California's Tax System in Crisis and Beyond

Testimony before the Committee on Revenue and Taxation
California Assembly

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March 23, 2009

Mr. Chairman and Members of this Committee:

I am pleased to be here to offer my views on the fiscal actions that California might wish to take during the current economic crisis as well as what measures might be adopted, particularly with respect to California's tax system, to put the state on a more stable and sustainable fiscal path that can promote economic growth and prosperity and help us avoid the type of budget crisis we have seen this year.

Short-Run Fiscal Policy and the Recession

It should hardly need to be said that California is in a difficult fiscal situation. You have already adopted severe budget measures, including spending cuts and tax increases, to address our large budget deficit, and more actions are likely to be needed soon, given the worsening economic conditions. In such a situation, it is basically impossible to undertake the types of policies called for by traditional Keynesian analysis – tax cuts and increases in spending. Moreover, such Keynesian policies are much more effective when adopted at the national level, since many actions taken by California alone to increase the demand for goods and services will have only a limited impact on the demand for goods and services produced *in California*. Thus, you have little room to maneuver; and even if you could, you are limited in your ability to influence economic conditions in California, acting on your own. Therefore, caution is appropriate as you evaluate proposals to stimulate California's economy, particularly as you are barraged with suggestions from different interest groups. It will be much easier to come up with policies that damage the California economy than policies that help it, particularly in these tight fiscal conditions. The approach I would advise is one of looking for tax increases and spending cuts that cause the least damage, while placing a big hurdle in front of any tax cut or spending increase that will simply make the task of short-run budget balance even more difficult.

As an example of the pitfalls of targeted tax cuts, I would cite the recently adopted tax credit for the purchase of new homes. It is easy to understand the motivation for such a credit, given the large stock of new, unsold homes in California; the credit should, indeed, help promote the purchase of such homes. But it is also likely to have negative effects as well. By providing

an incentive for the purchase of new homes, the credit will encourage additional construction, which is probably the last thing we should be doing right now. And providing the credit only for new homes will discourage the purchase of existing, previously occupied homes, thereby adding to the capital losses that homeowners have already suffered. In short, if one takes all of the policy's effects into account, it looks far less attractive. This is often the case for targeted provisions, and yet it may be hard to take all of a potential provision's important effects into account when facing the time pressure budget negotiations.

When thinking about more broad-based tax policies, there may still be differences in economic effects among different policies. For example, consider two recently adopted revenue-raising measures, the temporary increase in the personal income tax and the temporary increase in the sales tax. Both tax increases will discourage purchases by households by reducing disposable income; this is an inevitable and unfortunate effect of tax increases. But the sales tax increase may have a more negative impact per dollar of revenue raised, for two reasons. First, the sales tax falls more heavily on lower income households than does the income tax, and lower income households are less likely to be able to rely on accumulated savings to maintain previous levels of spending in the face of a loss of income. Second, a temporary sales tax increase is very much like a temporary price increase – a "negative" sale – that encourages households to defer spending until the tax increase expires. While this impact is likely small for staples that a household purchases every month, it could have a greater impact on the purchases of consumer durables – big-ticket items like automobiles and home appliances. Thus, the sales tax increase is not only more regressive than the income tax increase, but also likely more damaging in the short run in terms of its effect on household purchases. The temporary increase in the vehicle license fee will also discourage the purchase of automobiles somewhat, although the effect will not be large because most of the revenue from that measure will come from the existing stock of cars, not those newly purchased.

Should California introduce tax breaks similar to those recently adopted at the federal level? The main argument for doing so would be to maintain conformity with the federal income tax, but this argument is weak in the current context because the federal tax provisions are temporary, and because they generally do not involve changes in the personal income tax base, but rather credits against tax, such as the Making Work Pay tax credit. There may be debate about whether federal actions to date, including those included in the stimulus bill, are enough to help pull the economy out of recession. But if federal actions have been inadequate, one would hope that these shortcomings would be addressed by President Obama and Congress in the coming months.

<u>Fiscal Stability, Beyond the Recession</u>

As one looks beyond the current recession, which according to current, very uncertain forecasts will end some time late this year (at least at the national level), other questions about the tax system and the fiscal system overall take on greater relevance. First, what can be done to break the continuing cycle of budget crises? Second, what measures can be taken to reform California's tax system to provide a better environment for economic growth and prosperity?

The answer often given to the first of these questions is that California needs to find a way of making its tax system less volatile. Indeed, this was one of the charges given to the Commission on the 21st Century Economy that is currently deliberating. But this view – that a volatile revenue stream is a big problem – deserves further comment. In itself, a more volatile state revenue stream can actually be a *good* thing, because it is the result of shifting more of the fluctuations in statewide income from households and businesses to the state. For example, when personal income tax collections go down in a recession, this is because personal income has fallen. Because the state's tax collections fall, the decline in taxpayers' after-tax income is smaller than the decline in their before-tax income. This dampening of after-tax income fluctuations is what economists call an *automatic stabilizer*, because it occurs without any new actions on the government's part. A state *should* be in a better position to deal with income fluctuations than an individual household, because its access to capital markets is so much better. But this would require the state to save substantial amounts in good times to ensure that adequate funds are available in bad times. The state of California has not been able to do this, and so the volatility of revenues has been blamed for our budget crises. If California is destined to spend all or almost all of its revenues every year, then reducing volatility does become a worthy objective. But measures to make revenue volatility less damaging to the state's finances should be considered, too, and I will discuss these further below.

What can be done to decrease revenue volatility? To answer this question, it is useful to identify the reasons why California's revenues are so volatile to begin with. There are at least four contributing factors:

1. California relies much more heavily than the average state on revenues raised at the state level than on locally raised revenues. The mix of revenues at the state level (e.g., income taxes, sales taxes, etc.) has greater volatility than local revenues (e.g., property taxes).

2. Among sources of state-level revenue, California relies more on the income tax than on the sales tax, compared to other states. Income tax revenues are more volatile than sales tax revenues.

3. California's income tax is progressive, with fairly high marginal income tax rates. Thus, it is more sensitive to income fluctuations than the tax systems that are less progressive.

4. A significant share of California's income comes from particularly volatile sources, such as capital gains. Fluctuations in these sources of income have played an important role in producing revenue gaps, particularly in the past two recessions.

In light of these factors that contribute to volatility of revenues, it is clear how one could reduce volatility:

1. Rely more on local taxes, particularly property taxes, while shifting greater fiscal responsibility to local governments.

2. Rely more on the sales tax than on the income tax.

3. Reduce marginal income tax rates.

4. Tax less heavily the components of income that are particularly volatile.

Unfortunately, there are serious problems with each of these possible steps. Step 1 would require repeal of Proposition 13. I have now lived in this state long to enough to understand that a rational discussion of this subject is very difficult. I would point out, however, were Prop. 13 to be repealed, this would be the time to do it. Given the recent decline in home values, many houses in California are facing property taxes well below the Prop. 13 ceiling based on original purchase price. Thus, lifting that ceiling would have no immediate impact on many homeowners.

Step 2, relying more on sales taxes than one income taxes, could be accomplished by raising sales tax rates, but it would be preferable to do it by broadening the tax base. But however sales taxes are increased, substituting sales taxes for income taxes would be regressive. Likewise, it would be difficult to make much progress toward Step 3 without reducing the progressivity of the state income tax. While it would be possible to reduce marginal tax rates somewhat simply by reducing deductions and tax credits and using the extra revenue to lower rates, deductions and credits tend to be relatively unimportant among higher income individuals. Thus, reducing their marginal tax rates would mean reducing their taxes. The same issue arises with respect to Step 4, since capital gains and other very volatile sources of income, such as executive compensation stock options, are heavily concentrated among the state's very highest earners.

So, to achieve much lower revenue volatility, you have two broad options: modify or repeal Proposition 13 and shift greater fiscal responsibility to local governments, or reduce significantly the progressivity of state taxes. I have no illusion about the likelihood of either change, but if both are off the table then so is the prospect of a significant decline in revenue volatility.

If little reduction in revenue volatility can be accomplished, then alternative approaches are needed to break the budget-crisis cycle. Strengthening the government's ability to accumulate rainy-day funds, as would be accomplished through measures like Proposition 1A, is one such approach. Measures like this have their drawbacks, because they impose spending rules based on past revenue growth that might not reflect current needs or revenue prospects, but they can be effective at helping to make sure that spending is kept in line with revenues when there are economic fluctuations. Another approach is to try to lessen the extent to which spending grows autonomously. If much of the spending in the budget is based on formulas rather than on annual appropriation, then the remaining, unprotected parts of the budget must bear a disproportionate share of budget cuts, and this makes budget cutting more difficult.

Improving the State's Tax System

Leaving aside the issue of revenue volatility, what might be done to make the state's tax system more conducive to economic growth and prosperity? An obvious point here is that California is a relatively high-tax state, but the relevant issue is how well our taxes are spent. Given our overall level of taxes, however, improvements are certainly possible, starting with reform of the state sales tax to make it apply to a broader base of household purchases and to exclude the business purchases currently in the tax base.

Another area of concern is the state's corporate income tax, which has been amended by recent legislation. Like other states, California's corporate income tax uses a formula based on a corporation's sales, assets and payroll to determine the share of the company's profits that are taxable in California. As of now, this formula gives sales twice the weight of assets and payroll, but starting in 2011 companies will have the option of using a formula based exclusively on the location of sales. This change will have two obvious effects. First, it will reduce revenues, for the only taxpayers that will opt for the sales-only formula will be those that would have paid higher taxes under the basic formula. Second, it will encourage the location of production activities within California of multi-state corporations that sell primarily elsewhere, for they can largely avoid paying tax in California by adopting the alternate formula.

While encouraging businesses to locate in California is a good thing, this most recent change raises the question of what the California state corporate income tax is meant to accomplish. If we are moving toward a sales-only formula for all corporations, then the resulting tax will be in some ways much like a sales tax on what the corporations sell in California. But it would approximate a sales tax only on the things that corporations sell, and it would be higher for corporations with higher profit margins, thereby discouraging sales of their products more. Why we would wish to impose a sales tax in this way is not clear. So, the recent change might represent an improvement, particularly if we think that it will have a significant effect on corporate location decisions, but it also should lead us to think more about what our state corporate income tax is meant to accomplish. In thinking about this question, we need to keep in mind that taxes *paid* by corporations cannot be borne by the corporations themselves –only people can ultimately bear the burden of taxation – and are not necessarily borne by the corporations' shareholders, either. Especially in the case of a corporation income tax levied by an individual state, even a state as large as California, it is state residents, in their capacities as employees, consumers, and landowners, who will bear most of the burden of the state corporate income tax. If we continue to rely on the corporate income tax primarily because we think otherwise, then a reexamination of the role of this tax in the state fiscal system is warranted.

Finally, although income, sales and property taxes account for most of California's tax revenues, we do collect other taxes as well. A thorough examination of the tax system should include an evaluation of these taxes. For example, California relies less on motor fuels taxes than does the typical US state. While virtually all taxes have adverse effects on economic activity, an increased tax on motor fuels used to offset reductions in other taxes could promote environmental objectives and reduce road congestion without increasing overall tax burdens.

Conclusions

California faces difficult times in the months ahead, and an important task for its government is to meet its fiscal responsibilities while imposing the least possible harm on the California economy. A step toward achieving this objective is avoiding new targeted tax breaks unless a compelling *overall* benefit can be identified. Over the longer term, California's fiscal system needs reform if budget crises are not to be a regular occurrence. The volatility of California's revenues is a problem only in the sense that we have lacked the fiscal discipline to base spending on longer-term revenue capacity, and reducing revenue volatility would require measures not likely to be politically acceptable. Thus, measures to constrain spending and promote rainy-day fund saving, as unappealing as they might be when considered in isolation, present an attractive alternative. In addition to its role in addressing the budget process, tax reform can also serve to make California's tax system more conducive to economic growth and prosperity. The sales and the corporate income taxes are good candidates for reform.