California's Tax System in Crisis and Beyond

Testimony before the Committee on Revenue and Taxation
California Assembly

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Mr. Chairman and Members of the Committee. It is my great pleasure to appear before you to discuss California's tax system. I will begin my comments by discussing the fiscal volatility problem, and then I will attempt to answer some of the questions on tax policy that were sent to me by your staff.

The Fiscal Volatility Problem and State Budget Policy

- First, it is important to understand that were California able to save enough revenue during upturns, or to borrow enough during downturns, fiscal volatility would be desirable.
    - As Professor Auerbach has explained, it is good policy for governments to run deficits during economic downturns.
    - However, California's revenue structure is becoming increasingly volatile over time. To save enough revenue during upturns to cover revenue shortfalls during downturns would require far greater use of rainy day funds than we have ever seen done in the past. If adopted, Proposition 1A will be a step in the right direction, but its 12.5% target for funding its stabilization fund is likely to be inadequate. An adequate target would probably be closer to 30% or 40%.
    - In theory, it is also good policy for governments to borrow during downturns. But it is questionable whether states can be trusted to borrow responsibly. Moreover, due to California's history of budgetary shenanigans and to its supermajority requirements, borrowing would probably be too expensive to be a feasible option for fully dealing with fiscal volatility.

- Since California is unlikely to save enough during upturns, nor to be able to borrow enough during downturns, fiscal volatility is a serious problem.
- However, the only methods for reducing volatility through reform of the tax system are likely to be undesirable, not politically feasible, or both.
    - California could reduce volatility by:
        - Significantly increasing the use of property taxation,
        - Significantly reducing the progressivity of the state's income tax ,
        - Or, ending or limiting the taxation of capital gains
    - Increased use of property taxation would be good economic policy, and could be made progressive through the use of measures like circuit breakers. But this does not seem likely in the State of Proposition 13.
    - The question of whether to have a progressive tax system is a first order policy question that should be answered on its own merits. As Professor McLure so eloquently put it, to reduce progressivity in order to reduce volatility would be to let "a very small tail wag a very large dog."
        - Additionally, it is worth noting that the federal government subsidizes California's income tax in two ways: First, by allowing California to piggyback on the federal administrative and enforcement system. Second, through the deduction for state income tax payments in the federal income tax.
        - Moreover, the federal government effectively subsidizes California's taxation of capital gains by taxing capital gains at a much lower rate than ordinary income under the federal personal income tax.
            - It is well known that high income taxpayer use a number of techniques to convert what economists think of as labor income so that it is taxed at federal capital gains rates. California's tax on capital gains thus partially corrects for this distortion. The federal gap between ordinary income and capital gains rates should thus allow California's tax on capital gains to generate more revenue at less economic cost.

- **So what can California do to deal with the fiscal volatility problem?**
    - First, California should increase the use of rainy day funds to whatever degree is politically possible.
    - Then, during economic downturns, California will need to muddle through with a mixture of borrowing, temporary tax hikes, and temporary spending cuts.

<u>Questions on California's Tax Policy</u>

- **Could targeted state tax cuts stimulate the economy?**
  - Not likely.
  - As Professors Auerbach and McLure have explained, targeted tax cuts are almost always less effective than a general policy of maintaining a broad base and keeping rates as low as possible.
  - Moreover, targeted tax cuts create additional complexity which reduces the impact of the tax cuts.

- **Should California have offered an elective option for a single sales factor apportionment formula?**
  - Offering taxpayers a choice of apportionment methods is clearly a bad idea. Offering an election will lead to additional complexity, lost revenues, and more gaming opportunities for aggressive corporate taxpayers.
  - Whether California should return to multi-factor apportionment or should move to non-elective single sales factor apportionment is more controversial. I tend to look favorably on single sales factor apportionment, but many scholars would disagree.

- **Should California have increased its understatement penalties?**
  - Yes.
  - Both federal and state penalties for understatement are far lower than optimal. When combined with inadequate enforcement levels, these low penalties make it generally advantageous for sophisticated taxpayers to engage in extremely aggressive tax planning. The expected chance of penalties is much lower than the expected tax savings.
  - Increasing penalties retroactively is also sound tax policy. There may be constitutional challenges to the manner in which California raised its penalties, but these challenges are not likely to be successful.

- **When should California conform to the federal tax system and when should California not conform?**
    - It is generally sound policy to piggyback on the federal tax structure whenever possible. Imposing state level taxes that do not piggyback on the federal tax structure creates additional administrative and enforcement costs.
    - However, there are exceptions to the general rule in support of conformity:
    - It may not be desirable to conform to credits or deductions offered at the federal level. Indeed, it will often be optimal to not conform to credits and deductions, as the state tax system can raise revenues from taxpayers who aggressively overuse the credits and deductions. This is particularly true for credits and deductions that are generally thought to be poor tax policy.
    - If the federal government requires information reporting and then does not tax or imposes a tax at a reduced rate, it may be desirable for California to impose a higher tax than at the federal level. For instance, the federal income tax exempts inheritances, but requires information reporting on inheritances through its estate tax system. California could thus tax inheritances as part of its personal income tax base while piggybacking on the federal information reporting requirements in order to reduce administrative and compliance costs.

- **If the state must raise taxes, what kinds of tax increases would be least harmful to the economy?**
    - The best option for increasing revenues is to broaden the base of existing taxes. This includes expanding the sales tax to services and eliminating unnecessary credits and deductions from the personal and corporate income taxes.
    - California might also consider creating new taxes on negative externalities – meaning harmful activities like pollution. Were California to end the taxation of business inputs under its sales tax (as Professors Auerbach and McLure have recommended), while paying for this by implementing a new carbon tax, these changes would improve California's environmental policy without harming the economy. A carbon tax could also be implemented in order to raise additional revenues.
    - Additionally, California could raise revenues by closing tax expenditures and other gaps in the federal tax system. At a minimum, California should not conform to federal tax expenditures in California's taxes. California could go even further by imposing a small positive tax on the use of claimed federal tax expenditures.
    - Once these other methods have been exhausted, the best way to raise revenues is by increasing the rates of broad based taxes.