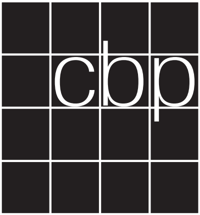

CALIFORNIA BUDGET PROJECT

SPECIAL REPORT

PRINCIPLES AND POLICY:

A GUIDE TO CALIFORNIA'S TAX SYSTEM

April 2013

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California Budget Project

This report was initially written by former executive director Jean Ross and was updated by Alissa Anderson and Samar Lichtenstein. The 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 the economic and social well-being of low- and middle-income Californians. Support for the CBP comes from foundation grants, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.

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INTRODUCTION: WHY WE SHOULD CARE

"Taxes are what we pay for civilized society."
Former Supreme Court Justice Oliver Wendell Holmes

Taxes are the collective price we pay for public goods and services. State and local taxes support our public schools, streets and highways, public hospitals that form the backbone of the state's trauma care system, parks and beaches, the public health infrastructure that ensures that our food is safe to eat and our water is safe to drink (and that delivers water to homes across California), as well as a range of other services. While the primary purpose of a tax system is to raise the money needed to support public services, tax policy can also serve as an end in itself, providing incentives for taxpayers to engage in desired activity or providing cash assistance to certain individuals.

Knowledge of how our tax system works is critical for advocates who want to influence state budget and policy priorities. The structure of the state's tax system determines the amount of resources that are available to support public services and, increasingly, the tax code serves as a tool to implement policy change. Tax policy debates are often within the purview of those with a vested interest in the narrow nuances of particular credits, deductions, and exemptions. The voices of advocates and voters, who generally care more about the quality of the services they receive, are often missing from the debate over how the revenues that support those services are raised. An understanding of the tax system is critical for advocates, particularly during tough budget times, since the structure of the state's tax system directly influences how much money is available to pay for services ranging from education to health care to transportation.

California's tax system has evolved over recent decades. Corporate income taxes account for a smaller share of the state's budget today, while personal income taxes account for a much larger share. During the late 1990s, lawmakers reduced the Vehicle License Fee – the tax paid by owners of vehicles registered in California – by more than two-thirds. More recently, federal action eliminated the state's share of revenues from the estate tax, a tax formerly shared by the state and federal governments. These changes influence both the equity – the distribution of the cost of public services among taxpayers – and the adequacy – whether the revenues raised are sufficient to meet the demands for services – of our state's fiscal system.

Most simply, taxes are the way governments raise the revenues necessary to support public services. While there is little disagreement over the purpose of state and local taxes, there is considerable controversy over what constitutes an appropriate level of taxation and how state tax systems ought to be structured. This guide provides basic information on California's tax system and an overview of the major issues in state and local tax policy.[1] It also includes a brief discussion of local taxes, such as the property tax. Finally, this guide outlines constitutional and voter-enacted constraints on tax policymaking and provides options for reform as well as a list of resources to learn more about California's tax system.

WHAT SHOULD A GOOD TAX SYSTEM DO?

While there is considerable debate over what constitutes an appropriate level of taxation, there is much broader agreement with regard to what makes a good tax system. Experts generally agree that a good tax system should:

- Provide an appropriate level of revenues on a timely basis;
- Distribute the cost of paying for public services fairly;
- Promote economic growth and efficiency;
- Be easily administered; and
- Ensure accountability.[2]

What Is an Appropriate Level of Taxes?

What constitutes an appropriate level of taxes depends on the level of public services desired by voters and their elected representatives. Particularly during tough budget times – when revenues are insufficient to pay for services – there is often disagreement over what constitutes an "appropriate" level of revenues. Experts argue that a state tax system should provide enough revenues to pay for budgeted expenditures and that, over time, the growth in state tax revenues should keep pace with increases in population, inflation, and taxpayers' ability to pay.[3]

Throughout much of the 2000s and early 2010s, California faced a structural deficit – a gap between the revenues brought in through the state's tax system and the cost of funding a "current services" budget, which reflects the cost of continuing the level of services required by current law, adjusted for inflation and population or caseload growth, as appropriate.[4] Temporary tax increases approved by voters

in November 2012, combined with lower expenditures due to years of deep budget cuts, resulted in projected operating surpluses beginning in 2013-14. However, these projections assume relatively modest spending increases that would fund many public systems below 2007-08 levels. Moreover, once the temporary tax increases expire, California is likely to experience tougher budget times and possibly a return to recurrent shortfalls.

What Is a "Fair" Tax System?

While everyone thinks a tax system ought to be fair, there is disagreement over what constitutes a fair or equitable tax system. Economists talk about two types of equity: vertical equity and horizontal equity. Vertical equity refers to the distribution of the impact of a tax among taxpayers of different income levels. Horizontal equity refers to the treatment of taxpayers in similar economic circumstances.

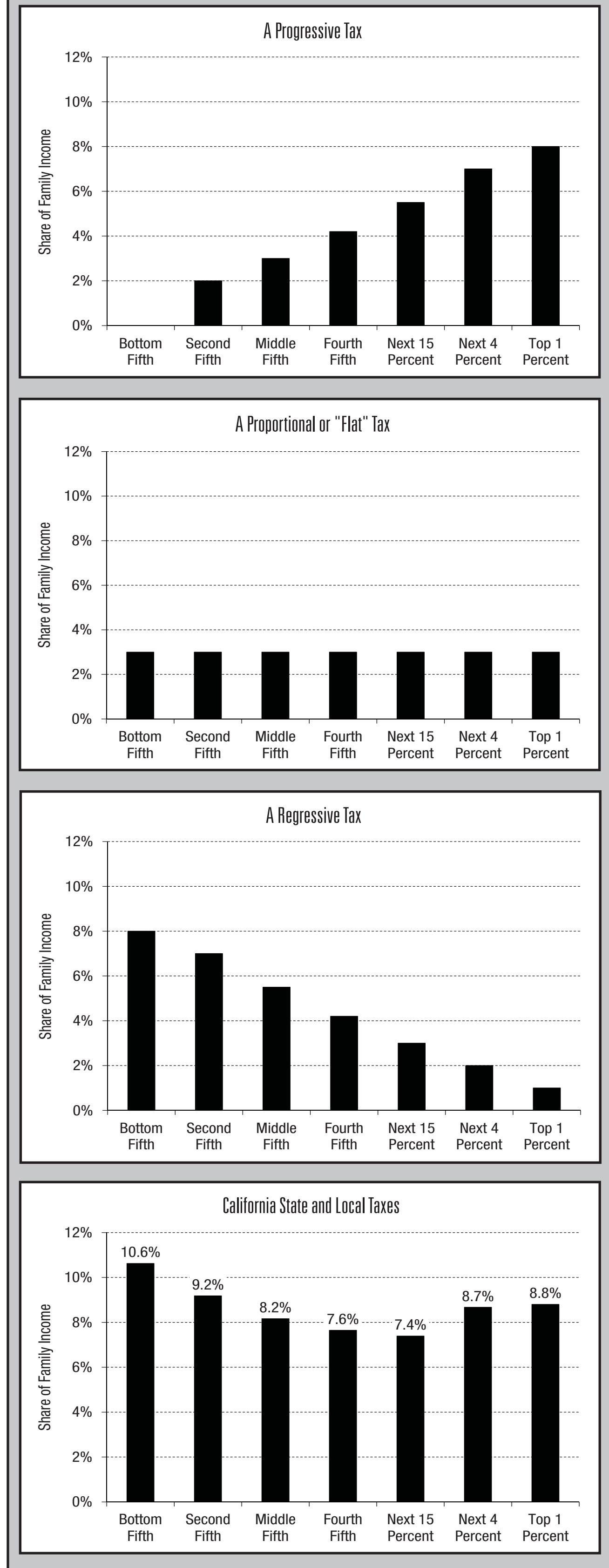
Most people agree that a fair tax system asks taxpayers to contribute to the cost of public services based on their ability to pay.[5] The share of a family's income that is paid in taxes measures the fairness of a tax system or an individual tax. Taxes are often described as:

- *Progressive* when higher-income families 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 low-income households pay a larger share of their incomes in taxes.

Some people argue 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 basic necessities, while higher-income households have more discretionary income and can afford to pay more in taxes without cutting what they can spend on shelter, food, health care, and other basic needs.

The overall fairness of a tax system depends on the balance among 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 local property taxes for federal income tax purposes.[6] Sales and excise taxes, such as alcohol and tobacco taxes,



are regressive taxes. 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 typically regressive. Contrary to popular perception, California's Vehicle License Fee is also a regressive tax.[7]

The overall regressivity of California's tax system results from the relatively large share of income that lower-income households pay in sales and excise taxes. While higher-income households pay a relatively large 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 the state's tax system also reflects the fact that lower- 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 lowest- and highest-income Californians would pay the largest share of their incomes in state and local taxes. This "U"-shaped distribution reflects the fact that lower-income households pay a larger share of their incomes in sales and excise taxes and the impact of California's progressive income tax on high-income households.

A Fair Tax System Treats Taxpayers in Similar Situations Similarly

A tax system that is horizontally equitable treats taxpayers 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, while an inequitable system provides preferential treatment to investment income relative to wages. The federal income tax is inequitable because it taxes investment income, which is disproportionately earned by high-income taxpayers, at a lower rate than wage and salary income. California treats income from investments the same as income from work, but taxes income from private pensions and not from Social Security.

The notion of horizontal equity is closely linked to that of efficiency. 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 a new business that purchased property at a higher price would face a larger property tax bill. 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 lead to inefficiency and encourage businesses to consider the tax consequences of their decisions, rather than respond to market demands. Economists also 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 California's and the federal income tax provide special benefits to families with children and allow taxpayers who itemize their deductions to deduct 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 succeeded in achieving their policy goals or whether they have resulted in unintended – and potentially undesirable – consequences.

What Is Tax Incidence Analysis?

Tax incidence analysis is a technique for measuring who pays how much of an individual tax or all taxes in the system as a whole. There are two types of tax incidence: initial incidence and final incidence. The initial incidence of a tax refers to who is legally obligated to pay a particular tax. The final incidence of a tax measures how the impact of a tax is distributed in the economy. For example, an apartment owner is legally responsible for paying the property tax due on an apartment building. However, the ultimate cost of the property tax falls on the tenants who rent from the landlord and pay the tax through their monthly rent checks. In this example, the initial incidence of the tax is on the landlord, while the final incidence falls on the tenants.

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.[8] The wealthiest 1 percent of Californians, with an average income of $1.4 million, received 21.3 percent of total income reported for tax purposes in 2010, up from 13.0 percent of income in 1987 – the earliest year for which data are available (Figure 2).[9] The share of income reported by the middle fifth of taxpayers dropped from 13.7 percent to 10.3 percent during the same period. Income from capital gains is distributed even more unequally, with taxpayers with incomes in excess of $500,000 – less than 1 percent of California households – reporting 83.5 percent of capital gains income in 2010.[10] Business income is also distributed unequally; the 0.2 percent of corporations with incomes of $10 million or more earned 65.7 percent of the corporate income reported for California tax purposes in 2010.[11]

Fairness also influences taxpayers' willingness to comply with the state's tax laws. Taxpayers are more willing to comply with tax laws when they believe that everyone is paying her or his fair share. Voluntary compliance increases revenue collections and reduces the cost of tax administration.

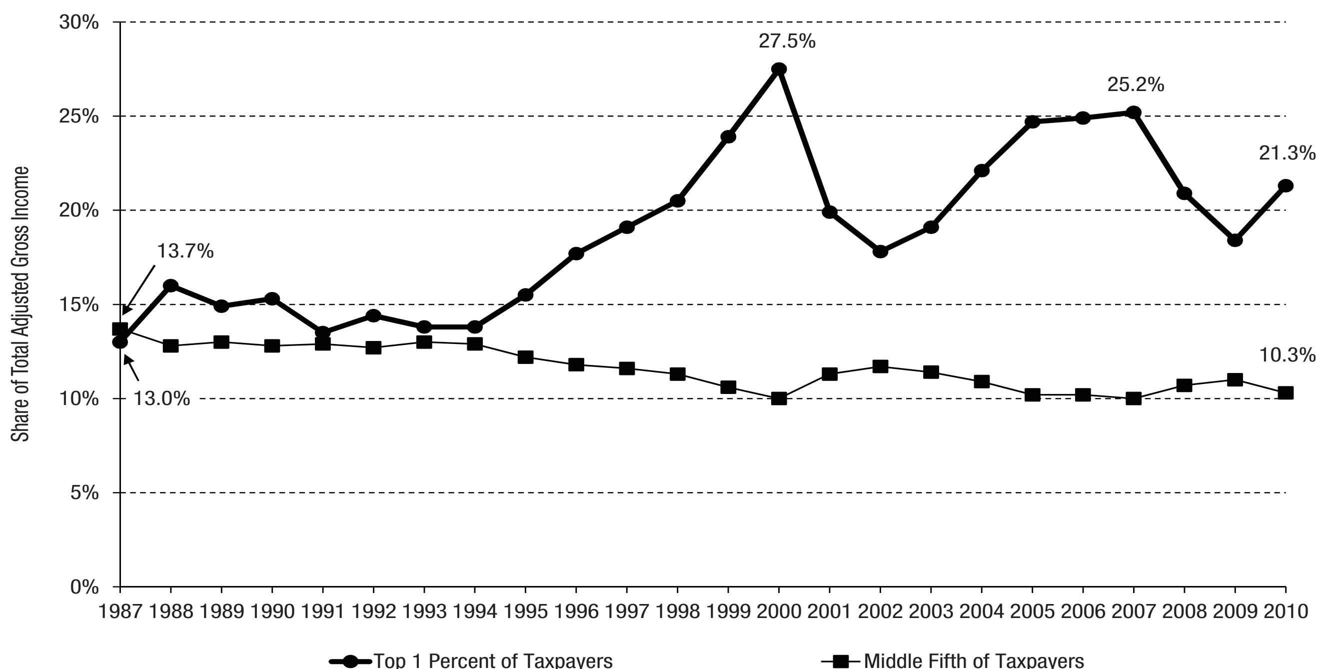
Taxes Should Be Easily Administered

Tax administration is an important, but little appreciated, component of tax policy. Ease of administration greatly affects taxpayers' opinions about the overall fairness of the tax system. A good tax system requires minimal effort on the part of both taxpayers and tax administrators. Simplicity helps reduce errors, enables taxpayers to understand how much they owe, and reduces perceptions that benefits are available to some and not to others.

Anti-tax activists use the complicated nature of the income tax to argue for flat and consumption-based taxes – both of which disproportionately impact low-income families. In fact, the complexity of the personal income tax is not attributable to its progressive rate structure, but rather is a result of the large number of credits, exemptions, and deductions.

Overly complicated taxes discourage compliance, reducing the revenues raised. Complicated taxes can also be costly to enforce. California's short-lived sales tax on "snack foods" exemplifies the problem that results from taxes that are difficult to administer. State tax administrators were left to determine what was and was not a snack – why a doughnut was a snack, but a bagel was not, even though both have holes and are often eaten for breakfast.

Figure 2: The Share of Adjusted Gross Income Going to California's Wealthiest Taxpayers Rose in 2010 and Remains Well Above the Share in the Late 1980s



Source: Franchise Tax Board

Bad publicity led to an initiative financed by snack food producers, and voters repealed the tax shortly after it was enacted.

More seriously, estimates suggest that California loses around $10 billion annually in income tax revenues alone to businesses and individuals that pay no taxes or pay less than the taxes they actually owe.[12]

A Good Tax System Promotes Accountability

"A tax should be what it seems to be."[13]

The National Conference of State Legislatures notes, "The essence of accountability is that tax burdens should be

Basic Tax Concepts

The **base** and **rate** determine the amount of revenue collected from a tax. The base of a tax is the universe of goods or types of income that are taxed. Taxes are often described as having a **narrow** or a **broad** base. A narrow-based tax applies to relatively few items, while a broad-based tax applies to most of the potential base. A tax **rate** is the unit of measurement for imposing a tax. Some taxes, such as the personal income and sales taxes, are imposed as percentages. Others, including tobacco, gas, and alcohol taxes, are imposed based on a unit of product. For example, the alcohol tax rate for beer is $0.20 per gallon.

A broad tax base is generally preferable to a narrow base, since it can generate the desired level of revenues at a lower tax rate. However, policy goals may make some narrowing of the tax base desirable. For example, California's exclusion of food and shelter from the sales tax base protects lower-income households that spend a larger share of their incomes on necessities. Similarly, California's personal income tax does not treat cash assistance benefits or unemployment insurance as income for tax purposes.

One measure of the breadth of the tax base is the revenue loss attributable to tax expenditures, such as credits and deductions, divided by the revenues collected by a tax.[14] Using this measure, the state's corporate income tax has the narrowest base, while the personal income tax and sales tax bases are relatively wider.

Tax Expenditures as a Percentage of Revenues Collected, 2012-13

State Taxes	Revenue (Millions)	Revenue Reduction Attributable to Tax Expenditures (Millions)	Tax Expenditure Revenue Loss as a Percentage of Total Revenue
Corporate Income Tax	$7,580	$6,000	79.2%
Personal Income Tax	$60,647	$33,000	54.4%
Sales and Use Tax	$20,714	$10,000	48.3%
Total	**$88,941**	**$49,000**	**55.1%**

Source: Department of Finance

The term "tax rate" can have several meanings. In general, the term tax rate refers to the rate that is statutorily imposed on a given tax base. This is often referred to as the **nominal** or **statutory** tax rate. For example, the sales tax rate that is imposed statewide is 7.5 percent.[15] A **marginal** rate is the rate at which the last increment of income is taxed. The top marginal personal income tax rate for high-income Californians was recently raised from 9.3 percent to 12.3 percent on a temporary basis.[16] For married taxpayers, the 12.3 percent marginal rate applied to taxable income above $1 million in 2012.[17] Finally, there is the **effective** tax rate, which is the percentage of the tax base that is actually paid in tax after taking into account applicable credits, exemptions, deductions, and other preferences. While the state's statutory corporate income tax rate is 8.84 percent, the effective rate was 5.2 percent in 2010.[18]

explicit and not hidden."[19] Issues of accountability arise when responsibility for raising a tax is separate from the responsibility for spending it. This occurs, for example, when the state imposes a tax that is spent by local governments. By providing special treatment, tax expenditures reduce the accountability of a tax system by making it more difficult to determine who actually pays a tax. Economists also argue that taxes that are passed through to, but not directly imposed on, consumers weaken a tax system's accountability.

How Does California Raise the Money It Needs to Fund State Services?

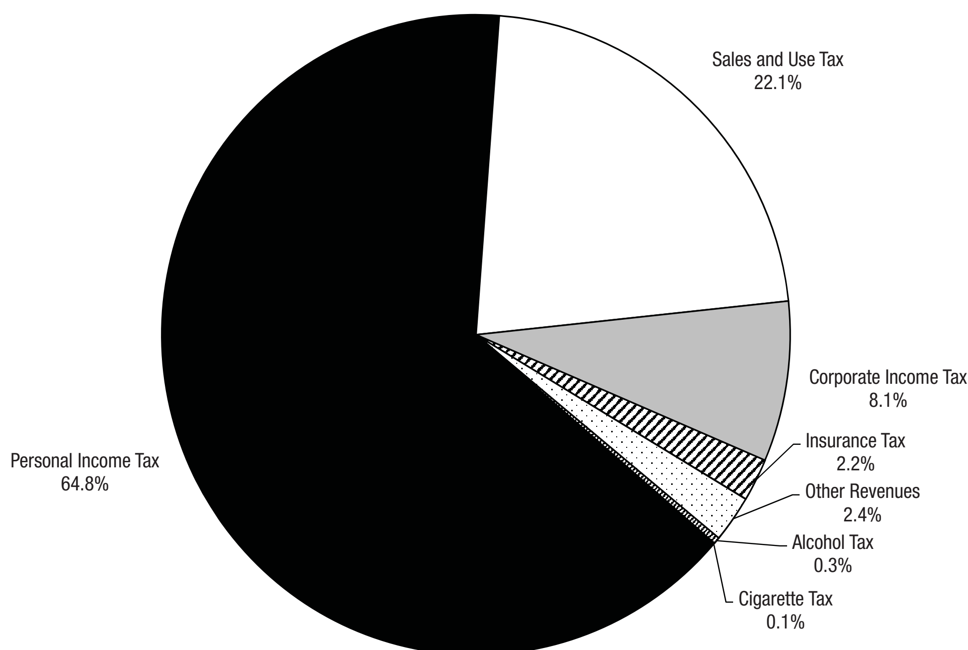
California, like other states, relies on a mix of taxes and fees to finance public services. A diverse revenue base helps assure stability and spreads the cost of paying for public services. Most discussions of state taxing and spending focus on the state's General Fund. General Fund revenues can be used for any purpose, while special funds, bonds, and federal dollars must be used for specific purposes. Three taxes provide the majority of California's General Fund revenues:

- The personal income tax provides nearly two-thirds of state General Fund revenues (Figure 3);
- The sales and use tax provides less than one-quarter of state General Fund revenues; and
- The corporate income tax provides less than one out of 10 General Fund dollars.

Over time, the share of the General Fund coming from the personal income tax has increased, while the shares provided by both the sales and corporate income taxes have declined. California relies more heavily on personal and corporate income taxes than most other states, and relies relatively less upon "sin" taxes.[20]

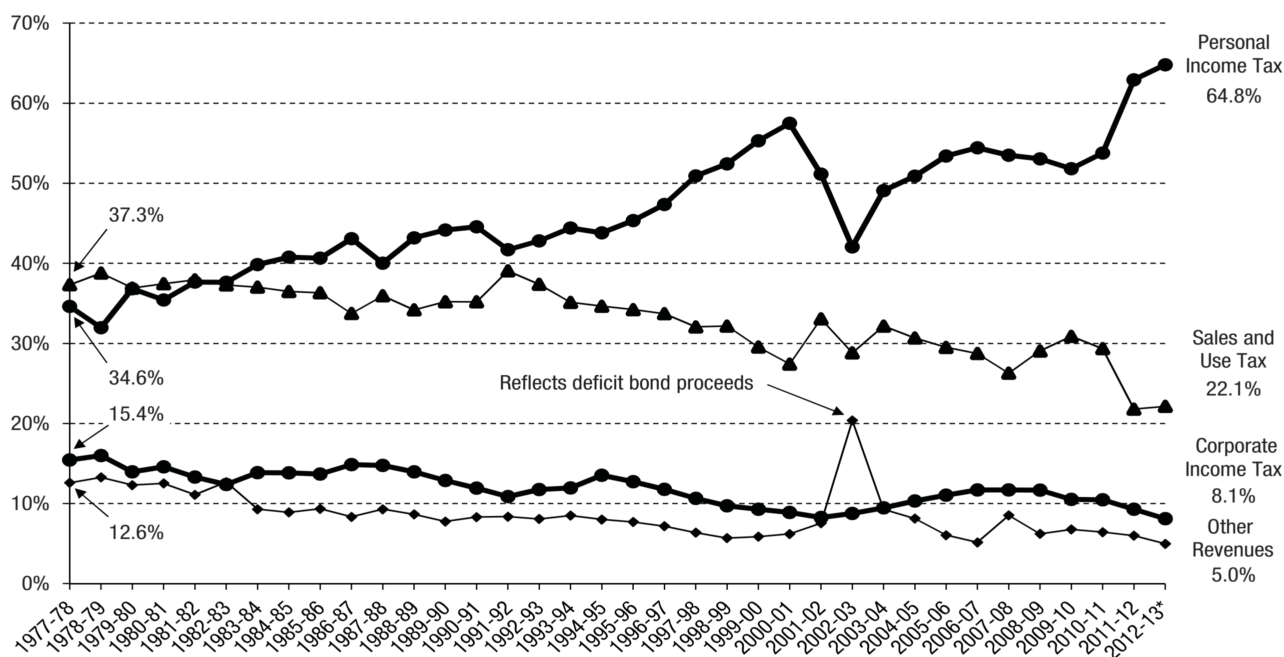
The most notable shift is the increase in the share of state revenues attributable to the personal income tax. In 1977-78, just over one-third (34.6 percent) of General Fund revenues came from the personal income tax (Figure 4). In 2012-13, the personal income tax provided nearly two-thirds (64.8 percent) of General Fund revenues.[21] All of the other major state taxes declined as a share of General Fund revenues during the same period. The share of General Fund revenues provided by the corporate income tax dropped by nearly half between 1977-78 and 2001-02, falling from 15.4 percent to 8.3 percent. In the mid-2000s, the share of state revenues from the corporate income tax rose to nearly 12.0 percent before beginning to decline in the late 2000s due to a series of legislated tax cuts, reaching 8.1 percent in 2012-13. The share of state revenues coming from alcohol taxes and fees fell by more than half between 1977-78 and 2012-13, from 1.0 percent

Figure 3: The Personal Income Tax Provides the Largest Share of General Fund Revenues



Estimated 2012-13 General Fund Revenues = $93.6 Billion

Source: Department of Finance



Recent Ballot Measures Boosted General Fund Revenues

In November 2012, voters approved two ballot measures that raise General Fund revenues and help balance the budget. The first, Proposition 30, added three new personal income tax rates for very-high-income Californians that will be in effect for seven years, from 2012 through 2018.[22] The measure also increased the state sales tax rate by one-quarter cent for four years, from January 1, 2013 through December 31, 2016. Taken together, the measure's tax increases are progressive, equal to 1.1 percent of the average income of Californians in the top 1 percent of the income distribution, compared to between 0.1 percent and 0.2 percent of the average income of Californians in each of the bottom four fifths of the distribution.[23] Proposition 30 is projected to provide approximately $6 billion annually through 2016-17, with smaller amounts in 2017-18 and 2018-19 as the taxes are phased out.[24] The measure's revenues are earmarked for K-12 schools and community colleges, but also count toward the Proposition 98 minimum school funding guarantee and thus free up General Fund revenues to help close the state's budget gap.

Proposition 39, the second revenue-raising measure approved by voters in November 2012, requires nearly all multistate and multinational corporations doing business in California to calculate the share of their income subject to the state's corporate income tax based on the percentage of their total sales that occur in the state, a policy known as "mandatory single sales factor apportionment," beginning in 2013.[25] This measure repealed a provision of state law that allowed corporations to choose between two methods of calculating the amount of income subject to tax in California in 2011 and 2012.[26] Proposition 39 will raise an estimated $1 billion annually in additional revenues.[27]

to 0.3 percent. The share of total state revenue derived from tobacco taxes has declined precipitously, falling from 1.4 percent in 1977-78 to 0.1 percent in 2012-13 due to declining consumption of tobacco products.[28]

The changes in the distribution of state revenues reflect both shifts in the economy and the impact of public policies. The increase in the personal income tax as a share of revenues reflects tremendous growth in the incomes of

What's a Tax? What's a Fee?

The California Constitution differentiates between taxes and fees. A tax is a charge against an individual or entity, such as a corporation or partnership, that governments use to pay for public services and facilities that provide benefits. There need not be a direct relationship between an individual taxpayer's relative benefit from services or facilities and the tax he or she pays. Taxes are not voluntary, and a taxpayer cannot refuse to pay a tax by avoiding the use of public services. For example, families that send their children to private schools cannot reduce their income taxes because they are not using the public school system. A fee, on the other hand, is an amount that is paid for a particular benefit or service received by the feepayer. For example, entrance fees are levied when people visit California's state parks.

In California, the distinction between a tax and a fee takes on a particular significance. The state's Constitution requires a two-thirds vote of the Legislature to pass any measure that increases state tax revenues or the amount paid by any taxpayer.[29] Fees, on the other hand, can be increased or enacted by a majority vote; however, the amount of a fee cannot be higher than the benefit received from or the cost of providing a service. A series of court decisions outlines the distinction between taxes and fees.[30] Proposition 26, approved by the voters in 2010, amended the state's Constitution to reclassify certain fees as taxes, thereby requiring a two-thirds vote of the Legislature, rather than a majority vote, to impose or increase the fee.[31]

the wealthiest Californians, who are subject to the highest tax rates. The decline in corporate income taxes as a share of revenues reflects a reduction in the corporate tax rate and growth in the number of corporate tax breaks.

How Does California Compare?

There are a number of ways to compare relative tax levels, and each has strengths and weaknesses. Most analysts use tax revenues collected as a share of personal income as a basis for comparing relative levels of taxation, since this approach makes it possible to compare the distribution of the impact of a tax or tax system across jurisdictions and over time by implicitly taking into account population growth and ability to pay.

California is a moderate tax state. In 2009-10, the most recent year for which data are available, California ranked 15th among the 50 states with respect to total "own source" revenues raised by state and local governments – the broadest measure of state and local revenues (Table 1). California ranked 11th with respect to state taxes as a percentage of personal income in 2010-11, up from 21st in 2008-09. This change reflects higher revenues from temporary increases in the personal income tax, which expired on December 31, 2010, and in the sales tax and Vehicle License Fee, which expired on June 30, 2011. California ranks relatively high with respect to personal and corporate income tax collections, and relatively low with respect to tobacco and alcohol taxes.

Table 1: How Does California Compare?

	California Rank	Revenues as a Percentage of Personal Income: California	US
Total State and Local Own Source (2009-10)	15	16.51%	15.65%
Total State and Local Taxes (2009-10)	10	11.30%	10.57%
State Taxes (2010-11)	11	7.24%	6.00%
Local Taxes (2009-10)	23	4.44%	4.71%
State Individual Income Tax (2010-11)	6	3.13%	2.05%
State Corporate Income Tax (2010-11)	4	0.60%	0.32%
State and Local General Sales Taxes (2009-10)	19	2.61%	2.37%
State General Sales Tax (2010-11)	23	1.92%	1.86%
State and Local Property Tax (2009-10)	24	3.53%	3.68%
State Motor Fuels Taxes (2010-11)	22	0.35%	0.32%
State Tobacco Tax (2010-11)	46	0.06%	0.14%
State Alcoholic Beverage Sales Taxes (2010-11)	42	0.02%	0.05%

Note: US excludes the District of Columbia.
Source: US Bureau of Economic Analysis and US Census Bureau

THE PERSONAL INCOME TAX

The personal income tax provides the largest share of the state's revenues. California's personal income tax was created by the Personal Income Tax Act of 1935 and raised $11.8 million during its first year of operation.[32] The state's first income tax had a maximum rate of 15 percent that applied to incomes of $250,000 or more, equivalent to $4.2 million in 2012 dollars. In 2012-13, the personal income tax provided an estimated $62.0 billion (46.3 percent) of the state's $133.9 billion in total revenue and $60.6 billion (64.8 percent) of the state's General Fund. Until 2005, all of the monies raised from the personal income tax were deposited into the state's General Fund. In 2004, voters approved Proposition 63, which imposed a 1 percent tax rate on the portion of taxable income that exceeds $1 million and allocated the revenues from the new tax rate to a special fund to support mental health services.[33]

How Does California's Income Tax Work?

California's personal income tax law is generally patterned after or "conformed to" that of the federal government. California's income tax has nine different rates – 1 percent to 12.3 percent – that apply to taxpayers at progressively higher income levels, and the additional 1 percent rate on all income earned over $1 million. The highest three rates – 10.3 percent, 11.3 percent, and 12.3 percent – are in effect on a temporary basis, from 2012 through 2018. To determine the amount of taxes owed, taxpayers use their federal adjusted gross income as a starting point and make adjustments where there are differences between state and federal definitions of income or allowable deductions. The personal income tax applies to income earned in California, even if a taxpayer lives outside the state.

California taxpayers calculate how much they owe starting with their adjusted gross income for federal tax purposes, adding and subtracting adjustments to reflect differences in state and federal law, subtracting their itemized deductions or the state's standard deduction, subtracting any tax credits claimed including personal and dependent credits, and adding any other taxes owed (Table 2).

What Income Is Subject to Tax?

California's personal income tax applies to wage income, taxable pension income, investment income (such as capital gains, interest, and dividends), income from non-corporate businesses (such as sole proprietorships), and income that is passed through to shareholders from Subchapter S corporations, partnerships, and similar entities.[34] California taxes:

- Wage and salary income, but not the value of benefits, such as health coverage, that workers receive from their employers. Workers pay taxes on their employer's contribution to pension plans when they retire, and employees' contributions to deferred compensation plans, such as 401(k) plans, are not taxed until the money is paid out at retirement.

- Income from investments such as capital gains, dividends, and interest just like wage and salary income, unlike the federal government.

- Business income, profits from unincorporated businesses, partnerships, limited liability companies, and income from S corporations. Individuals can also subtract losses from business activities from their income.

Table 2: How Does California's Income Tax Work?	
California taxpayers start with:	Adjusted gross income for federal tax purposes
Subtract:	Federal income exempt from state tax (including state income tax refunds, unemployment compensation, taxable Social Security benefits, and differences in capital gains or losses)
Add:	State income exempt from federal tax (including interest on state or municipal bonds for other states, fringe benefits, and differences in capital gains or losses) and federal adjustments not allowed
Which equals:	California adjusted gross income
Subtract:	Deductions (California standard deduction or federal itemized deductions adjusted for differences in federal and state law)
Which equals:	California taxable income
Calculate tax with tax rate schedule	
Subtract:	Tax credits (including personal and dependent credits)
Add:	Other taxes (including alternative minimum tax, tax on early use of IRA, and mental health services tax)
Subtract:	Prepayments and payments (including withholding and estimated tax)
Add:	Voluntary contributions
Which equals:	Overpayment/Balance due

California taxes income that is earned in or "sourced to" California regardless of whether the earner resides in California. For example, California taxes the earnings of baseball players for the New York Yankees based on the number of games they play in California.

The Wealthy Pay the Largest Share of State Income Taxes

The personal income tax is the most progressive of the state's revenue sources, with high-income earners paying most of the tax. High-income households pay most of the state's personal income tax due to the structure of the state's personal income tax rates combined with the state's widening gap between the rich and poor. The top 1 percent of personal income taxpayers reported 21.3 percent of 2010 income, up from 13.0 percent in 1987, while the share earned by the top 10 percent of taxpayers increased from 37.0 percent to 47.9 percent during the same period.[35] In contrast, the bottom 90 percent of taxpayers reported just over half – 52.1 percent – of 2010 income, down from 63.0 percent in 1987.

The increased concentration of income among the wealthy reflects the fact that the incomes of the wealthy have risen much faster than those of low- and moderate-income Californians. Between 1987 and 2010, the average adjusted gross income of taxpayers in the wealthiest 1 percent increased by 82.0 percent, after adjusting for inflation. In contrast, the average adjusted gross income of middle-income Californians – those with incomes in the middle fifth of the income distribution – fell by 16.8 percent during the same period, and that of taxpayers in the bottom fifth of the income distribution fell by a similar 18.8 percent.[36]

As a result of these trends, the percentage of personal income taxes paid by the wealthy has increased. In 1987, the top 10 percent paid 61.4 percent of the personal income tax. By 2010, the share of taxes paid by the wealthiest 10 percent had increased to 74.2 percent.[37] The share of the personal income tax paid by the wealthiest 1 percent increased from 28.6 percent to 40.9 percent during the same period.

California Has High Income Tax Thresholds

California has the highest income tax thresholds – the income level at which an individual or family begins to owe taxes – of any state.[38] In 2012, California's threshold was $53,336 for a married-couple family with two children (Table 3). The primary reason for California's high income tax thresholds is the state's relatively generous dependent credit. In 2012, Californians could claim $321 for each qualifying dependent.[39]

Table 3: California's Personal Income Tax Thresholds Are High

	2012 Tax Threshold	2012 Federal Poverty Line	2012 Tax Threshold as a Percentage of the 2012 Federal Poverty Line
Single, no children	$15,769	$11,945	132.0%
Married, no children	$31,537	$15,374	205.1%
Head of household, one child	$42,392	$15,825	267.9%
Head of household, two children	$50,738	$18,498	274.3%
Married, one child	$45,311	$18,480	245.2%
Married, two children	$53,336	$23,283	229.1%

Note: Assumes tax filers claim the standard deduction and the renter's credit. The federal poverty line assumes nonelderly householders.
Source: Franchise Tax Board and US Census Bureau

California's high tax thresholds have important policy implications.[40] Tax credits, deductions, and other income tax preferences provide no benefit to families with incomes below the tax threshold.[41] Thus, efforts to provide assistance through the tax code are likely to be of little or no benefit to low-income families. For example, a credit or deduction aimed at helping the uninsured purchase health coverage would be of no benefit to a family of four with earnings of less than $53,336, despite the fact that low-income families are most likely to lack coverage.

California's high income tax thresholds mean that low- and moderate-income families, particularly those with children, pay very little of the state's income taxes. In 2010, for example, households earning less than $100,000 per year received 42.9 percent of total adjusted gross income, but paid 17.8 percent of total personal income taxes.[42] In contrast, households earning $100,000 or more received 57.1 percent of total income, but paid 82.2 percent of total personal income taxes.[43]

What Makes California's Income Tax Progressive?

Several factors make California's personal income tax among the most progressive in the nation. First, California has a graduated rate structure. Families with low incomes are taxed at a lower rate than are those with high incomes. Second, unlike the federal income tax, California uses personal and dependent credits rather than deductions. Credits reduce the amount of taxes owed on a dollar-for-dollar basis and are worth the same to families in all tax brackets. Deductions, in contrast,

Major Differences Between California's and the Federal Personal Income Tax

California's personal income tax differs from the federal personal income tax in a number of ways. Key differences include the fact that California:

- Taxes income from wages and investment at the same rate. In contrast, federal law taxes wage income at a higher rate than certain types of investment income.
- Does not tax income from Social Security. The federal income tax applies to a portion of the Social Security benefits received by higher-income seniors.
- Does not have a "marriage penalty." The income of married couples is taxed on the same basis as that of two single persons with the same total income.[44] Federal law taxes the incomes of some married couples – generally two moderate-income earners – at a higher rate than two single individuals with the same total income, but taxes other married couples – generally those with only one earner – at a lower rate than two single individuals with the same income.
- Allows registered domestic partners to file their income tax returns either as single individuals or as a married couple.

provide a greater benefit to higher-income taxpayers, who are taxed at a higher rate. Third, California has large dependent credits, which are available for taxpayers' children or other qualified relatives supported by the taxpayer. These credits, which were increased significantly in 1997, eliminate the entire tax liability of many families with dependents.

Issues for Consideration

California's tax brackets are narrow. While California's personal income tax has a progressive rate structure, the state's tax brackets – the bands of income taxed at a given rate – have historically been relatively narrow. The state's highest permanent personal income tax rate, excluding the 1 percent rate on incomes over $1 million, is 9.3 percent. In 2012, the 9.3 percent rate applied to married taxpayers with incomes of $97,884 or higher and single individuals with incomes of $48,942 and above.[45] When tax brackets are narrow, a small increase in an individual's income can result in a significant increase in the amount of tax that they owe. Policymakers could address this problem by widening the brackets that apply to lower-income individuals, which would result in a loss of tax revenues, and permanently adding new, higher rates at the top end of the income distribution to make up for the loss of revenues.

California's personal income tax revenues tend to vary with the health of the economy. Observers often note that personal income tax collections fluctuate over time. That is, they tend to rise and fall significantly as the economy expands and contracts. The fluctuation of the state's income tax collections stems from the progressivity of the income tax. High-income individuals, who pay the majority of the tax, receive a larger share of their income from investments than from wages and salaries, and investment income tends to fluctuate more significantly in response to changes in the stock market and other factors. Taxpayers with incomes in excess of $500,000, for example, claimed 83.5 percent of 2010 capital gains, while accounting for less than 1 percent of tax returns filed.[46] Although the incomes of the wealthy dropped during recent downturns in the economy, they rebounded quickly. For example, the wealthiest 1 percent of the nation's households received 93 percent of the income gains in 2010 – the first full year of recovery from the Great Recession.[47] While some suggest that California should reduce its reliance on the personal income tax or the share of tax paid by the wealthy, doing so would have significantly reduced the growth of state revenues in recent years. Alternatively, lawmakers could put away a larger share of revenues as a reserve during good times to cushion against a drop in revenues during bad times.

THE SALES AND USE TAX

California's second-largest revenue source is the sales and use tax. California's sales tax primarily applies to tangible goods and excludes many essentials – such as food and utilities – as well as a number of items exempted by specific laws. In general, the sales tax is a regressive tax. That is, low-income households pay a larger share of their incomes in sales tax than do higher-income households. The regressivity of the sales tax reflects the tendency of higher-income households to save a portion of their incomes or to spend larger shares of their incomes on services and investments, which are not subject to the sales tax.

California's sales and use tax is actually two separate taxes, a tax on the sale of tangible goods that takes place within California and a tax on goods purchased outside of the state for use in California. By law, individuals who purchase goods from an out-of-state retailer by mail or via the Internet owe use tax to the state in an amount equal to what they would have paid in sales tax had the purchase been made in California. In reality, very few individuals pay this tax.[48] The state audits major businesses to collect use taxes owed on out-of-state purchases. Over time, the share of consumers' incomes spent on taxable goods has declined due to a shift in consumption patterns from goods to services and, more recently, due to the rise in mail-order and Internet sales.

What Does the Sales Tax Apply To?

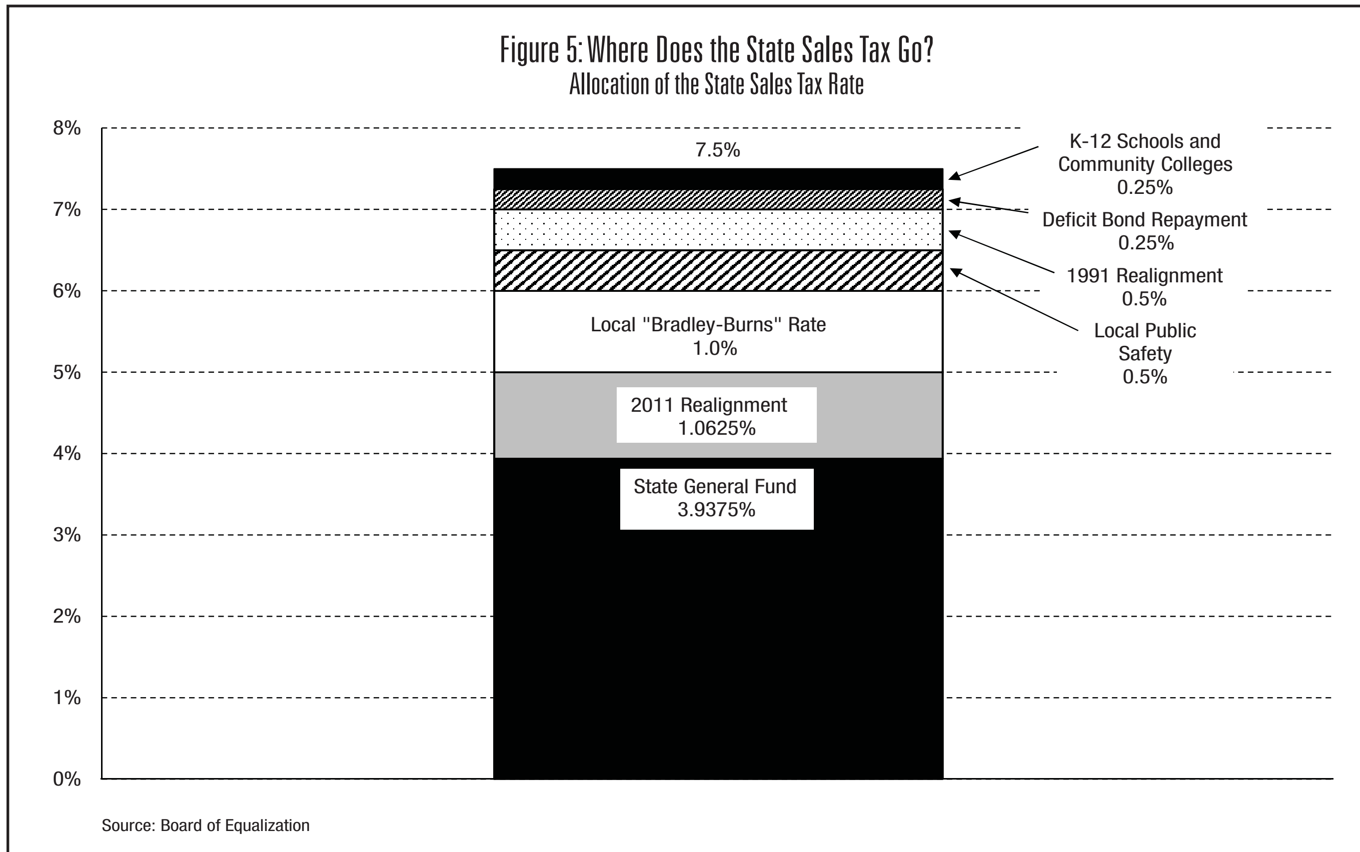
California's sales tax is primarily a tax on tangible goods. California does not tax most services, such as auto repair, health care, or legal services, nor does it tax a number of necessities, including food purchased for home consumption, water, or prescription medicines.

Not taxing most services has reduced the yield of California's sales tax – the revenues raised by each quarter cent of the sales tax rate – over time as the economy has shifted from one based primarily on goods, to a more service-oriented economy. Most states tax a wider array of services than does California. In fact, only nine states tax fewer services than California does.[49] Economists note that the distinction between goods and services leads to disparate tax treatment of purchases that fulfill similar goals. For example, bug spray or "roach motels" purchased for home pest control are taxed, while the services provided by an exterminator are not. Similarly, a consumer who purchases a bicycle to exercise on pays sales tax, while membership in a gym where one can exercise on a bicycle is not taxed.

What Does the Sales Tax Support?

California's sales tax is the product of a number of individual rates levied by the state and local governments. The statutory statewide rate is 7.5 percent, with a number of counties and some cities imposing additional rates for local programs and services (Figure 5). The individual rates include:

- 3.9375 percent for the state's General Fund;
- 1.0625 percent for the Local Revenue Fund 2011, which provides dedicated funding to support public safety, health, and human services programs that were transferred – or "realigned" – to counties in 2011;



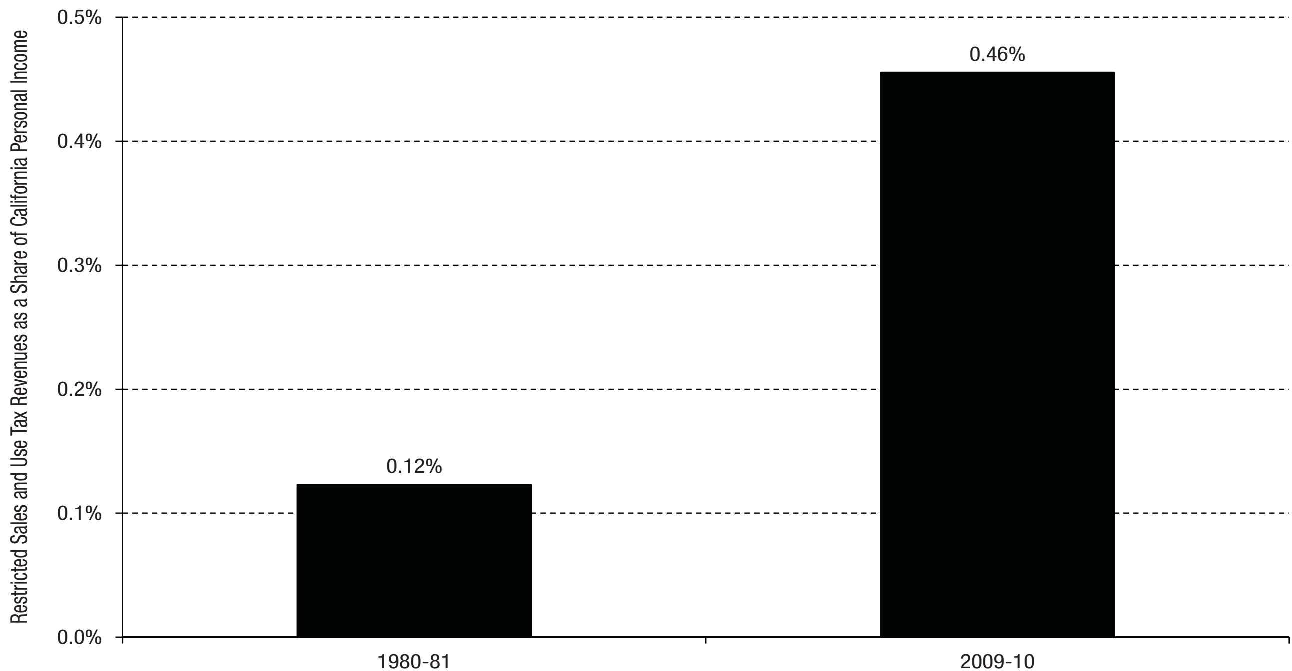
- 1.0 percent allocated to cities and counties, of which 0.75 percent is unrestricted and 0.25 percent is for county transportation programs;
- 0.5 percent for local public safety programs;
- 0.5 percent for the Local Revenue Fund, which provides dedicated funding to support health and human services programs realigned to the counties in 1991;[50]
- 0.25 percent to pay debt service on deficit-financing bonds that were authorized by voters by Proposition 57 of 2004;
- A temporary 0.25 percent rate for the Education Protection Account within the state's General Fund to help support K-12 schools and community colleges; and
- Up to 2.0 percent in optional local rates that local governments may adopt for transportation and other purposes.[51]

Between 1980-81 and 2009-10 – the most recent year for which data are available – the share of sales tax revenues restricted for specific uses, such as transportation, county health and human services, and public safety, increased almost fourfold (270 percent) as a share of personal income (Figure 6).[52] The substantial increase resulted from the 1991 realignment, Proposition 172 of 1993, and the 2011 realignment.

THE CORPORATE INCOME TAX

California's third-largest revenue source is the corporate income tax, which applies to all corporations that earn income derived from or attributable to sources in California.[53] Three separate taxes comprise the corporate income tax: the corporation franchise tax, the corporation income tax, and the bank tax. The franchise tax is not a tax on income but rather is a tax for the privilege of "doing business" in California – actively engaging in any transaction for the purpose of financial gain or profit. Every corporation doing business in California is subject to the franchise tax. Corporations that derive income from California but are not sufficiently present to be considered doing business in the state are subject to the corporation income tax – a tax nearly identical to the franchise tax.[54] Banks and financial institutions doing business in California are subject to an additional tax known as the bank tax. Banks pay this tax in lieu of property tax on equipment and other personal property and local business taxes.

The corporate income tax provides a declining share of state General Fund revenues. Between 1977-78 and 2012-13, the share of General Fund revenues provided by the corporate income tax dropped by 7.3 percentage points. That said,



California has relatively high corporate income tax rates, receives a larger share of revenues from corporate income taxes than do states as a whole, and in 2010-11 – the most recent year for which data are available – ranked fourth in the United States in corporate income tax collections as a share of personal income.

There are a number of reasons for the decline in corporate tax revenues relative to the budget as a whole, including:

- An increase in the use of and expansion of corporate tax credits;
- An increase in the share of economic activity accounted for by "pass-through" entities, which pass income through to shareholders and pay little or no tax at the entity level;[55]
- An increase in the weight given to sales in the formula used to allocate the income of multistate or multinational corporations to California; and
- Corporate-tax planning strategies that reduce both state and federal income tax liabilities through the use of tax sheltering, such as moving income to offshore "tax havens."

In the early 1990s, the Legislature enacted a number of corporate tax reductions in response to pressure from business lobbyists, who claimed that the state's high corporate tax burden was an impediment to economic growth. The most substantial package, enacted in 1993, created a manufacturers' investment tax credit, reduced the Subchapter S corporation tax rate, made the state's research and development (R&D) tax credit permanent, provided a sales tax exemption for materials used in space flight, repealed a fee charged to corporations that elected to file tax returns on a "water's edge" basis, and created a tax break for capital gains attributable to small California businesses. The cost of these breaks was partially offset by a reduction in business meal and entertainment deductions. The corporate income tax rate was reduced from 9.3 percent to 8.84 percent in 1996.

The September 2008 and February 2009 budget agreements included three permanent business tax cuts that, once fully implemented, were estimated to cost the state more than $1.5 billion per year. These tax cuts included:

- **Tax credit sharing.** Legislation approved in September 2008 allows corporations to transfer tax credits among members of a combined reporting group – a commonly controlled corporate "family."[56] Transferred credits could be used to reduce taxes beginning January 1, 2010. Previously, only the corporation earning the tax credit could claim that tax credit.

- **Net operating loss carrybacks.** A September 2008 law change allows businesses to "carry back" and deduct losses incurred against taxes in a prior year. Net operating loss (NOL) carrybacks allow businesses to claim refunds of taxes already paid in the prior two years by claiming a tax deduction if they incur a NOL. California previously only allowed businesses to "carry forward" and deduct operating losses against future income.[57]

- **Elective single sales factor apportionment.** Legislation approved in February 2009 allowed multistate and multinational corporations to base their corporate income tax solely on their sales within California and to choose whether to use this method or the prior method based on sales, payroll, and property beginning in 2011.

These tax breaks primarily benefit a very small number of very large corporations.[58]

Pass-Through Entities Receive Preferential Tax Treatment

One reason for the erosion of the corporate tax base is the proliferation of ownership forms that have some or all of the legal advantages of corporate status, but that are not subject to the corporate income tax. These entities, called pass-through entities, are businesses that pass their income or losses, and thus their taxes owed, through to shareholders. Types of pass-through entities include:

- **Partnerships.** Partnerships are the simplest form of pass-through entity. A partnership is a business owned jointly by two or more people. In contrast to a corporation, each partner is completely liable for the debts and negligent acts of other partners, and the partnerships may not sell stock. Instead of paying the corporate income tax, partnerships pass through income or losses to their partners, who then pay taxes on this income through the personal income tax.

- **Subchapter S Corporations.** Subchapter S corporations are corporations with no more than 75 shareholders. In contrast to other corporations, Subchapter S corporations face a tax rate of 1.5 percent or $800, whichever is larger. Any income or losses are passed through to shareholders and taxed through the personal income tax. Subchapter S corporations combine the limited liability of a corporation with the lower tax rate of a partnership.[59]

- **Limited Liability Corporations (LLC).** Limited liability corporations share two characteristics with a corporation: the owners have limited liability, and LLC members may participate in management without risking personal liability. There is no limit on the number of owners that can participate in an LLC. LLCs pay a minimum tax of $800

Taxing Corporate Income: What Belongs to California?

A basic principle of state taxation holds that states should only tax income that is attributable to activities that take place within that state. For corporations that do business in a number of states or countries, states need a method of determining how much income is appropriately subject to tax in their state. The allocation of income among states and countries raises a number of complex and contentious issues, and a detailed discussion of the taxation of multinational corporations is beyond the scope of this publication.

California taxes the income generated by business activity that is attributable to California. For corporations that only do business within the state, determining the income that is subject to state tax is straightforward. For multistate corporations, the Franchise Tax Board notes that:

"The phrase 'income attributable to California' refers to situations in which a corporation does business both within and outside of California and its operations outside of California are 'unitary' with the business activity within California. This connection can take several forms that convey a high degree of interdependence between operations, such as centralized decision making, purchasing, selling, accounting, and financing."

The traditional method of allocating income used a formula based on three equally weighted factors: property, payroll, and sales. Each factor represents the share of a corporation's total activities that take place in a given state. States traditionally used this method – called "formula apportionment" – to equally weigh the three factors in order to apportion income among states for tax purposes.[60] Currently, California taxes most multistate and multinational corporations based on the share of their total sales that occur in California.[61]

Income apportionment is one of the more complex areas of corporate taxation. In practice, corporations shift income and corporate activity based on tax considerations. Historically, California's Franchise Tax Board (FTB) was recognized for its record for ensuring effective compliance. However, aggressive efforts on the part of the business community and their allies have attempted to weaken the state's enforcement powers.

Prior to 1987, California required multinational corporations to calculate their California income based on their total worldwide income and total worldwide property, payroll, and sales. This approach was known as worldwide combination. Beginning in 1987, California allowed corporations to choose whether to use their worldwide operations or only operations within the US and specified tax havens – the so-called "water's edge." Between 1987 and 1993, corporations choosing the "water's edge" approach were required to pay a fee. This fee was repealed in 1993 while the US Supreme Court considered a challenge to California's method of taxing multinational corporations in *Barclay's Bank PLC versus California Franchise Tax Board*. The challenge was in response to threats that California's tax system might set off a trade war with Britain and possibly other countries. Currently, multinational corporations choose which of the two methods – worldwide combination or water's edge – results in the lower tax liability and use that method to compute their tax.

The debate over how to treat income earned outside the US continues. Multinational corporations are currently advocating for a "territorial" approach to federal corporate income taxation that would exempt income earned outside the US from taxation.

The complexity of issues affecting the taxing of multinational corporations gives rise to concerns over potential abuses and inequities. One common concern is the ability of corporations to manipulate transactions between related businesses to shift a greater share of activity to low-tax havens. Another concern is the proliferation in the number of states that use formulas other than the traditional three-factor method to allocate income to different states, which allows corporations to minimize their liability by exploiting the differences between the tax systems in various states.

and an annual fee based on income and pass through any income or losses to the owners. The state then taxes the income passed through to owners through the income tax.

- **Limited Liability Partnerships (LLP).** LLPs are partnerships that provide liability protection to the owners. Currently only licensed accountants, architects, and attorneys are eligible to register as an LLP. LLPs pay a minimum franchise tax of $800 and forward all other income to the partners. The state then taxes this income under the personal income tax.
- **Regulated Investment Companies (RIC).** Regulated investment companies are corporations where the majority of income comes from dividends and interest. The typical RIC is a mutual fund. The state applies the corporate income tax to all RIC income, excluding dividends distributed out to shareholders. Shareholders pay taxes on the value of the dividends. This type of taxation is different from a corporation where both individuals and the corporation pay taxes on the value of dividends.

OTHER STATE TAXES

The rest of the state's tax revenue comes from insurance gross premiums, alcohol, cigarettes and tobacco products, motor vehicles, and vehicle fuel taxes.

Insurance Gross Premiums Tax

Insurance companies pay the insurance gross premiums tax on the premiums paid by consumers for most types of insurance.[62] California taxes most premiums at a rate of 2.35 percent. Insurers pay the gross premiums tax, but are exempt from all other state and local taxes and licenses, except for the local property tax and motor vehicle fees. The state's Constitution prescribes most of the major features of the gross premiums tax, including the tax rate.

Three separate state agencies share responsibility for administering the gross premiums tax. The Department of Insurance processes tax returns and audits taxpayers, the Board of Equalization issues assessments and hears appeals, and the State Controller handles refunds of overpayments and delinquent tax payments.[63]

Insurance tax revenues have grown more slowly than General Fund revenues as a whole, rising by 421.7 percent between 1977-78 and 2012-13, as compared to a 594.4 percent increase for all General Fund revenues.[64]

Alcohol Taxes

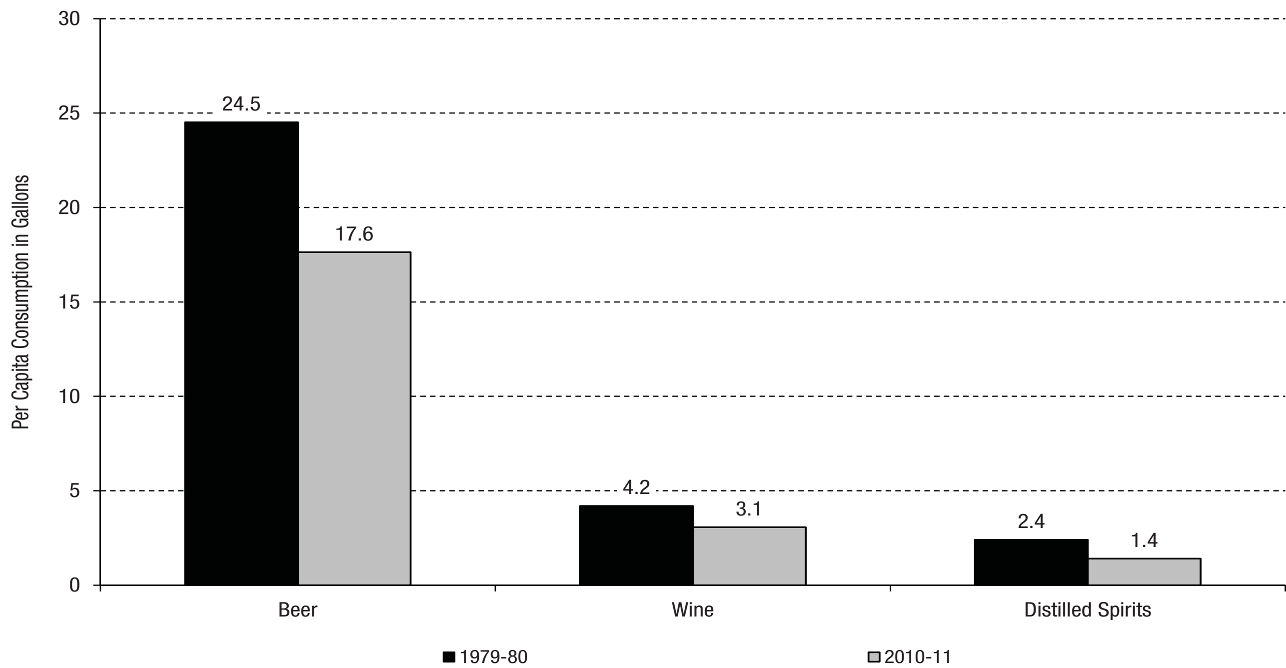
California taxes alcoholic beverages at a flat rate per gallon, with different rates applying to different beverages. California taxes beer and wine, for example, at a rate of $0.20 per gallon, while the tax on hard liquor is $3.30 per gallon.[65] The federal government also taxes alcoholic beverages on a per gallon rate, with a higher tax imposed on hard liquor than on wine, beer, or other products. Revenues collected from state taxes on alcoholic beverages support the state's General Fund. California's alcohol tax rates were last increased in 1991.

Alcohol taxes are regressive. That is, lower-income individuals pay a larger share of their income in alcohol taxes than do higher-income individuals. The regressivity of alcohol taxes stems from the fact that low-income households spend a larger share of their incomes on alcohol than do higher-income households. Proponents of raising alcohol tax rates often argue that higher taxes would discourage consumption and reduce the negative health and social impacts of alcohol abuse.

Alcohol taxes have declined as a share of state revenues and have remained relatively flat in actual dollar terms due to declining per capita consumption. Per capita consumption of alcoholic beverages peaked in the late 1970s and early 1980s and has generally declined ever since, with the steepest drop in hard liquor consumption, which is taxed at the highest rate (Figure 7). The drop in alcohol tax collections as a share of state revenues also reflects the fact that the tax is imposed on a per gallon basis, rather than as a percentage of cost. As a result, the amount of tax collected has remained constant despite rising beverage prices. One option for stemming the decline in alcohol tax revenues would be to tax alcohol at a percentage of the retail product's price, rather than by volume, similar to the sales tax. This would allow revenues to keep pace with inflation.

Taxes on Cigarettes and Tobacco Products

The state taxes cigarettes and tobacco products with four separate tax rates, including two rates imposed by voter-approved initiatives. A $0.10 per pack tax rate goes to the state's General Fund, a $0.25 per pack rate goes to health and related programs as required by Proposition 99 of 1988, and a $0.50 per pack rate goes to early childhood programs pursuant to Proposition 10 of 1998. In 1994, the Legislature imposed a tax rate of $0.02 per pack to support breast cancer research and screening services.[66] The state also taxes other tobacco products – such as cigars and smokeless tobacco – based on a percentage of the wholesale price of tobacco. The federal government imposes a $1.01 per pack tax on cigarettes.



California also receives payments through a national legal settlement between major tobacco companies and state attorneys general. In 2011, the state received $360.8 million, and counties and the cities of Los Angeles, San Diego, San Francisco, and San Jose received a total of $360.8 million.[67] These payments are economically similar to a tax in that they are built into the price that consumers pay for cigarettes.

Tobacco tax collections have declined over time due to declining consumption of tobacco products (Figure 8). Between 1973-74 and 2010-11, per capita consumption of cigarettes dropped by 80.4 percent.[68] The decrease in consumption is primarily attributable to concerns over smoking-related health problems and changing societal norms; however, increases in tobacco prices have contributed to the drop in smoking as well. Research suggests that demand for cigarettes declines by 2 to 6 percent for every 10 percent increase in cigarette prices.[69] The significant drops in per capita cigarette consumption that occurred after the enactment of the two significant increases in tobacco taxes imposed by voter-approved initiatives support this hypothesis. Per capita cigarette consumption was 21.6 percent lower in 1999-00, the first full fiscal year after the implementation of Proposition 10, than it was in 1997-98, and consumption dropped by 17.6 percent between 1987-88, prior to the implementation of Proposition 99, and 1989-90, the first full fiscal year after its enactment.

Several states have raised their tobacco tax rates in recent years. Between 2009 and 2012, 19 states and the District of Columbia raised their tobacco tax rates.[70] California's $0.87 per pack tax rate is the 32nd highest in the nation (Figure 9).[71] Nationally, the median tax rate – the rate at the midpoint of the distribution of rates among the states and the District of Columbia – was $1.36 per pack as of January 1, 2013.

Who Pays Tobacco Taxes?

Tobacco taxes are regressive taxes. That means that low-income individuals spend a greater share of their incomes on tobacco products and therefore shoulder a disproportionate share of their income in tobacco taxes. A $1.50 per pack increase in the tobacco tax, for example, would equal 0.5 percent of the average income of the poorest fifth of California taxpayers. In contrast, the same increase would translate into 0.004 percent of the average income of the wealthiest 1 percent of taxpayers.[72] This disparity results both from the lower income of poor households and the fact that smoking is more prevalent among low-income individuals. Researchers found that in 2008, 19.8 percent of California adults with incomes less than $20,000 smoked, while just 7.8 percent of those with incomes in excess of $150,000 smoked.[73]

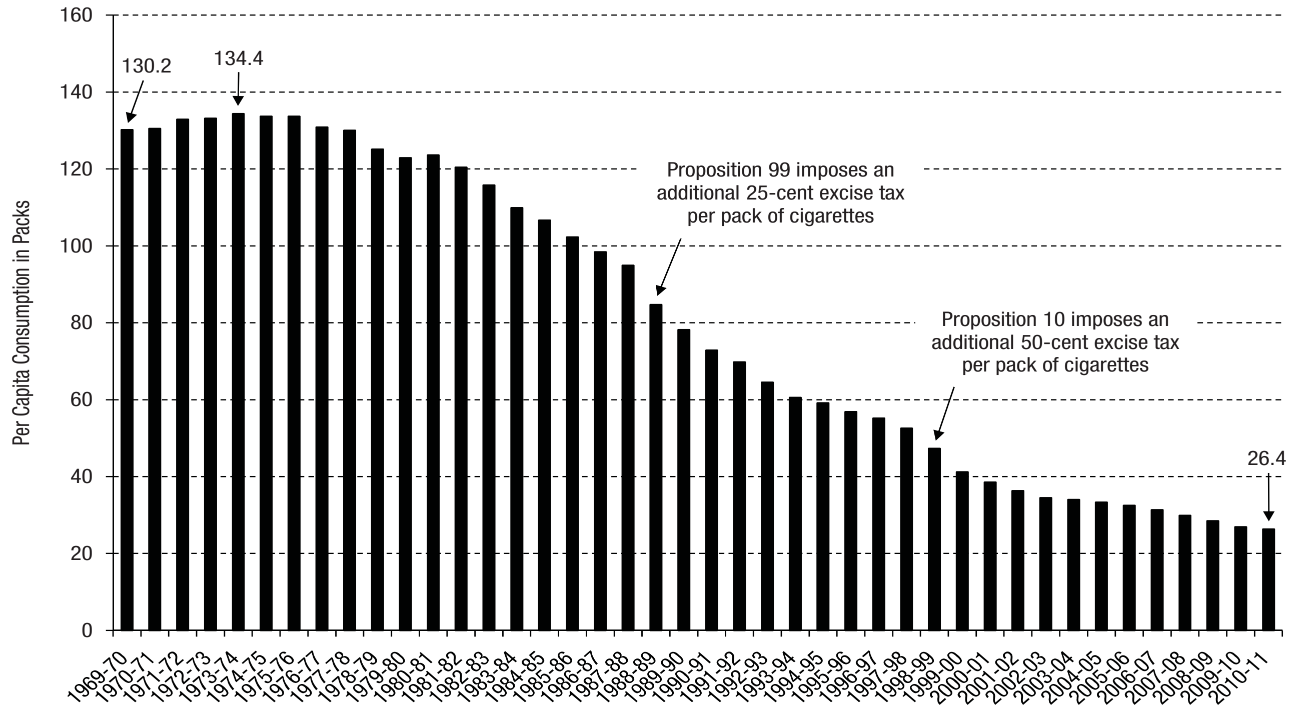


Figure 8: Per Capita Cigarette Consumption Has Declined Substantially in California Since the Mid-1970s
Per Capita Consumption in Packs
130.2
134.4
Proposition 99 imposes an additional 25-cent excise tax per pack of cigarettes
Proposition 10 imposes an additional 50-cent excise tax per pack of cigarettes
26.4
Source: Board of Equalization

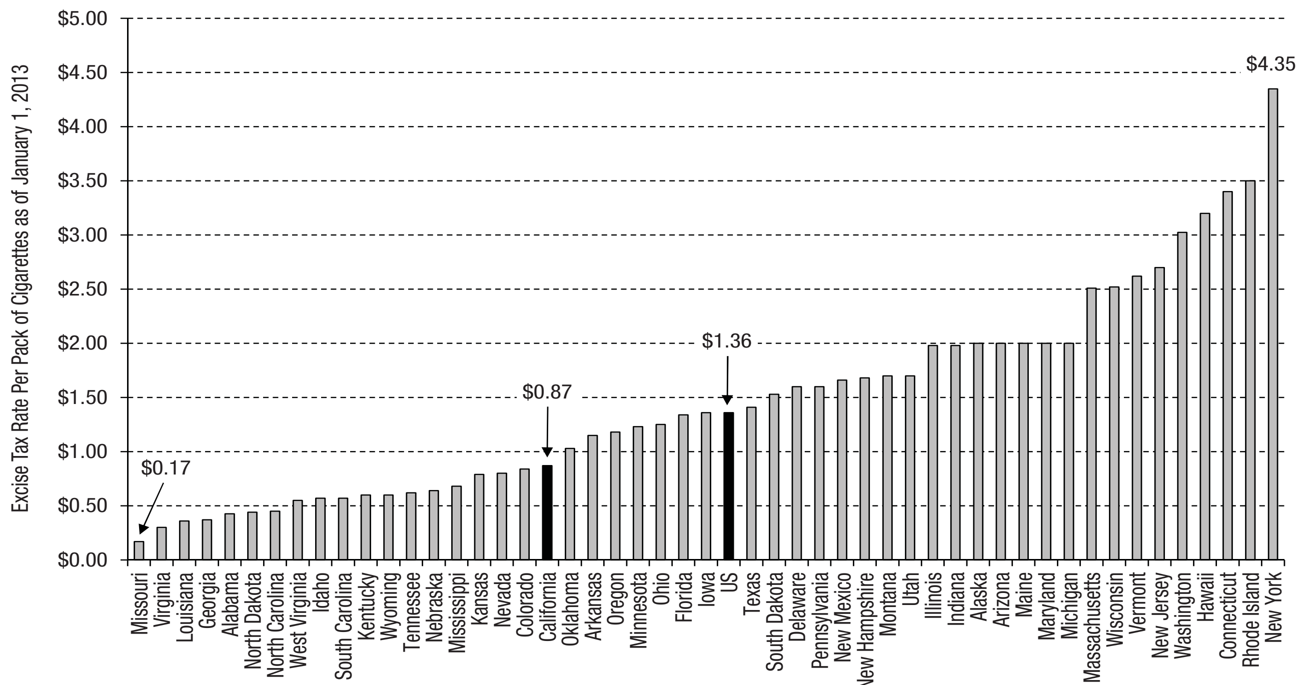


Figure 9: The Tax on Cigarettes Is Lower in California Than in Most Other States
Excise Tax Rate Per Pack of Cigarettes as of January 1, 2013
$0.17
$0.87
$1.36
$4.35
Note: The US rate reflects the median tax rate for all states and the District of Columbia.
Source: Federation of Tax Administrators

Tobacco taxes also disproportionately impact population groups that are more likely to smoke. Surveys show that men and African-Americans are more likely to smoke than women or whites, Latinos, and Asians, respectively. People without a high school degree and those who graduated from high school, but have no additional education, are more likely to smoke than those who graduated from college.

Some advocates argue that higher tobacco taxes are desirable precisely because they reduce tobacco consumption, particularly among youth. Research suggests that higher prices are more likely to result in reduced consumption by youth, young adults, low-income adults, and blacks and Latinos.[74] While higher tobacco taxes may be desirable from a public health standpoint, tobacco taxes may not be an appropriate revenue source for funding public services for the same reasons. As noted above, tobacco tax revenues have declined over time in response to falling consumption and additional tax increases would likely lead to steeper reductions in consumption. Thus, tobacco taxes would not provide sufficient revenues to support programs where costs are anticipated to rise over time.

Some researchers argue that reducing tobacco consumption could result in increased health care costs to the extent that former smokers live longer than they would have if they had continued smoking. However, a number of studies find that the long-term health care costs of people who stop smoking are lower or not substantially different from those of people who continue to smoke, particularly after accounting for productivity gains due to improved health.[75]

Taxes on Vehicles and Vehicle Fuels

The Vehicle License Fee (VLF, also referred to as the "car tax") is administered by the state, and revenues are allocated to cities and counties as general purpose revenues and to counties for support of specified health, social service, and public safety programs as part of the 1991 and 2011 transfer of responsibilities from the state to county governments generally referred to as "realignment."[76] A 1998 reduction and subsequent measures cut the VLF tax rate to 0.65 percent – approximately one-third of the pre-1998 rate. The VLF is a modestly regressive tax.[77] Proposition 1A of 2004 requires the state to maintain payments to local governments for revenue lost as a result of the 1998 VLF rate cut and any future reduction in the VLF rate below 0.65 percent. The same measure locked in the allocation of VLF revenues to cities and counties and other local governments.

The state also taxes motor vehicle fuels, and these taxes are some of the most regressive state taxes. As part of a complex "fuel tax swap" enacted in 2010, the Legislature increased the excise tax on gasoline from $0.180 per gallon to $0.353 per gallon and exempted gasoline from the General Fund portion of the state sales tax effective July 1, 2010.[78]

Over time, gas and diesel fuel tax revenues have not kept pace with the number of miles traveled on California's roads. As the gas tax increased from 9 cents per gallon to 18 cents per gallon during the early 1990s, inflation-adjusted gas tax revenues generally kept pace with vehicle miles traveled. Between 1995-96 and 2009-10, inflation-adjusted gas tax revenues per 1,000 vehicle miles traveled declined by 36.9 percent, while vehicle miles traveled increased by 18.2 percent.[79] This is significant since gas tax revenues support highway construction and upkeep. When gas tax revenues fail to keep up with inflation, less money is available to maintain and build streets and highways.

What Happened to the Estate Tax?

California formerly received a portion of the federal estate tax, known as the "pick up" tax. The "pick up" tax gave states a share of the revenues collected by the federal tax from estates within that state. However, a 2001 federal tax law phased out the federal estate tax, with full repeal occurring in 2010, and phased out the portion of the tax shared with states between 2002 and 2005. Under that law, the estate tax, including the portion allocated to states, was scheduled to be reinstated in 2011 at its 2001 level. However, that was forestalled by legislation enacted in December 2010 which, among other things, extended the repeal of the estate tax until 2013. In 2013, Congress permanently extended the federal estate tax – locking in substantial tax breaks for the wealthy – and permanently eliminated the "pick up" tax.

Fifteen states that levied "pick up" taxes before 2001 retained the estate tax in the wake of the 2001 federal tax changes, including 12 states that "decoupled" from the federal phase-out of states' portion of the estate tax by passing legislation imposing a state tax equal or similar to the amount of the former federal tax.[80] In total, 22 states impose some type of tax on estates or inheritances. California has not decoupled in part because Proposition 6 of 1982 repealed the state's inheritance tax and prohibited the imposition of any estate, inheritance, wealth, or other tax related to transfers occurring upon death, and thus reinstatement would require voter approval.

Contrary to popular perception, very few and only very large estates paid the estate tax. In 2003, fewer than 3 percent of California estates – just 6,143 out of 239,325 – owed any tax whatsoever. In 2001-02, the last full year of revenues received by the state, the estate tax provided the General Fund with $915.6 million in revenues.

The Property Tax

The property tax provides revenues for schools and for counties, cities, and other local governments. The state's Constitution requires that taxes collected on all locally assessed property remain in the county where the property is located.[81] State law allocates property tax revenues to schools (K-12 and community colleges), counties, cities, and special districts. The structure of the property tax is outlined in the state's Constitution, leaving policymakers with little flexibility to make changes in the level of taxation.

Local property tax collections do affect the state budget. This results from the interaction between local property tax revenues allocated to schools and the state's funding obligation to K-14 education under the Proposition 98 school-funding guarantee.[82] In brief, under most circumstances, the state's funding obligation is determined by the sum of state and local revenues received by school districts, county offices of education, and community colleges. If the amount of property tax revenues received by these jurisdictions increases, the state's funding obligation goes down.[83]

Proposition 13

In June 1978, California voters enacted Proposition 13 by a vote of 65 percent to 35 percent. Proposition 13 reduced local property tax revenues by approximately $6.1 billion (53 percent) virtually overnight by capping property tax rates at 1 percent and rolling back property values for tax purposes to the 1975-76 level. Provisions capping annual increases in property tax bills at 2 percent and allowing reassessment only when property changed ownership slowed growth in property tax revenues. Proposition 13 also made raising taxes more difficult by requiring state tax increases to receive approval of two-thirds of the Legislature and by imposing restrictions on the taxing authority of local governments. Exit polls suggest that the measure garnered broad support among voters of all incomes and educational levels, losing only among blacks, public employees, renters, and self-described liberals.

The roots of the taxpayer revolt can be traced to rapidly rising local property tax bills, a bulging state surplus, and legislative inaction. By 1977, California property tax payments, measured as a percentage of property values, had risen to the eighth highest in the country.[84] While property tax rates peaked in the early 1970s, rising property values continued to push tax bills higher. Prior to Proposition 13, counties' share of costs for the Medi-Cal and SSI/SSP programs was tied to the assessed valuation of property in each county.[85] Increases in property value pushed counties' costs higher and limited the ability of local officials to lower tax rates as a means of providing relief. At the same time, state revenues rose faster than inflation due to the strength of the economy and the state's share of total program costs for Medi-Cal and SSI/SSP fell as that of counties rose. As a result of a strong economy and the balance of revenues and responsibilities between the state and county governments, the state accumulated a $3.8 billion surplus by 1977-78.[86]

Homeowners' resentment mounted since rising tax bills failed to translate into improvements in the quality or quantity of public services. The Legislature responded to the growing crisis with the introduction of three major reform packages in 1977. The measures differed in the magnitude of relief offered, the method of distributing relief among taxpayers, the balance of revenue increases and decreases between homeowners and businesses, and the method used to finance the reduction in local property taxes. After a long summer of negotiations, proposals, and counterproposals, legislators failed to reach a compromise among competing proposals for reform.

When the Legislature returned in 1978, an election year for statewide officeholders, Howard Jarvis and Paul Gann had already submitted 1.2 million signatures placing the initiative that became Proposition 13 on the June ballot. Governor Jerry Brown opposed efforts to use the state's surplus to pay for relief for property taxpayers. Republicans seized on the taxpayer revolt as an election year issue, and the Democrat-dominated Legislature failed to produce a compromise measure capable of achieving broad-based support. The Legislature belatedly reached agreement to place a competitor to Proposition 13, SB 1, on the ballot as Proposition 8.[87] The compromise proved to be too little, too late. Voters approved Proposition 13 by a 65 percent to 35 percent margin, while defeating Proposition 8 by a vote of 47 percent to 53 percent.

Proposition 13 made six basic changes to the state's Constitution:

- **One percent rate cap.** Proposition 13 capped, with limited exceptions, property tax rates at 1 percent of full cash value at the time of acquisition. Prior to Proposition 13, local jurisdictions independently established their tax rates, and the total property tax rate was the composite of the individual rates.
- **Assessment rollback.** Proposition 13 rolled back property values for tax purposes to their 1975-76 level.
- **Responsibility for allocating property tax transferred to the state.** Proposition 13 gave state lawmakers responsibility for allocating property tax revenues among local jurisdictions. Prior to Proposition 13, jurisdictions established their tax rates independently and their property tax revenues depended on the rate levied and the value of the property located within the jurisdiction's boundaries. Subsequent ballot measures – Proposition 1A of 2004 and Proposition 22 of 2010, for example – significantly constrained the Legislature's ability to change the allocation of property taxes among local jurisdictions.[88] For example, the Legislature is prohibited from shifting property tax dollars from local governments (cities, counties, and special districts) to schools. In addition, reallocation of property tax dollars among local governments requires a two-thirds vote of each house of the Legislature and can only apply to a single fiscal year.
- **Reassessment upon change of ownership.** Proposition 13 replaced the practice of annually reassessing property at full cash value with a system based on cost at acquisition. Under Proposition 13, property is assessed at market value for tax purposes only when it changes ownership. Increases in value are limited to an annual inflation factor of no more than 2 percent.
- **Vote requirement for state taxes.** Proposition 13 requires any measure enacted for the purpose of increasing state revenues to be approved by a two-thirds vote of each house of the Legislature.[89]
- **Voter approval for local "special" taxes.** Proposition 13 requires taxes raised by local governments for a designated or "special" purpose to be approved by two-thirds of the voters.[90]

TAX ADMINISTRATION: WHY IT MATTERS

The effectiveness of tax laws depends on the efforts of the agencies and departments that collect state taxes and enforce the state's tax laws. Several state agencies administer California's tax system. These agencies are charged with implementing laws passed by the Legislature and collecting the taxes that taxpayers owe under the state's tax laws.

Tax administration is more important than it might seem. Some taxpayers make decisions regarding whether to comply with the state's tax laws based on whether they believe that noncompliance will be caught through an audit or other tax collection efforts. Tax administration also influences perceptions regarding the fairness of the tax code. A perception that the wealthy, large corporations, or others do not pay their fair share of taxes can breed resentment and encourage further noncompliance.

Two agencies share responsibility for the "big three" state taxes – the personal income, corporate income, and sales and use taxes. The Franchise Tax Board (FTB) administers the personal and corporate income taxes. The Board of Equalization (BOE) administers the sales and use tax. The BOE also serves as an appeals panel for taxpayer disputes with the FTB.

Franchise Tax Board. The FTB administers state personal and corporate income taxes. In 2011-12, these two taxes raised $58.0 billion, 70.9 percent of General Fund revenues. The FTB also collects debts on behalf of other state agencies and local governments by deducting amounts owed from tax refunds. These collections generate well over $200 million each year. A three-member board consisting of the State Controller, the Chair of the BOE, and the Director of the Department of Finance governs the FTB.

Board of Equalization. The BOE administers the sales and use, fuel, alcohol, and tobacco taxes and collects a number of business taxes and environmental fees and property taxes paid by public utilities. The BOE also has oversight responsibility for local property tax administration. The Board consists of the State Controller and four members elected by district.

Other agencies with tax collection and enforcement responsibilities include the Department of Motor Vehicles, which collects vehicle registration fees and the Vehicle License Fee; the Department of Insurance, which processes insurance tax returns and audits insurance taxpayers; the State Controller's office, which oversees the disbursement of state funds; and the Employment Development Department (EDD), which administers personal income tax withholding and collects state payroll taxes that support the Unemployment and State Disability Insurance Funds.

CONSTITUTIONAL AND VOTER-ENACTED CONSTRAINTS ON TAX POLICYMAKING

A number of provisions in the state's Constitution limit the ability of the Legislature and local governments to raise taxes or modify various tax policies. Most of these changes were made through voter-sponsored and voter-approved initiatives, while some were placed before the voters by the Legislature. California's Constitution can only be amended by the voters. Key constraints on tax policymaking include:

- **The two-thirds vote requirement for the Legislature to approve any measure enacted for the purpose of increasing state tax revenues.** This requirement was added to the Constitution by Proposition 13 of 1978. Measures that reduce state tax revenues can be approved by a simple majority of the Legislature. Proposition 13 also required that taxes raised by local governments for a designated or "special" purpose be approved by two-thirds of the voters. In addition, Proposition 13 capped the local property tax rate, imposed a 2 percent limit on annual property value increases, and required the reassessment of property at market value only when property changes ownership. Proposition 26 of 2010 amended the Constitution to require a two-thirds vote for the Legislature to enact or increase many types of fees that formerly could be approved by majority vote and to approve any measure that would increase taxes for any single taxpayer in California, even if the measure would not result in an overall increase in state tax revenues.
- **Proposition 218 of 1996, which requires a majority of voters to approve any new or increased general purpose tax imposed by local governments.** Proposition 218 also required local voter approval of assessments and made it more difficult to impose fees.[91]
- **Earmarking most of the proceeds of the tobacco tax.** Proposition 10 of 1998 imposed a $0.50 per pack tax on cigarettes along with an equivalent tax on other tobacco products, with most of the revenues devoted to early childhood development programs. Proposition 99 of 1988 imposed a $0.25 per pack rate along with an equivalent tax on other tobacco products to support a number of purposes, including smoking cessation programs and health care services.
- **Proposition 1A of 2004 and Proposition 22 of 2010, which limit the state's ability to reallocate proceeds of local property taxes.**[92] In addition, Proposition 1A limits the state's ability to reallocate local sales tax proceeds.
- **Proposition 1A of 2004, which prohibits the state from reducing the VLF rate below 0.65 percent unless it replaces revenues lost by cities and counties.** In addition, Proposition 22 of 2010 eliminated the state's ability to reallocate revenues raised by the VLF's 0.65 percent rate in order to reimburse local governments for new or increased program costs.
- **Proposition 163 of 1992, which prohibits the state from imposing the state's sales tax on food.** This measure prohibits the state from taxing any food product that was not taxed on November 3, 1992. This initiative was designed to repeal the "snack tax" enacted in 1991.

CONCLUSION: ISSUES AND OPTIONS FOR REFORM

While there's broad agreement on the need to modernize the state's tax system, there's less agreement on how that should be achieved. Efforts to reform the state's tax code through the Legislature and/or increase state revenues have been thwarted by Proposition 13's requirement that measures increasing state revenues must be approved by a two-thirds vote of each house of the Legislature. Moreover, many fundamental changes must be submitted to the voters for approval. Current issues include:

- **The adequacy of the state's revenue system.** Throughout much of the 2000s and early 2010s, California faced chronic structural budget shortfalls – gaps between the revenues raised by the state's tax system and the cost of providing a given level of services adjusted for inflation and population or caseload growth, as appropriate. Lawmakers bridged the state's budget gap primarily through spending cuts that left many public services stretched thin. While state analysts project surpluses in coming years as a result of temporary tax increases and lower expenditures due to years of deep spending cuts, budget shortfalls are likely to emerge once again when temporary revenue increases expire.

- **Erosion of the sales tax base.** Over time, the share of consumers' income spent on taxable goods has declined significantly, eroding the sales tax base. Two factors are responsible for this trend: The long-term shift in economic activity from goods to services and the rise of online and mail-order sales that escape taxation. The erosion of the sales tax base due to the shift to services could be remedied by imposing the sales tax on some or all services. This broadening of the sales tax base could be structured either to increase revenues or in a revenue-neutral fashion by reducing the sales tax rate. Closing the online/mail-order sales tax loophole is more difficult. A series of US Supreme Court decisions limits states' ability to require out-of-state merchants to collect the sales tax owed on purchases that in-state merchants are legally obligated to collect. Reversing these decisions would require an act of Congress. A 2011 California law, however, could help narrow the state's sales tax gap by boosting the collection of taxes legally owed on online and mail-order purchases.[93] National efforts to help states close their sales tax gaps are under way as well. The Streamlined Sales Tax Project is attempting to simplify and align state sales tax laws to make it easier for national retailers to collect the tax across multiple states.[94]

- **Taxing business property at market value.** Proposition 13 provided the same protections to business property owners that it provides to homeowners. From an economic standpoint, providing preferential taxation to business property based on the value at the time of purchase disadvantages new businesses, while subsidizing long-time property owners. The disparity places new businesses at a competitive disadvantage and discourages economic growth. The Legislature could, by majority vote, change the definition of ownership used to trigger reassessment for property tax purposes. However, the method that could be adopted statutorily would be cumbersome and potentially easy to circumvent. More fundamental change, such as requiring commercial property to be assessed at market value, would require voters to amend the state's Constitution.

- **The two-thirds vote requirement.** The two-thirds vote requirement for increasing state tax revenues makes it difficult, if not impossible, to remove obsolete or low-priority tax expenditures from the tax code; shifts the burden of balancing budgets to spending reductions, rather than revenue increases; limits attempts to significantly improve public services; and makes systemic tax reform extremely difficult. Changing the two-thirds vote requirement would require California's voters to approve a change to the state's Constitution. Proposition 56 of 2004 would have reduced the approval requirement for tax increases and passage of the state budget, but it was defeated by the voters. Proposition 25 of 2010 reduced the vote requirement for passage of the state budget from two-thirds to a simple majority, but not for measures that increase state taxes.

- **Restrictions on the taxing power of local governments.** New or higher local taxes must be approved by the voters, and taxes dedicated for a specific purpose must be approved by a two-thirds vote. These restrictions limit the ability of local governments to improve public services and limit policymakers' ability to balance budgets by increasing revenues during tough budget years. Modifying these restrictions would require voter approval.

- **Lack of accountability in current policies.** A lack of reporting and evaluation requirements makes it impossible to determine whether California is receiving benefits from tax expenditure programs commensurate with their cost because the state does not collect the information necessary to do so. The state's tax expenditure reporting is limited to an accounting of the revenues foregone because of specific provisions. In order to improve accountability, the Legislature could require the FTB to identify firms receiving tax preferences and the amount of benefit received. A more comprehensive approach would link delineated policy objectives with a measurement of the progress made toward achieving these goals and ensure that adequate data are available to assess the cost effectiveness and efficiency of tax incentives. The state could also establish a sunset review process to ensure that state resources support programs with the greatest economic return.

Resources to Learn More About California's Tax System

Assembly Committee on Revenue and Taxation, *Revenue and Taxation Reference Book 2011* (July 2012), available at http://arev.assembly.ca.gov/sites/arev.assembly.ca.gov/files/MASTER%202012.pdf.

Board of Equalization, *Annual Report 2010-11*, available at http://www.boe.ca.gov/annual/annualrpts.htm.

Department of Finance, *Tax Expenditure Report 2012-13*, available at http://www.dof.ca.gov/research/economic-financial/.

Franchise Tax Board, *Annual Report 2010*, available at https://www.ftb.ca.gov/aboutftb/plans_reports.shtml.

Franchise Tax Board, *Tax Expenditure Report 2009*, available at https://www.ftb.ca.gov/aboutftb/plans_reports.shtml.

ENDNOTES

[1] For additional information, see Assembly Committee on Revenue and Taxation, *Revenue and Taxation Reference Book 2011* (July 2012).
[2] National Conference of State Legislatures and National Governors' Association, *Financing State Government in the 1990s* (December 1993), p. 16.
[3] See, for example, National Conference of State Legislatures, *Principles of a High-Quality State Revenue System* (June 2007).
[4] A current services budget does not take into account proposed changes to current laws or policies.
[5] Ronald Snell, *New Realities in State Finance* (National Conference of State Legislatures: April 2004), p. 15.
[6] 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 taxes they pay for federal income tax purposes.
[7] Jennifer Dill, Todd Goldman, and Martin Wachs, *The Incidence of the California Vehicle License Fee* (California Policy Research Center, University of California, Berkeley: 1999).
[8] Elizabeth McNichol et al., *Pulling Apart: A State-by-State Analysis of Income Trends* (Center on Budget and Policy Priorities: November 15, 2012).
[9] Franchise Tax Board, Revenue Estimating Exhibits (May 2012), Exhibit A-10, pp. 2-3 and personal communication with the Franchise Tax Board. Income is adjusted gross income reported for tax purposes.
[10] Franchise Tax Board, Revenue Estimating Exhibits (May 2012), Exhibit A-6, p. 5.
[11] Franchise Tax Board, Revenue Estimating Exhibits (May 2012), Exhibit B-2, p. 3.
[12] Franchise Tax Board, *What Is the Tax Gap?* (no date), downloaded from https://www.ftb.ca.gov/Tax_Gap/index.shtml on March 13, 2013.
[13] Charles E. McClure, Jr., *Thinking Strategically About State Tax Policy: Basic Principles, Sales Tax Exemptions for Business Purchases, and Corporate Income Taxation* (Hoover Institution, Stanford University: no date).
[14] The term tax expenditure refers to the various tax exclusions, exemptions, preferential tax rates, credits, and deferrals that reduce the amount of revenues collected from the state's basic tax structure.
[15] This rate includes a 1.0625 percent rate that goes to the Local Revenue Fund 2011 to fund public safety realignment.
[16] Proposition 30, approved by voters in November 2012, added three new personal income tax rates that will be in effect for seven years, from tax year 2012 through tax year 2018. The measure created a 10.3 percent rate that applies to taxable income between $500,001 and $600,000 for married taxpayers and between $250,001 and $300,000 for single taxpayers; an 11.3 percent rate that applies to taxable income between $600,001 and $1 million for married taxpayers and $300,001 and $500,000 for single taxpayers; and a 12.3 percent rate that applies to taxable income above $1 million for married taxpayers and above $500,000 for single taxpayers.
[17] An additional 1 percent rate applies to taxable income earned above $1 million. Revenues from this rate are dedicated to mental health services.
[18] Corporations reporting net income. Franchise Tax Board, Revenue Estimating Exhibits (May 2012), Exhibit B-2, p. 2.
[19] National Conference of State Legislatures, *Tax Policy Handbook for State Legislators* (December 1997), p. 8.
[20] US Census Bureau, State Government Tax Collections (2011).
[21] The share of General Fund revenues provided by the personal income tax increased from 53.8 percent in 2010-11 to 62.9 percent in 2011-12 primarily because the share of General Fund revenues provided by the sales and use tax dropped from 29.3 percent to 21.8 percent during that period. This drop was largely due to the shift of a portion of sales and use tax revenues from the state to counties as part of the 2011 transfer – or "realignment" – of responsibility for certain public safety, health, and human services programs from the state to counties. The state's sales and use tax revenue as a share of General Fund revenues is down from 37.3 percent in 1977-78.
[22] For more information, see California Budget Project, *What Would Proposition 30 Mean for California?* (September 2012).
[23] Institute for Taxation and Economic Policy.
[24] Legislative Analyst's Office. "Proposition 30. Temporary Taxes to Fund Education. Guaranteed Local Public Safety Funding. Initiative Constitutional Amendment. Analysis by the Legislative Analyst," in Secretary of State's Office, *California General Election Tuesday, November 6, 2012: Official Voter Information Guide,* p. 12. The Department of Finance projects that Proposition 30 will provide an estimated $5.4 billion General Fund revenues in 2012-13 and $6.2 billion in 2013-14. Department of Finance, *2013-14 Governor's Budget Summary* (January 10, 2013), p. 135.
[25] Multistate and multinational corporations in agriculture, resource extraction, the savings and loan industry, and finance continue to use a separate, equally weighted, three-factor formula for determining the taxable income subject to California's corporate income tax. In addition, certain cable companies are allowed to exclude some of their California sales when calculating their corporate income tax liability. For more information, see California Budget Project, *What Would Proposition 39 Mean for California?* (October 2012).
[26] Elective single sales factor was enacted as part of the 2009-10 budget agreement and took effect in 2011.

[27] This amount is projected to increase over time. Between 2013-14 and 2017-18, half of the new revenues, up to $550 million, will be used to fund energy efficiency and clean energy initiatives with the remainder deposited into the state's General Fund. After 2017-18, all of the revenues provided by the measure will be deposited into the General Fund. Legislative Analyst's Office. "Proposition 39. Tax Treatment for Multistate Businesses. Clean Energy and Energy Efficiency Funding. Initiative Statute. Analysis by the Legislative Analyst," in Secretary of State's Office, *California General Election Tuesday, November 6, 2012: Official Voter Information Guide*, p. 70. The Department of Finance projects that Proposition 39 will provide an estimated $440 million General Fund revenues in 2012-13 and $900 million in 2013-14. Department of Finance, *2013-14 Governor's Budget Summary* (January 10, 2013), p. 135.

[28] The share of state revenues from alcohol and tobacco taxes and fees has declined despite significant increases in tax rates. For example, the tax rates on most alcoholic beverages were raised substantially beginning July 15, 1991. See Board of Equalization, *Annual Report 2010-2011*, Statistical Appendix, Table 27, downloaded from http://www.boe.ca.gov/annual/2010-11/appendix.html on September 10, 2012. The cigarette tax increased by 25 cents per pack on January 1, 1989 after voters approved Proposition 99 and increased by another 50 cents per pack on January 1, 1999 after voters approved Proposition 10. See Board of Equalization, *Annual Report 2010-2011*, Statistical Appendix, Table 30A, downloaded from http://www.boe.ca.gov/annual/2010-11/appendix.html on September 10, 2012.

[29] Proposition 26, approved by voters in November 2010, amended the state's Constitution to require a two-thirds vote of the Legislature to approve any measure that would increase taxes for any single taxpayer in California, even if that measure does not result in an overall increase in state tax revenues.

[30] For more information, see California Budget Project, *What Are the Differences Between Assessments, Fees, and Taxes?* (August 1996).

[31] See California Budget Project, *Proposition 26: Should the State and Local Governments Be Required to Meet Higher Voting Thresholds to Raise Revenues?* (September 2010).

[32] Franchise Tax Board, *Annual Report 2003*, p. 13.

[33] The new rate took effect January 1, 2005.

[34] A Subchapter S corporation is a type of corporation that has no more than 75 shareholders.

[35] Franchise Tax Board, Revenue Estimating Exhibits (May 2012), Exhibit A-10, p. 3 and personal communication with the Franchise Tax Board.

[36] Franchise Tax Board, Revenue Estimating Exhibits (May 2012), Exhibit A-10, p. 2 and personal communication with the Franchise Tax Board.

[37] Franchise Tax Board, Revenue Estimating Exhibits (May 2012), Exhibit A-10, p. 4 and personal communication with the Franchise Tax Board.

[38] Phil Oliff, Chris Mai, and Nicholas Johnson, *The Impact of State Income Taxes on Low-Income Families in 2011* (Center on Budget and Policy Priorities: Revised April 17, 2012).

[39] In order to claim a dependent, a taxpayer must provide at least half of that person's support. Dependents must also meet age, income, and family relationship restrictions.

[40] As part of the 2011-12 budget package, the formerly refundable credit for child and dependent care expenses, which provided cash back to families with incomes below the income tax threshold who had qualifying child care expenses, was made non-refundable beginning in tax year 2011.

[41] California currently has no refundable tax credits. Refundable tax credits, such as the federal Earned Income Tax Credit, provide a cash refund to taxpayers whose liability is less than the amount of credit for which they are eligible. In general, tax credits are not refundable. Specific statutory authorization is needed in order for a credit to be refundable.

[42] Franchise Tax Board, *Annual Report 2011*, Table B-3.

[43] Franchise Tax Board, *Annual Report 2011*, Table B-3.

[44] However, the 1 percent tax rate surcharge applied to incomes in excess of $1 million does have a marriage penalty since it applies to incomes in excess of $1 million regardless of whether that amount is earned by a single individual, head of household, or married couple.

[45] In November 2012, voters approved three additional personal income tax rates for tax years 2012 through 2018. In 2012, the top marginal rate of 12.3 percent for married taxpayers applied to taxable income of above $1 million. In 2019, the state's highest tax rate will revert to 9.3 percent.

[46] Franchise Tax Board, Revenue Estimating Exhibits (May 2012), Exhibit A-6, p. 5 and Exhibit A-4, p. 5.

[47] Emmanuel Saez, *Striking It Richer: The Evolution of Top Incomes in the United States* (Updated With 2009 and 2010 Estimates), March 2, 2012.

[48] A 2011 California law – AB 155 (Calderon, Chapter 313 of 2011) – could help increase the collection of taxes legally owed on online and mail-order purchases. Estimates suggest that this legislation could boost California's sales tax collections from online and mail-order purchases by hundreds of millions of dollars each year.

[49] Federation of Tax Administrators, *FTA Survey of Services Taxation – Update* (July 2008), downloaded from http://www.taxadmin.org/fta/pub/services/btn/0708.html on May 9, 2012.

[50] A portion of the Vehicle License Fee rate provides additional revenues to support the programs realigned to counties in 1991.

[51] The adoption of an optional rate requires a two-thirds vote of the local governing board and voter approval.

[52] California Board of Equalization, *Annual Report 2010*, Table 2 and personal communication with the Board of Equalization.

[53] Insurance companies are exempted from the corporate income tax and instead are subject to the state gross premiums tax.

[54] Very few corporations file under the corporation income tax.

[55] Pass-through entities are alternative business structures such as Subchapter S corporations, limited liability companies, and limited liability partnerships. Subchapter S corporations are taxed at a 1.5 percent rate, and the income they pass through to shareholders is taxed at the individual income tax rate. Traditional corporations, in contrast, are taxed at a rate of 8.84 percent.

[56] This provision applied only to corporate taxpayers and to both newly earned and previously accrued credits.

[57] The September 2008 law allows businesses to carry back half of any loss incurred in 2011, 75 percent of any loss incurred in 2012, and 100 percent of any loss incurred beginning in 2013. The same law also extended the length of time businesses could carry losses forward and use NOL deductions from 10 to 20 years.

[58] See California Budget Project, *To Have and Have Not* (June 2009).

[59] A change in federal law in 2004 allowed Subchapter S corporations a maximum of 100 shareholders. State conformity to this change would further decrease bank and corporate revenues.

[60] California used this approach prior to 1993. In 1993, California shifted to a formula that gave twice as much weight to the fraction of sales that occurred within the state. This approach, called "double weighting" the sales factor, places greater tax liability on companies with a higher share of sales in California relative to their share of property and payroll in the state. The double-weighted sales factor formula did not apply to businesses that derived more than half of their gross business receipts from agricultural, extractive, savings and loan, or banking and financial services activities. These businesses continued to use the traditional three-factor formula.

[61] Proposition 39 of 2012, approved by the voters on the November 2012 ballot, eliminated the ability of corporations to choose between the two formulas and requires corporations to use the sales-only formula.

[62] Most companies pay the tax based on the gross amount paid in premiums by the consumer; title insurers and ocean marine insurers pay a tax based on income and profits, respectively. Insurers that sell earthquake insurance through the California Earthquake Authority are tax-exempt. See Assembly Committee on Revenue and Taxation, *Revenue and Taxation Reference Book 2009* (March 2010), pp. 101-102.

[63] The Controller is the state's chief financial officer and is elected every four years. The primary function of the State Controller is to provide sound fiscal control over both receipts and disbursements of public funds.

[64] In 1992, the insurance tax rate was cut from 2.46 percent to 2.35 percent, where the rate remains today.

[65] The tax is $3.30 per gallon for distilled spirits that are 100 proof or less, and $6.60 per gallon for distilled spirits that are over 100 proof.

[66] AB 478 (Friedman, Chapter 660 of 1993).

[67] The City and County of San Francisco receives payments as both a city and a county. Office of the Attorney General, *Tobacco Master Settlement Agreement Payments to Counties and Cities, 1999-2011* (no date), downloaded from http://oag.ca.gov/tobacco/settlements on April 23, 2012.

[68] As part of the 2002-03 and 2003-04 budget agreements, California issued bonds backed by the payments received from the national tobacco settlement (i.e., "securitized" tobacco settlement dollars). The $5.6 billion in proceeds were used to help balance the state's budget. See California Budget Project, *Proposition 29: Should California Increase the Cigarette Tax?* (May 2012).
[69] JP Pierce et al., *Tobacco Control in California: Who's Winning the War? An Evaluation of the Tobacco Control Program, 1989-1996* (University of California, San Diego: June 30, 1998), p. 8-3.
[70] Federation of Tax Administrators, *Cigarette Tax Increases 2000-2013* (no date).
[71] Excludes the District of Columbia.
[72] Institute on Taxation and Economic Policy. Such an increase would equal a larger share of the income of a smoker and would be zero for an individual who did not purchase tobacco products.
[73] California Department of Public Health, *Two Decades of the California Tobacco Control Program: California Tobacco Survey, 1990-2008* (December 2010), p. 23.
[74] See, for example, US Centers for Disease Control and Prevention, "Response to Increases in Cigarette Prices by Race/Ethnicity, Income, and Age Groups – United States, 1976-1993," *Morbidity and Mortality Weekly Report* 47 (July 31, 1998).
[75] See, for example, Paul A. Fishman et al., "Health Care Costs Among Smokers, Former Smokers and Never Smokers in an HMO," *Health Services Research* 38:2 (April 2003); P.A. Fishman et al., "Changes in Health Care Costs Before and After Smoking Cessation," *Nicotine and Tobacco Research* 8:3 (June 2006); Susanne R. Rasmussen et al., "The Total Lifetime Health Cost Savings of Smoking Cessation to Society," *European Journal of Public Health* 15:6 (December 2005); and Wenya Yang et al., "Simulation of Quitting Smoking in the Military Shows Higher Lifetime Medical Spending More Than Offset by Productivity Gains," *Health Affairs* 31:12 (December 2012).
[76] In 2011, the Legislature redirected a portion of VLF revenues to counties to cover the cost of local public safety programs.
[77] Jennifer Dill, Todd Goldman, and Martin Wachs, *The Incidence of the California Vehicle License Fee* (California Policy Research Center, University of California, Berkeley: 1999).
[78] The additional excise tax rate on gasoline – $0.357 as of July 1, 2011 – is adjusted annually so that revenues raised will equal the revenues that would have been raised by the General Fund portion of the state sales tax on gasoline.
[79] Board of Equalization, California Department of Transportation, Department of Finance, and US Department of Transportation.
[80] Elizabeth C. McNichol, *State Taxes on Inherited Wealth Remain Common: 22 States Levy an Estate or Inheritance Tax* (Center on Budget and Policy Priorities: Updated January 4, 2012).
[81] Locally assessed property includes all property other than property owned by large public utilities.
[82] The state is constitutionally required to provide a minimum funding level for K-12 education and community colleges guaranteed by Proposition 98, an initiative passed by voters in 1988. For an overview of Proposition 98, see California Budget Project, *School Finance in California and the Proposition 98 Guarantee* (April 2006).
[83] Proposition 98 of 1988 established a three-part "test" for determining the annual school-funding guarantee. One of these tests is based on a percentage of General Fund revenues. However, this test only applied in two years between 1988-89, when the guarantee was established, and 2011-12. For more information, see California Budget Project, *School Finance in California and the Proposition 98 Guarantee* (April 2006).
[84] Arthur O'Sullivan, Terri A. Sexton, and Steven M. Sheffrin, *Property Taxes and Tax Revolts: The Legacy of Proposition 13* (New York: Cambridge University Press: 1995), p. 25.
[85] Legislative Analyst's Office, *An Analysis of Proposition 13: The Jarvis-Gann Property Tax Initiative* (1978), pp. 86-87.
[86] William H. Oakland, "Proposition 13 – Genesis and Consequences," *Federal Reserve Bank of San Francisco Economic Review* (Winter 1979), p. 11.
[87] Dean C. Tipps, "California's Great Tax Revolt: The Origins and Impact of Proposition 13," in *State and Local Tax Revolt: New Directions for the '80s* (Washington, DC: Conference on Alternate State & Local Policies, 1980), pp. 73-78. Proposition 8 would have reduced homeowners' property taxes by 30 percent and contained none of the limits on government taxing authority included in Proposition 13.
[88] California Constitution, Article VII, Section 25.5.
[89] Proposition 26 of 2010 amended the state's Constitution to require a two-thirds vote of the Legislature to approve or increase many types of fees that formerly could be approved by majority vote and to approve any measure that would increase taxes for any single taxpayer in California, even if the measure would not result in an overall increase in state tax revenues.
[90] However, Proposition 13 did not explicitly define what constitutes a special tax. Proposition 218 of 1996 clarified that a special tax is a tax designated for a special purpose. See California Budget Project, *Proposition 218: A Summary of Its Provisions and Impacts* (January 1997) and California Local Government Finance Almanac, *Reforming California Local Finance: Should the Local Vote Rules Be Reversed?* (no date).
[91] California Budget Project, *Proposition 218: A Summary of Its Provisions and Its Impacts* (January 1997).
[92] Proposition 11 of 1998 allowed the Legislature to authorize local sales tax sharing agreements, but specified that such agreements must be approved by two-thirds of the governing body of each jurisdiction that is a party to the agreement.
[93] AB 155 (Calderon, Chapter 313 of 2011). Estimates suggest that this legislation could boost California's sales tax collections from online and mail-order purchases by hundreds of millions of dollars each year.
[94] A copy of the Streamlined Sales and Use Tax Agreement and information on this effort can be found at http://www.streamlinedsalestax.org/index.html. State officials involved in the project hope that if a sufficient number of states streamline their policies, Congress will be more inclined to pass legislation requiring online retailers to collect the sales tax in those states.