California Outlook: Tax Reform Talk Continues; Perennial Targeted Levies May Rise Again

The people have spoken, and they said, "Raise somebody else's taxes."

Californians have not approved a general tax increase on a statewide ballot since 1990. During this same period, voters have approved seven targeted tax increases, three just this past November.

At the statewide general election, voters agreed to extend the tax on upper-income residents for another 12 years, continuing a $6 billion annual tax hike on wealthy Californians (see sidebar). They also agreed to hike the tobacco tax by $2 a pack, increasing levies by more than $1 billion a year, mostly on poor Californians. And along with legalizing the recreational use of marijuana, voters added new taxes to the previously pariah product.

(The other four earlier-approved targeted tax increases were a tobacco tax hike in 1998, a "millionaire's" income tax hike in 2004, an increase on certain corporations domiciled out of state in 2012, and the original income tax hike on upper-income Californians, also in 2012.)

At local elections, voters were more inclined to open their own wallets. Measures raising property, sales and parcel taxes passed in every region of the state. By last count, voters approved more than 80% of local tax measures, including many that required a two-thirds supermajority.

So where does this rush of tax-ivism leave Californians on state fiscal issues? Can we expect still further legislative and popular efforts to raise business and targeted taxes? More important, will those efforts be successful?

Fiscal Outlook

First, some fiscal and economic context.

California is entering its seventh year of economic recovery, the fourth-longest post-war period of growth uninterrupted by recession.

The state's budget also is in relatively good shape. According to the nonpartisan Legislative Analyst, the state should end the next fiscal year (2017–18) with total reserves of about $11.5 billion, assuming continued moderate economic growth and no new budget commitments. This includes nearly $9 billion in reserves dedicated to offsetting future budget emergencies.

Over the longer term, the Analyst estimates that if the state experiences a mild economic downturn in 2018, it would have enough in reserves to cover almost all of its operating deficits through 2021. That is, the state's fiscal house is strong enough to weather a mild recession without raising taxes or cutting spending.

Even absent the inevitable downturn in the business cycle, however, the state faces significant fiscal threats over the long term. Chief among them are debts that do not appear on the balance sheet, such as public employee pension and post-retirement health benefits.

In early 2016, Governor Edmund G. Brown Jr. estimated long-term obligations for these commitments for state and university employees and teachers at nearly $220 billion. These commitments come due in increasing amounts every year.

Other inevitable budget pressures will arise from an intersection of California's aging population and its persistently high poverty rate. Health care costs for poor Californians will continue to rise faster than overall budget growth, as will health care costs for state, university and school employees. Health care costs will demand an ever-increasing share of the state budget.

Finally, the state's long-term growth trajectory is vulnerable to strong headwinds, either unaddressed or abetted by policymakers. California's high cost of housing, expensive energy, prescriptive labor market rules, and difficult regulatory environment present steep costs to starting and growing small businesses. Together these burdens may sap California's future growth potential.

Legislative Risks

Democrats have a near-lock on policymaking in Sacramento. Tax increases require a two-thirds supermajority to pass the Legislature. With more than a two-thirds vote advantage in the Assembly and that exact threshold in the Senate, Democrats on paper (assuming the Governor's assent) have the votes to raise taxes.

That's the theory, anyway. In practice, legislative tax increases will continue to be problematic in 2017. Both houses comprise healthy memberships of "moderate" Democrats from swing legislative districts who remain skeptical of tax increases. Since advocating his temporary income tax hike in 2012, Governor Brown has kept talk of tax increases at arms-length, with the exception of two he proposed in 2016— an increase on managed care health plans that he signed, and a package of transportation-related tax increases that remains bogged down in the Legislature.

Indeed, just look back to 2013 when Democrats enjoyed a two-thirds majority in both houses. They neither raised taxes nor jammed through constitutional amendment ballot proposals to lower vote thresholds for local taxes. The politics of tax increases are more complex than simply the partisan shade of the Legislature.

In short, general tax increases (with the possible exception of transportation taxes) are unlikely to survive the legislative gauntlet. More vulnerable are targeted taxes on pariah products or people.

Targeted Taxes

Three liberal California cities—Berkeley, San Francisco and Albany—adopted 1-cent per ounce excise taxes on sugar-sweetened soft drinks. Although these were general tax increases requiring a simple majority vote, two of the jurisdictions raised these taxes with a two-thirds supermajority of voters.

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State Personal Income Tax Relies Heavily on Top Brackets

California's income tax is nothing if not superlative.

Among the 50 states:

- California has the highest top marginal income tax rate.
- California has the most steeply progressive income tax.
- The income tax is the most volatile tax source.
- The income tax raises the most revenues of any tax.
- The income tax dominates the state's General Fund.

Last November, California voters agreed to maintain California's "superlative" income tax by extending the top marginal tax rates, originally enacted in 2012, for another 12 years. California will maintain these top rates for single-income taxpayers (double the bracket for taxpayers filing jointly):

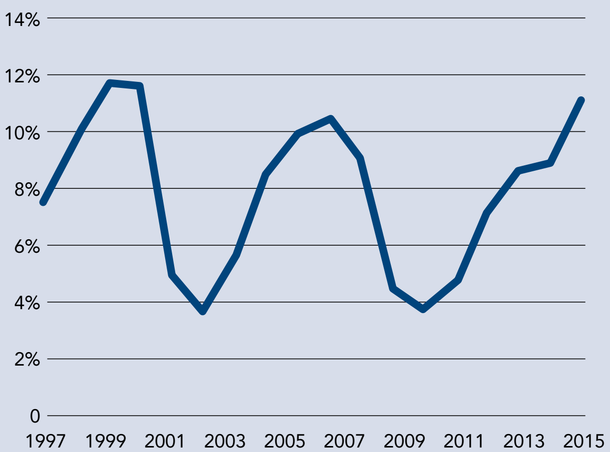
Bracket	Marginal Rate
$268,750	10.3%
$322,499	11.3%
$537,498	12.3%

Plus an additional 1% surtax for incomes greater than $1 million, no matter the filing status.

The effect of significantly higher tax rates on taxpayer behavior is difficult to measure. Anecdotes abound of wealthy investors, entertainers and sports figures fleeing the state for the friendlier confines of Nevada, Texas or Florida—states without an income tax. On the other hand, Franchise Tax Board (FTB) data show that the absolute number of high-income taxpayers has increased steadily since the depths of the recession and the imposition of higher rates in 2012. Whether imposition of virtually permanent (2030 expiration) top tax rates will change behavior remains to be seen.

There is no debate about the volatility of this revenue source and the dependence of the state General Fund on high income taxpayers.

Rough LAO Estimate: Taxes on Capital Gains as Percent of General Fund Revenue by Fiscal Year



Source: Legislative Analyst's Office

California's personal income tax is noteworthy because capital gains are fully taxed at the marginal personal income tax (PIT) rate. When the economy is booming, capital gains income rolls in—from stock market returns, real estate holdings and sales of business stakes. On the other hand, when the economy dips, capital gains income dives.

Volatility wouldn't be much of a worry if income taxes on the wealthy weren't integral to the state's budget.

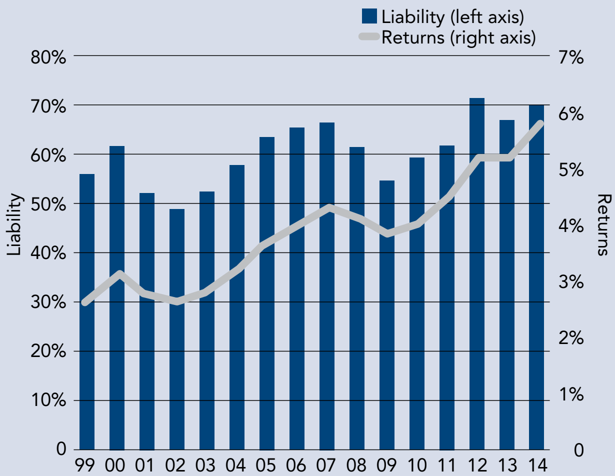
As California's economy has recovered, it's gotten more crowded at the top. The share of taxes being paid on ever-higher income tax collections is concentrating even more the share of taxes on upper income taxpayers.

According to the FTB, state income tax filers with more than $200,000 adjusted gross income increased their share of overall tax payments in 2014 to 70%, up from 55% in 2009.

At the same time, the income tax has become the overwhelming source for the state's General Fund. The Legislative Analyst's Office (LAO) projects that next year income taxes will account for 70% of all general revenues—a record high dependence on this revenue source. Translation: little more than 900,000 taxpayers (out of 39 million residents) will account directly for 49% of all General Fund revenues.

Tying state finances to such a small number of upper-income earners is very risky. As the Governor warned before the adoption of Proposition 55, what goes up inevitably will come back down. This trend underscores the wisdom of California voters in adopting the Proposition 2 rainy day reserve in 2014, to hedge against further downturns.

Tax Share of >$200k Personal Income Tax Filers



Source: California Foundation for Commerce and Education

The Legislature considered a similar proposal to increase taxes on sweetened beverages in 2016 (AB 2782; Bloom; D-Santa Monica). The measure never moved out of its original committee, a fate similar to that suffered by its predecessor in 2015. But the success of the local measures will surely inspire legislative sponsors to re-up the soda tax in 2017.

Another "pariah tax" likely to be reintroduced in 2017 is the "CEO tax." Back in 2014, then-Senator Mark DeSaulnier (D-Concord) introduced SB 1372, which would have increased corporate taxes on a sliding scale for publicly traded companies whose CEO's total compensation was above the median wage of the company's employees. The higher the ratio of the CEO compensation to median employee wages, the higher the corporate tax would increase.

Although this proposal was easily defeated on the Senate floor in 2014, it may gain new momentum in light of larger Democratic legislative margins, not to mention the example of the adoption of a similar tax penalty by the city of Portland.

Transportation Taxes

The last general tax increase voters levied on themselves was a 9-cent increase in the gasoline tax in 1990. In the intervening two-and-a-half decades, neither the voters nor the Legislature have increased statewide transportation taxes.

In the meantime, transportation revenues have lost purchasing power to inflation and lost the tax base to more fuel-efficient vehicles. Indeed, state environmental policy affirmatively promotes personal transportation choices not reliant on fossil fuels.

Understanding the corrosive effect this dynamic has on financing the transportation system, Governor Brown proposed a revenue fix as part of a special legislative session that would have modestly increased a variety of transportation-related taxes. But never mind the manifest need to resuscitate road and transit finances, the Legislature was unable to agree on a politically acceptable revenue package. The issue will continue to ripen in 2017. (See further detail in the Transportation article, page 98.)

Indirect Tax Increases

Another category of tax increases is the indirect tax hike—changing the Constitution to authorize the state Legislature or local governments to more easily increase taxes. Placing a constitutional amendment on the ballot also requires a two-thirds legislative vote, but does not require the Governor's signature.

Assemblymember Cristina Garcia (D-Bell Gardens) has announced her intent to introduce a constitutional amendment to exempt candy and snack food from the prohibition against applying the state sales tax to food products. Voters added this proscription to the Constitution by a 2 to 1 margin in 1992 after the Legislature carved out snack foods for taxation during the 1991 recession. Assemblymember Garcia was inspired to introduce this tax increase after the Governor vetoed her bill to exempt feminine products from the state sales tax.

Cap-and-Trade Auction Tax May Come Before Legislative Supermajority

As discussed in the "Climate Change" chapter, the Legislature in 2017 will likely consider a market-based mechanism among the policy choices to reduce California greenhouse gas emissions.

The most important attribute of a market-based mechanism is its economic efficiency–providing the least impact on industry and consumers while reducing requisite emissions. The pricing signals created by capped emissions and tradable allowances allows the marketplace to determine the most cost-effective suite of strategies to meet the state's climate goals.

For many in the Legislature, though, the key attribute of a cap-and-trade mechanism is its inherent option to provide for state-auctioned allowances that can raise revenues for public programs. The current design of the state's cap-and-trade program includes an auction administered by the Air Resources Board, which has raised $4.4 billion since the auction's inception in late 2012.

The CalChamber is litigating the constitutionality of the revenue-raising auction, arguing that cap-and-trade is an appropriate and indeed preferred approach, but that the auction mechanism is simply a tax by another name, and cannot be lawfully levied without a two-thirds vote of the Legislature. The authorizing legislation, AB 32 from 2006, passed by a simple majority vote. Oral arguments on the litigation are scheduled before the court of appeal in early 2017.

Authority for the cap-and trade mechanism, along with the auction tax, expires in 2020. The Legislature can re-up cap-and-trade by a simple majority vote. But if legislators want to authorize the revenue-raising auction feature, they will need to pass the law by a two-thirds vote. An auction mechanism may be one of the few tax votes facing the newly minted Democratic supermajority in the coming session.

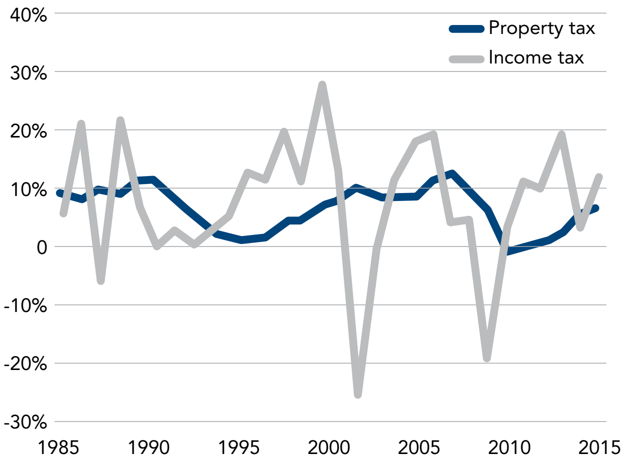
Legislators also have unsuccessfully proposed easing the ability of local governments to increase local taxes. Local "special taxes," which include parcel taxes and sales taxes dedicated to a special purpose, like transportation, require a two-thirds local vote to take effect. The proposals usually change the two-thirds requirement to a 55% threshold, mimicking the lesser supermajority required for local school bonds. This also is usually a two-step process, proposing a statewide vote to amend the Constitution, followed by the actual statewide vote.

None of the half-dozen proposals during the last several years to reduce the vote threshold for special taxes or local bonds moved out of their original houses of introduction. Given the generally successful passage rate of local measures, especially parcel taxes, it is unlikely that attempts to reduce local vote thresholds will get very far.

Services Tax

An increasingly popular discussion topic in fiscal circles is

Annual Volatility of Taxes



Source: California Foundation for Commerce and Education

applying the state's retail sales tax to the consumption of services, usually in the context of a broader push for tax reform. The concept has evolved from justifications advanced in the prior decade, which were simply as a response to a budget crisis.

The transformation of the California economy is most often cited as the basic rationale to tax services. Californians consume relatively more services and fewer goods than they did three or four decades ago, yet the tax base has remained static. California taxes relatively few services. As a result, proponents argue, the sales tax grows less robustly than does the overall economy.

Opponents argue that a services tax is fundamentally a tax on labor, the essential element of services. Therefore, a tax on services will result in less labor, meaning fewer jobs and more services that are either imported or insourced into companies.

Senator Bob Hertzberg (D-Van Nuys) has convened a working group to explore the adoption of a services tax in the context of larger tax reform, which could include reducing the income tax, sales tax or corporate tax. State Controller Betty Yee also has convened a panel of experts that has touted the benefits of a services tax within the context of tax reform.

Taxation of services fares better around the discussion table than it does in democratic forums. A commission formed by Governor Arnold Schwarzenegger in 2007 proposed a version of a services tax as part of a tax reform effort—it never found a legislative sponsor. A group of eminent citizens under the Think Long banner proposed a ballot measure to impose a tax on services while reducing other state general taxes—they never wound up collecting signatures. During the budget crisis in the last decade, Governor Schwarzenegger proposed imposing sales taxes on a small range of personal services—all were rejected by the Legislature. And just last November, the voters of Missouri passed a ballot measure prohibiting the Legislature from adopting any new taxes on services.

Tax reform is an evergreen subject, and California's tax system has many severe shortcomings. But advocates of tax reform and especially of a tax on services have a daunting public education task to achieve before considering any legislative or initiative policy effort.

Ballot Box Taxation

Given the state's healthy budget surplus and the political obstacles to legislative action, the greatest risk of a tax increase adverse to business remains at the ballot box.

The clearest threat is a property tax hike, either by adoption of a split roll property tax or of a more general increase in property taxes.

For more than 38 years, Proposition 13 has protected property taxpayers from arbitrary increases. It moderated growth in what had been a volatile tax that at its worst drove middle-income taxpayers and retirees from their homes.

When it comes to stability, property taxes are far more reliable than are income taxes, giving local governments and school more certainty than other state programs.

Not that the property tax isn't a massive revenue generator. Last year it brought in more than $55 billion for local governments and schools, making the property tax the second largest tax source in the state, after the income tax.

Report on California Property Tax System

In 2016 the Legislative Analyst examined the California property tax system, and made several findings:

• The property tax has grown faster than the economy. Personal income has grown at an average annual rate of 6.3% since 1979. Over the same period, revenue from the 1% property tax rate has grown at an average annual rate of 7.3%.

• The property tax is a stable revenue source, far less volatile than other revenue sources during the recent recession.

• Some homeowners and businesses may move less frequently. Homeowners and businesses may invest less in property improvements.

• Residential properties do not turn over more often statewide; in fact, residential, commercial and industrial properties appear to be turning over at relatively similar rates. Residential properties are not reassessed more frequently than commercial and industrial properties.

• Homeowners pay a slightly larger share of property taxes today than they did when Proposition 13 passed. Proposition 13 does not appear to have caused this increase. In part, this may be due to faster growth in the number of residential properties than the number of commercial and industrial properties.

• New commercial property owners pay higher taxes than existing owners, but it is not clear that this significantly deters creation of new businesses.

Now approaching its 40th anniversary, Proposition 13 remains remarkably popular with voters. A recent California Chamber of Commerce poll found that voters have a favorable view of Proposition 13 by a 4 to 1 margin, regardless of voters' age, location, gender or income. Even the least supportive group—Democrats—favored Proposition 13 by a 3 to 1 margin.

Notwithstanding its popularity and effectiveness, advocates for new spending programs may yet take a shot at Proposition 13 at the 2018 or 2020 ballot.

Split Roll Proposals

Proposals for a split roll property tax—assessing or taxing business property at a higher rate than residential property—have surfaced regularly for decades, although few have reached the ballot.

The most recent ballot test of a split roll proposal was in 1992, where Proposition 167 was defeated by a wide margin.

More recently, proposals have surfaced like trial balloons, only to be shot down when the political support didn't appear or if more fruitful tax increase options eclipsed the property tax hike.

The most recent example of this was in 2015, when a coalition of poverty groups, under the banner of "End Child Poverty in California," proposed a massive increase in property taxes. This measure was different because it was not a split roll measure focusing just on business property, but a tax increase on all property assessed at more than $300,000.

Although supported by influential poverty organizations in Southern California, proponents declined to move forward, possibly to clear the ballot of a competitor to the income tax hike, or possibly to discourage a property tax increase proposal aimed at poverty programs, rather than benefiting programs traditionally staffed by unionized public employees in schools and local governments.

Article written by Loren Kaye, president, California Foundation for Commerce and Education.

Staff Contact
Jennifer Barrera
Senior Policy Advocate

jennifer.barrera@calchamber.com
California Chamber of Commerce
P.O. Box 1736
Sacramento, CA 95812-1736
(916) 444-6670
www.calchamber.com
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