In High-Tax California, Low, Fair, Stable, Predictable Levies Important to State's Competitive Position

California is a high tax state. Voters don't seem to mind—if the higher taxes are not on them.

Since 2012, California voters have raised taxes five times—twice on upper-income Californians, once on certain multistate corporations, and once on smokers. The 2016 measure to legalize the recreational use of marijuana also established new taxes on growers and purchasers.

Each of these measures targeted arguably unpopular or isolated subpopulations of taxpayers.

The Legislature also recently raised taxes—four times in just the last two years. The one general tax increase, on gasoline and cars, has resulted in potential voter blowback. A member of the Senate is under threat of recall, and a San Diego politician has proposed a voter initiative to roll back the gas tax hike.

When fully in effect, the taxes increased in just 2016 and 2017 will amount to more than $15 billion annually. (See the nearby boxes for details on these tax increases.)

Public and political reaction to the transportation tax increases virtually guarantees the Legislature will avoid further general tax increases in 2018. But this doesn't mean individual legislators will forbear from proposing tax increases aimed at businesses.

Targeted Tax Increases

In 2017, the Legislature proposed several tax increases targeted at specific businesses, business practices or products. Vigorously opposed by the California Chamber of Commerce and a coalition of business and taxpayer organizations, each of these proposals was defeated.

- **AB 1003** by Assemblymember Richard Bloom (D-Santa Monica) would have imposed a new excise tax of 2 cents-per-ounce on sugar-sweetened beverages for programs to address diabetes, obesity, heart disease, and dental disease.
- **AB 479** by Assemblymember Lorena Gonzalez Fletcher (D-San Diego) would have increased the excise tax on distilled spirits by $1.20 or $2.40 a gallon, depending on proof strength, to offset a proposed sales tax exemption for adult and child diapers and for feminine sanitary products.
- **ACA 2** by Assemblymember Cristina Garcia (D-Bell Gardens) would have proposed a constitutional amendment to allow the levy of a sales tax on candy and snack foods. A constitutional amendment would be required in this case because the state Constitution currently exempts all food products from the sales tax.

Voter-Approved Tax Increases since 2012

2012

Proposition 30 Sponsored by Governor Brown, a quarter-cent increase in the sales tax through 2016 and in addition, through 2018, of three new brackets at the upper end of the income scale: 10.3% for incomes over $500,000 (joint filers); 11.3% for incomes over $600,000, and 12.3% for incomes over $1 million. Increased taxes by about $6 billion per year.

Proposition 39 Sponsored by hedge fund billionaire and environmentalist Tom Steyer, changed the apportionment of state corporate taxes by companies that generally sell more goods or services in California but employ relatively few workers or own relatively little property in the state. Increased taxes by about $1 billion per year.

2016

Proposition 55 Sponsored by the California Teachers Association. Extended the Proposition 30 income tax hikes by another 12 years, through 2030. Maintains about $6 billion in annual tax increases and enshrines this level of personal income taxes in the state Constitution.

Proposition 56 Sponsored by the California Medical Association and other health care organizations. Increased the tobacco tax by $2 per pack of cigarettes, and an equivalent amount on other tobacco (and e-cigarette) products. Raises about $1.25 billion a year, and declines as the intended reduction in tobacco use occurs.

Proposition 64 Sponsored by a coalition of cannabis organizations. Legalized the recreational use of marijuana and established a regulatory regime for cannabis use, sale, production and taxation. Over time will increase taxes by up to $1 billion annually by levying a tax on growers, a 15% excise tax, and applying the state and local retail sales tax to marijuana purchases.

CalChamber

Expanding Opportunity
An Agenda for All Californians

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• **AB 1512** by Assemblymember Kevin McCarty would have imposed a new excise tax on the distribution of opioid drugs at the rate of one cent-per-milligram of active opioid ingredient for programs to fund addiction prevention and rehabilitation programs.

• **AB 1356** by Assemblymember Susan Talamantes Eggman (D-Stockton) would have added an additional 1% personal income tax rate on incomes above $1 million, raising the total marginal tax rate on that income to 14.3%, to be used to reduce higher education fees and tuition.

• **SB 567** by Senator Ricardo Lara (D-Bell Gardens) would have removed the corporate tax deduction for compensation of senior corporate executives above $1 million, even if based on performance. The bill also would have removed the ability of heirs to step up the basis of inherited property for purposes of personal or corporate income taxes. The bill also would have increased charitable remainder requirement of trusts from 10% to 40%. These provisions would have brought California tax law out of conformity with federal income tax law.

Although none of these bills even survived the originating house, legislative and special interest proponents maintain a strong appetite to pursue these issues. When new health or social services or education programs cannot successfully compete for budget allocations, advocates will seek to tie what may appear to be a popular-sounding program to a pariah product or industry.

This impulse will only be intensified by the passage of federal corporate and individual tax reductions and reform.

Many in the Legislature will doubtless salivate over the prospect of enacting conforming base-broadening measures to increase revenues, while conveniently ignoring the overall thrust of the federal measure to reduce taxes and ease compliance.

Transportation Taxes

With CalChamber support, the Legislature approved SB 1 by Senator Jim Beall (D-San Jose), which creates a user-paid program that provides the long-term funding source necessary for capital improvements. Californians drive more than 350 billion miles a year—more than any other state—yet California had not raised the gas tax in 23 years. The purchasing power of the existing gas tax is half of what it was in the 1990s, creating a $6 billion funding gap every year between what the state can afford to fix now and what it needs to fix.

The measure increased transportation revenues by about $5 billion a year, including:

• Increasing the gasoline excise tax by 12 cents a gallon.

• Increasing the diesel excise tax by 20 cents a gallon.

• Increasing the sales tax on diesel by 4 percentage points.

• Adding a fee based on the value of vehicles of $25 to $175 a year.

• Adding an additional fee in 2020 on vehicles fueled by electricity or hydrogen.

Energy Taxes

Also indirectly affecting the price of gasoline, diesel and other fossil fuel energy sources is the reauthorization of the cap-and-trade program. This hotly debated legislation (AB 398 by Assemblymember Eduardo Garcia; D-Coachella) was necessary to implement legislation from 2016 that created a new mandate to reduce in-state greenhouse gas (GHG) emissions by 50% per capita between now and 2030.

Cap-and-trade is widely acknowledged as the most cost-effective means to reduce GHGs to meet this aggressive mandate. The alternative command-and-control measures are orders of magnitude more expensive to individual businesses, employees and the overall economy.

The Governor and Legislature agreed with CalChamber's legal interpretation that the cap-and-trade mechanism is a tax, thereby requiring a two-thirds vote of the Legislature, which created the condition to adopt a legitimate market-based system with effective cost containment measures.

Tax Cuts

As part of a comprehensive, bipartisan solution implementing the state's ambitious climate change goals, the legislation that extended the cap-and-trade program also included several useful tax reductions.

These tax cuts will help mitigate cost increases on rural Californians and partially offset some costs for California manufacturers and energy producers.

Manufacturers gained a partial, temporary exemption from state sales taxes, beginning in 2014, through 2022, limited to an aggregate of $200 million per year. Similar to legislation proposed by Senator Cathleen Galgiani (D-Stockton), SB 600, and Assemblymember Jim Cooper (D-Elk Grove), AB 600, the cap-and-trade measure extends this sales tax exemption for an additional eight years, through 2030, and expands its coverage to include equipment used for renewable energy production, storage and distribution. In addition, if any of these manufacturing/R&D/renewable energy activities occurs in an agricultural setting, the equipment would now qualify for an exemption.

Since 2011, the state has charged a fee on parcels with habitable structures on lands within the "State Responsibility Area," which are lands that are protected by the California Department of Forestry and Fire Protection (that is, not served by municipal fire departments or federal agencies). The fee was $150 per parcel, annually adjusted for inflation, and is used to help pay for fire prevention and protection services by the department. The cap-and-trade measure suspends assessment of the fee immediately and repeals it in 2031. Revenues from cap-and-trade will be used to continue paying for the fire protection services previously funded from the tax.

Tax Administration

State tax administration was roiled earlier in 2017 when state audits and press reports revealed widespread self-dealing and

Legislative Tax Increases since 2016

2016	
Managed care provider tax (SB X2 2; Hernandez; D-West Covina)	Restructures taxes to conform with federal law
2017	
Transportation taxes (SB 1; Beall; D-San Jose)	$5 billion annually
Document transfers (SB 2; Atkins; D-San Diego)	$250 million annually
Cap-and-trade (AB 398; E. Garcia; D-Coachella)	$2 billion–$10 billion annually

Legislative Tax Cuts since 2016

2017	
Eliminate fire protection tax	$85 million
Extend/expand sales tax exemption for manufacturing and R&D	$90 million, plus extending expiration date to 2031

nepotism at the state Board of Equalization (BOE), not to mention maladministration of tax records. Elected board members were criticized for redirecting civil service staff for political use, posh office redecorations, and inappropriate intervention in staff functions.

In response, the Legislature and Governor adopted a hurry-up restructuring of the board in the guise of a budget trailer bill, which facilitated a reorganization of functions and reporting without normal public hearings and debate.

The sweeping overhaul stripped the BOE of its high-profile mandate as California's tax court and shed almost 90% of its 4,800 employees. Most of its functions were placed in a new revenue department called the Office of Taxpayer Appeals that would report to the Governor's Office. Tax disputes would be settled by civil service administrative law judges instead of elected members on the BOE.

The BOE would continue to have four members elected from geographic districts. They would become advocates for taxpayers but lose their authority to investigate complaints. They also would retain vestigial responsibilities for property tax equalization, which is based in the Constitution.

Local Taxes

The exception to the voters' "tax the man behind the tree" attitude is with local taxes. Voters opened their wallets to cities, schools and special districts in 2016, approving four out of five local tax and bond measures, including nearly three out of five measures requiring a two-thirds voter approval. In many cases these measures were carefully drafted to provide local accountability for specific projects or services promised by the measures' advocates.

Meanwhile, the California Supreme Court last summer decided to make it easier to raise some local taxes. But how much easier remains to be seen.

For two decades, local tax increases usually have been governed by Proposition 218, whether proposed by a local government agency or by citizen initiative. Passed by voters in 1996, Proposition 218 requires voter approval of all local tax increases. The measure also mandates that tax proposals appear on general election ballots (as opposed to primary or special elections). More controversially, most local tax proposals require approval of two-thirds of the voters.

In the case of *California Cannabis Coalition v. City of Upland*, the court by a 5-2 majority held that statutes proposed by voter initiative need not be held to the same procedural standards as statutes proposed by local government agencies.

The opinion by Justice Mariano-Florentino Cuéllar held that Proposition 218 "does not limit voters' 'power to raise taxes by statutory initiative.' A contrary conclusion would require an unreasonably broad construction of the term 'local government' at the expense of the people's constitutional right to direct democracy, undermining our longstanding and consistent view that courts should protect and liberally construe it."

The court distinguished between the procedures that a local agency must comply with in approving a tax increase, which the justices agreed is governed by Proposition 218, and the procedures a citizens' initiative must comply with, which are not necessarily governed by Proposition 218.

The issue in *Upland* was whether the tax measure should be set for a vote in the general election, or at an earlier special election. Plaintiffs preferred the special election because it would enact the ordinance more promptly. Sponsors of Proposition 218 included the general election mandate to ensure the broadest possible electorate to consider tax matters.

Having established a procedural distinction between tax measures based on their provenance, the court left open the reach of this distinction. While the rhetoric was broad, the remedy was limited. The court ruled that the tax proposal should have been considered at a special election.

Timing of elections is one thing, but the procedural hurdle that really matters is the vote threshold. Proposition 218 requires special taxes be approved by a two-thirds supermajority. The court opened this question, but did not answer it.

Business and taxpayer organizations have filed a proposed ballot measure with the Attorney General to overturn the *Cannabis v. Upland* decision. They will decide later this year whether to collect signatures for this proposal.

Fiscal Context

Notwithstanding all this talk of new or increased taxes, California's fiscal picture is stable and positive.

Governor Edmund G. Brown Jr. in January proposed a 2018–19 budget topping $190 billion without raising taxes and setting aside $13 billion in a rainy-day reserve.

For the first time since 1998, it appears that a retiring governor will not pass along a budget deficit to his successor. Nonetheless, the Governor insisted that fiscal prudence must guide decisions this year, emphasizing that, "we prepare for the recession, not when it comes, but years before." The Governor noted that by the end of the next fiscal year, the economic expansion will be the longest post-war period of uninterrupted growth. A moderate recession, according to the Department of Finance, would drop state revenues by more than $20 billion annually.

The Legislative Analyst's Office (LAO), while differing on the details, agrees that 2018 should continue to feature a strong and growing economy—until it doesn't. The LAO agrees that rainy-day reserves will cover recession-induced revenue losses for no more than a couple of years.

Both the Governor and LAO warn of influential outside variables—the outcome of federal tax reform, any changes in federal health care policy, and the consequences of changing international trade relationships.

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.

Governor Brown estimated long-term obligations for these commitments for state and university employees and teachers at $275 billion. Even after enacting some modest reforms earlier this decade, 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.

California Tax System

California's tax system is both very progressive and very regressive.

State coffers are dominated by the personal income tax. California has the most progressive income tax with the highest top rates. As a result, personal income taxes make up nearly 70% of state general funds—and half of the income tax is paid by just 300,000 taxpayers. Among other reasons for this: the top income tax rate is 13.3% on incomes over $1 million—by far the highest in the nation.

On the other hand, the changing economy has effectively narrowed the sales tax. In some parts of the state, the sales tax is more than 10%—among the highest in the land. But taxable sales—on clothing, cars and other tangible goods—comprise much less of overall sales than in the past. The state sales tax rate is the highest in the land, and the combined state/local rate ranks California in the top 10 of all states.

The Proposition 13 property tax system is the source of the greatest myths. Property tax rates remain relatively low—1% of assessed valuation with that valuation growing only 2% a year unless the property is sold. But property values in California are notoriously high, meaning taxes go up—sometimes sharply—when property turns over. As a result, property taxes bring in north of $50 billion a year, the second highest tax source in the state. That does not keep tax advocates from regularly promoting a "split roll" property tax, to assess or tax commercial and industrial property at a higher rate than residential property.

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. Voters in a 2017 CalChamber poll gave Proposition 13 resounding support, no matter their party, where they live, or whether they rent or own their home. By a 3 to 2 margin, voters oppose putting higher taxes on commercial property.

Notwithstanding its popularity and effectiveness, advocates for new spending programs may yet take a shot at amending Proposition 13 to create a split roll property tax at the 2020 ballot.

Tax Reform

Many policymakers advocate "tax reform," but like beauty, reform is in the eye of the reformer. For unions and special interests, reform usually means eliminating tax incentives or taxing business property at higher rates than personal residences—all in the interest of squeezing out more revenues for government programs. But advocates for economic growth and budget hawks also have seized on tax reform, noting that a revenue system dominated by taxes on income and investment—especially those paid by high wealth individuals—increases the volatility of revenues and depresses economic growth.

Even if any and every interest group or ideology can justify some version of tax reform, it's hard to divine a sweet spot where the ideologies converge. Even harder to map out is the path by which any tax reform worth the name could be approved by voters, since both income and property tax rates are set in the state Constitution.

Even without tax reform, tax rates and application will be a continuing struggle in the Legislature and at the ballot. Voters may continue to oppose general tax increases, but California will remain a high-tax state as voters and elected leaders demand and accommodate a high-service state.

Ballot Box Tax policy

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. However, tax increases are less likely to appear on the 2018 ballot, since it is a gubernatorial election year, with turnout traditionally lower and skewing more and more conservative.

Indeed, the three tax-related initiatives most likely to qualify for the November ballot are tax limitation measures:

• Repeal the major transportation taxes adopted in 2017 in SB 1, and require future such taxes to be approved by the voters;

• Overturn the *Cannabis v. Upland* decision and require a two-thirds vote for special taxes placed on the ballot by local initiative; and

• A proposal by the California Association of Realtors to amend Proposition 13 to allow older homeowners who buy a new home to adjust, for property taxation purposes, the market value of their new home to reflect the assessed valuation of their existing home, to remove the disincentive that long-time homeowners may have for moving into a new house, but losing their low property tax assessments.

A fourth proposed ballot measure was recently proposed to enact a split roll property tax system, where commercial and industrial property (not including production agriculture and rental housing) would be reassessed annually to market value. As of this writing, it is not clear if proponents have the resources to qualify this measure for the November ballot.

CalChamber Position

The key imperative for policymakers should be to keep taxes on new investment and business operations low, fair, stable and predictable. While tax rate reduction would improve the state's competitive position, policymakers should above all resist making the tax climate worse.

Oppose punitive taxation that thwarts economic development and stability of investments:

• Discriminatory or punitive taxation of targeted industries or groups, including consumer products, services industries or high-income workers or investors.

• Undermining or limiting tax incentives or equitable treatment for businesses, such as incentives regarding research and development or net operating losses.

• A split roll property tax that increases rates or assessments of commercial and industrial property, including parcel taxes that differentiate among types of property ownership.

Increase manufacturing jobs: California took an important first step to provide competitive treatment for California's remaining manufacturing industry by exempting manufacturing and research and development (R&D) equipment investments from the state portion of the sales tax. We should take the next step to exempt these job-creating investments from local and regional sales taxes.

Revive local economic development tools: Local economic development suffered a one-two punch with the elimination of both enterprise zones and redevelopment agencies. Although criticized for waste, abuse and inefficiencies, these tools nonetheless provided cities the ability to incentivize economic development in disadvantaged or rundown neighborhoods. Enterprise zones have been replaced by a temporary, narrower incentive, but cities utterly lack the tools to redevelop blighted or urbanized neighborhoods. Policymakers should revive the tax increment tool, with better monitoring and accountability.

Defend the two-thirds legislative vote for tax increases: No matter the partisan split in the Legislature, the two-thirds vote requirement for increasing taxes remains the surest check on overspending and growth of government. Hold the Legislature and local governments accountable to abide by voter-approved Proposition 26, which narrowed the definition of "fees" and requires two-thirds legislative vote or local approval of fees not connected to a legitimate regulatory program.

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