Improving California's Tax System:

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I. Introduction

Good afternoon, Mr. Chairman, Members of the Committee. It is a pleasure to appear before you. Most of my remarks will concentrate on how to make California's system more nearly neutral and more conducive to investment and competitiveness, drawing on remarks I made several weeks ago to the Commission on the 21st Century Economy. I will then comment briefly on how to avoid recurrent budgetary crises and tax measures that might be taken to deal with the present crisis.

You may find it useful if I highlight one aspect of my professional experience. As Deputy Assistant Secretary of the US Treasury for Tax Analysis from 1983 to 1985, I was responsible for developing the Treasury Department's proposals to President Ronald Reagan that became the basis of the Tax Reform Act of 1986, the most comprehensive reform of the US income tax since its introduction in 1913. Even after two decades of erosion, the 1986 Act remains the high-water mark of post-war federal tax reform.

Reform of the California tax system – and much less, state tax policy in a time of budgetary crisis – is not the primary focus of my research. There may thus be questions, particularly of fact, that I cannot answer. I am sure that the experts from your own staff, the Legislative Analyst's Office, the Franchise Tax Board, or the Board of Equalization can answer them.

II. The Long-term Perspective

A. Reforming the Sales Tax for Economic Neutrality, Investment, and Competitiveness

If someone were to come before you today and suggest that California should impose a tax on production occurring in the state that would distort production incentives, discourage investment, and reduce the competitive position of the states's producers in California markets, in other domestic markets, and in export markets, you would probably think they were crazy. Such a proposal violates common sense, as well as accepted tax policy norms. But that is exactly what the California sales tax does. In 2003 some 45 percent of sales tax collections came from business purchases, not sales to households. It is important to eliminate sales tax on business purchases.

Some may argue that this action is not needed, either because California's reliance on sales taxes on business purchases is only slightly above the national average, 43 percent, or because much of the tax on business purchases is exported to purchasers in other states. These views reflect faulty thinking. A simple analogy from sports refutes the first point. Suppose that each team in a basketball league inexplicably tied their players' shoelaces together. A team could clearly improve its competitiveness by untying its players shoelaces, no matter what other teams did. Similarly, whether California can improve its competitive position by rationalizing its sales tax does not depend on whether other states have equally irrational sales taxes.

California cannot export its sales tax on business purchases to out-of-state buyers unless it dominates the relevant regional, national, or international market. California is large, but not that large. Since it dominates few markets, its sales tax on business purchases is likely to reduce employment and the incomes of its least geographically mobile factors of production, land and labor. Nor does it matter that its reliance on taxation of business inputs only slightly exceeds the national average. In appraising how California's taxes affect prices, employment, and incomes, taxes levied elsewhere are not relevant.

Drastically reducing the taxation of business purchases would reduce sales tax revenues, unless the tax base were expanded or rates were increased. Actually, both would be required. The sales tax base should be expanded, by including intangible products and services provided to households that are now exempt – but not those provided to business. Taxing primarily goods requires higher rates, distorts consumer choices and has undesirable distributional consequences.

Taxing intangible products and services would not fully offset the reduction in the tax base occasioned by eliminating taxation of business purchases; a rate increase would be required to maintain revenue neutrality. But such a *rate* increase would not represent a *tax* increase. It would bring the tax that is now concealed in the prices of products into the open, making the cost of government more transparent.

B. The Streamlined Sales Tax Project

A third defect of all state sales taxes, including California's, exists because the US Supreme Court ruled in *Quill* that a state cannot require an out-of-state vendor to collect a state's use tax, unless it has a physical presence in the state. Since consumers are not likely to remit the tax voluntarily, the result is a loss of revenue, a competitive disadvantage for local merchants, and relatively higher taxation of low-income households.

Since 2000 most of the sales tax states have been engaged in the Streamlined Sales Tax Project, an effort to reduce the complexity for multistate vendors that underlay the *Quill* decision, induce voluntary collection of use tax, and perhaps convince Congress to override that decision. California is not among the 22 states that are in compliance with the Streamlined Sales and Use Tax Agreement (or is scheduled to be in compliance by July 1). I urge you to enact the legislation that is required to bring California into compliance.

C. How about a State VAT?

The value added tax is a sophisticated sales tax that allows VAT-registered businesses a credit for tax paid on purchases against liability for tax on sales. Thus only sales to households are ultimately taxed. This, plus its administrative advantages, makes the VAT the revenue workhorse in more than 130 countries. Some believe that the federal government should – and will – enact a VAT to reduce its budget deficit.

Since the Canadian province of Quebec imposes a VAT, it is natural to ask whether California should also introduce a VAT. This is worth considering. But Quebec's VAT is imposed in the context of a federal VAT, with which both the design and administration of the Quebec tax are coordinated. Only if (and when) the federal government imposes a VAT should California consider doing so.

D. The Corporate Income Tax: Why Gut it? Why Not Kill It?

It is hard to think of a good reason to tax corporate income, except to keep individuals from avoiding the individual income tax by incorporating – the "backstopping" rationale. The case against state corporate income taxes is especially strong. Economists observe that a jurisdiction that cannot affect the world price of capital should not tax the return required to elicit investment within its boundaries. (This presumption does not hold in the special case of location-specific economic rents – returns in excess of what is required to elicit investment.) The difficulty of taxing corporate income where it originates is a further reason not to try to tax it.

States have long used formulas to apportion the nationwide income of multistate corporations, based on their fraction of the taxpayer's operations. Until the mid-1970s virtually all states used a formula that assigned equal weights to the state's percentages of nationwide payroll, property, and sales. Since 1978, when the US Supreme Court upheld the constitutionality of Iowa's use of only sales to apportion income, there has been a dramatic shift to assigning greater weight to sales and less weight to payroll and property. Almost 80 percent of states that tax corporate income now assign at least one half the weight to sales, at least six states now use only sales to apportion income, and California has recently given corporations the option to use sales-only apportionment, beginning in 2011. No one seriously suggests that sales-only apportionment accurately reflects where income is earned. Rather, states are adopting sales-only apportionment to encourage economic development.

In appraising this development it is useful to note that, for a corporation with little of its operations in California, an apportioned income tax is not really a tax on income earned here. It is a set of taxes on the factors used to apportion income. Sales-only apportionment produces a strange amalgam of taxes ranging from a tax on corporate profits earned in California by firms operating only here to a peculiar form of tax on California sales for firms operating primarily elsewhere.

So, how should we think about the corporate income tax? Here I think of President Harry Truman's plea for a one-handed economist. On the one hand, the corporate income tax does not make much sense, except as a backstop to the individual income tax. But if we are going to tax corporate income, shouldn't we do it in a way that reflects where income originates, something sales-only apportionment dos not do? On the other hand, sales only apportionment is probably more conducive to economic development. But if that is the objective – and if the sales tax can be reformed by eliminating tax on sales to business, wouldn't it make more sense, and be more transparent, simply to reduce – or even eliminate – the corporate income tax and replace the revenues with a higher sales tax rate? Is backstopping the individual income tax the only reason to retain this crazy tax? Does the federal tax provide adequate backstopping?

E. Revenue Stability

California tax revenues have recently been highly unstable, especially because of the increase and subsequent decline in income tax revenues, including those attributable to capital gains and the exercise of stock options. If expenditures are expanded in good times and cannot be contracted in lean times, budgetary crises occur.

I can think of a few ways to reduce revenue instability, but would not endorse most of them. We could eliminate the taxation of capital gains and change the tax treatment of stock options, but that would allow a relatively small tail to wag a very large dog. The tax treatment of capital gains and stock options should be decided on principles such as equity, economic efficiency, effects on innovation and investment, and costs of compliance and administration.

We could rely less on the income tax and more on the sales tax or on excises such as the tobacco tax. Again, I think the tax mix (and the role of excises)should be based on first principles.

Eliminating the sales tax exemption for food would reduce instability, allow lower tax rates, and reduce the distortion of consumption choices. It would also increase the tax burden on low-income families, but that should not be a dispositive objection, if there are other ways to address distributional concerns.

At bottom, the perceived problem of revenue instability is not one of tax policy. It is one of budget policy. The solution is straightforward in concept, if not politically. When revenues greatly exceed their trend line growth rate, most of the excess should be placed in a "rainy day fund," not spent.

F. Summary of Long-term Recommendations

To summarize, I have made several suggestions for long-term reform.

- First, eliminate the sales tax on business purchases.
- Second, include sales of services and intangibles in the sales tax base.
- Third, consider a state VAT only after a federal VAT has been enacted.
- Fourth, reduce the corporate income tax and replace lost revenues by increasing the sales tax.
- Fifth, institute a budgetary rules that places most revenues in excess of a trend line in a "rainy day fund."

III. Fiscal Policy in a Time of Crisis

In the remainder of my time I will address the four questions Chairman Calderon posed in his invitation.

A. What actions can the state take to help save and even create jobs?

The current economic downturn is one of nationwide (indeed, worldwide) inadequate aggregate demand. Many think that policies the federal government has undertaken to stimulate demand will not be effective; I will not address that issue. In any event, single states cannot do much to stimulate demand for their products, both because of balanced budget constraints and because much of any stimulative effect would leak out into demand for products of other states or nations.

B. Could targeted state tax cuts stimulate the economy? If so, which tax cuts might be most effective?

Even if there were no balanced budget constraint, tax cuts provided by a single state are not likely to be very effective, because of leakages of demand. Moreover, in trying to craft targeted tax cuts to stimulate business investment, it is necessary to take account of constitutional constraints.

C. If the state must raise taxes ..., what kinds of tax increases would be least harmful to the economy?

There are no good answers. The best kind of tax increases for this purpose would not impinge directly on the demand for labor or for products produced in California and would not involve putting in place new procedures for compliance and administration. An increase in motor fuels taxes, which can be justified on other grounds (e.g., reducing pollution and congestion) is one alternative that deserves consideration

D. Does it make sense for the state to conform to some of the tax breaks implemented at the federal level as part of President Obama's economic stimulus plan?

It probably does not, if the objective is to stimulate demand, because of the balanced budget constraint and leakages of demand. It may, if the objective is simply to cushion the burden of the economic downturn. Conformity might simplify taxpayer compliance. In any event, the balanced budget constraint reduces the state's options.