



# FISCAL FACT

July 2009  
No. 181

---

## Finding Stable Ground: California Reform Commission Puts Tax Overhaul on Table

### *Net Receipts Tax Could Replace General Fund Sales Tax and Corporate Income Tax*

By Micah Cohen and Kiran Sheffrin

#### **Introduction**

As California legislators and the governor postpone the day of budgetary reckoning, a special commission is considering a permanent solution: fixing the state's tax system. Earlier this year, Governor Arnold Schwarzenegger assembled the Commission on the 21st Century Economy to suggest reforms to the state's tax code. These reforms are to be revenue-neutral, i.e. raising the same amount of tax revenue as current laws do and taking the political catfight over raising and lowering taxes out of the equation.

California relies heavily on volatile revenue sources, and this reliance has contributed to the budget crisis. For example, according to one report, "Corporate income taxes fell 24% in the last recession, increased 115% in five years, and have fallen more than 20% in this recession."<sup>1</sup> By collecting revenue disproportionately from sources that experience exaggerated ups and downs, the tax code shares in this dramatic year-over-year volatility. The reform commission hopes that its proposals will combat the fluctuations which leave the state penniless in times of recession, primarily by broadening the tax base, lowering the rates, and reducing current distortions.

The Commission must report a final plan to the Governor and Legislature in September 2009.

---

<sup>1</sup>Robert Cline, "Analysis of Business Net Receipts Tax." Ernst and Young. June 16, 2009, p. 4.

## **Two Proposals on the Table**

On June 16, the Commission on the 21st Century Economy met to discuss tax reform packages on the table. After much debate and tailoring of numerous possible packages, two proposals emerged for further consideration. Both proposals offer big changes to the current system: rate reductions, base broadening and even partial or complete elimination of sales and income taxation. They were numbered 1B and 2 in the commission's documents. Here we call them simply Proposals 1 and 2.

### *Proposal 1*

- Eliminate the state general fund sales tax (currently 5%), leaving other sales taxes in place;
- Eliminate the corporate income tax (currently at a 8.84% rate);
- Flatten the individual income tax (currently with a top rate of 10.55%) to one rate of 6%, allowing only personal exemptions and deductions for mortgage interest, charitable donations, and property taxes; and
- Add a new business net receipts tax at a rate of 2.77%.

### *Proposal 2*

- Simplify the personal income tax to two tax brackets at rates of 3.5% and 7%, with standard deductions of \$15,000 (singles) and \$30,000 (couples), retaining current deductions and credits;
- Eliminate the investment tax credit;
- Reduce the corporate income tax rate from 8.84% to 7%;
- Reduce the state sales and use tax rate

Additionally, each package includes an optional severance tax and/or increased fuel tax on gasoline, diesel, and jet fuel imposed at the refinery level.

## **Proposal 1's Net Receipts Tax Is a Type of Value-Added Tax**

Proposal 1 offers as replacement for two repealed taxes a new type of tax: the net receipts tax (NRT). Not to be confused with a gross receipts tax (GRT), a highly distorting tax on a business's total revenue with few if any deductions, a net receipts tax (NRT) is levied as a percentage of total receipts minus the costs of labor, capital, interest, rent, royalties, and inputs. The most important difference between an NRT and a corporate income tax is the treatment of capital equipment which under the NRT is deducted like any other expense without resort to depreciation tables. The NRT can be described as a consumption tax or a value added tax (VAT).

VATs are a type of consumption tax widely used around the world because they do not unfairly burden some goods and services over others, and because they are to some extent self-enforcing. Economically speaking, a VAT is similar to a retail sales tax levied on all end-user goods and services. From an administrative point of view, a VAT is collected at each stage of production on the value added at that stage (sale price minus input costs), instead of at the point of final sale like a retail sales tax. This can be an enforcement advantage for VATs because when each business in the production chain reports its value added to the tax authorities, it is effectively confirming the VAT reports of the businesses it buys from and the businesses it sells to.

If legislators can avoid enacting numerous exemptions, perhaps aided by constitutional provision, VATs can raise large amounts of revenue with low rates and fewer economic distortions than

income taxes and most other consumption taxes. VATs have been under discussion in the United States for decades (most recently floated as a way to pay for President Obama’s health care proposals), but are often considered unpopular on both the left and right of the political spectrum.

The NRT in the California proposal would apply to traditional “C-corporations” and other “pass-through” entities, such as LLCs and S-corporations. Profits earned by these entities are currently taxed in different ways. C-corps pay the state’s corporate income tax at 8.84%; pass-through entities pay a 1.5% franchise tax before distributing profits to the business owners, who must then pay the individual income tax. The net receipts tax, on the other hand, would be a uniform 2.77% rate on both corporations and other business forms.

Members of the commission argued that applying the VAT-type tax to this broader base, while eliminating the corporate income tax, would eliminate some distortions in the way businesses structure their firms and make decisions. Exempted from the NRT would be federal, state, and local government institutions; non-profit, religious and charitable organizations; financial services; and insurance. Companies with a tax base of less than \$500,000 would also be exempt.

For multi-state companies, the NRT would apply only to the portion of their income earned in California under apportionment formulas. Mirroring European VAT practice, “exports” out of a state would be subtracted from the NRT base, while “imports” into a state would be added.

As expected with any consumption tax, consumers would bear the majority of the burden of the tax in higher prices, almost 71 percent, according to Ernst & Young.

Even with the elimination of the corporate income tax and general fund portion of the sales tax, Proposal 1 as a whole is revenue-neutral. At a rate of 2.77%, the NRT is projected to raise approximately \$28 billion per year. Table 1 shows what the commission believes is the approximate revenue potential at each of several tax rates.

NRT Tax Rate	Tax Revenue Raised (\$Billions)
0.5%	\$ 4.7
1.0%	\$ 9.4
1.5%	\$ 14.1
2.0%	\$ 18.8
3.0%	\$ 28.3
4.0%	\$ 37.7
5.0%	\$ 47.1
6.0%	\$ 56.5

Source: Ernst & Young

*State Corporate Income Tax Elimination and Sales Tax Reduction Are Good Steps*

The current structure of the corporate income tax (CIT) favors debt—some would say excessive debt—by allowing firms to take a tax deduction for their interest payments but not for their

payments to equity holders. Over the long term, this subsidy has contributed to instability as companies become highly leveraged and more vulnerable to economic downturns, as we saw with this current crisis. The Commission's proposal attempts to reduce these distortions.

Compared to the repeal and replacement of the CIT, the sales tax reform in the plan is less dramatic. The plan does repeal the biggest chunk of the retail sales tax, the general fund rate of 5%, but that would still leave in law a complex structure of sales tax rates. Here is the current, overly complex web of sales tax rates:

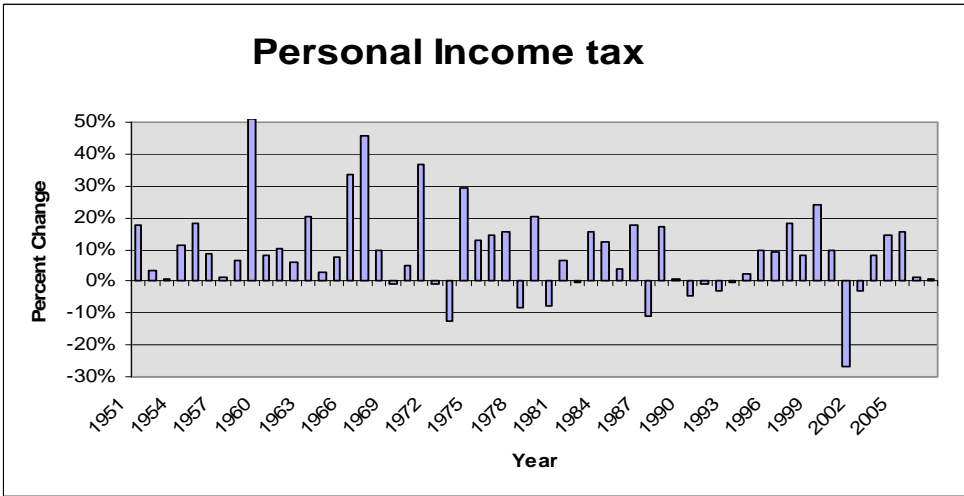
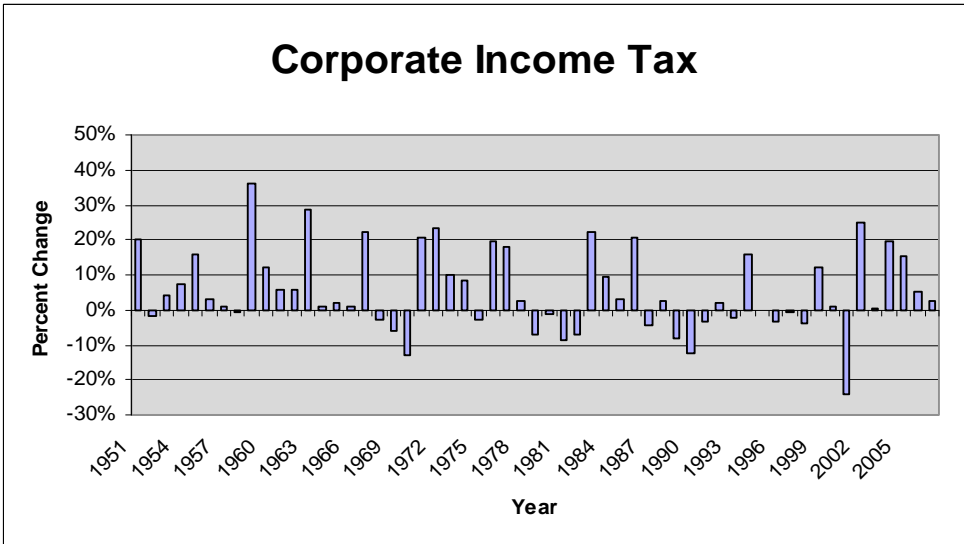
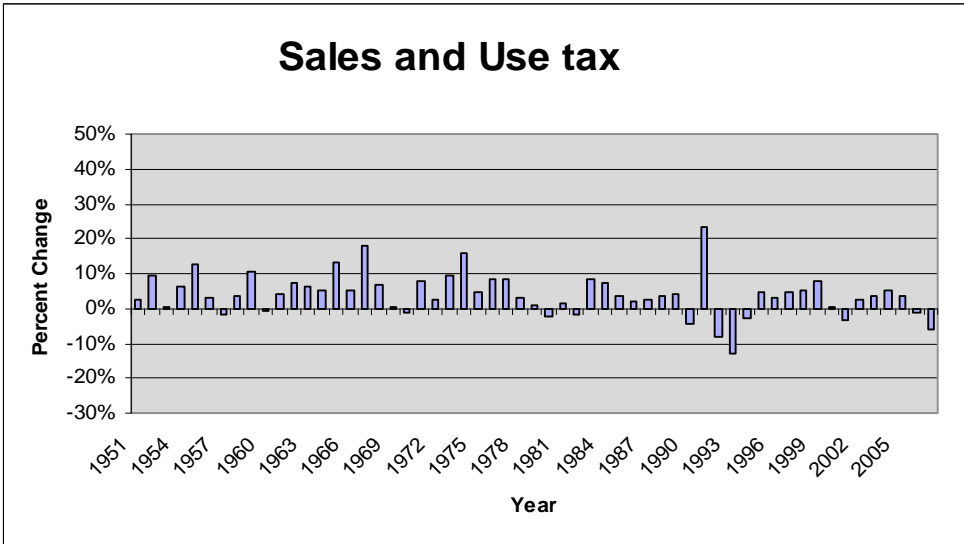
- 5% general fund rate
- 0.25% shifted to the state general fund from localities
- 0.5% distributed to local health/welfare programs
- 0.5% distributed to local public safety programs
- 0.75% "Bradley-Burns" tax, returned to the local jurisdiction where the sale occurred
- 0.25% "Bradley-Burns" tax returned to the county where the sale occurred for transportation purposes, and
- 1% temporary increase due to the recent budget crisis.

Additionally, many counties add up to 2% more in sales tax rates for local purposes. If the commission's proposal were in place today, Los Angeles's sales tax would be 4.75% instead of 9.75%, San Francisco's would be 4.5% instead of 9.5%, and the small communities of Pico Rivera and South Gate, with the highest sales taxes in the state, would be at 5.75% instead of 10.75%.

Many states, including California, created their sales tax code more than 50 years ago. Because at the time the economy was mostly goods-based, sales taxes were imposed upon only tangible goods. As in most states now, service industries are a large part of California's economy. By exempting most services from the sales tax, California distorts consumer decisions and does not enjoy the advantage of stability that comes from a broader tax base.

As the graphs below illustrate, despite its narrow base, the sales tax is stable compared to income taxes. Under the Commission's Proposal 1, part of the sales tax is eliminated and replaced with the NRT, a broader-based, more stable revenue source than the traditional sales tax. Proposal 2, which does not include the net receipts tax, does not address the distortion of the narrow sales tax base. If enacted, one reform that could help decrease California's volatility would be to broaden the base for the sales tax by extending it to service industries.

The graphs below show the volatility of the three major state-level taxes over the past 60 years:



Source: Tax Foundation calculations of inflation-adjusted changes based on data from the Legislative Analyst's Office

California’s tax structure is more progressive than other states’ and more dependent on personal and corporate income taxes. One of the prices of that arrangement is greater volatility. As the charts show, both of the income taxes experience fluctuations that are far too great for a state to make dependable spending plans.

*Flat Tax Is Important Step in Reducing Revenue Volatility*

The commission’s Proposal 1 includes a single personal income tax rate of 6% with a personal exemption and deductions for mortgage interest, charitable donations, and property taxes. Such a change would stabilize tax revenue. The current California personal income tax code has the opposite effect; its 7 brackets, with a top rate of 10.55%, put the state on a revenue roller-coaster (see Table 2).

During times of economic prosperity, tax revenues go up in general but incomes earned by individuals in high brackets see exaggerated increases. During a recession, however, the opposite effect occurs. If a state relies heavily on those high-income earners, it is subject to massive fluctuations in year-over-year revenue. While revenue from a single-rate tax will still fluctuate with the economy, it provides a more stable structure than the current code.

Bracket	Current Rate
> \$0	1.25%
> \$7,168	2.25%
> \$16,994	4.25%
> \$26,821	6.25%
> \$37,233	8.25%
> \$47,055	9.55%
> \$1,000,000	10.55%

A flat tax proposal is not as radical as it seems, and California is ripe for change. Seven states have a flat individual income tax: Illinois, Indiana, Michigan, Pennsylvania, New Hampshire, Tennessee, and Utah, and another seven states do not tax income at all. Seventeen countries also have a flat tax. Eliminating deductions broadens the income tax base and reduces distortions, and is not as regressive as it sounds because currently, high-income earners generally benefit the most from tax deductions that would be eliminated under a flat tax. A flat tax would provide more steady projections of revenue for California’s legislatures. Simplifying the personal income tax system from seven brackets down to one makes the tax code simpler for filers.

**Proposal 2 and the Proposed Severance Tax Are Less Impressive**

The Commission’s Proposal 2 simplifies the current tax system, lowers rates and broadens the tax base somewhat, all positive features. It represents a significant step forward, even if it pales by comparison to the bolder Proposal 1. The revenue stream produced by the still progressive personal income tax and corporate income tax would be less volatile than at present but still unreliable compared to what it would be under a more fundamental reform like Proposal 1.

Proposal 2 would cut the number of individual income tax brackets from seven to two, with rates of 3.5% and 7%, a noteworthy improvement over the status quo. And on the corporate income tax, it shaves the single rate from 8.84% to 7%. Both changes would boost California's competitive standing compared to other states. However, the proposal leaves in place many deductions and special provisions that are the source of much tax complexity.

It does, however, eliminate the investment tax credit, a controversial change for the business community. California's negative business tax climate is such that many believe that the investment tax credit is needed to remain competitive. By overhauling the corporate income tax system, California might reduce or eliminate the need for the investment tax credit and still reduce the overall burden on business.

Adding a severance tax, essentially a gasoline tax but paid at the producer level, would add another hidden, complicated tax when California should be moving away from such taxes. The debate over whether to raise energy taxes is one with merits on both sides, but whether they go up or down, all taxes should be visible to taxpayers. Certainly, a per-gallon excise tax on gasoline is better understood by those who bear the burden than a severance tax.

### **Neither Plan Addresses the Volatility of Capital Gains Taxes**

Neither Proposal 1 nor Proposal 2 directly addresses one of the most volatile portions of California's tax code: capital gains taxes. Tax revenue from capital gains is perhaps the revenue source that is most dramatically affected by economic swings; the year-over-year change in these revenues over the past ten years ranges from plus 40% to negative 60%. There was discussion about a capital gains tax reduction in the commission's original proposals, but it did not make it into the final recommendations.

### **An Alternative "Blue Proposal" Offers More Reform**

In addition to Proposals 1 and 2, the Commission discussed other options at its July 16 meeting. Notable among them is one from Santa Cruz County Treasurer Fred Keeley, dubbed the "blue proposal" for its left-of-center backers. Many of the blue proposal's reforms are beneficial, but overall it would not help the state as much as Proposal 1 or Proposal 2.

One part of the blue proposal is a longtime goal of Governor Schwarzenegger's: creating a rainy day fund. All excess revenues would have to be deposited into the fund, with "excess" defined as any revenue that exceeds by more than 5% the amount the state budgeted for. Rather than spending the money in good times and being left hanging when revenues drop, California would instead set the money aside for the future, insulating the budget from business cycle fluctuations.

The proposal also positively limits the use of revenues from taxes on capital gains, permitting only one-third of the revenue to go into the general fund. Another one-third would be used for debt reduction and the remaining one-third would go to the rainy day fund. This idea also serves the purpose of preventing the state from relying too much on a source of revenue that soars in good times but sours in bad times.

The blue proposal shelves the net receipts tax idea but lowers the corporate income tax rate by two percentage points and broadens the sales tax base to services while lowering the rate at a revenue-neutral level.

Other parts of the blue proposal threaten to steer the state in the wrong fiscal direction. It would reverse Proposition 218 (1996) by lowering the threshold required for local sales tax increases from two-thirds to a simple majority. Since the current rate is 8.25%, far higher than in most states, and because many local sales tax increases pass each election, we see little evidence that California's sales tax rate is too difficult to raise.

The blue proposal would also weaken Proposition 13 (1978) by reassessing commercial property more frequently than residential property, an additional administrative burden that would probably yield little revenue. And if it did extract more from California's already overtaxed commercial property, the result would be a non-neutral and indirect tax on business, distorting economic decisions. There is no truth to the oft-repeated claim that Proposition 13 is to blame for the state's fiscal woes; California is a high-tax state already.

Most significantly, the blue proposal would adopt a carbon tax on energy, with the revenues redistributed to state residents (estimated to be between \$100 and \$300 per household) via income tax credits, resembling the "prebate" in the FairTax reform proposal. The carbon tax would be structured so as to create a de facto price floor on gasoline, but it seems unlikely that such a provision could survive a nationwide dip in gasoline prices that left California voters paying a dollar or two per gallon more than the rest of the nation. On the other hand, when gasoline prices spike, the carbon tax is designed to phase out. To the extent the carbon tax is intended to encourage development of alternative energy, this tax phase-out undermines this goal by essentially guaranteeing the long-term price of petroleum products and preventing them from going too high.

If California adopted a carbon tax, it would also be at a competitive disadvantage relative to other states without such a tax. Because the revenue from the carbon tax will be distributed to state residents, it would do little or nothing to solve the state's structural budget imbalance and would further complicate the personal income tax.

## **Conclusion**

Commission Proposal 1 puts a VAT-like net receipts tax on the table, which would replace part of one consumption tax, the retail sales tax, with another consumption tax levied on business. Consumption taxes, while able to raise large amount of revenue, do raise prices for consumers. Getting rid of the general fund sales tax would remedy some of these problems. This plan does simplify California's tax code in a big way by repealing the state corporate income tax, flattening the personal income tax, and simplifying the sales tax, resulting in a broad-based tax system less likely to suffer severe volatility or discourage economic growth.

The addition of a VAT-like consumption tax would be a big change for California, and indeed, the United States. All proposals on the table will encounter political opposition, whether because they disturb entrenched interests or reduce progressivity or both. However, no great progress can be made in California without doing both, because much of the volatility stems from the highly progressive nature and the innumerable special exemptions, credits and deductions in California's tax code.

The additional "blue" proposals offer some ideas for even more reform of California's tax code, but those are coupled with some problematic ones. The creation of the rainy day fund, the extension of the sales tax to include services, and the reapportionment of the capital gains tax

could be important additions in the total outlook for the state's revenue volatility woes. But more frequent commercial property reassessments, tax increase threshold reductions, and a carbon tax combined with a rebate could hinder the creation of a simple, neutral, stable, and transparent tax system.

The Commission will present its recommendations to Governor Schwarzenegger in September 2009.

© 2009 Tax Foundation  
Ph: (202) 464-6200  
[www.taxfoundation.org](http://www.taxfoundation.org)