Chapter 5

Other Issues at Stake

Any change to California's tax system will necessarily take into account other relevant policy issues. For example, tax expenditures have been enacted over the years to address specific policy goals, such as encouraging homeownership with the mortgage interest deduction. Conversely, one might assert the development of public policy generally has been shaped by the limitations of our tax system. One such limitation is new taxes that address different policy outcomes, often resulting in the layering of burdens on the same group of taxpayers (e.g., sales tax levies for transportation, public safety, and libraries).

Sound fiscal management requires focusing on oversight of current tax expenditures, examining the state-local relationship, promoting economic growth, and minimizing income and wealth disparities. In addition, regulatory costs are perceived by many in the business community as analogous to taxes and merit consideration as such.

Tax Expenditures

Although the Council refrained from considering expenditure proposals (spending side reforms), the members generally discussed tax expenditures, recognizing that they reflect special tax provisions that result in foregone revenues.

Federal law defines tax expenditures as revenue losses attributable to provisions of federal tax law that allow a special exclusion, exemption, credit, preferential tax rate, or a deferral of tax liability.[23] According to the congressional Joint Committee on Taxation (JCT), legislative history indicates that tax expenditures should be thought of as deviations from the "normal income tax structure."

Figure 14
Top Expenditures of Personal Income Tax in CA
(Dollars in millions)

Personal Income Tax	Description	Revenue Loss	Federal Conformity
Home mortgage interest deduction	A deduction for interest paid for acquiring, constructing, or redefining a principal residence and one other residence.	$5,000	Yes
Basis step-up on inherited property	The basis of property acquired by bequest, devise, or inheritance is the fair market value at the date of death. Appreciation that occurred prior to death is not taxed.	$4,100	Yes
Exclusion of capital gains on sale of principal residence	An individual may exclude up to $250,000 of gain realized on the sale of a principal residence. For joint returns, the exclusion is $500,000.	$2,600	Yes
Real estate, personal property, and other tax deductions	Individuals may deduct certain taxes as itemized deductions.	$2,100	Yes
Dependent exemption in excess of personal exemption credit	A nonrefundable personal exemption credit is allowed for all taxpayers and their dependents. The exemption credit for dependents is more than three times greater than the exemption allowed for the taxpayer or spouse.	$1,400	No

Source: California Department of Finance (2014) and California Franchise Tax Board (2012)

Reports on California tax expenditures, prepared by both DOF and Franchise Tax Board (FTB), generally have followed the JCT methodology.

Figures 14 through 16 show the top tax expenditures for the personal income tax, the corporation tax, and the sales and use tax. (See Appendix IV on page 79 for more extensive lists.)

For most tax expenditures, legislative intent is not stated but there are often specific policy goals. For example, most corporate tax expenditures are meant to support businesses based on type or location. The legislative intent for the manufacturing exemption from the sales tax is to attract and expand manufacturing businesses. Most tax expenditures do not include a sunset date.

In August 2015, the California Bureau of State Audits initiated a review of the top six corporation tax expenditures. The objective of the review was to determine their purposes; whether studies have assessed their effectiveness and/or benefits to the state economy; whether some are more effective than others; and the impact of the state placing a cap on certain tax expenditures.

The review found that five of the six corporation tax expenditures required additional study to determine whether they were achieving their purposes. The audit concluded that implementing oversight methods from other states could improve the effectiveness of the state's current and future tax expenditures. It also recommended that the state conduct regular, comprehensive reviews of tax expenditures and their policy objectives.

Figure 15

Top Expenditures of Corporation Tax in California

(Dollars in millions)

Corporation Tax	Description	Revenue Loss	Federal Conformity
Research and development credit	Businesses are allowed a credit for increased research expenditures. The revenue loss is corporation and personal income tax.	$1,800	No
Sales factor apportionment	Corporations with income derived from sources both within and outside of California must apportion income to California. As of January1, 2013, most corporations are required to use the single-sales factor.	$974	No
Like-kind exchanges	No gain or loss is recognized when business or investment property is exchanged solely for like-kind property. The revenue loss is corporation and personal income tax.	$450	Yes

Figure 16

Top Expenditures of Sales and Use Tax in California

(Dollars in millions)

Sales & Use Tax	Description	Revenue Loss	Federal Conformity
Candy, confectionery, snack foods, and bottled water	Candy, confectionery, snack foods, and bottled water are exempt.	$1,503	N/A
Manufacturing exemption	Manufacturers and certain research and development businesses may qualify for a partial exemption.	$525	N/A
Farm equipment	Sales of farm equipment, machinery, and their parts are partially exempt when sold to qualified people engaged in producing and harvesting agricultural products.	$180	N/A

Figures 15 and 16 Source: California Department of Finance (2014) and California Franchise Tax Board (2012)

Many policy goals are embedded in tax expenditures. A broader conversation may focus on the following questions:

- Should a similar review be performed for the personal income tax, and the sales and use tax expenditures?
- Should tax expenditures that conform to federal law remain regardless of their effectiveness?
- Should tax expenditures that outlived their original policy goals or usefulness be modified, suspended, or repealed? Should current and newly enacted tax expenditures be subject to periodic review or sunset?
- Considering how the Legislature has suspended or changed the law for net operating loss deductions, should these deductions be treated as a tax expenditure?
- In general, should the definition of tax expenditures be changed?
- Are there more efficient ways to accomplish the same policy goals—through direct spending, for instance?

The State-Local Relationship

The connection between state and local governments is vital in the tax structure conversation. It is important to consider which level of government has the authority to impose taxes, for what purposes, and whether such authorities and responsibilities should be shared.

Fiscal control and responsibilities have shifted between state and local entities since the state's birth in 1850. In its earliest days, the state had limited responsibility for programs and narrow taxing authority. At least through 1900, counties were the most prominent level of government, with the greatest budgetary responsibility and revenue streams.

Economic shifts, governance and fiscal changes, and policy decisions have led to the concentration of tax resources at the state level.

Some have tried to rationalize the state-local fiscal relationship to reflect social and financial needs. A "separation of sources" policy, in place until 1935, was an attempt to create fiscal independence for both state and local governments. Voters repudiated this experiment during the Depression in part because local funding could not fully support K-12 schools, leading the Legislature to levy the sales tax and the personal income tax.

Local Governments at the Heart of Economic Growth. Some argue that while it may be important to compare California's tax structure to other states, it is imperative to compare the state's tax resources with those of local governments. Economic shifts, governance and fiscal changes, and policy decisions have led to the concentration of tax resources at the state level. Of particular note, the state's repeal of redevelopment laws eliminated what many consider the most important local financing tool for affordable housing and economic development.

Local governments are key players in growing the economy through job creation and private investment.

Today, the state-local relationship is so intertwined that local governments are key players in growing the economy through job creation and private investment. They provide the services and train the workforce that lays the groundwork for economic vitality. Businesses care about the functions local governments oversee, including public safety, street maintenance, housing construction, and quality-of-life amenities. Therefore, local governments, just like the state, need predictability and revenue growth aligned with service demands (population and job growth). In this regard, state tax volatility creates local volatility. Local governments need flexibility to increase taxes locally—especially in higher-cost communities that aspire to higher service levels. For example, some local officials have called for the authority to levy local sales taxes on services.

Regional Approaches Met with Limitations. Affordable housing production stalled after the 2011 repeal of redevelopment. Some cities are putting new tools in place, such as impact fees. However, these tools are just ramping up and will not come close to generating the level of financial investment that redevelopment did for low- and moderate-income housing.

To what extent should state law facilitate a regional response to addressing housing demand? California's tax structure encourages cities to use their land for commercial uses rather than housing. Except at high densities, even commercial uses do not generate the tax revenue to pay for services. In light of this, some propose allocating a portion of the sales tax not by situs (place of sale) but by proxy (where the purchaser resides).

Additionally, state and local governments have long recognized the regional nature of transportation. However, the shrinking sales tax base and the decline in fuel consumption are creating pressure for raising the cap on the combined local sales tax, especially in regions that have collaborated on regional transportation through a series of countywide sales tax measures.

In recognition of these limitations, some suggest that the state authorize new local and regional tax levies.

Constitutional Provisions to Encourage Local Revenue Sharing. Article 13 of the California Constitution authorizes cities and counties to share locally generated sales tax revenue. Under some circumstances, voters must approve these revenue-sharing agreements, a process that can lead to delays and cumbersome requirements.[24]

As an alternative, the state may want to authorize greater flexibility in sharing revenues—especially discretionary revenues—across local boundaries. Voluntary revenue-sharing agreements could help overcome limited local revenue capacity. For example, a revenue-sharing agreement to create a cross-jurisdictional fire department might be more efficient than a fire-service contract between two cities.

Promoting Economic Growth and Minimizing Economic Disparities

California and the nation are witnessing unprecedented levels of income disparity, stagnating household income, and record-setting compensation for corporate executives. The pay gap between CEOs and other employees continues unabated. California is among the top four states in income disparity as estimated by the Gini coefficient, a common measure of inequality based on income distribution among the nation's residents.[25] (The other three are New York, Connecticut, and Louisiana.)

Many assert growing income disparity dampens economic growth as income is concentrated in fewer hands and the wealthy spend less in local economies. In addition, growing economic disparity results in a rising demand for public services.

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A Wealth Tax. Some have suggested a wealth tax could be phased in with a reduction to the income tax, offering some smoothing to state tax revenues. According to Daniel Altman, an economist from New York University, wealth tax brackets have been suggested of zero percent for up to $500,000 in wealth, 1 percent for wealth between $500,000 and $1 million, and 2 percent for wealth above $1 million.

Under this model, a family with $500,000 in wealth and $200,000 in annual income would pay $50,000 in federal income tax per year and no wealth tax. However, a family with $4 million in wealth and $200,000 in annual income would pay a total of $65,000 each year. Families relying more on wealth would pay more than they do now, while families depending on earnings would pay less.[26]

Investing in Californians. The sustainability of any tax structure relies on a well-trained workforce with high-wage jobs. Investing in the productive potential of individuals is

essential to cultivating broad-based prosperity. Critical investments include K-14 education, higher education, child care, and flexible training and retraining opportunities. Offering means-tested support to help people move up the income ladder is a proven approach to growing economic prosperity. If employers are better engaged with the education and training community, curricula will be more relevant and employers will benefit from more successful outcomes.

Regulatory Challenges
... and Opportunities

> ***Costs and delays translate into revenue losses for any business or organization.***

Business interests that must comply with regulations, especially those associated with labor, assert the layering of local mandates on top of state mandates (and vice versa) results in excessive costs, unintended consequences, and unfair compliance burdens. While understanding and even supportive of the objectives of these mandates, they cite as an example the recently enacted state minimum wage increase to $15 per hour causing salary compaction with those already earning $15 per hour for performing more complex duties.

Across all industries and business sizes, the reform commonly identified as likely to have the most positive impact on California's business climate, housing development, job growth, and economic prosperity is revising the California Environmental Quality Act of 1970 (CEQA) in a meaningful way. CEQA was well-intentioned to protect our state's precious natural resources. Over time, it has spawned an approval process that is complex, burdensome, and prone to time-consuming and costly litigation. Speed to market can make or break a business, and projects can be brought to a halt by competitors or special interests abusing the CEQA process for their own material gain. These costs and delays translate into revenue losses for any business or organization, including the state. Reforming CEQA is as important as reforming our tax system. Similarly, it will require diverse stakeholders to rise above self-interests that impede any meaningful attempts to improve the situation.

Yet many of these business interests see new economic opportunities as the state colors the business climate green with its focus on sustainability. They regard the state as already invested in promoting an economic framework directed at environmental sustainability with a focus on greenhouse gas reductions by all sectors (e.g., public, private, utility, transportation). Therefore, there is potential to improve the tax system and induce economic development to achieve a more sustainable economy by blending green economic incentives and tax policy; and leveraging state laws that can foster public-public and public-private partnerships to generate investments.