution (11.4 percent).[8]

The combination of variable income and the realization of this income by taxpayers paying the highest marginal rate make for highly volatile revenue, with capital gains taxes going from $3.6 billion in 1997 to $10.2 billion in 2000, dropping to $2.7 billion in 2002, increasing to $10.9 billion in 2007, before declining to $2.3 billion in 2009. Other favored compensation methods show similar patterns. Revenues from capital gains and stock options combined exploded from $2 billion in 1995-96 to $17 billion in 2000-01, before falling to about $5 billion in 2001-02.[9]

COMMISSION EMPHASIZES VOLATILITY, RATES AND DISTRIBUTION

Absent of well-defined guidelines, the Commission's direction was heavily influenced by the ongoing budget "crisis" as well as the severe economic downturn in the state. Together with other accompanying factors, this environment caused the Commission to quickly direct its attention to two main concerns: (i) the volatility of the existing tax structure, which was seen as a major cause of the state budgetary crises,[10] and (ii) marginal tax rates for the state major revenue sources, which it perceived to be contributors to the state's lack of competitiveness.

Thus, despite the existence of other criteria, the Commission chose to strictly narrow its energies. A few observations regarding this emphasis:

- First, concentrating on marginal rates is largely in keeping with traditional public finance theory which posits the benefits of low tax rates coupled with broad tax

bases; however, eliminating or reducing volatility as one of the primary objectives of tax reform seems unusual as a preeminent objective. Volatility may be a short-lived phenomenon. In addition, this thrust is potentially incompatible with traditional tax reform goals, such as equivalent taxation of income or establishing a broad tax base.[11]

- Second, in working towards achieving these two primary objectives, it became apparent there were other ancillary goals that might be achieved simultaneously. Some members decried California's relatively high filing threshold and advocated that all taxpayers should pay some PIT. Others cited the narrowness of certain taxes and proposed that they be broadened while some viewed complexity as an issue and sought to eliminate at least one of the state's taxes.
- Third, the omission of an explicit endorsement of consumption taxes over production taxes is curious, in that many economists see this as a salutary means of addressing a state's tax competitiveness. Rather, the Commission appeared to back into this alternative only by virtue of a discussion of other related issues. This may have unnecessarily undercut the case for expanded consumption-based taxes.[12]

In its pursuit of a competitive and stable tax regime, the Commission faced another hurdle. Among the Commission's goals was to "ensure the tax system is fair and equitable." This directive to the Commission fast became more than just a cipher, but rather quickly became a central component of the analysis of the considered alternatives. Over the course of analyses, it became apparent that any reform the majority of the Commission members desired would entail a significant redistribution of the tax burden. This aspect generated significant interest in potential winners and losers in any tax reform package.

The impact of this "accidental" focus was twofold. First, it effectively shortchanged the tax discussion with respect to other important considerations, such as ease of administration, compliance and enforcement, simplicity and clarity, and economic efficiency and tax competitiveness. Second, and perhaps equally as important, the additional impact was to impart to the distributional analysis a precision that far exceeded the analytical reach of the available tools given the abbreviated amount of time allocated to the exercise.

This second point warrants additional explanation. Initial distributional analyses conducted for the Commission were clearly described as illustrative and, following established protocols, were limited to the PIT and consumer share of the SUT.[13] While no initial efforts were made to model the incidence and distribution of business taxes, the Commission later directed that these be incorporated as well, requiring numerous incidence assumptions with respect to capital, labor and consumption factors and distribution across income groups. The Commission also directed the distributional analysis account for a federal "offset" for both individual and business taxes, resulting in additional assumptions and adding to the uncertainty and complexity.[14]

Numerous caveats were presented along with the presentation of these "more complete" analyses, but were not necessarily heeded. Unfortunately, what emerged from the incidence and distributional exercise was lack of understanding of the assumptions made, no recognition of the tremendous number of other possible outcomes, and little appreciation for the imprecision inherent in any such analysis. While the Commission never claimed that its plan was distributionally-neutral, the report does state that the plan retained "overall progressivity" and that all income groups would get a tax reduction.[15] This latter point was occasionally simplified to a glib assertion that "every taxpayer gets a tax reduction." This was assuredly not the case.

TAX OPTIONS EXAMINED.....AND UNDEREXAMINED

The Commission's examination of alternatives encompassed three general approaches: (i) internal changes to each tax; (ii) shifts in reliance among taxes; and (ii) elimination of existing or introduction of new taxes. Various combinations within each of these were explored, although not all with the same level of detail or intensity. Sustained examination of the various alternatives was generally based on their impact on volatility, marginal rates, and distribution.

- Internal tax options included adjustments to tax expenditure programs (TEPs) across all the major taxes. Changes to the SUT

included expanding to include services, exempting capital equipment purchases, and exempting all business purchases. PIT changes included elimination or adjustments to certain TEPs, a simplified rate structure, across-the-board rate reductions, and special treatment of volatile income components.[16]

- Shifts among the various major state-related taxes generally consisted of a reduced reliance on the PIT and, to a lesser extent the CT, through a reduction in the tax rates and base changes. Increased reliance on the SUT and, to a limited extent, the PT was also explored.
- Elimination of existing taxes consisted of an examination of the ramifications of eliminating each of the state-related major taxes — except the PT. The only new tax proposed — and which was later recommended by the Commission — was the business net receipts tax (BNRT), as discussed below.

Each of the alternatives had drawbacks. Taxation of services was seen as economically disruptive, administratively complex, and full of political problems. Reforming the PT was perceived as politically unpopular and might require constitutional changes. Altering the PIT in virtually any respect could significantly change the distribution of the tax burden. Finally, eliminating a tax or introducing a tax introduced a large amount of uncertainty during an economically and fiscally uncertain time. In the process of the analysis and consideration of alternatives, it became clear that the Commission's options would face challenges on a number of fronts.

Given the Commission's focus on volatility and high marginal rates as the primary weaknesses of California's tax system, it is not surprising it focused primarily on reforming or reducing reliance on the PIT and, to a lesser extent, the CT. The fundamental conundrum facing the Commission was that any change that addressed the issue of volatility and high rates required less reliance on the PIT or, alternatively, its internal reform. Either of these paths would reduce the progressivity of the entire tax system. To address this, the Commission put forth the option of a new tax that it argued, would export more of the tax burden.

Commission Makes its Recommendations

The Commission's recommendations involved the following major changes in the state tax structure:[17]

- Elimination of the corporation tax.
- Elimination of the state portion of the sales and use tax.
- Restructured personal income tax:
  - Reduced tax rates
  - Collapsed tax brackets
  - Elimination of certain itemized deductions
  - Increased standard deduction
- Establishment of business net receipts tax.

The Commission was of the view that the proposal would broaden the tax base by including all businesses within the scope of the BNRT; improve tax competitiveness by reducing the SUT, reducing PIT rates and eliminating the CT; and, stabilize revenue by reducing reliance on the PIT and instituting a broad-based business tax, the BNRT.[18] The analysis indicates that this approach would have been a reasonable means, in theory, of achieving most of the objectives. The new system would raise approximately 50 percent of General Fund revenues from the BNRT, 40 percent from the PIT, and the remainder from minor revenue sources.

The biggest question mark in this equation was the reliance for a large portion of state revenue on an unknown and untested BNRT. Designed to tax the value a business adds to its production of goods and services in California, the BNRT was an attempt to approximate the benefits of services and programs used by business.[19] The Commission proposed a phase-in plan for the BNRT (and corresponding phase-out for offsetting SUT reductions), but to many critics this was not enough to eliminate concerns or warrant the BNRT's inclusion in any tax plan.

To these critics, the BNRT suffered from profound and fundamental flaws that would prevent it from functioning as a suitable alternative to the state's existing system of taxes.[20] Most significantly, opponents cite the problems of instituting a state-only value added tax due to the lack of full border adjustments and the ensuing disadvantage to California businesses; the potential economic distortions and administrative complexities associ-

ated with expensing of capital acquisitions including special treatment of out-of-state firms; and, legal issues such as those related to the concept of economic nexus and differential treatment of in-state and out-of-state investment.

On top of these issues were criticisms — both ill- and well-founded — from other circles, that the tax amounted to a tax on labor (largely not true), would encourage out-sourcing of work as opposed to hiring employees (probably true), required businesses with zero income to pay the tax (certainly true), and would encourage "gaming" more than the corporate tax (unknown, but possibly true).

Notable Options Left Underexplored

The Commission's focus on volatility and marginal rates, and the limitations imposed by distributional concerns, largely defined its path. But while the Commission's path was constrained, it was by no means dictated. In fact, there existed other alternatives that were left significantly underexplored. The most notable of these options were alterations to various TEPs, changes to the local PT, reforms to the SUT, and combinations of various tax and budgetary measures. Each of these points is addressed briefly below.

One: Constrain Tax Expenditure Programs

California's PIT, SUT, and CT, are littered with TEPs, which in aggregate, result in reduced annual revenues of roughly $50 billion. Many of these are federal conformity items, such as the mortgage interest deduction ($5 billion). Others, such as California's generous research and development tax credit ($1 billion) are non-conformity items. These include credits, deductions and other special tax programs.

The Commission conducted initial analyses of altering major TEPs. These analyses suggested that TEP elimination would result in a substantial shift in tax burden to the middle income stratum as well as a more stable PIT.[21] Deterred by the shift in tax burden, the Commission did not pursue this alternative. Further examination could have revealed variations that could have reduced volatility and lessened the shift in the tax burden, including potentially limiting only certain TEPs (such as the mortgage interest or charitable contributions), eliminating the phase-out limitation for high-income taxpayers, or reducing business TEPs.[22]

Two: Institute Changes in the Property Tax

Time and time again, the Commission heard testimony to the effect that the most notable aspects of California's tax system were that the rates of state taxes for PIT, SUT and CT were high relative to other states and that property was under-taxed. Despite these frequent admonishments, the Commission left much of the PT option unexplored and largely left this option off the table. This was likely the result of political reasons or potential constitutional complications.[23]

Exploring the PT option in a sustained fashion could have addressed several issues simultaneously. First, the PT is exceptionally stable, with very low volatility and low susceptibility to business cycle fluctuations. Second, changes to the tax could raise substantial revenues, allowing a reduction in other state taxes.[24] Third, as others have noted, most revenue changes in the PT would result in imposing a large share of the increase on owners of capital.[25] Thus, the PT option could have reduced rates for other taxes, decreased volatility in the system, and lessened adverse impacts on the existing distribution of the tax burden.

Three: Reform Sales and Use Tax

One of the notable aspects of the Commission proposal is that it suggested significant alterations to the internal structure to the PIT; however, for the SUT it suggested not reform but rather outright elimination. An analysis of the SUT suggests that it would be possible to develop a number of reforms that could make it resemble a more broad-based consumption tax. Reducing reliance on the PIT and increasing reliance on the SUT would result in a more stable system.

One approach to reform would entail the taxation of selected consumption services, taxation of consumption of goods now excluded from the base tax base, and exclusion of business purchases now included in the base. To the extent these resulted in unacceptable distributional impacts, they could be offset by credits or deductions in other tax programs. To the extent the combined impact of changes to the SUT to resemble a consumption tax resulted in revenue decreases, increases in other taxes might be required.

Four: Combine Realistic and Known Alternatives

The Commission explored a number of alternatives that, in and of themselves, would not have addressed all the concerns with the state's tax and revenue system. What the Commission failed to consider in a deliberate and systematic manner, is how a combination of several of these components (including those outlined above) could have moved towards improved system performance, while reducing the fiscal and political uncertainty.

One form of this would be to move the SUT towards a consumption tax by taxing consumption services and reducing the tax on business inputs; reducing the PIT rates and curtailing certain TEPs; instituting budgetary reserves or other "volatility-management" tools as an integral part of the plan; and establishing various measures to address negative distributional outcomes. Although much less dramatic than the proposal recommended by the Commission, an approach along these lines would, in the end, result in more certainty, accomplish many if not all of the specified objectives, represent a step forward in tax policy, and likely meet with less political resistance.

LESSONS AND CONCLUSIONS

The overall response to the Commission's recommendations displayed a near unanimity that is rare in Sacramento; support for the proposal was almost nowhere to be found. Many thought the effort represented a missed opportunity.

In many obvious respects, the Commission's efforts were a failure. The linchpin of the proposal was an untested new tax not even fully-formed in concept; distributional changes inherent in the proposal appeared unfair and inequitable; significant administrative issues were ignored or inadequately addressed; and, supposed benefits with respect to tax competitiveness and economic growth were remote and uncertain. The Commission's recommendations were never considered by the Legislature and no bill related to the proposal was introduced.

Despite these negatives, the Commission's efforts have resulted in some important lessons, both for California and other states embarking on similar endeavors. Perhaps an overriding caveat before a tax reform effort even begins is to allocate the process sufficient time to allow for appropriate education, analysis and consideration. The Commission's work was originally allotted just four short months; its extended life of nine months proved to be only slightly less inadequate. To be credible, tax reform proposals in a state as complex as California, might be developed over a period of two to three years.

Some of the most important substantive lessons that emerged from the California experience relate to:

- **Goals, Objectives, and Theory:** General goals given to tax reformers can allow "buy-in" but may prove virtually useless in terms of operational guidance. Reform efforts can benefit from a clear approach to the issues by adding specificity to objectives and common agreement on their meanings. In addition, public finance themes can get lost in the shuffle. Given the tendency to focus on winners and losers, other issues of tax policy are frequently overwhelmed.
- **Competitiveness and Distribution.** California is now in a place where practically any structural change to its tax system designed to improve economic efficiency, competitiveness or revenue stability will result in a shift in the tax burden from high-income taxpayers to middle- and low-income taxpayers. This is likely to be the case for other states heavily reliant on a PIT, especially those with a progressive rate structure.
- **State Consumption Taxes.** Efforts to move towards consumption taxes and away from production taxes will result in a shift in the tax burden — and potentially a significant one. The shift in the tax burden is immediate and apparent, whereas the benefit of this change for state economies is longer-term and not readily apparent. To make the case for such taxes, the issue should be directly addressed and not obscured.
- **Increased Deductibility.** Increased federal deductibility can be a selling point in tax reform but it is possible to be "too cute by half." If one is going down this road, there should be an emphasis regarding the uncertainty in the assumptions and how alternative models can lead to very different outcomes. Furthermore, if this analysis is not commonly conducted by the state (as in California), its use in a reform context will raise quite reasonable skepticism and objections.

- **Fiscal Uncertainty.** Tax reform is a Herculean task in any environment and super-Herculean during periods of economic and fiscal uncertainty. Tax reform efforts have a greater opportunity of success to the extent they involve incremental changes to an existing structure. Wholesale elimination of taxes and establishment of new taxes add to any existing uncertainty. History matters. Given this, it is unrealistic to expect equanimity from taxpayers expected to make large adjustments from past behavior.
- **Importance of Context.** Tax reform discussion occurring in the context of budget crisis and extreme revenue swings will almost force a focus on revenue volatility. This feature would be part of state tax reform discussion in any context, but its prominence will vary depending upon the objective circumstances. The unfortunate impact is to reduce the focus on important long-term concerns in tax reform. This is particularly unfortunate if volatility is only a temporary feature of the tax system.
- **Costs and Benefits.** Tax reform efforts should account for attendant costs as well as potential benefits. Significant tax changes can result in ongoing administrative headaches, severe business disruptions, and divisive debates on distribution. Reform efforts can have an unspoken bias to "doing something" even if the costs exceed any benefits that might accrue. This suggests that policy makers should constantly ask the question "Is a change worth it?"

Where does that leave California? Some positive steps have been made in understanding the design and impacts of the state's tax system. In addition, the Commission succeeded in raising some important issues related to state tax policy. What remains is to address these policies in a systematic and dispassionate fashion, examine various options and inherent trade-offs, and then apply these lessons in the context of the California economy.

Acknowledgements

The author was staff director of California's 2009 tax commission, the Commission on the 21st Century Economy. The views expressed represent those of the author and not necessarily those of the Assembly Committee on Budget, the Chair, or its members. Phil Spilberg and Dave Vasche' provided helpful comments on this paper but are not accountable for its content.

Notes

1 An additional requirement imposed by the administration, but not included in the executive order, was that the recommendations of the Commission be "revenue neutral" in that no more revenue be raised under any new system than would have been raised under the existing system. This was tacitly but never formally embraced by the Commission.

2 The Commission report can be found at: http://www.cotce.ca.gov

3 Since taxable sales include business purchases, the share of actual personal consumption is lower by roughly one-third. The Board of Equalization which administers the SUT estimates that approximately 30 percent of taxable sales are the result of business purchases.

4 Since 2005, incomes in excess of $1 million have also been subject to a 1 percent rate that goes to a special mental health services fund and not to the state's General Fund.

5 Pass-through income, allowed thorough provisions of the CT, is largely subject to the top tax rate and has resulted in increased PIT revenues.

6 Coefficient of variation is defined as standard deviation divided by average growth rate and has been calculated based on rolling ten-year periods. Analysis of discrete 10-year periods from 1950 through 2010 reveals a very similar pattern.

7 For the period 1990-91 through 2010-11, the average coefficients of variation (based on ten-year averages) were: PIT 2.10; CT 2.76; SUT 1.49; major tax revenues 1.65. By way of comparison, the coefficient of variation for the PT during this period was 0.49.

8 Tax year 2008 unweighted/weighted figures for other income components of the PIT are: Wages 73.0 percent/61.3 percent; Dividends 2.8 percent/3.6 percent; Partnership income 4.6 percent/10.3 percent.

9 See *Revenue Volatility in California*, California Legislative Analyst's Office, January 2005.

10 One of Governor Schwarzenegger's first major acts was to reduce significantly the state vehicle license fee, which is among the more stable revenue sources.

11 Some on the Commission viewed revenue volatility as purely a budgeting issue rather than something to be addressed through the tax system. The Legislative Analyst's Office has regularly opined that one-time revenues should be used for one-time expenditures, although determining whether revenues are "one-time" is a more successful exercise on an ex-post than an ex-ante basis.

[12] State consumption taxes may be competitively advantageous, but their destination basis can remove the link between production of value added and to either a benefits-based or ability-to-pay criterion.

[13] The common simplifying assumption that these taxes are not shifted but rather "stick where they hit" was consistent with previous state-conducted analyses.

[14] Exporting of state taxes through federal deductibility is recognized as a means of reducing state tax burdens on residents for personal income taxes. See, for example, "Tax Exportation," Donald Phares in *The Encyclopedia of Taxation and Tax Policy,* 1999. Joseph J. Cordes, Robert D. Ebel and Jane G. Gravelle, editors. The Commission's application of the concept to business taxes introduced additional complexities as to how business tax burdens might be shifted among various factors as well as exported.

[15] Maintaining "overall progressivity" was distinguished from maintaining the same "degree" of progressivity.

[16] For example, income averaging for capital gains and other non-wage income or reduced rates of tax on capital gains and similar types of income.

[17] The Commission also recommended establishing an independent forum for tax disputes, replacing the current Board of Equalization, an elected body making final administrative level decisions in tax matters.

[18] Although billed as a consumption tax by some, the BNRT does not tax some consumption inside California (of goods from outside the state) and also taxes some consumption outside California (of goods from inside the state).

[19] A more complete description of the BNRT and draft legislation is included in the *Report of the Commission on the 21st Century Economy***,** September 2009. The report can be found at: http://www.cotce.ca.gov.

[20] See for example, September 5, 2009 letter to the *Commission on the 21st Century Economy.* The letter can be found at: http://www.cotce.ca.gov/documents/correspondence/public/.

[21] The revenue neutral analysis reduced all tax rates to offset the revenue from TEP elimination. This had the effect of reducing taxes on volatile types of income and increasing the tax on wages.

[22] Oddly, the Commission recommendation included retaining the deductions for mortgage interest, property taxes, and charitable contributions. The benefits of the charitable contribution deduction accrue largely to high-income taxpayers.

[23] The PT is local tax and revenues must stay in the county in which the tax is levied; however, PT increases could offset state payments to education, reducing required state support and allow for a reduction in other taxes.

[24] A split roll approach which would assess commercial property at market value rather than acquisition value as is currently the case, could raise $6.7 billion annually. An alteration to what constitutes a change in ownership would result in $600 million annually in new revenues.

[25] See Sheffrin, Steve, "Economic Aspects of a Split-Roll Property Tax," paper to the *Commission on the 21st Century Economy*, February 5, 2009. The paper can be found at: http://www.cotce.ca.gov/documents/correspondence/public/.