

# **How Do/Should We Tax?**

## **Tax Reform for California's New Economy**

**An Introduction by Mark Paul, Senior Scholar, New America Foundation**

I'm happy to see so many of you here today to try to do something quite rare in this state capital: to shed some light on California's tax system, not just heat.

The heat is usually generated, of course, over the question of whether taxes should be lowered or raised. But there's more to tax policy than asking, How much?

How we tax matters, too — to the stability of public services, to the growth of our economy, and to the environment.

And that is what we want to talk about today. We hope that we can usefully begin a discussion of how well California's tax system fits its 21st century New Economy, and in what ways we might think about reforming it to better meet the our challenges and needs.

This is a good time to think about these questions.

It's a good time because there's a spirit of political openness across the land, a sense that old answers don't suffice, a feeling that it's time to start exploring issues, instead of just fighting about them.

It's a good time because California's history teaches us that the big changes in how we tax usually get made under duress, in years like this one, when a large budget deficit forces action.

And it's a good time because history also teaches that, once made, those decisions leave a enduring imprint on the state and its revenue system. When change comes, you want to get it right.

How enduring is the imprint? Well, the answer is that the major elements of the tax system that we use here in California in the 21st century were set in place in a very different California, during the Great Depression.

The modern versions of the Corporation and bank tax went into effect in 1929, just before the stock market crashed.

In 1933 came the sales tax and in 1935 its companion, the use tax.

In 1935 came income tax, with top rate of 15 percent on incomes over \$250,000

1937 California created the statewide uniform Vehicle License Fee as a replacement for the hodge-podge of local property taxes on vehicles.

These elements were added to the existing 1923 gasoline tax

That California was very different state than today.

It had a population of only 6 million, half the size of New York, about the size of Minnesota and Wisconsin combined. It also had a solar economy, though not in quite the way we think about it now. Its basic industries—agriculture, motion pictures, tourism—relied on the sun, and shipped a lot of their products to market in cans: peaches, sardines, and movies. In that economy, location and resources mattered a lot: Sunshine, soil, water, oil, forests.

The sun still shines in California, but today's economy is mostly powered by people, not natural resources.

California remains big in agriculture, but agriculture has been dwarfed in California.

The basic industries that now drive the economy—software, information services, high-tech manufacturing, diversified manufacturing, movies, video games, entertainment, tourism, professional and business services—run on knowledge, creativity, technology.

They operate in a global market and face competition that can arise anywhere from Boise to Bucharest to Bangalore. Many of those industries are potentially footloose; they can locate wherever there are fast broadband communications, good transportation, a pool of skilled workers, and a high quality of life to attract and hold employees.

How well does a tax system put in place in the depression fit with California's New Economy?

There are several different ways of looking at the issue.

One important question asks how well the tax system is linked to the state's economic and demographic fortunes and how well it yields the revenue needed for the public services voters want the state to deliver?

When the revenue system doesn't reliably provide the needed dollars, there is — I believe this is the technical term — hell to pay. The main business of state government, to borrow a phrase, is to “educate, medicate and incarcerate.” More than 80% of California's budget goes to education, healthcare and criminal justice. The need for, and cost of, those services don't vary widely from year to year, and rarely get smaller.

When the tax system doesn't fill the coffers, the state ends up where we are today—and pretty much where we've been for five years running—spending our energies in crisis mode, struggling to pay for things almost everyone believes we need, fighting about how to make budget ends meet, instead of debating how to improve outcomes and keep California globally competitive.

The next question involves what the economists call efficiency. In raising the needed amount of revenue, how much does the tax system distort incentives for saving, consumption, investment, and work in California?

This question is as old as California, and has been often framed in colorful ways. More than a century ago, this is how opponents of the railroad regu-

lation and tax provisions of the 1878-79 constitution put it. If the constitutions passed, they warned, “we should be shunned by all the world. The emigrant would avoid us. Capital would keep away from us.”

Apparently 19th century focus groups weren’t as fond of the phrase “job killers.”

On the evidence of the last 130 years, it looks like California has so far avoided being shunned. The recent work by Jed Kolko and David Neumark at the Public Policy Institute of California on business relocations and job shifts have put some of the hyperbole on this issue in perspective.

Still, in a world where a lot of places are fighting for the high-wage, high skill jobs of the future, it makes sense for California to be alert that its tax system not unnecessarily hobble us in that competition. So we’ll talk about that today.

A third question we will talk about today is linked to this second one: Does the California tax system help or hurt in dealing with the negative effects of certain activities, things like traffic congestion, pollution, and greenhouse gases?

California has taken the national lead in setting targets for reducing emissions of carbon dioxide and other contributors to global warming. Meeting those targets will require big changes in the state’s economy. Are there ways we can reform the tax system to help California get where it needs to go?

Before I finish, let me quickly sketch out some tax trends worth noting as we try to answer these questions.

When it comes to sales taxes, California has among the highest sales tax rates—the combined state and local rate ranges from 7.25 to 8.75 around the state—piled on a relatively narrow base. Food, utilities, medicines, and most services aren't taxed. As the economy has shifted toward services, sales tax revenues have lagged behind personal income growth. A penny of sales tax today captures about 30 percent less of personal income than it did in 1979.

With the declining yield of the sales tax—and the declining yield of the corporation tax too—the personal income tax now carries more of the load of supporting state services, accounting for over half of state revenues. This bothers some observers, who complain that the state is too dependent on income taxes, which they see as too volatile a revenue source.

I think it's worth noting three things here:

First, paradoxically, the income tax has become more important even as California has lowered it. The dependent credit was raised a decade ago and the top marginal rate, which was set at 11 percent by Gov. Reagan, has been lowered—to 9.3 percent for general fund purposes (voters in 2004 enacted a 1 percentage point surcharge on incomes over \$1 million and earmarked the revenue for new mental health programs).

Second, it's impossible to think about the income tax without also considering the enormous shift of income toward households at the very top of the economic ladder.

Since 1979, households at the 90th percentile and every level below it have lost income share to the top 10 percent, and mostly to the richest 1 percent. Nationally, the top 10 percent of households now receive about as much income as all of the households in the bottom 80 percent combined. If California's income tax brings in growing sums from high earners, it's because that's where the money is going.

We should also be careful not to mistake the Internet bubble of the nineties for business as usual. You only get one roller-coaster ride through "the greatest legal creation of wealth in the history of the planet," as Silicon Valley venture capitalist John Doerr famously called the dot-com era. The stock market bubble was, as Doerr suggested, an unprecedented event. Despite the strong stock markets and real estate markets of the last five years, capital gains in relation to personal income have not returned to the stratospheric levels of 1999 and 2000.

Finally, we should take note of the decline of fuel taxes and the big change in highway financing. Historically, California relied on fuel taxes to fund much of its highway maintenance and improvements; drivers paid for the highways they used roughly according to how much they drove.

That feedback loophole has now been significantly weakened.

Fuel tax rates have not kept up with inflation or the growth of the economy. The revenue from fuel taxes today covers only half of California's highway maintenance needs, and none of its expansion needs, according to the California Transportation Commission.

Instead, California has looked increasingly to general taxpayers instead of drivers to pay for highway and other transportation projects: through local special transportation sales taxes, the Prop. 42 diversion of the sales tax on gasoline to transportation, and state general obligation bonds.

This shift raises two issues. Should California be shifting the burden of funding highway improvements to a general fund budget that is already persistently out of balance? And should we be abandoning the principle of user-pay for road infrastructure at a time when our new global warming goals suggest the need to reduce the amount of driving and gasoline usage?

I'm sure that, with all the talent assembled here today, we'll get answers to all these questions.