

## INSTITUTE OF REGIONAL AND URBAN STUDIES

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DATE: July 8, 2003

TO: Budget Project Friends

FROM: Stephen Levy

SUBJECT: Analysis of California's Three Major Tax Bases

1. In June 2003, the Institute of Regional and Urban Studies (IRUS) was awarded a grant from The James Irvine Foundation to provide information and analysis on both short and long-term budget issues in California. The IRUS focus is on understanding the relationship between budget choices and the California economy.

IRUS is the non-profit affiliate of the Center for Continuing Study of the California economy (CCSCE).

2. This memo is the first in a series of brief reports on issues related to the state budget and economy.

California depends on three major taxes for the majority of state and local tax revenue. The personal income tax and sales tax are the largest sources of tax revenue for the state budget and property taxes and sales taxes are the largest source of tax revenues for most local jurisdictions including school districts.

The Commission on Tax Policy in the New Economy and many others have called attention to the question of whether the state's existing tax structure needs to be reformed. One part of that discussion focuses on the volatility and long-term growth of the state's three major tax bases—1) personal income, 2) taxable sales and 3) the assessed value of property.

This memo provides some data and analysis of the growth and volatility of these three tax bases.

3. I tabulated data for the period 1980-2002 for total personal income from the United States Department of Commerce and for taxable sales and assessed valuation from the California Board of Equalization. I looked at

two major time periods—1980 through 1990 and 1990 through 2002. All of the data and original graphs are in the accompanying file Tax Bases.xls.

#### **4. Summary**

Taxable sales is the slowest-growing and most volatile of California's three major tax bases. These characteristics will continue unless the taxable sales base is broadened to include spending on selected fast-growing service sectors. Broadening the sales tax base will also reduce volatility by a small amount.

Assessed valuation had the highest growth rate in the 1980s and the second highest since 1990. Volatility was similar to that for personal income. Future growth rates will depend on the level of private sector building and the rate of turnover. The two major reforms currently under consideration, sales/property tax "swaps" and periodic reassessment of commercial property, are being advanced primarily to address inequities and disincentive effects stemming from the unintended consequences of Proposition 13.

Personal income is expected to be the fastest growing and most progressive of the state's three major tax bases. Recent volatility in the portion of the income tax base related to the stock market has gained attention as a concern for the future. Consideration should be given to treating this as an **expenditure reform** issue through 1) the creation of a reserve account funded with "extra" stock market related revenues and/or 2) using the "extra" revenues exclusively for one-time investment purposes.

#### **5. Tax Base Growth**

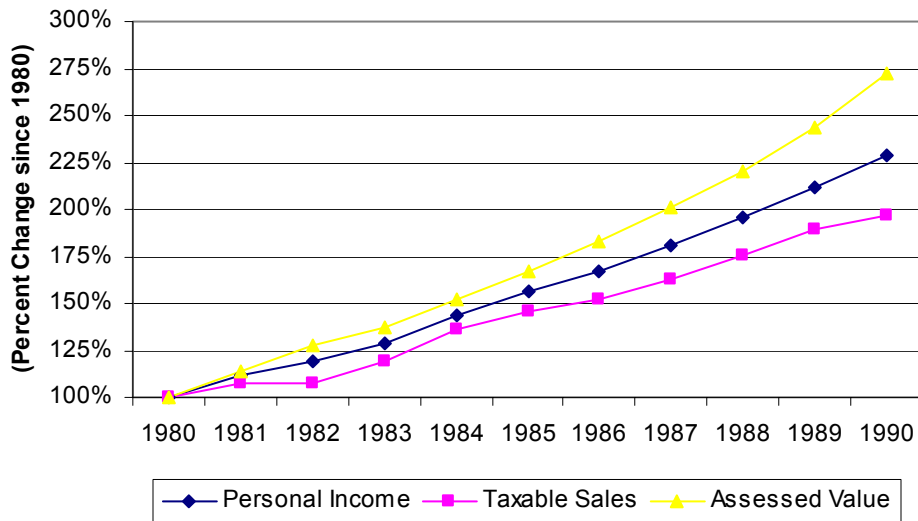
In the 1980s, assessed valuation grew faster than both personal income and taxable sales. Between 1980 and 1990, assessed valuation in California grew by 172.5% or 10.5% per year. Personal income increased by 129% or 8.6% per year and taxable sales rose by 96.6% or 7.0% per year. The California Consumer Price Index increased by 5.1% per annually.

**California**  
**Personal Income, Taxable Sales and Assessed Valuation**  
 (Billions)

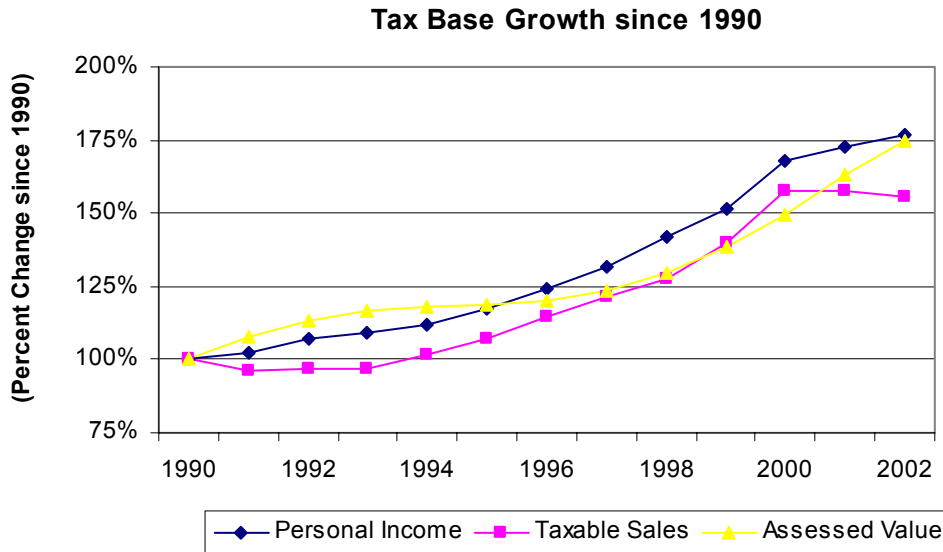
	1980	1990	2000	2002	Average Annual Growth Rate		
					1988-1990	1990-2000	1990-2002
Personal Income	\$286.3	\$655.6	\$1,100.7	\$1,158.7	8.6%	5.3%	4.9%
Taxable Sales	142.8	280.6	441.9	436.1	7.0%	4.6%	3.7%
Assessed Valuation	579.0	1,577.9	2,355.4	2,755.8	10.5%	4.1%	4.8%

The growth rate for inflation and population combined in the 1980s was 7.5% per year.

**Tax Base Growth in the 1980s**



Since 1990, personal income and assessed valuation have grown at roughly the same rate while taxable sales grew more slowly. Between 1990 and 2002, personal income increased by 76.7% or 4.9% per year while assessed valuation rose by 74.6% or 4.8% per year. Taxable sales increased by 55.4% or 3.7% per year while the California Consumer Price Index rose by 2.7% annually.



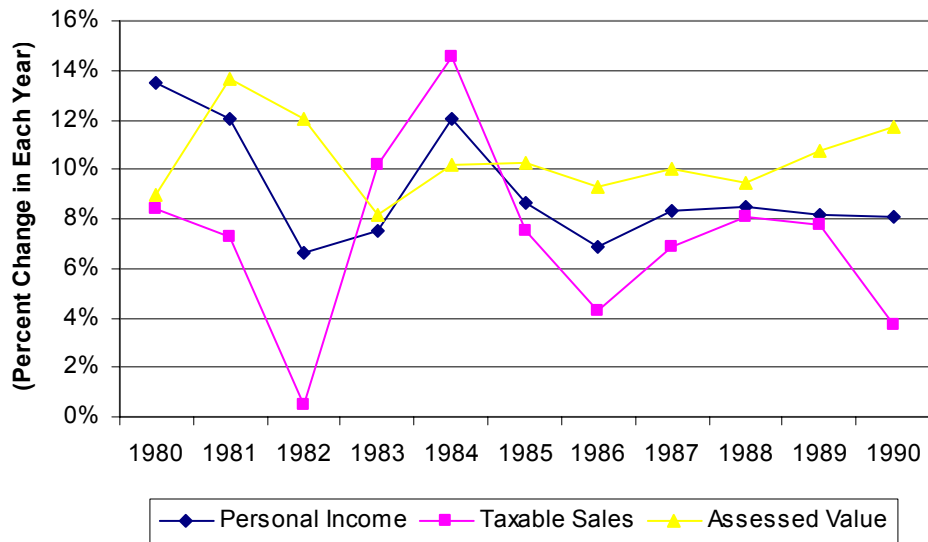
The growth rate for inflation and population combined between 1990 and 2002 was 4.2% per year.

### 6. Tax Base Volatility

Volatility refers to how much the growth rates of the tax base vary from year to year. For example, if the ten year average growth rate is 4.9% and the growth rate for each year within the ten year period is also 4.9%, then that particular tax base would be consider very stable. If, on the other hand, the 4.9% average growth rate for the ten-year period included two years of negative growth and three years of growth above 10%, then that tax base would be considered volatile.

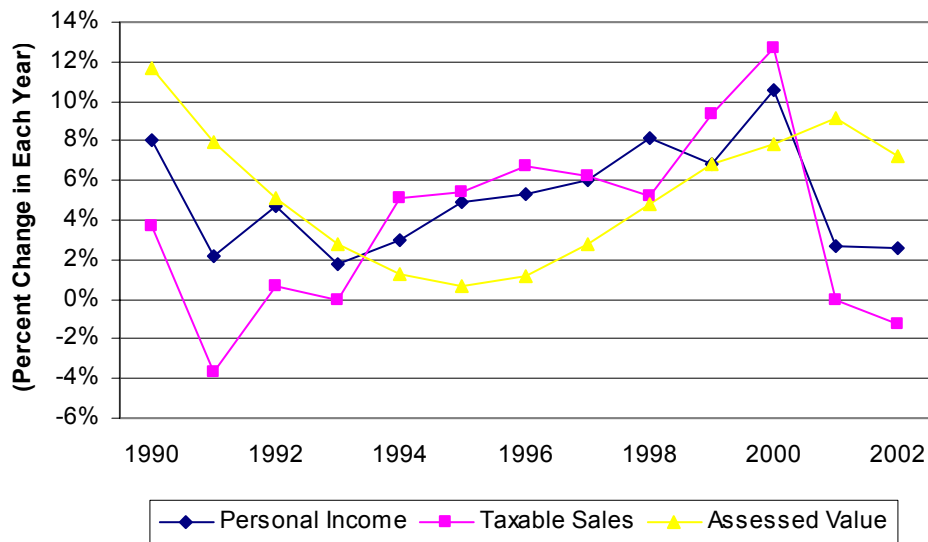
In the 1980s, as shown below, the taxable sales series was quite volatile having both the highest and lowest single year growth rates among the three tax bases being analyzed. Both personal income and assessed valuation growth rates rose and fell during the early 80s recessions and then have relatively stable annual growth rates starting in 1985.

**Tax Base Volatility in the 1980s**



Between 1990 and 2002, the taxable sales series had the highest volatility; once again having both the highest and lowest single year growth rate as well as five years where taxable sales growth was less than 1%. The personal income series was the most stable through 2000 and then had two years of low growth. The assessed value series had the sharpest drop in the early 90s and had five years in the middle 90s with the lowest growth rate among the three series.

**Tax Base Volatility since 1990**



Personal income tax **receipts** were quite volatile after 1998 as stock option income and capital gains rose rapidly and then fell rapidly, even

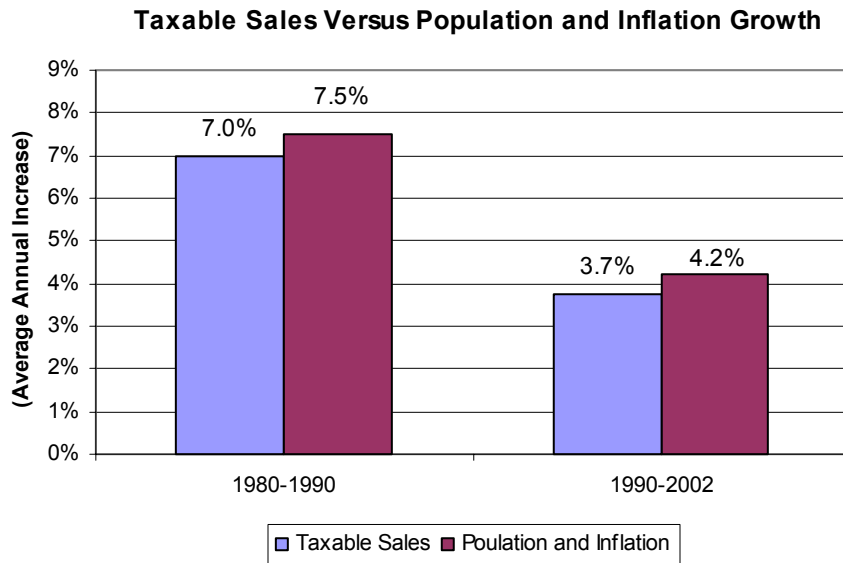
though the underlying personal income series did not vary as much. The implications of differing growth rates in personal income and personal income tax receipts are discussed below.

## 7. Interpretation and Implications

What are some of the implications of this data for discussions about the adequacy of California's tax structure for the current and future economy?

### Taxable Sales/Sales Tax Revenues

Taxable sales have been the slowest growing and most volatile of California's three major tax bases. As shown below, taxable sales growth did not keep pace with population and inflation growth in either the 1980s or the period since 1990. In the 1980s, taxable sales rose by 7.0% per year, while population and inflation increased by 7.5% annually. Between 1990 and 2002, taxable sales rose by 3.7% per year while population and inflation increased by 4.2% annually.



The charts above show that taxable sales have been the most volatile of the state's three major tax bases.

The slow growth of taxable sales is explained by the absence of fast growing expenditure items such as services and housing from the taxable sales base. These past trends are expected to continue as services represent a rising share of consumer spending.

The volatility of taxable sales is explained by the close link between business and consumer spending and the business cycle. In all recent

recessions, spending has fallen by more than income. It is reasonable to expect that taxable sales will continue to be the most volatile of the three major tax bases.

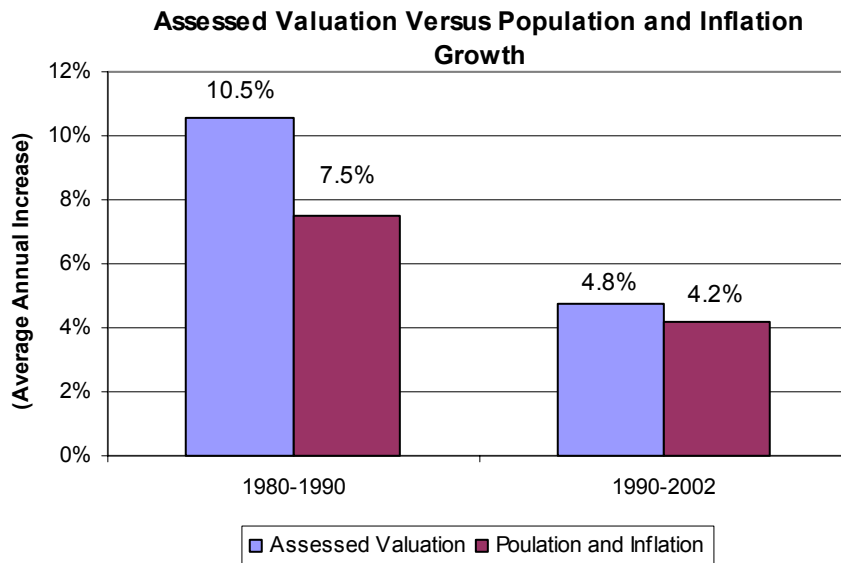
**The principal sales tax reforms being discussed address both the slow growth and volatility of the sales tax base.** The major sales tax reforms involve broadening the sales tax base to include services. These reforms range from the narrower goal of including all Internet transactions in the state sales tax base to broader efforts that involve extending the coverage of taxable sales to various expenditures on services such as legal, consulting, repair and, possibly, medical services.

Broadening the sales tax base would be effective, in my opinion, in raising the sales tax growth rate and in slightly reducing the volatility of sales tax revenues.

Whether broadening the sales tax base should be accompanied by tax rate reductions depends on overall budget and revenue considerations.

### Assessed Valuation/Property Taxes

Assessed valuation grew faster than population and inflation combined in both the 1980s and the period since 1990. As shown below, assessed valuation grew by 10.5% per year between 1980 and 1990 compared with the 7.5% annual increase for population and inflation. Since 1990 assessed valuation growth (4.8% per year) has been slightly faster than the 4.2% annual growth rate for population and inflation.



Assessed valuation grew rapidly in the 1980s driven by record residential and nonresidential construction, and rising home prices and high turnover

rates at the end of the decade. Assessed valuation growth slowed significantly in the 1990s as construction levels fell during the early 90s and, except for public construction, which does not affect the tax base, have not since approached previous record levels.

In the short term, AV growth is expected to slow. Nonresidential construction levels will remain low until existing vacancies are worked off. New housing construction is rising, but the volume of re-sales will level off and fall soon as interest rates rise. It is important to understand how much of recent housing market activity has been driven by record low mortgage rates.

In the longer term AV growth will probably keep pace with population and inflation increases as in the 1990-2002 period.

**The AV reform issues deal with equity and land use incentive considerations more than the overall level of AV growth.**

One set of reform suggestions deals with increasing the share of property tax revenues allocated to local governments with an offsetting decrease in sales tax revenues. This proposal is “revenue neutral” meaning that it will not raise or lower the amount of taxes collected.

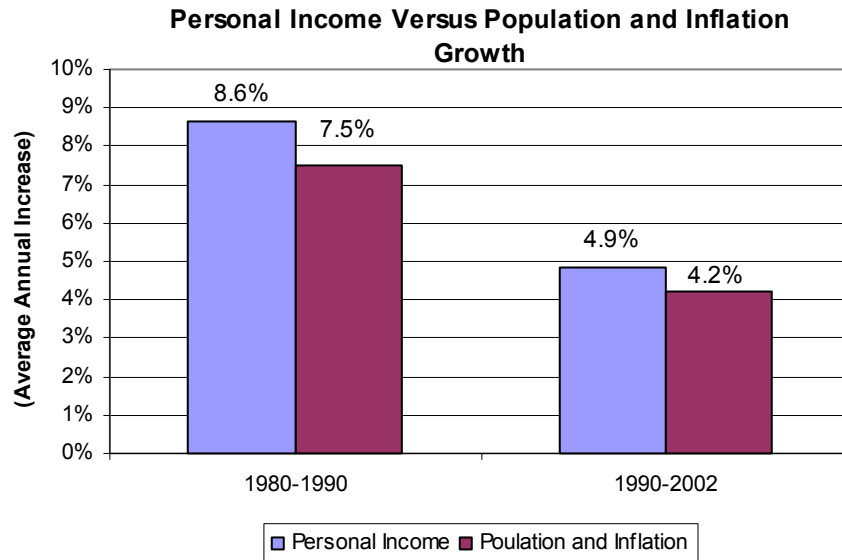
Reforms that provide stronger fiscal incentives for local governments to approve housing developments **will directly address regional equity and economic goals as housing, particularly housing for lower and middle-income families is critical to maintain regional economic competitiveness.**

Another proposed reform, increasing the assessed valuation of nonresidential properties, potentially addresses revenue growth, equity and incentive considerations. The increased revenues from changing the rules on commercial property assessment could go either to raising overall local government revenues or, if offset by reductions elsewhere, go more to correcting inequities between comparable group of property owners and improving the incentives for new developments.

**Personal Income/Income Tax Revenues**

In discussing the future of the income tax, it is important to distinguish trends in personal income and trends in stock option income and capital gains. Capital gains is **not** counted in personal income but **is** counted in income for tax purposes.

Personal income grew faster than population and inflation combined in both the 1980s and the period since 1990. As shown below, personal income grew by 8.6% per year between 1980 and 1990 compared with the 7.5% annual increase for population and inflation. Since 1990 personal income growth (4.9% per year) has been slightly faster than the 4.2% annual growth rate for population and inflation.



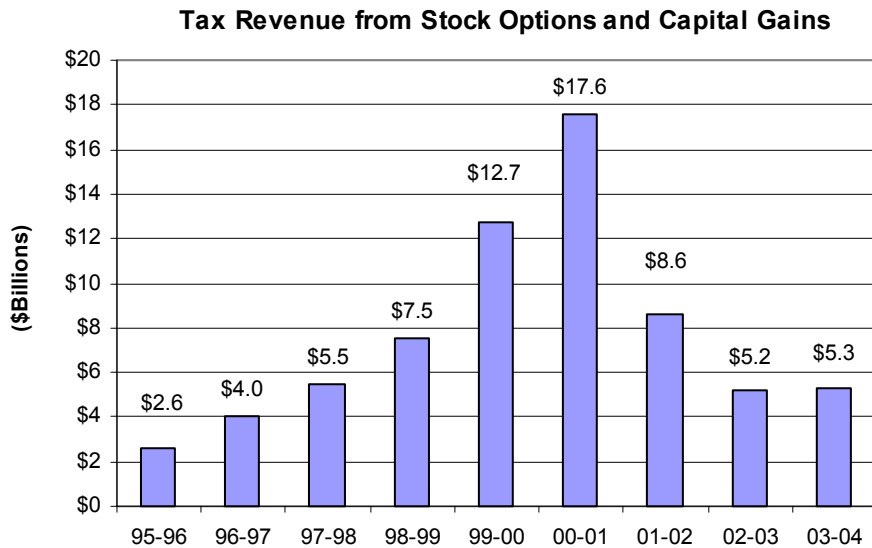
Personal income growth rises and falls with the business cycle, but personal income volatility is no greater than for assessed value and is less than the volatility in taxable sales.

Over the long-term, personal income is expected to **grow faster than** taxable sales and assessed valuation, at least as these tax bases are currently structured.

Personal income tax **revenues** have been volatile since 1998 because the personal income tax base is affected by variations in stock option income (which is included in personal income) and variations in capital gains, which are not included in personal income as compiled by the United State Department of Commerce and the California Department of Finance. Thus, there is a distinction between the personal income series and the personal income tax base.

As shown below, tax revenues from stock option income and capital gains rose and then fell by approximately \$12 billion between 1997-98 and 2002-03. Similar fluctuations in stock option income and/or capital gains

could occur in the future if the stock market and tech economy surge again.



**The policy question is what to do about these revenue fluctuations.**

I offer two ideas from an economic policy perspective. One, it does not make sense to de-emphasize the income tax. Personal income is expected to be the fastest growing of the state's three major revenue bases and the personal income tax is the most progressive component of California's tax structure

Two, it does make sense to take account of these fluctuations. While fluctuations in stock option income and capital gains cannot always be predicted ahead of when they occur, they **are** identifiable after the fact. Legislators **did** know in 2001 and 2002 that stock option and capital gains revenue had risen and was currently falling.

This ability to identify fluctuations in revenue caused by stock options and capital gains suggests the policy approach, already widely discussed, of treating these revenues **differently from the point of view of the spending side of the budget**. Indeed, there was an early attempt by Governor Davis and the Legislature to use these revenues for one-time expenditures.

Appropriate policy can insulate the state's spending from revenue fluctuations in stock option income and capital gains. Technically (politically may be a different story) one-time surges in revenues can be matched with one-time expenditures and/or put into a reserve fund.

Thus, it is possible to reform the way we treat income tax revenues without diminishing the importance of the personal income tax in California's tax structure.