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California's Major Revenue Sources and Tax Agencies

LEGISLATIVE ANALYST'S OFFICE

Presented to:
Assembly Revenue and Taxation Committee
Hon. Phil Ting, Chair

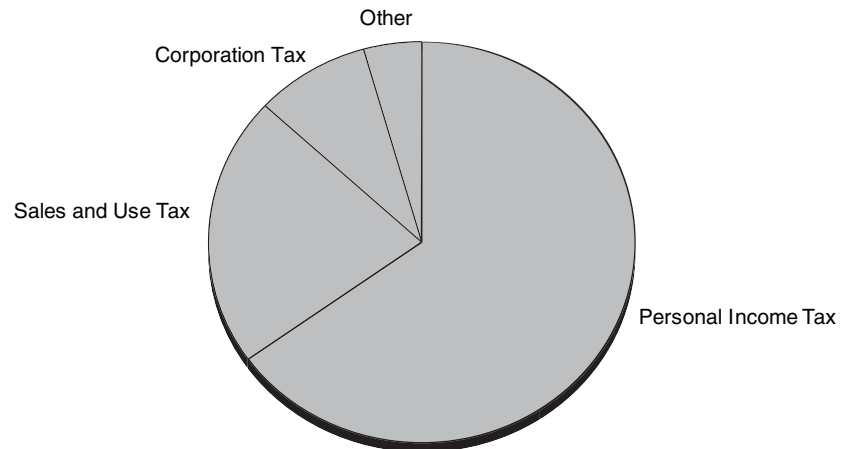




Overview of General Fund Revenue

Most General Fund Revenue Comes From Three Taxes

2013-14



The “Big Three” Taxes Provide About 95 Percent of General Fund Revenues

- Personal income tax (PIT).
- Sales and use tax (SUT).
- Corporation tax (CT).

Sources of other revenue to the General Fund include the insurance premium tax; unclaimed property; royalties from state lands; tribal gaming revenue; and other various taxes, fees, penalties and legal settlements.



Overview of General Fund Revenue

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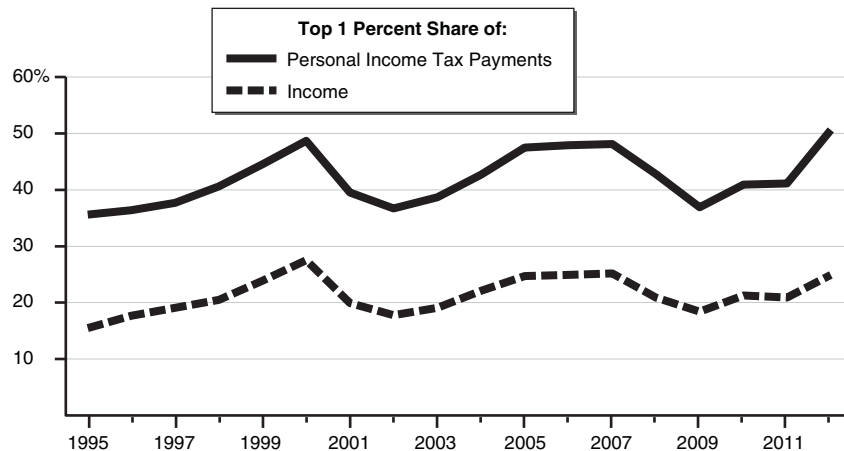


Local Property Taxes Interact With State Budget. Local property taxes are the largest source of local revenue but are not directly received by the state. Property tax revenue directly affects the state budget in one way: higher property tax collections for school districts tend to reduce required state education costs.



Personal Income Tax

Top 1 Percent of Income Earners Paid Half of Income Taxes in 2012



State's Largest Source of Revenue. California taxes the income of individuals—this includes wage income, interest income, business income, capital gains, and other income. By far the largest source of General Fund revenue, the PIT raised about \$67 billion in 2013-14.

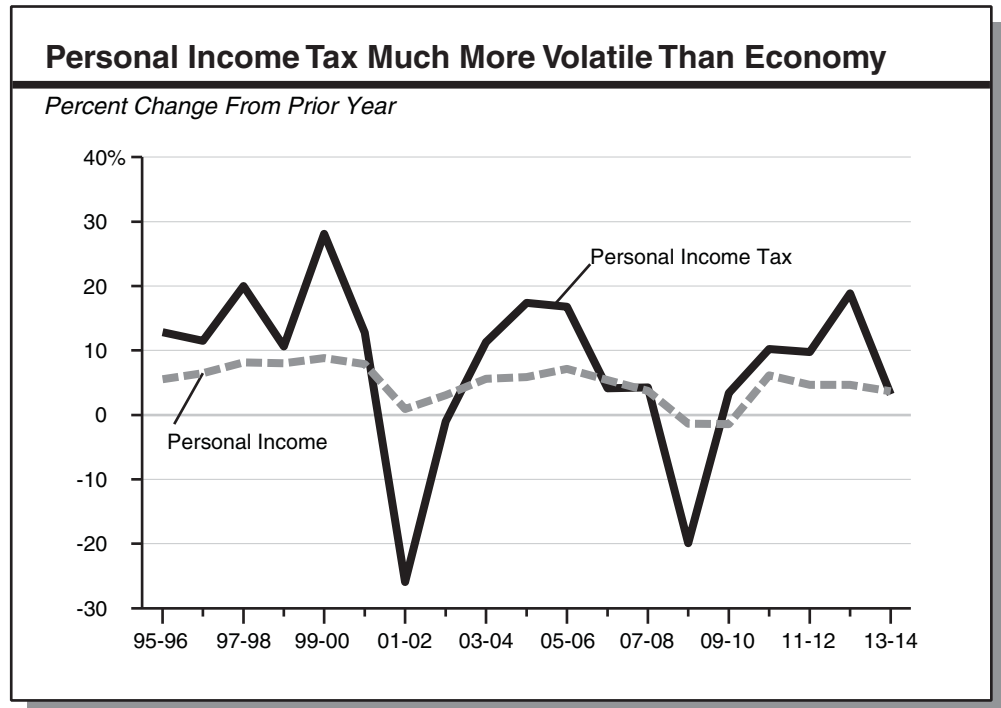


Progressive Tax Rate Structure. In California, higher income taxpayers pay higher tax rates. The highest marginal rate for the General Fund portion of the PIT is 12.3 percent. Because of the rate structure, the top 1 percent of income earners earn about 25 percent of all income and pay about half of income taxes. In addition to the General Fund portion of the PIT, filers with taxable income of over \$1 million pay a 1 percent rate to a separate mental health services fund.



Personal Income Tax

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The PIT Is a Volatile Source of Revenue. Income tax on wage income is fairly steady from one year to the next. However, the PIT is much more volatile than statewide personal income largely because of capital gains. Capital gains are especially volatile and mainly go to high-income taxpayers who pay the highest tax rates. Income fluctuations among the wealthiest Californians can cause state revenues to rise or fall by billions of dollars each year.

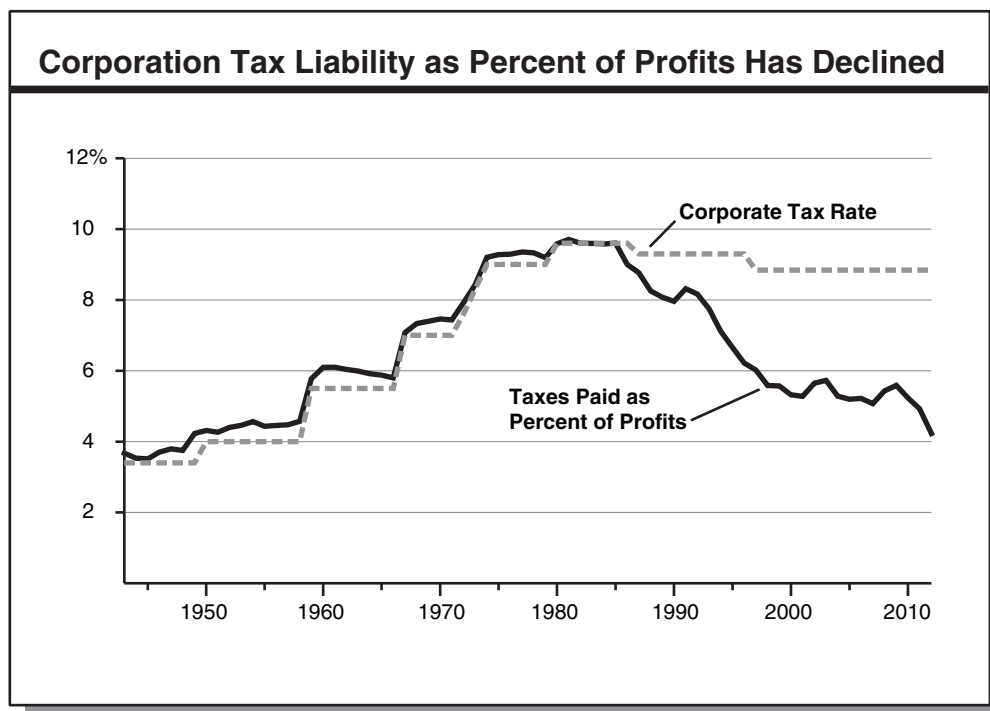


Corporation Tax



Corporations Pay Tax on California-Source Income.

All corporations doing business in California must pay tax on their California-source income. The main tax rate for a traditional C-corporation is 8.84 percent. Banks pay a higher rate. S-corporations, which pass on their income directly to shareholders, pay much lower rates.



Credits and Other Tax Law Provisions May Reduce CT Liability.

Historically, average CT liability—as a percent of reported profits—has closely tracked the statutory tax rate. This relationship changed beginning in the mid-1980s as the state made various major changes in corporate tax law. These include expansions of some tax credits and changes in corporations’ ability to deduct prior losses from current income.



Sales and Use Tax

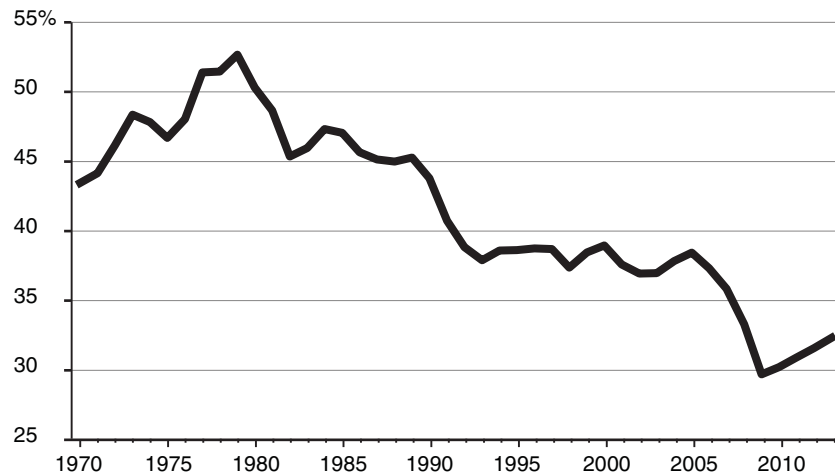
- SUT Levied on Tangible Goods.*** This tax has two parts: a sales tax on tangible goods sold by California retailers, and a use tax on tangible goods purchased from other retailers.
- Rate Ranges From 7.5 percent to 10 percent.*** The SUT rate varies across cities and counties due to optional local sales taxes. The average rate is about 8.5 percent.
- Roughly Half of SUT Revenue Goes to General Fund.*** Revenue from the SUT funds both state and local governments. Roughly half of SUT revenue goes to the General Fund and the other half funds local programs. Most of that money is for specific programs, but some is available for general purposes.



Sales and Use Tax

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Consumers Are Spending a Declining Share of Income on Taxable Goods



Since 1970, Tax Base Has Grown More Slowly Than

Economy. The SUT base has grown more slowly than the overall economy because the prices of tangible goods have risen more slowly than prices of services. However, due to rate increases, total SUT revenue has grown faster than the state's economy.

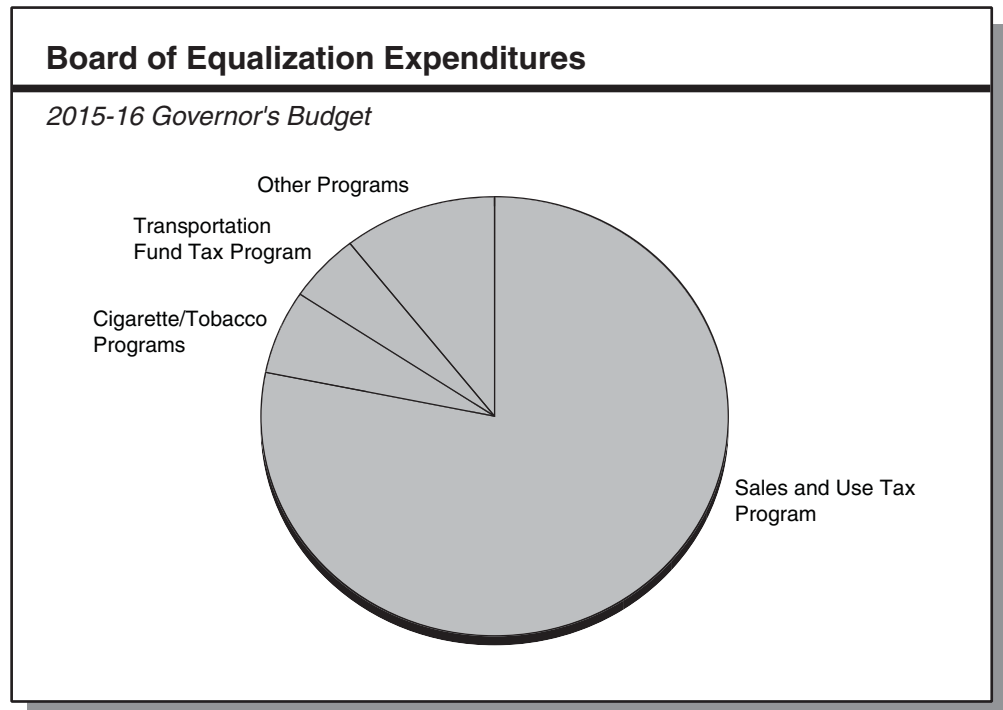


Proposition 30

- 2012 Ballot Measure.** Voters approved Proposition 30 in the November 2012 election. This constitutional amendment included temporary rate increases for the PIT and SUT.
- Temporary PIT Increase.** Proposition 30 raised marginal PIT rates on higher incomes from the 2012 tax year through the end of the 2018 tax year. Before the ballot measure, the marginal rate on these incomes was 9.3 percent. Proposition 30 created new brackets with rates of 10.3 percent, 11.3 percent, and 12.3 percent.
- Temporary SUT Increase.** Proposition 30 raised the SUT rate by a quarter-cent from 2013 through the end of 2016.
- Revenue.** Preliminary estimates for 2013-14—the first full fiscal year of Proposition 30—indicate that these tax increases raised about \$7 billion. This estimate includes \$5.6 billion of PIT revenue and \$1.4 billion of SUT revenue. Due to its reliance on the volatile high-income PIT base, year-to-year changes in Proposition 30 revenue are difficult to predict.
- Not Necessarily a “Cliff Effect” as Proposition 30 Expires.** The state budgets on a fiscal year basis (July to June), not a calendar year basis. As a consequence, the structure of Proposition 30 results in its revenues phasing out over several fiscal years when the tax increases expire. This likely will slow revenue growth over several fiscal years, but will not necessarily result in a sudden drop of state revenues.



State Board of Equalization



- State Board of Equalization Administers Several Taxes and Fees.** The Board of Equalization (BOE) has 4,830 employees and an annual budget of \$578 million in 2015-16. The SUT is BOE's largest tax program, accounting for four-fifths of its budget. The BOE also administers many other taxes and fees, such as the cigarette tax and the motor vehicle fuel tax. Most of these taxes and fees fund specific programs, although a few—such as the alcoholic beverage tax—go to the General Fund.
- Headed by Directly Elected Board.** The five member board is the only elected tax commission in the country. Four members are directly elected by district. The fifth member is the State Controller.



State Board of Equalization

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- Adjudicates Tax Disputes and Appeals.*** BOE's board serves as an appellate body for the taxes it administers, as well as for the PIT and CT.

- Property Tax Roles.*** BOE assesses certain statewide property of utilities and railroads. It also oversees county assessors' administration of the local property tax.



Franchise Tax Board

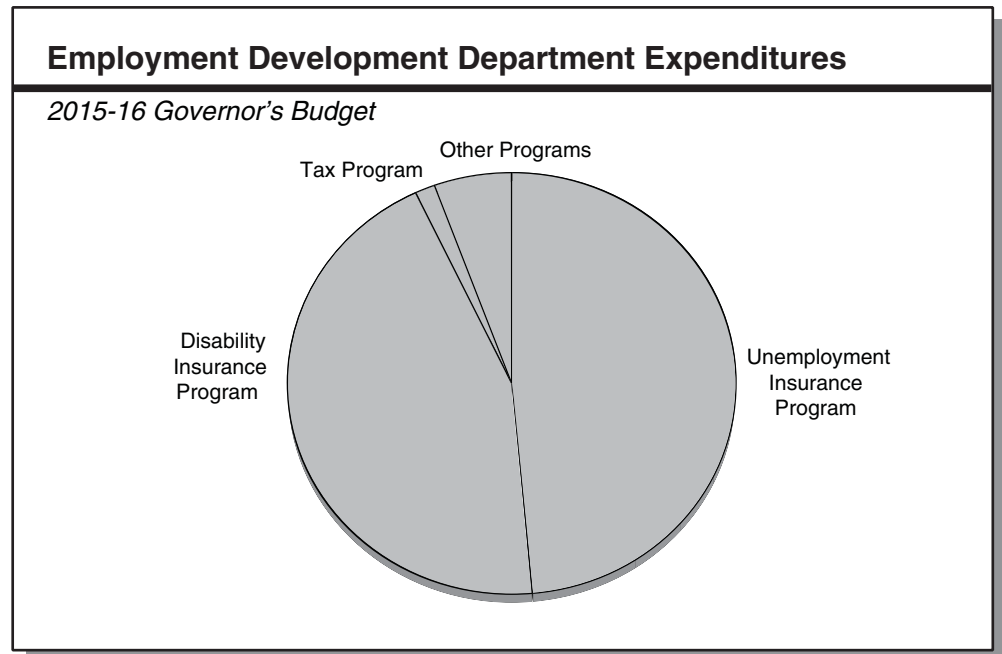
- Franchise Tax Board Administers the PIT and CT.*** The Franchise Tax Board (FTB) has 5,885 employees and an annual budget of \$699 million in 2015-16. It is responsible for administering the PIT and CT.

- Headed by Three Member Board.*** The three members of the board are the State Controller, the chair of the BOE, and the Director of Finance.

- FTB Also Collects Debt for Other State Agencies.*** The FTB uses its resources to collect delinquent fees, taxes, and penalties on behalf of the Department of Motor Vehicles. In addition, the FTB also collects delinquent fees, penalties, and orders of the courts.



Employment Development Department



- The Employment Development Department Collects Taxes From Wages.** The Employment Development Department (EDD) has 8,543 employees and an annual budget of \$14 billion in 2015-16. It is responsible for administering the unemployment insurance and disability insurance programs. The tax program collects employee contributions to these programs and several taxes.
- EDD Collects Substantial Amount of PIT Revenue.** The EDD tax program withholds PIT payments from employee wages earned. In the 2013-14 fiscal year, EDD collected \$47 billion—about 60 percent of the total \$78 billion in PIT receipts.
- EDD Provides Other Workforce Services.** The department also administers the federal Workforce Innovation and Opportunity Act program (which will replace the Workforce Investment Act program on July 1, 2015) which provides employment training services.



Consolidation of Tax Agencies

- No Central Tax Agency.*** Historically, as California adopted new taxes, a method of collection and appeals was improvised for each particular tax. Largely as a result of this pattern of development, there are no central agencies with responsibilities for the different functions of tax collection and appeals. The distribution of tax collection responsibility among several agencies presents a complicated picture to the taxpayer.

- LAO, Others Recommend Tax Agency Consolidation.*** Our office has generally supported the consolidation of the tax agencies, in one form or another, since 1943. Prior administrations, the Little Hoover Commission, and others have also analyzed California's complex tax collection and administration structure and have over the past several decades developed varied restructuring proposals.

- Consolidation May Yield Benefits.*** We believe that consolidating the tax agencies could simplify tax administration and taxpayers' experiences in interacting with the state. The state potentially could reduce ongoing tax administration costs and improve collections. Consolidating could clarify the authority of tax management, simplify tax appeals, and encourage efficiency and internal collaboration, and also improve taxpayers' perception of tax administration in California.



Consolidation of Tax Agencies *(Continued)*

- Consolidation Would Be a Very Challenging Undertaking.*** There are several factors that make tax agency consolidation a very challenging undertaking.

 - No single existing agency currently has enough space to house all state tax functions. Some capital and information technology costs would be required to fully integrate their operations.
 - Thousands of state employees would be affected by changes required to implement a consolidation, potentially including reductions in the state workforce to achieve all possible efficiencies.
 - The BOE is a constitutional body, although most of its key duties are statutory.

- Tax Agency Consolidation Options.*** Should the Legislature reconsider tax agency consolidation, it has a range of options.

 - Although most challenging, a complete consolidation is possible.
 - A range of partial restructurings has been proposed over the years.
 - A virtual consolidation option would present a more consistent and unified external face to the taxpayer, while maintaining some or most of the current administrative organization.

- Consolidation and Planning for New BOE Building.*** The requirements for any new building or campus to house BOE will change significantly should the state consolidate its tax agencies. If the Legislature wishes to pursue tax agency consolidation, it should aim to make this decision before deciding whether to approve a new BOE building.