

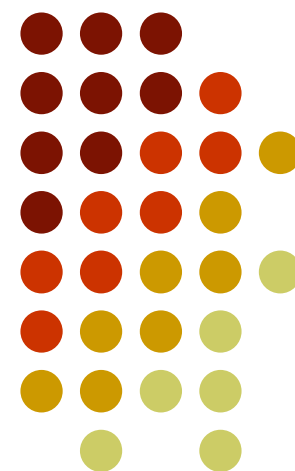
# **Business, Consumers, Innovation and Taxes in the New California Economy**

---

**Annette Nellen**

Professor, San José State University  
Irvine Fellow, New America Foundation

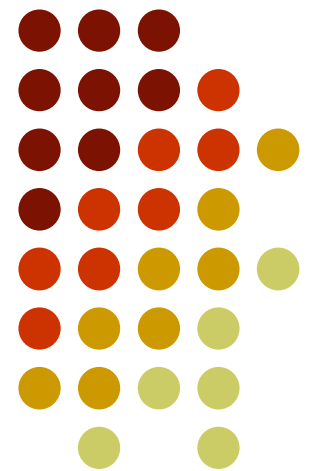
2/27/08



# Moving California's Tax System into the 21<sup>st</sup> Century

---

**21st Century Taxation**





# Proof we're in the 20th century

- Key tax rules designed w/o e-commerce in mind
- Sales tax base excludes today's consumption of digital goods and most services
- Use tax still unknown to many
- Telecom treated specially (a 19<sup>th</sup> Century situation!)



## Two key points:

1. California can (and should) improve its tax systems and budget situation without resorting to tax rate increases.
2. Need to follow principles of good tax policy.

# Problem with rate increases - 1



Tax problems are in the base

- Rate increases can make them worse
- Rate increases just postpone fixing the base problems, which get tougher to fix the longer we procrastinate

# Problem with rate increases - 2



California tax rates are already high

- CA's state sales tax rate of 6.25% is the 8th highest among states (at 1/1/07).
  - ❖ highest is 7%
  - ❖ lowest is 4%
- 10.3% maximum personal income tax rate (9.3% + 1% special tax) is highest maximum rate among states



## EX – Broadening SUT Base

- Broaden sales tax base and lower the rate
- If necessary, can be done in a way that could raise more revenue than is raised today
- Proof of that math:
  - ❖  $\$1000 \times 6.25\% = \$62.50$
  - ❖  $\$1300 \times 5.5\% = \$71.50$

# Reasons for broadening SUT base - 1



1. Allow for rate reduction
2. Economically, there is no reason not to tax all consumption.
  - ❖ No reason to tax lawn mower, but not gardening services, to tax laundry detergent but not dry cleaning services
3. Exemptions for necessities of life, such as food, are poorly targeted
  - ❖ Exemption for bread and milk, but also \$30 block of gourmet cheese
  - ❖ Exemption for utilities also exempts 3000 sq foot home

# Reasons for broadening SUT base - 2



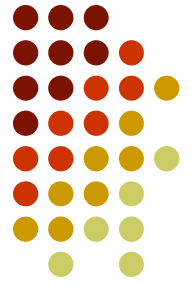
4. Consumption patterns have changed
  - ❖ 1970 to 2001, consumption of services increased from 31% of household consumption to 44% (CBPP)
  - ❖ 1981- 48% of consumption represented items subject to CA sales tax, dropped to 38% by 2005 (LAO)
  - ❖ In the 1990's, spending on media and information services increased from \$365 to \$641 per person (Pew)
  - ❖ iTunes - 3<sup>rd</sup> largest music retailer

# More on consumption changes



5. Changes in consumption not consistent across income groups – makes SUT more regressive and unfair
  - ❖ In March 2006, 21% of households with income below \$30,000 had broadband access while 68% of households with income over \$75,000 had such access (Pew)

# Reasons for broadening SUT base - 3



6. Reduce volatility
7. Other states do it (thus, not a far fetched idea)
8. Helps cities with land use decisions (won't be incentivized to just get big box retailers)
9. Exemptions should be reviewed regularly – CA's exemptions are causing base erosion
10. Better enable SUT to meet principles of simplicity, neutrality, efficiency and fairness



# How to broaden SUT base - 1

- First – educate public about SUT base problems and its adverse affects to CA economy and budget
- Implement expansion gradually. Enacting statute should specify items added to base with effective dates spanning a future time period. This allows more time for BOE to help businesses that become subject to tax collection, and for consumers to adapt to the changes.



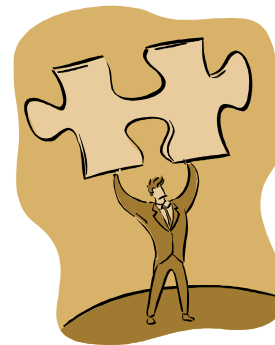
## How to broaden SUT base - 2

- Don't make pyramiding worse – avoid expansion to services mostly used by businesses. Also helps competitiveness.
  - ❖ Sales tax on hair cuts won't cause hair salons to leave state, but SUT on info tech services may cause businesses to leave or not expand here



## How to broaden SUT base - 3

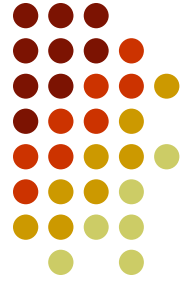
- Compensate vendors – give refundable credit to cover start-up costs + compensate all vendors for collecting the tax
- Learn from other states that tax services and digital goods and some of the other items CA exempts





# How to broaden SUT base - 4

- Be legal –
  - Review federal and state cases on (1) how to avoid constitutional challenges, (2) how to determine nexus and (3) how to apportion when service is performed and/or delivered in more than one state
- Simplify compliance for businesses thru use of technology and minimum number of reporting periods



## How to broaden SUT base - 5

- Targeted relief - If consumption items added to the base are ones likely to impact low-income taxpayers, also enact a refundable income tax credit (or similar type relief) for such taxpayers.



## How to broaden SUT base - 6

- Avoid creating or exacerbating other weaknesses in the tax system
  - For example, don't earmark revenues for a special purpose
  - Be sure changes or process does not harm local governments
- **Lower the rate!!!**



# In summary

- CA has tax base problems
  - ❖ Can't solve with rate increases – will only make systems more unfair, volatile and inefficient
- Be strategic and methodical in making the SUT base changes – not all changes at once, but follow a plan
- Lower the rate when base is broadened
  - ❖ Makes it clear base broadening isn't just for revenue needs, but to improve and modernize the tax system
- Follow principles of good tax policy

# 21<sup>st</sup> Century Taxation Info



- Reports, articles, links and the 21<sup>st</sup> Century Taxation Blog at:

[http://www.cob.sjsu.edu/nellen\\_a/  
TaxReform/21st\\_century\\_taxation.  
htm](http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm)