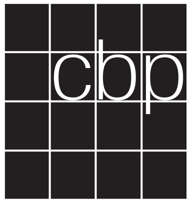


CALIFORNIA BUDGET PROJECT

BUDGET BACKGROUNDER

MAY 2012

MAKING DOLLARS MAKE SENSE

WHAT MAKES A TAX SYSTEM "FAIR"?

While everyone believes a tax system ought to be fair, there is disagreement as to what constitutes a fair or equitable tax system. This *Budget Backgrounder* describes what economists generally believe makes a tax system fair, examines how fair California's tax system is, and discusses why fairness matters.

Defining a Fair Tax System

Most people agree that a fair tax system should ask taxpayers to contribute to the cost of public services based on ability to pay. Economists typically measure the equity of a tax system or a particular tax based on the percentage of a family's income. Taxes are often described as:

- Progressive when higher-income households pay a larger share of their incomes in taxes (Figure 1);
- Proportional, or "flat," when the share of income paid in taxes is the same at all income levels, regardless of how much or how little households earn; or
- Regressive when lower-income households pay a larger share of their incomes in taxes.

Some people argue – and public opinion research suggests that many people believe – that proportional, or flat, taxes are the fairest, since everyone pays the same tax rate. However, this argument does not account for the fact that lower-income households spend most or all of their incomes on necessities, while higher-income households have more discretionary income and can afford to pay more in taxes without cutting into what they can spend on shelter, food, health care, and other basic needs.

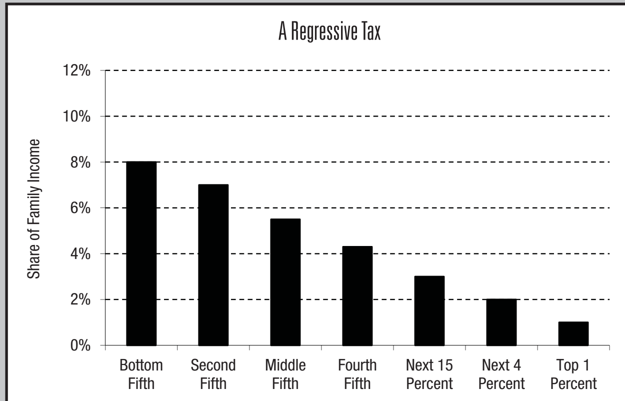
The overall fairness of a tax system depends on the balance between the various taxes that make up the state's revenues. A system that relies more heavily on progressive taxes will be more progressive, while one that is a mix of progressive and regressive taxes will be proportional. California's tax system is modestly regressive after taking into account taxpayers' ability to deduct state income and property taxes for federal income tax purposes.[1] Sales and excise taxes, such as alcohol and tobacco taxes, are regressive taxes (Table 1). An income tax with a graduated rate structure, such as California's, is a progressive tax. Fuel and energy taxes – including taxes based on carbon emissions – are regressive taxes. Contrary to popular perception, California's Vehicle License Fee is also a regressive tax.[2] The overall regressivity of California's tax system results from the relatively large share of income that lower-income households pay in the form of sales and excise taxes. While higher-income households pay a larger share of their incomes in personal income taxes, they can deduct these amounts from their federal income taxes, significantly reducing the total amount of taxes that they pay.

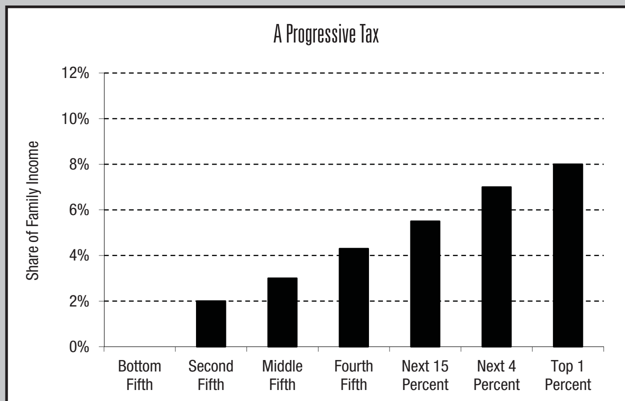
The regressivity of California's tax system also reflects the fact that low- and middle-income households spend all, or nearly all, of their incomes on necessities, including on many goods that are subject to tax. Sales and excise taxes are generally not deductible for federal tax purposes, and this exacerbates the disparities between low- and middle-income households and high-income households. Without considering federal deductibility, the distribution of California's taxes would be "U"-shaped, with the lowest- and highest-income households paying the largest share of their incomes in taxes. This shape reflects the significant burden of sales and excise taxes on low-income households and the impact of California's extremely progressive income tax on high-income households.

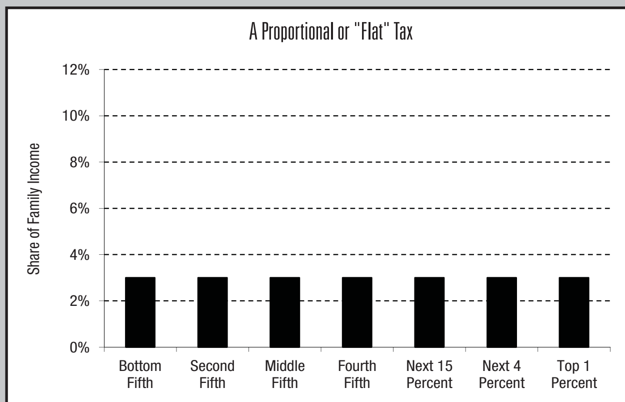
A Fair Tax System Treats Taxpayers in Similar Situations Similarly

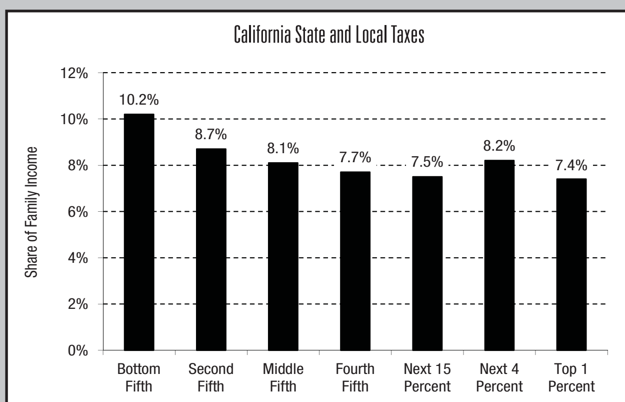
Economists also talk about another type of equity – horizontal equity. A tax system that is horizontally equitable treats taxpayers

Figure 1: Comparing Different Tax Systems









in similar economic situations similarly. Horizontal equity is important since it influences taxpayers' perceptions of the fairness of the tax system. A tax system that is horizontally equitable, for example, taxes all forms of income at the same rate. An inequitable system provides, for example, preferential treatment to investment income relative to wages. The federal income tax taxes income from capital gains at a lower rate than that from wages, and California taxes income from private pensions, but not from Social Security.

Most economists believe that a good tax system is one that does not attempt to influence the allocation of resources in the economy. California's property tax provides preferential treatment to businesses that have owned their property for a long time, while property owned by new businesses is taxed at or near fair market value. Many critics argue that this feature of California's tax code discourages new investment and economic development. Similarly, many economists argue that tax laws that provide special treatment to certain industries or activities leads to inefficiency and encourages businesses to consider the tax consequences of their decisions, rather than respond to market demand. Economists across the political spectrum argue that the best taxes are those applied to a broad base and at a low rate.

All tax systems provide some types of special treatment. For example, both the state and federal income taxes provide special benefits to families with children and allow taxpayers who itemize their deductions to deduct their charitable contributions. California's corporate income tax provides special treatment to businesses located in certain geographic areas and for research and development in certain, but not all, sectors of the economy. Economists argue that decisions to provide special treatment should be made explicitly and reviewed periodically. Periodic evaluation provides an opportunity to assess whether such policies have achieved their policy goals or whether they have resulted in unintended – and potentially undesirable – consequences.

Table 1: Examples of Taxes That Are Typically Progressive or Regressive
Typically Progressive Taxes
Corporate Income Tax
Personal Income Tax
Property Taxes Paid by Businesses
Typically Regressive Taxes
Fuel Taxes (Gasoline, Carbon)
Property Taxes Paid by Homeowners
Sales Tax
"Sin" Taxes (Tobacco, Alcoholic Beverages)
Vehicle License Fees

Why Does Fairness Matter?

Tax fairness is important for several reasons. First, a regressive tax system raises money from those who have the least of it. Income is distributed unequally, and California's income distribution is becoming more unequal. The wealthiest 5 percent of Californians received 36.6 percent of the income reported for tax purposes in 2010, up from 27.7 percent of income in 1993. The share of income reported by the bottom 60 percent of personal income taxpayers dropped from 22.8 percent to 18.1 percent during the same period.[3] Income from capital gains is distributed even more unequally, with the top 5 percent of personal income taxpayers receiving 94.2 percent of income from capital gains in 2009.[4] Business income is also distributed unequally; the 0.2 percent of California corporations with incomes of $10 million or more earned 65.7 percent of the corporate income reported for tax purposes in 2010.[5]

What Other Factors Matter?

A complete discussion of what constitutes a good tax system is beyond the scope of this paper. However, in brief, experts argue that a good tax system should provide an appropriate level of revenue on a timely basis, distribute the cost of taxation fairly, promote economic growth and efficiency, be easily administered, and ensure accountability.[6]

Debates over what constitutes a good or bad state "business climate" typically focus on tax rates and total tax collections on a per capita basis or as a share of a state's economy. While more comprehensive studies show that various business climate "indexes" have little relationship to a state's rate of economic growth and even less of a relationship to state residents' economic well-being, these comparisons do matter. Economists generally believe that states should not be "outliers": states should avoid tax levels that are significantly above those in other states. California has relatively high personal and corporate income taxes, but relatively low property taxes due to the limits imposed by Proposition 13. Experts often argue that the state's tax system would be better balanced by a greater reliance on property taxes, which tend to be relatively stable, and a lower reliance on income taxes.

Jean Ross prepared this Budget Backgrounder *with assistance from Samar Lichtenstein. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.*

ENDNOTES

1 Figure 1 shows that California's lowest-income families pay the largest share of their incomes in state and local taxes (Institute on Taxation and Economic Policy). Federal income tax law allows taxpayers who itemize their deductions to deduct income and property taxes paid, including vehicle license fees that are treated as a tax on personal property. Businesses can deduct all of the state and local taxes they pay from their federal income taxes.

2 Jennifer Dill, Todd Goldman, and Martin Wachs, *The Incidence of the California Vehicle License Fee* (California Policy Research Center, University of California, Berkeley, 1999).

3 Franchise Tax Board, *Revenue Estimating Exhibits* (May 2012), Exhibit A-10, p. 3.

4 Franchise Tax Board, *Revenue Estimating Exhibits* (December 2011), Exhibit A-9, p. 1.

5 Franchise Tax Board, *Revenue Estimating Exhibits* (May 2012), Exhibit B-2, p. 3.

6 National Conference of State Legislatures and National Governors Association, *Financing State Government in the 1990s* (December 1993), p. 16.

Appendix A: California State and Local Taxes as a Share of Family Income for Non-Elderly Taxpayers							
					Top Fifth		
Income Group	Bottom Fifth (Less Than $20,000)	Second Fifth ($20,000 to $34,000)	Middle Fifth ($34,000 to $55,000)	Fourth Fifth ($55,000 to $94,000)	Next 15 Percent ($94,000 to $208,000)	Next 4 Percent ($208,000 to $620,000)	Top 1 Percent ($620,000 or More)
Average Income in Group (2007)	$12,600	$27,100	$43,800	$72,000	$133,000	$321,300	$2,257,000
Sales, Excise, and Gross Receipts Taxes	6.5%	5.4%	4.1%	3.2%	2.3%	1.5%	0.8%
Property Taxes	3.6%	2.8%	3.0%	3.1%	3.0%	2.4%	1.4%
Property Taxes on Families	3.5%	2.7%	2.9%	3.0%	2.9%	2.1%	0.7%
Business Property Taxes	0.1%	0.0%	0.1%	0.1%	0.1%	0.3%	0.7%
Income Taxes	0.1%	0.5%	1.2%	2.0%	3.4%	5.3%	7.5%
Personal Income Tax	0.1%	0.5%	1.1%	1.9%	3.3%	5.1%	7.1%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.5%
Total Before Offset for Federal Deductibility of State Taxes	10.2%	8.7%	8.3%	8.3%	8.8%	9.2%	9.8%
Offset for Federal Deductibility of State Taxes	0.0%	0.0%	-0.2%	-0.6%	-1.2%	-1.0%	-2.3%
Total After Offset for Federal Deductibility of State Taxes	10.2%	8.7%	8.1%	7.7%	7.5%	8.2%	7.4%

Source: Institute on Taxation and Economic Policy