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RECOMMENDATIONS ON CALIFORNIA'S STATE BUDGET CRISIS
Policies to achieve revenue sufficiency

CALIFORNIA WORKING FAMILIES POLICY SUMMIT
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INTRODUCTION

Even before the major economic downturn, the state faced a structural deficit in which expenditures annually outstripped revenues. While the origins of that structural deficit include the failure to replace revenue from the cutting of the vehicle license fee in 2003, the revenue crisis stems from many failures in the tax system. While these failures may not be as apparent or costly when the economy is strong, they are magnified when it is weak.

How should the state make up a $40 billion deficit over a two-year period, and set the state back on a healthy fiscal track over the longer term? We suggest a few principles:

1. **Eliminate waste, fraud and abuse in the tax code**.
   The California tax code is riddled with provisions that provide tax benefits with no commensurate benefit to the state's economy. These provisions provide "money for nothing," that is, reward activity which will otherwise take place; permit manipulation and tax sheltering; fail to collect revenues owed; and treat similarly-situated taxpayers unfairly. Particularly during a recession, these loopholes in the tax system can be eliminated with a minimum of economic impact.
2. **Fairly spread the burden of taxation**.
   Maintaining progressive principles of ability to pay is even more necessary during a recession and has fewer economic impacts. At the same time, spreading the burden so that smaller amounts are paid by a larger number of people limits the burden on any one group or sector of the economy. While budget cuts are directly targeted to critical public investments, widely dispersed revenue sources have limited economic impact.
3. **Structural change is necessary**.
   In 1991, a major budget crisis received a two-thirds vote for billions in new taxes, postponing the day of reckoning with this structural impediment to sound budgeting and democratic government. If this were a normal government by majority, our crisis would be nowhere near as profound. But the two-thirds vote in the era where ideological commitments hold sway over term-limited officials exacerbates the crisis enormously. The decision to tax is a difficult one, but a majority is willing to stand by it.

   In addition, the single largest and most irrational part of the tax system is the way the state assesses non-residential property under Proposition 13. While statutory action is possible to address part of the problem, constitutional change must take place on the ballot.

POLICY OBJECTIVE #1
Eliminate waste, fraud and abuse in the tax code.

Background

While programs for poor and working families have been cut continually for several years, no systematic reduction of the failures of the tax system has taken place. Program expenditure review is constant, while tax expenditure review only takes place periodically, either in legislative hearings or in written materials presented by the tax agencies and the Legislative Analyst's Office. However, action is rarely taken on the many categories of waste, fraud, and abuse in the tax system, in large part because loopholes which are created by majority vote can only be eliminated by two-thirds, as a "tax increase."

These loopholes are particularly important to eliminate during a recession. It is commonly said that all taxes and cuts are bad during a recession, and painful choices have to be made. While elimination of much of this abuse will transfer money from a taxpayer to the state, it will not change economic decision-making in a recession. Example: Giving Wal-Mart hiring credits for locating their distribution centers in an enterprise zone has no beneficial impact on hiring, because these distribution centers are a necessary part of their business in California. But they receive state dollars for doing so: a classic case of "money for nothing." Similarly, allowing multi-national corporations to park income in offshore tax havens to avoid taxation provides no economic benefits, just revenue loss.

While some of these tax expenditures are not large, many cuts with real impacts on services and programs are on the order of $100 million or less. Eliminating even a few of these worthless sections of the tax system could save significant programs. In a major step forward, the Senate created Budget Subcommittee #5, on revenues and the economy, which will allow examination of these revenue options as part of the budget process.

Recommended Actions

A. Continue the limit on the use of corporate tax credits to reduce a taxpayers tax liability by no more than 50%, and eliminate the carryback of losses and trading of credits among taxpayers in a unitary group, new loopholes contained in last year's budget deal.

Revenue generated: About $1.5 billion in 2010-11, continuing indefinitely.

Many large corporations zero out their state tax liability by using generous credits in the tax code, particularly for research and development. The legislature limited the ability to zero out liability on a temporary basis, and should maintain the restriction on using credits to reduce no more than 50% of corporate tax liability permanent.

The legislature must also eliminate two de-stabilizing loopholes which have not yet taken effect. The ability to carry-back losses and receive tax refunds has never before been allowed in California, and would require refunds to corporations for taxes already paid at a time when programs are being cut. The ability to trade credits among affiliates opens up a new area of tax sheltering and should be eliminated before significant losses are incurred.

B. De-couple from the federal bank bailout tax break.

Revenue loss avoided: $300 million yearly, $2 billion over 5 years.

Actions of the U.S. Treasury, not Congress, allowed banks which purchased other banks with huge losses to use those losses to shelter their current income, in violation of current law (e.g Wells Fargo purchasing Wachovia). The Franchise Tax Board can take regulatory action to block conformity, but the legislature should also eliminate this potential loss before it becomes an issue. Several bills have been proposed.

C. Block tax sheltering by multinational corporations.

i. Eliminate the ability to shelter income in tax havens.
Annual revenue generated: $65 million, probably more.

California-based corporations and multinational corporations can park income in Caribbean tax havens to avoid paying taxes on income which should be attributed domestically. Tax havens should become part of the "water's edge" for purposes of California taxation, as prior legislation has proposed.

ii. Require worldwide combined reporting.
Annual revenue generated: $500 million.

Multinationals are given the choice whether to include their worldwide income and apportionment factors or their domestic income and apportionment factors. Providing this choice, which occurred in the 1980s, has led to no discernible change in the attractiveness of California for multi-national investment, but has resulted in a cumulative loss of billions of dollars in tax revenues.

D. Reform or repeal enterprise zone program.

Annual revenue generated: $100-$400 million.

The program is full of obsolete and outdated policies that are exploited by a cottage industry of consultants to inform businesses that they're eligible for credits they never even sought. It is so overly broad that it fails to achieve its originally limited purpose—helping poor people—and instead gives credits for location in major downtown areas of San Francisco, San Jose and Oakland. It does not yield new jobs, nor are benefits targeted to the poor. Reforms proposed in prior legislation would yield $100 million annually. Scrapping an obsolete program entirely would yield over $400 million annually.

E. Eliminate like-kind exchanges for commercial property.

Annual revenue generated: $290 million.

Commercial property owners reap enormous capital gains on sale but never pay tax on them, because they roll over their gains into additional commercial properties. This happens even on out-of-state properties where the capital gain in California escapes taxation forever. The incentives from this avoidance are driven entirely by federal tax considerations, not state taxes, so the state experiences a major revenue loss with no return to the state in economic activity.

F. Eliminate nowhere income.

Annual revenue generated: $50-65 million.

Multi-state corporations are permitted to treat the accounting of stock purchases and asset sales differently for federal and state law. This allows them to avoid state tax, thereby allowing them to be taxed on less than their full income—"nowhere income." Requiring the same choice to be made for state and federal taxes, as we do for virtually all other choices, would close this pure loophole.

G. Clarify sales tax nexus.

Annual revenue generated: $55 million, eventually significantly more.

Amazon has thousands of "associates" in California who get paid to refer sales to their company, but claims to have no "nexus"—that is, presence—in the state. New York passed a statute which tightens the nexus standard, and now Amazon is collecting on sales to New York. The California State Legislature can close this loophole through a majority vote.

H. Tighten statutory change of ownership rules.

Annual revenue generated: $1-2 billion.

When Martini Bros. sold their entire winery to Gallo Bros., there was no change of ownership because they could structure the loophole-ridden law to avoid re-assessment. Change of ownership is defined by statute in the loosest way possible, more loophole than tax. Tightening those rules is a first step toward structural commercial property tax reform (see section 3, below). (This was once considered majority vote, but has recently been ruled to be two-thirds.)

I. Enact oil severance tax.

Annual revenue generated: $400 million or much more, depending on the price of oil.

California is the only state without a tax on oil production, and the only place *in the world* which receives neither tax nor royalty revenue. Fortunately, Governor Schwarzenegger has now added his support to collecting the billions of dollars California has historically left on the table, at a rate of 9.9%.

J. Improve tax collections (majority vote).

i. Require reporting on the difference between book and tax income for multi-state and multi-national corporations.
Annual revenue generated unknown: perhaps $100 million in tax avoidance.

ii. Require data match with financial institutions to collect from tax avoiders (budget conference proposal).
Annual revenue generated: $35 million, growing to $100 million.

iii. Various legislative proposals: conform to federal back-up withholding, suspend professional licenses for tax debtors, deny sales tax refunds to lenders on worthless accounts, require use tax collection on income tax forms.
Annual revenue generated: $100 million.

iv. Require withholding on independent contractor income.
Annual revenue generated: $200 million or more (with $2 billion in accelerated tax collection).

K. Restore Subchapter S tax rate to original 2.5%.

Annual revenue generated: $600 million.

"Subchapter S" corporations are closely-held businesses which pay only a 1.5% rate on their corporate income, compared to 8.84% for regular corporations. The 1.5% rate was a cut from the compromise of 2.5% which originally permitted the use of Subchapter S in California. While some Subchapter S corporations are small businesses, many large companies qualify for Subchapter S under relaxed federal rules, which results in significant loss of tax revenue. Restoring the 2.5% rate will predominantly fall on the larger Sub S companies.

POLICY OBJECTIVE #2
Fairly spread the burden of deficit reduction.

Background

California has had a long-term structural deficit even before it entered the current steep decline in revenues and economic activity. The cut in the vehicle license fee currently costs the state $6 billion yearly, which has amounted to nearly $20 billion in lost revenue over the last 5 years—more than the $15 billion the state borrowed to meet its budget shortfall and itself another cause of the structural deficit. California in the past few years gained revenue from the crackdown on abusive tax sheltering and from a one-time amnesty, which covered over much of the structural deficit. The LAO expects shortfalls of as much as $20 billion annually through 2013.

A temporary recession will do permanent damage to the economic health of California if services are allowed to be decimated. On the other hand, fairly spreading the burden of maintaining vital services will not have permanent impacts. The following proposals are options for raising taxes in order to minimize damage both to services and to economic activity.

Recommended Actions

A. Restore the tax on the upper brackets at levels of $250k and $500k.

Annual revenue generated: $3-4 billion, significantly more after economic recovery.

The top 1% of the population now has 23% of the income, up from 8% in 1980 and the highest since 1928. While that income may be volatile, taxing the top 1% has the least possible impact on the economy, since the tax payment to the state is deductible from federal taxes at the highest marginal rate and the marginal expenditures of wealthy taxpayers have little stimulative effect on the California economy. These brackets would restore the Wilson-Reagan level of taxation on the top taxpayers.

B. Enact income tax surcharge of 5% of tax liability to get through the recession.

Annual revenue generated: $2.5 billion**.**

Since the personal income tax is progressive, a surcharge on final tax liability maintains that progressivity, is deductible from federal taxes, and has limited impact on taxpayers. A taxpayer earning $60-70,000 would pay $75 more, a taxpayer paying between $90-100,000 would pay $145 more, and a taxpayer earning between $150-200,000 would pay about $450 more. Most of the burden of this increased liability is relatively small—e.g. less than $3 per week for the family earning $8000/month. Working families with income under $50,000 would pay little or no increase, and those whose incomes decline in a recession would be similarly protected.

The Democrats took a step in this direction by passing a 2.5% surcharge as part of their budget package, replacing half of the Governor's proposed increase in the sales tax with this and other tax proposals.

C. Partially restore the vehicle license fee (VLF) to 1% of value.

Annual revenue generated: $1.3 billion, growing slowly with economic recovery.

The VLF is supposed to be a proxy for a personal property tax on automobiles. Restoration to 1% of depreciated value, as proposed by the LAO, would provide equal taxation with all other property and may be broadly acceptable. It is also deductible from federal income taxes.

D. Expand narrow sales tax base to non-labor consumer goods and services more broadly.

i. Many consumer purchases are mis-categorized as "services", which are generally the temporary rental of space, occupancy, or the use of a digital commodity. Entertainment, recreation (e.g. golf, ski lifts, amusement parks), admissions (professional sports), hotels and lodging, digital downloads, parking lots, cable and satellite TV should be considered a temporary rental or purchase subject to tax. Most of these are discretionary expenditures and do not involve the taxation of labor services.
Annual revenue generated: $2-4 billion.

ii. Labor services, such as attorneys, advertising, accountants, architects and auto repair, could also be part of a transactions tax which would tax all sales equally throughout the economy and could be used to lower the sales tax rate.
Annual revenue generated: Over $10 billion, depending on the rate and the services included.

E. Shift the paradigm – Establish a carbon tax.

Annual revenue generated: $8 billion, minus $1.2 billion in lower-income offsets.

Economists across the political spectrum prefer to "tax bads, not goods," so as to discourage pollution rather than production. Taxing 400 million tons of carbon dioxide at $20/ton would generate $8 billion. Because the effects are on gasoline (18 cents/gallon at this rate) and electricity, both potentially regressive, an estimated 15% of the revenue should be used to ensure that lower-income people are not disproportionately burdened. These offsets might include an earned-income tax credit or low-income rate assistance, or both. Establishing a carbon tax would create a strong revenue source without negative consequences in a recession while sending signals to change polluting behavior.

POLICY OBJECTIVE #3
Promote structural reform on the ballot.

Background
As the current budget stalemate has made clear, the supermajority two-thirds vote requirement for taxes and a budget can make decision-making on taxes virtually impossible. In fact, it is almost impossible to have a discussion about the relative merits of the proposals above because the minority will not consider any of them. Moreover, the only way to get a budget in these circumstances is to open new tax loopholes, as the legislature did last year (see 1.A), or as Republicans have proposed as part of their budget solution this year. And to make matters worse, new tax loopholes can be passed by *majority* vote, but they can only be repealed by a two-thirds vote, which leads to a "roach motel" effect: Once loopholes crawl into the tax code they can never be repealed, because that would be a "tax increase."

Because the decision to enact taxes is one of the most politically difficult a politician can make, the two-thirds vote requirement in this era puts reasonable tax solutions out of reach. Changing the two-thirds vote requirement will require that a majority of voters approve a constitutional amendment that is placed on the ballot either through an initiative or by the Legislature with a two-thirds vote in each house.

Another needed change will also require action on the part of voters. The voters will also be required to ratify a constitutional amendment to close the most irrational and largest hole in the state's tax system, the assessment of non-residential property under Proposition 13. The current, irrational assessment system shifts the tax burden from commercial property to homeowners and is:

- *bad economics*, taxing new construction and new investment heavily, and competitors unfairly, while failing to tax windfalls—the reverse of good economics;
- *bad law*, allowing tax avoidance through manipulation of "change of ownership" rules;
- *bad fiscal policy*, failing to collect the revenues from growth or from infrastructure investment; and
- *bad land use*, permitting speculation and sprawl.

Recommended Actions

A. End the supermajority two-thirds vote requirement for legislative tax and budget decisions.
The legislative vote threshold should be lowered to less than two-thirds, preferably by majority, or by a smaller supermajority perhaps more acceptable to the voters. The difficulty which must be overcome to pass such a measure is whether the opposition argument, "makes it easier to raise taxes," can be effectively countered in a campaign.

An alternative: Change current law to allow a majority (not two-thirds) of the legislature to put a tax measure on the ballot. This "double majority," also known as "Taxpayer Right to Vote," does not directly confront the two-thirds legislative vote requirement, but provides a safety-valve alternative. While by no means a desired solution, it would break the stalemate over taxation by making it easier to take tax measures to the voters.

B. Reform the assessment of non-residential property

Annual revenue generated: $4-6 billion, likely more.

"Non-residential property shall be assessed at market value." This simple change in the constitution would generate revenues that would be distributed to cities, counties, and school districts under the terms of Propositions 1A and 98. This amendment would make the tax system far more rational and less loophole-ridden, and the impacts on local services and schools would be direct and visible to voters. It would also have a number of business-friendly impacts and encourage economic development at the local level.