Consumption Tax Options for California

Alan J. Auerbach
California’s Tax System Is Volatile...

State and local tax revenues relative to trend

- California
- New York
- Texas
...And Tax Rates Are High

- Taxes are volatile because income tax rates are high
  - Top personal income tax rate is over 10%
  - Corporate tax rate is 8.84%, among the highest in the country
- High income tax rates hurt California’s competitiveness
  - Higher production costs
Outline

- Why consumption taxes?
- Possible reforms and their effects
- Conclusions
Why Turn to Consumption Taxes?

- Consumption is
  - A large part of income
  - Less volatile

- Consumption tax would lower costs of production and employment
  - Based on where products are used, not where they are produced
Are Consumption Taxes Regressive?

- Depends on
  - The type of consumption tax
  - Who ultimately bears the tax, not who formally pays it
- Progressivity of taxes and spending overall is what matters
Outline

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Several Reforms Are Possible

- Reform the retail sales tax
  - Include more consumer spending, fewer businesses expenditures
- Modify the corporate income tax
  - Include more businesses, bring closer to a consumption tax
- Adopt a new system
  - Gross receipts tax
  - State-level value added tax (VAT)
  - Business net receipts tax (BNRT)
California’s Sales Tax Base Has Eroded

Taxable sales as a percent of personal income in California

- 20%
- 30%
- 40%
- 50%
- 60%

Steps to Reforming the Sales Tax

- Reduce taxes on business purchases
- Increase taxes on services
- Replace blanket exemptions for necessities (food, clothing, etc.) with more targeted aid
Evaluating Sales Tax Reform

- Pros:
  - Modifies current system

- Cons:
  - Difficulty targeting internet and mail-order sales, given legal obstacles
  - Enforcement a problem if rate gets too high
Modifying the Corporate Income Tax

- Corporate income is taxed using an apportionment formula
  - Based on the location of assets, payroll and sales

- Reform could shift apportionment toward consumption, simulating a tax on consumption itself
  - Sales-only apportionment is a close approximation

- Reform could make sales-only apportionment mandatory
Evaluating Corporate Income Tax Reform

- **Pros:**
  - Builds on current system
  - Progressive: excludes wage and salary income from tax base

- **Cons:**
  - Would need to extend to large non-corporate businesses to work well
  - Volatility
Some States Have Adopted a Gross Receipts Tax

- A tax on all business receipts
- Pros:
  - Simple, with a broad base
  - A lot of revenue even for a low tax rate
  - Less volatile than an income tax
- Cons:
  - Applies to all sales to businesses
  - Worsens tax on business inputs
- California can do better
A Value Added Tax Works in Stages

- A tax on all receipts
  - Credit for taxes paid on purchases by businesses
  - No net tax on business inputs
Evaluating the VAT

- **Pros:**
  - A true consumption tax
  - Less volatile than an income tax

- **Cons:**
  - A new tax to implement
  - As with the sales tax, legal problems with internet and mail order sales

- A stronger option if US adopts a national-level VAT
Adopting a Business Net Receipts Tax

- Like a VAT, but
  - Based on US value added
  - Apportioned using sales

- Like a sales-apportioned corporate income tax, but
  - Applies to all businesses
  - Has no deduction for wages and salaries
Evaluating the BNRT

- **Pros:**
  - Less volatile than the corporate income tax, has broader coverage

- **Cons:**
  - A new tax to implement
  - Less progressive than other options
Outline

- Why consumption taxes?
- Possible reforms and their effects
- Conclusions
Reform of Current System May Be Most Effective Strategy

- Reform the sales tax
  - Broaden base to include many more consumption expenditures
  - Reduce taxation of business purchases
- Modify the corporate income tax
  - Mandate sales-only apportionment
  - Extend to large non-corporate businesses
Extra Revenue Would Have Three Key Potential Uses

- Reducing personal income tax
- Addressing budget imbalance
- Dealing with equity issues
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Notes on the use of these slides

These slides were created to accompany a presentation. They do not include full documentation of sources, data samples, methods, and interpretations. To avoid misinterpretations, please contact:

Alan Auerbach: (510) 643-0711, auerbach@econ.berkeley.edu

Thank you for your interest in this work.