

# Things Your Mother Never Told You About California's Tax System

Jean Ross  
California Budget Project  
921 11th Street, Suite 502  
Sacramento, CA 95814  
916-444-0500

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"Taxes are what we pay for a civilized society."

Oliver Wendell Holmes, former Justice of the  
United States Supreme Court

## California's Tax System

- Where does the money come from? How has this changed over time?
- How does California's tax system fare in terms of equity?
- How does California's tax system compare to that of other states?
- What special features of California's tax system should be taken into account when considering policy proposals?

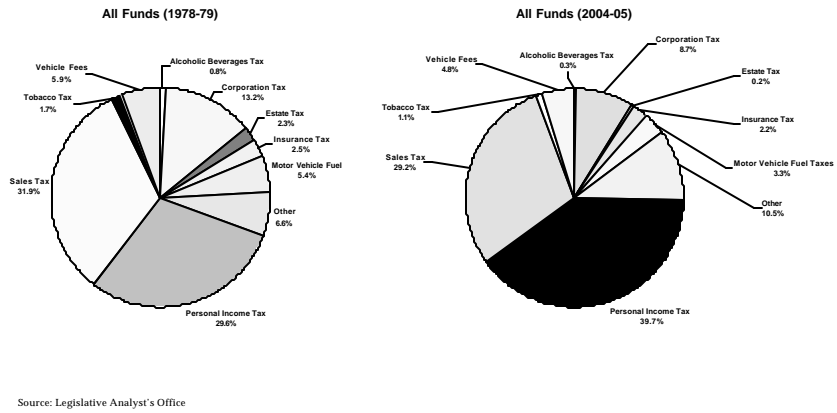
3

## Where Does the Money Come From?

- The personal income tax is the largest single state revenue source. The share of state revenues provided by the personal income tax has increased over time, but has dropped since 2000-01.
- The shares of revenues provided by the corporate income tax and "sin taxes" have declined over time.
- Other revenues, such as tobacco settlement dollars, provide an increasing share of state funds.

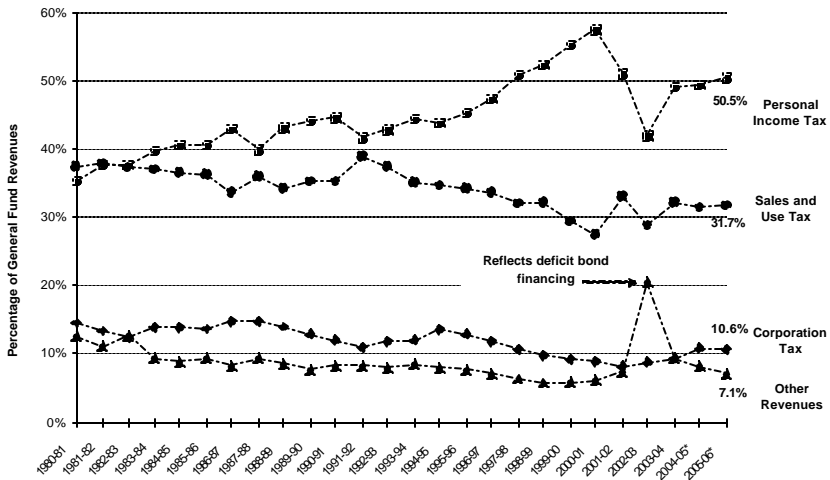
4

# Then and Now



5

## Personal Income Tax Provides the Largest Share of State General Fund Revenues



\*2004-05 estimated and 2005-06 projected.  
 Note: "Other Revenues" includes Alcoholic Beverage Tax, Cigarette Tax, Horse Racing License Fees, Estate Tax, Insurance Tax, Trailer Coach License Fees, and Minor Revenues. Excludes Loans and Transfers.

6

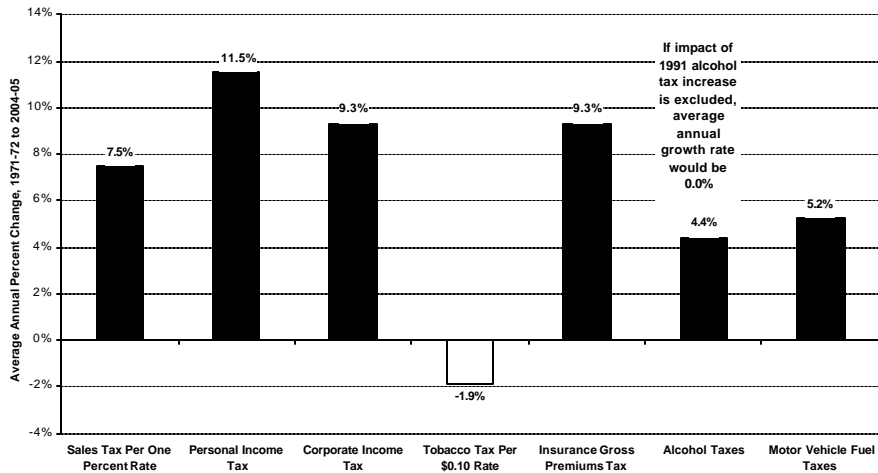
## 2004-05 Revenues

	General Fund	All Funds
Alcoholic Beverages Taxes & Fees	\$ 312,000	\$ 312,000
Corporation Tax	\$ 8,678,000	\$ 8,678,000
Cigarette Tax	\$ 119,000	\$ 1,064,700
Horse Racing (Pari-mutual License Fees)	\$ 2,335	\$ 42,799
Estate, Inheritance & Gift Tax	\$ 209,000	\$ 209,000
Insurance Gross Premium Tax	\$ 2,230,000	\$ 2,230,000
Trailer Coach License (In-Lieu) Fees	\$ 19,972	\$ 22,360
Motor Vehicle License (In-Lieu) Fees	\$ -	\$ 2,143,558
Motor Vehicle Fuel Tax (Gasoline)	\$ -	\$ 2,841,392
Motor Vehicle Fuel Tax (Diesel)	\$ -	\$ 515,921
Motor Vehicle Registration	\$ -	\$ 2,672,438
Personal Income Tax	\$ 39,527,000	\$ 39,781,000
Retail Sales and Use Tax (Realignment)	\$ -	\$ 2,524,900
Retail Sales and Use Tax	\$ 25,168,000	\$ 25,573,691
Retail Sales and Use Tax (Fiscal Recovery)	\$ -	\$ 1,167,000
<b>Major Revenues</b>	<b>\$ 76,265,307</b>	<b>\$ 89,778,759</b>
Emergency Telephone Users Surcharge		\$ 125,486
California State University Fees		\$ 1,111,298
Income from Pooled Money Investments	\$ 200,000	\$ 200,111
Income from Surplus Money Investments	\$ 6,000	\$ 88,586
State Lands Royalties	\$ 139,308	\$ 164,508
Abandoned Property	\$ 392,090	\$ 392,090
Settlements & Judgments	\$ 77,741	\$ 78,263
All Other Minor Revenue	\$ 823,490	\$ 8,330,400
<b>Minor Revenues</b>	<b>\$ 1,638,629</b>	<b>\$ 10,490,742</b>
Transfers & Loans	\$ 315,163	\$ 19,172
<b>TOTAL</b>	<b>\$ 78,219,099</b>	<b>\$ 100,250,329</b>

Source: Legislative Analyst's Office

7

### Personal Income Tax Posts the Highest Average Annual Growth Rate Over Time



Source: CBP calculations from Legislative Analyst's Office data

8

## The Basic Concepts

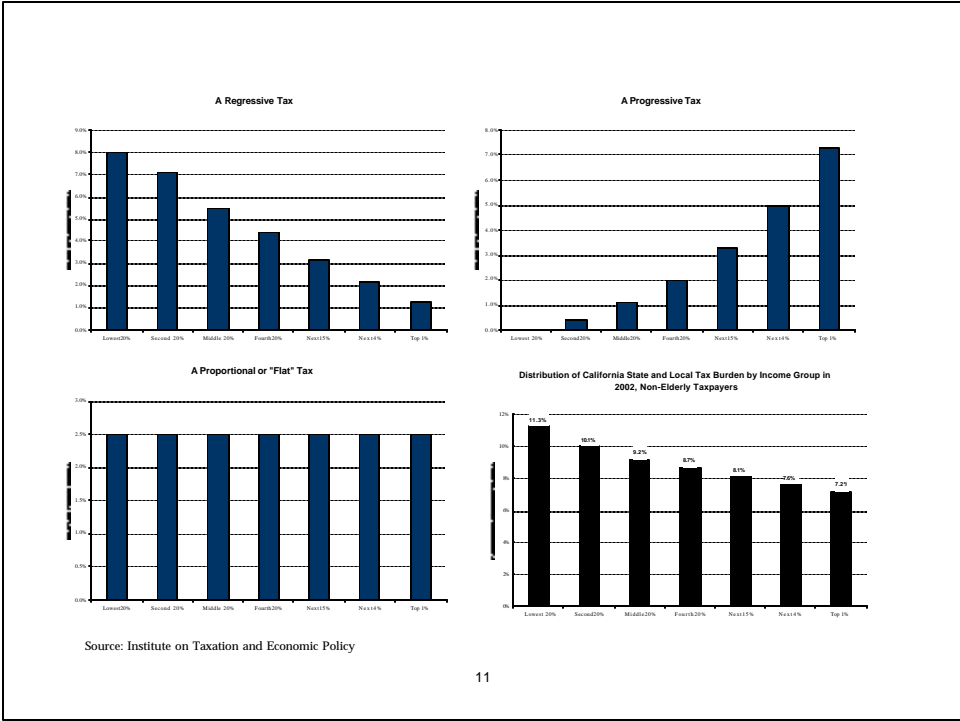
- **Tax Base:** The “base” of a tax refers to what is subject to tax. Examples of a tax base include income, property values, and tangible goods. A tax base can be broad or narrow. Broad-based taxes have few exemptions, credits, or deductions, while narrow-based taxes have a large number of exemptions, credits, and deductions.
- **Tax Burden or Incidence:** The incidence of a tax refers to who actually pays a tax. In some cases, the economic incidence of a tax may be different from the legal incidence. Here are three basic types of taxes: progressive, regressive, and proportional or “flat.”
- **Tax Expenditures:** Economists refer to provisions of the tax law that provide special treatment for certain activities or types of income as “tax expenditures.” Tax expenditures include credits, deductions, exemptions or special treatment, as well as items excluded from the tax base (i.e., the exclusion of income from Social Security for state income tax purposes). Tax expenditures may be enacted to provide tax relief; encourage certain activities; or simplify and reduce the costs of program administration.

9

## Interaction with Federal Taxes

- The ultimate burden of a state or local tax depends on how it interacts with federal tax law.
- Individuals who itemize their deductions can deduct state income and property taxes (including vehicle license fees, VLF) for federal tax purposes.
- Businesses can deduct all of the state and local taxes they pay for federal tax purposes.
- When the state reduces a tax that is deductible for federal purposes, part of the benefit goes to the federal government in the form of higher federal taxes.

10



### Who Pays California State and Local Taxes? 2002, Non-Elderly Taxpayers

	Top 20%						
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$18,000	\$18,000 - \$30,000	\$30,000 - \$47,000	\$47,000 - \$80,000	\$80,000 - \$168,000	\$168,000 - \$567,000	\$567,000 and Above
Average Income in Group	\$11,100	\$23,700	\$38,300	\$61,900	\$111,000	\$242,000	\$1,630,000
<b>Sales &amp; Excise Taxes</b>	<b>8.6%</b>	<b>7.3%</b>	<b>5.6%</b>	<b>4.4%</b>	<b>3.2%</b>	<b>2.1%</b>	<b>1.2%</b>
General Sales—Individuals	4.4%	4.1%	3.2%	2.7%	2.0%	1.4%	0.7%
Other Sales & Excise—Ind.	1.4%	0.9%	0.6%	0.4%	0.3%	0.2%	0.1%
Sales & Excise on Business	2.8%	2.3%	1.7%	1.3%	0.9%	0.6%	0.4%
<b>Property Taxes</b>	<b>2.5%</b>	<b>2.1%</b>	<b>2.2%</b>	<b>2.3%</b>	<b>2.4%</b>	<b>2.1%</b>	<b>1.1%</b>
Property Taxes on Families	2.5%	2.0%	2.2%	2.2%	2.3%	1.9%	0.7%
Other Property Taxes	0.1%	—	—	0.1%	0.1%	0.2%	0.4%
<b>Income Taxes</b>	<b>0.2%</b>	<b>0.8%</b>	<b>1.7%</b>	<b>2.7%</b>	<b>4.0%</b>	<b>5.6%</b>	<b>8.4%</b>
Personal Income Tax	0.2%	0.8%	1.6%	2.6%	4.0%	5.5%	7.9%
Corporate Income Tax	0.0%	—	—	0.1%	0.1%	0.1%	0.4%
<b>Total Taxes</b>	<b>11.3%</b>	<b>10.2%</b>	<b>9.4%</b>	<b>9.3%</b>	<b>9.6%</b>	<b>9.8%</b>	<b>10.6%</b>
Federal Deduction Offset	—	—	-0.3%	-0.7%	-1.5%	-2.2%	-3.4%
<b>Total After Offset</b>	<b>11.3%</b>	<b>10.1%</b>	<b>9.2%</b>	<b>8.7%</b>	<b>8.1%</b>	<b>7.6%</b>	<b>7.2%</b>

Source: Institute on Taxation and Economic Policy

### Where Are The Loopholes?

	1998-99 Revenues (millions)	1998-99 Tax Expenditures (millions)	Tax Expenditures as a Percentage of Tax
Personal Income Tax	\$ 28,526	\$ 17,821	62%
Sales Tax	\$ 22,554	\$ 5,965	26%
Other Taxes	\$ 16,290	\$ 125	1%
Corporate Income Tax	\$ 5,926	\$ 3,178	54%
<b>TOTAL</b>	<b>\$ 73,296</b>	<b>\$ 27,089</b>	<b>37%</b>

Source: Legislative Analyst's Office

	Top Ten Personal Income Tax Expenditures, 2004-05	Cost (in Millions)	Top Ten Corporate Income Tax Expenditures, 2004-05	Cost (in Millions)
1	Home Mortgage Interest Deduction	\$4,235	Subchapter S Corporation Status	\$990
	Exclusion of Pension Contributions & Earnings	\$3,785	Water's Edge Election	\$460
2	Exclusion of Employer Contributions to Health Plans	\$3,465	Research and Development Credit	\$430
3	Exclusion of Capital Gains at Death	\$1,595	Carryover of Net Operating Losses	\$400
4	Charitable Contributions Deduction	\$1,380	Manufacturers' Investment Credit	\$205
5	Dependent Credit	\$1,320	Research, Exploration and Development Expensing Deductions	\$180
6	Personal Exemption	\$1,020	Enterprise Zone Hiring, Sales & Use Tax Credit	\$180
7	Exclusion of Social Security Benefits	\$1,000	Exempt Status for Corporate Minimum Tax	\$125
8	Real Property Tax Deductions	\$995	Charitable Contributions Deductions	\$100
9	Standard Deduction	\$980	Exclusion of Investment Income on Life Insurance & Annuity Contracts	\$50
10				

Source: Franchise Tax Board, State Tax Expenditure Estimates, Fiscal Years 2002-03 through 2004-05

## Factors to Consider When Evaluating Tax Policy Proposals

- Who benefits? Is the benefit substantial enough to encourage the desired behavior?
- How does California compare to other states?
- Does a proposal improve the equity of the state's tax code?
- Is it simple to administer?
- Is there an interaction with the federal tax code?
- What are the trade-offs between a tax expenditure and a program expenditure?

15

## Some Policies Have Conflicting Goals

- The public health goals of higher tobacco taxes – a reduction in tobacco consumption – directly contradict the goals of raising additional revenues to support public services.
- If fewer people smoke, or if they smoke less, revenues will be lower than anticipated.
- Tobacco taxes may help fill a short-term gap, but are a bad bet as a long-term revenue source (especially as a source to fund programs where the demand and cost of providing the service increase over time).

16

## How Does California Compare?

- California has:
  - The highest state income tax threshold – i.e., the point at which taxpayers begin to owe personal income taxes.
  - Income tax brackets that are indexed for inflation.
  - A very progressive personal income tax.
  - But relatively high excise taxes.
  
- In sum, while regressive, California's tax system is one of the most progressive of the 50 state systems.

17

### How Does California Compare? Revenues as a Percentage of Personal Income

	CA Rank <sup>a</sup>	CA	US
Total State & Local Own Source (2001-02) <sup>b</sup>	18	15.69%	15.11%
Total State & Local Taxes (2001-02)	14	10.59%	10.32%
State Taxes (2002-03)	16	6.76%	6.06%
Local Taxes (1999-00)	32	3.47%	4.04%
State & Local General Sales Taxes (2001-02)	19	2.75%	2.54%
State & Local Property Tax (2001-02)	35	2.66%	3.18%
State General Sales Tax (2002-03)	27	2.13%	2.05%
State Motor Fuels Taxes (2002-03)	44	0.27%	0.36%
State Tobacco Tax (2002-03)	32	0.09%	0.13%
State Alcoholic Beverage Taxes (2002-03)	39	0.02%	0.05%
State Individual Income Tax (2002-03)	8	2.79%	2.02%
State Corporate Income Tax (2002-03)	6	0.59%	0.32%

<sup>a</sup>All rankings exclude the District of Columbia.

<sup>b</sup>Total Own Source revenues, which excludes federal government transfers, is the broadest measure of state and local government revenues.

18

Source: US Census Bureau and Bureau of Economic Analysis

	2004 Tax Threshold	2004 Poverty Line	Threshold as a Percentage of Poverty
Single	\$13,515	\$9,827	138%
Married, no children	\$26,980	\$12,649	213%
Head of household, one child	\$35,780	\$13,020	275%
Head of household, two children	\$42,380	\$15,219	278%
Married, one child	\$37,880	\$15,205	249%
Married, two children	\$44,480	\$19,157	232%

Note: Assumes families claim standard deduction and the renters' tax credit. Measured as a percentage of 2004 poverty threshold for non-elderly householders.

A tax threshold is the level at which a household or individual becomes subject to tax. Families with incomes below the threshold receive no benefit from tax credits or other personal income tax reductions (unless they are refundable) since they have no income tax liability. In 2003, California's median household income was \$49,300.

19

## Credits vs. Deductions

- Credits provide the same dollar benefit to all taxpayers regardless of their marginal rate.
- Deductions provide a greater benefit to taxpayers in higher tax brackets.
- For example, \$1,000 in deductible mortgage interest reduces the taxes of a family in the 9.3 percent bracket by \$93, but reduces the taxes of a taxpayer in the 2 percent bracket by only \$20.

20

## Tax Credits vs. Spending Programs

- Tax expenditures have relatively low administrative costs.
- However, they are expensive because they are broad-based.
- As a result, advocates should carefully define their goals in deciding which strategy to use.

21

## An Example: The Child Care Tax Credit

- In 2001, 619,100 households claimed \$177.5 million in dependent tax credits, for an average credit of \$287 per tax return.
- Alternatively, \$177.5 million would “buy” an expansion of state general child care programs by 25,755 children based on an estimated cost per child of \$6,892 in 2004-05.
- Is it better policy to provide 619,100 households with a tax credit that subsidizes 4.2 percent of the cost of child care for an infant, or pay the full cost of child care for 25,755 low-income children?

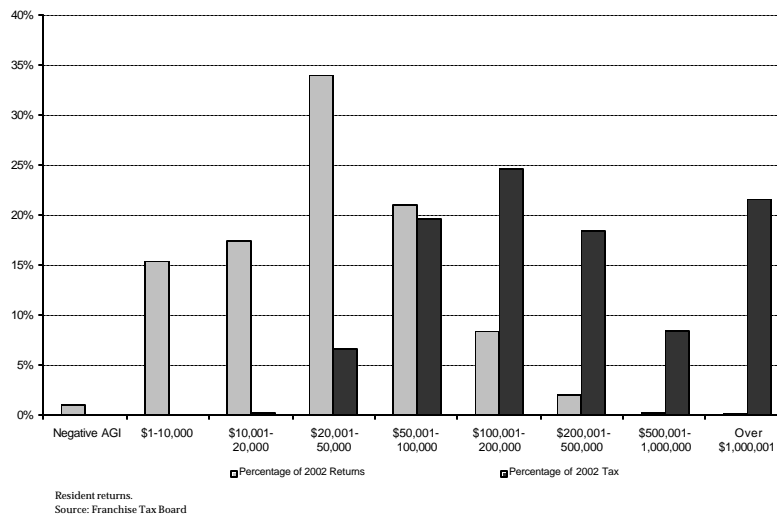
22

## The Personal Income Tax

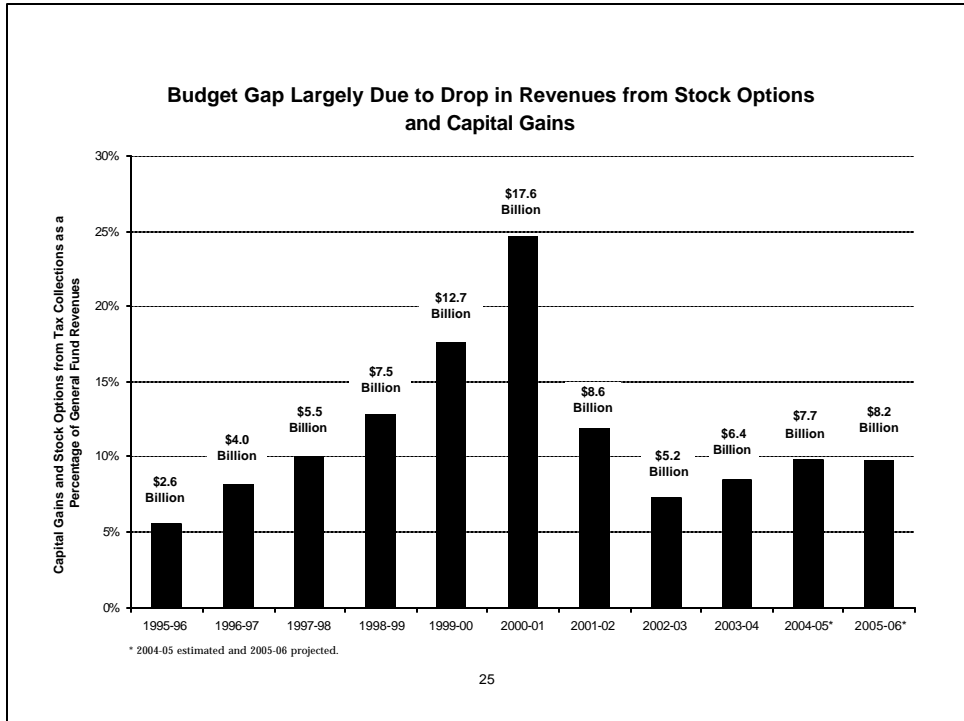
- Provides 39.7 percent of all state revenues and 50.7 percent of General Fund revenues in 2004-05.
- Personal income tax revenues rose by 44 percent (\$13.7 billion) between 1998-99 and 2000-01 and then dropped by \$9.5 billion between 2000-01 and 2003-04.
- California's personal income tax is highly progressive. The wealthiest 0.5 percent of taxpayers paid 30.0 percent of the personal income tax in 2002.
- In 2000-01, taxes paid on stock options and capital gains accounted for approximately 25 percent of General Fund revenues. Collections attributable to these two income sources dropped by \$12.4 billion between 2000-01 and 2002-03.

23

California Has a Progressive Income Tax



24



## The Sales Tax

- The sales tax is a regressive tax. However, unlike some states, California exempts many basic necessities such as food and medicine.
- California relies less on the sales tax than do most other states.
- The yield on the sales tax - that is sales tax collections from a one percent rate as a share of personal income - has declined due to changes in the economy and the rise of e-commerce.
- The proceeds of the sales tax go to the state's General Fund, state transportation programs, county and city general funds, county transportation programs, repayment of the deficit bonds, local public safety programs, and realignment. Counties and some cities impose local rates for transportation, health care, and other purposes.

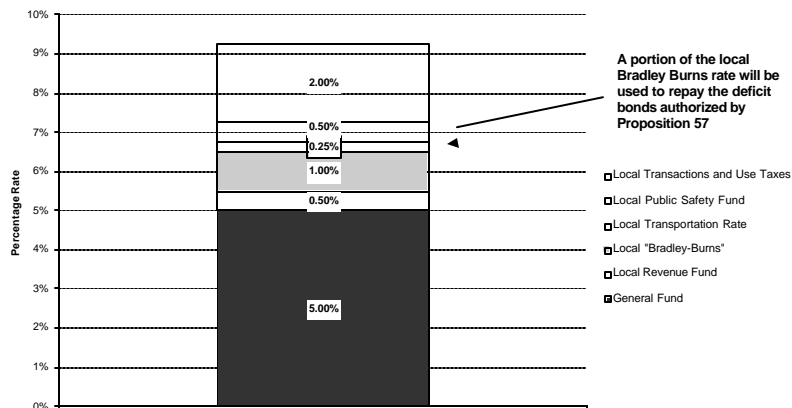
26

## The Sales Tax

- The local general purpose portion of the sales tax is distributed to counties and cities based on the place of sale. Prop 1A would limit the state's ability to change the formula for allocating local sales tax revenues.
- The state Constitution prohibits the imposition of a sales tax on food, except foods taxed before November 3, 1992.
- Federal law limits the state's ability to collect sales taxes from retailers that lack physical presence in California.
- California taxes relatively few services. While taxing services would make the state's sales tax more stable, it would not reduce the general regressivity of the sales tax.

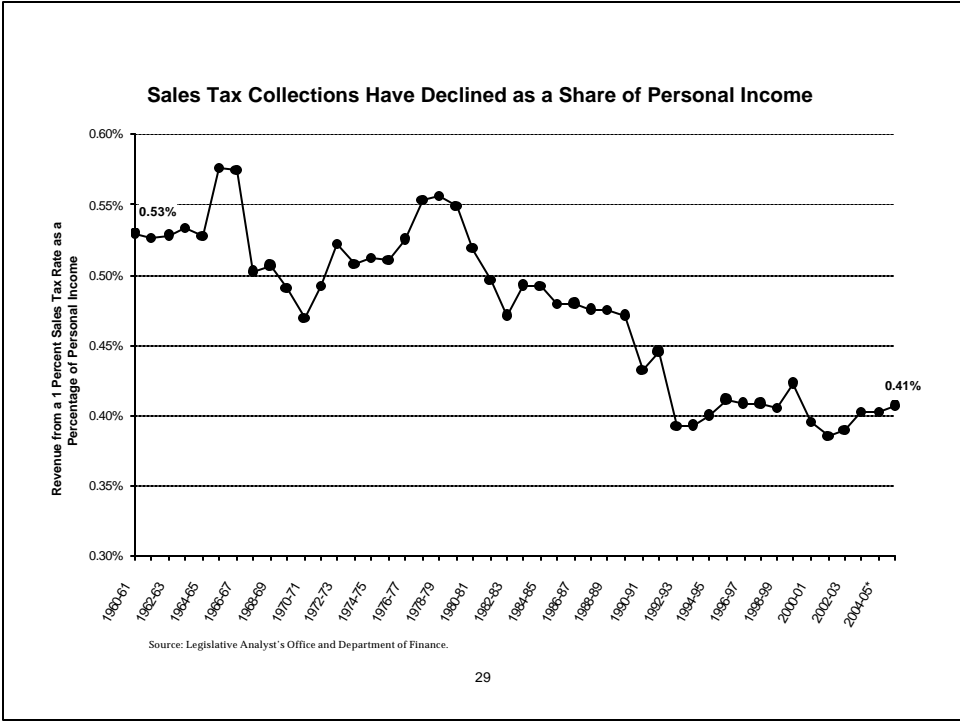
27

### Where Does the Sales Tax Go?



Note: A portion of the "Bradley-Burns" rate will be temporarily transferred to the state to pay off the economic recovery bonds and most jurisdictions do not impose the maximum allowable transactions and use tax.  
Source: Department of Finance

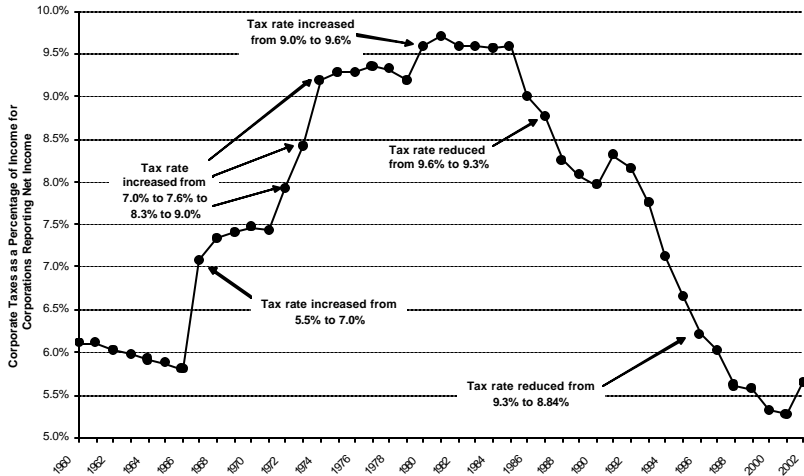
28



## Corporate Income Tax

- Corporate income tax collections have declined as a share of both the General Fund and corporate profits.
- The decline in corporate tax collections is attributable to an increase in the number and magnitude of corporate tax breaks.
- However, California still ranks very high among the states with respect to corporate tax collections as a share of personal income.
- Economists argue that corporate profits taxes are passed through to shareholders.

**Despite Modest Increase in 2002, Share of Corporate Income Paid in Taxes Has Fallen 42 Percent Since 1981**

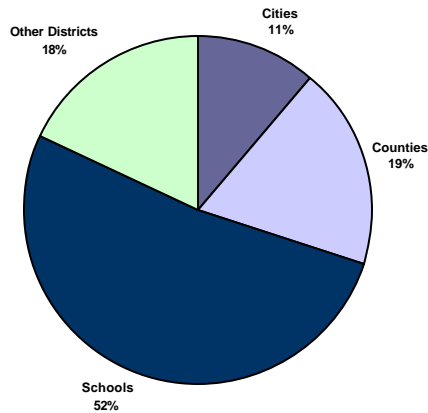


Source: Franchise Tax Board.

## The Property Tax

- The property tax is a local revenue source - all revenues go to cities, counties, schools, and special districts.
- Proposition 13 limited property tax rates to one percent and created a system based on "acquisition value" plus an annual inflation adjustment of no more than 2 percent. Proposition 13 also gave control over the allocation of property tax revenues to the state.
- In recent years, homeowners' share of the total property tax bill has increased.

### Over Half of the Property Tax Goes to Schools 2002-03



Source: Board of Equalization 2002-03 Annual Report

33

## Other State Taxes

- Collections from so-called "sin" taxes have fallen due to declining consumption of alcohol and tobacco products. These taxes are also very regressive. Fuel taxes are the most regressive of all state taxes.
- The Legislature has reduced the state's VLF by 67.5 percent since 1998. The VLF is a local revenue source (the state reimburses cities and counties for the loss) and is also a modestly regressive tax.
- Other revenue sources include the estate tax, fuel taxes, and the insurance gross premiums tax.

34

## Constraints on Tax Policymaking

- Measures enacted for the purpose of increasing tax revenues require a 2/3 vote of both houses of the Legislature, while measures that reduce revenues require a simple majority.
- Proposition 13 capped property tax rates at one percent, with reassessment only upon change of ownership.
- Proposition 218 requires majority voter approval of local general tax increases and 2/3 voter approval for local tax increases dedicated to a specific purpose (“special taxes”). Proposition 218 also requires local voter approval of assessments and made it more difficult to impose fees.
- Gas taxes must be spent for transportation; most tobacco taxes go to early childhood (Prop 10) or health programs (Prop 99).

35

## Options for Reform

Options for reforming the state’s tax system include:

- Restoring local elected officials’ ability to raise revenues without voter approval.
- Eliminating the 2/3 vote requirement for measures that increase state taxes. Alternatively, require new tax expenditures to be approved by a 2/3 vote of the Legislature.
- Extending the sales tax to a broader range of services.
- Requiring tax expenditures to be evaluated as part of the annual budget process.
- Establishing a level playing field between electronic and “brick and mortar” sales.

36

**Selected State Revenue Raising Options**

	<b>Revenues</b>
	<b>(In Millions)</b>
Tax Commercial Property at Market Value*	\$ 3,350
Impose a 5% Surtax on Pre-Credit Personal Income Tax Liability	\$ 2,900
Restore Top Income Tax Brackets	\$ 2,200
Impose a 1% Sales Tax on a Broad Range of Services, Excluding Health Services	\$ 1,380
Reduce the Dependent Credit by 50%	\$ 750
Increase General Fund Sales Tax Rate by 0.25%	\$ 1,321
Impose the State's Sales Tax on Legal Services	\$ 1,195
Impose the State's Sales Tax on Engineering, Architectural, and Surveying Services	\$ 1,030
Impose the State's Sales Tax on Accounting, Auditing, and Bookkeeping Services	\$ 830
Impose the State's Sales Tax on Computer Systems Design and Related Services	\$ 724
Increase Corporate Tax Rate by 1% to 9.84%	\$ 690
Impose the State's Sales Tax on Management, Scientific, and Consulting Services	\$ 670
Impose the State's Sales Tax on Repair Labor	\$ 550
Increase the Cigarette Tax by \$0.50 per pack	\$ 543
Restore Subchapter S corporation Tax Rate to 2.5%	\$ 480
Eliminate Deduction for Research and Exploration Costs	\$ 400
Limit Corporate Income Tax Credit Use to 50% of Liability	\$ 380
Cap Mortgage Interest Deductions at Interest on \$500,000 of Debt (\$250,000 Single)	\$ 380
Impose a 6% Oil Severance Tax	\$ 370
Impose the State's Sales Tax on Custom Software	\$ 350
Suspend Indexing of the Personal Income Tax Brackets	\$ 295
Impose the State's Sales Tax on Cable TV and Other Program Distribution	\$ 282
Eliminates Enterprise Zone Tax Credits	\$ 240
Restore Net Operating Loss Deductions to 50%	\$ 207
Impose the State's Sales Tax on Laundry and Dry Cleaning Services	\$ 158
Repeal Double Weighted Sales Factor in the Corporate Income Tax	\$ 100
Impose the State's Sales Tax on Satellite TV/DBS	\$ 83
Limit the Dependent Care Credit to Taxpayers Earning \$50,000 or Less	\$ 80
Increase California's Alcoholic Beverage Tax Rates to the National Average	\$ 73
Close the Expatriate Corporate Tax Loophole	\$ 50
Limit Mortgage Interest Deductions to a Maximum of \$50,000	\$ 47
Suspend the Small Business Stock Exclusion	\$ 45

\*Revenues raised would go to schools, cities, counties, and special districts. The state's school funding obligation would be reduced by approximately half of the revenues raised.