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# Consumption Tax Options for California

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## SUMMARY

California's ongoing budget crises have prompted a serious evaluation of the state's revenue system. The state's revenue is more volatile than that in other states, and this volatility can be attributed, in part, to California's tax structure.

Also of considerable concern is whether the state's tax system promotes economic activity while providing a fair distribution of the tax burden. Moreover, California relies heavily on state-level tax collections to finance state and local public expenditures, and thus its tax structure plays a critical role in the functioning of the state's economy.

In the 2009–10 fiscal year, California collected roughly $27 billion in sales and use taxes for the state's general fund, $45 billion in individual income taxes, and $10 billion in corporate income taxes (Legislative Analyst's Office, 2010). These three taxes together consistently account for over 90 percent of the state's general fund revenues. As in many states, California's tax system relies heavily on taxing both personal and corporate income. However, many have suggested that a greater reliance on consumption taxes—taxes based on the consumption that occurs in California, rather than on the income earned in the state—might improve the performance of the revenue system. This report reviews concerns about the current tax system and evaluates five potential consumption-based tax reforms.

**Retail sales tax (RST) reform.** Much household consumption is excluded from taxation, including services and Internet sales, both of which have been growing steadily as a share of

household consumption. And a large share of the state's sales tax is derived from purchases by businesses, raising the cost of doing business in California. Reforming the retail sales tax could address both of these issues, increasing the state's revenue base while reducing the burden on businesses.

**Corporate income tax reform.** The California corporate income tax is a volatile source of revenue, but it can be improved. Basing its apportionment exclusively on sales could enhance the state's business climate.

**Gross receipts tax (GRT).** This tax, recently introduced by several other states, would apply to all business sales, including interstate sales and sales to other businesses. It would broaden the tax base and provide greater stability in state revenues. However, it would raise production costs and reduce California's competitiveness by increasing the taxes imposed on business purchases.

**Value added tax (VAT).** Like a retail sales tax levied only on sales to consumers, a value added tax is levied on consumption. Unlike a retail sales tax, a value added tax would impose taxes in stages, as production occurs. A value added tax might be less susceptible to tax evasion than the retail sales tax, but this potential advantage would need to be weighed against implementation costs.

**Sales-apportioned tax on value added.** This tax, called a "business net receipts tax" (BNRT), would be based on national value added, with California's share determined using a sales-only apportionment formula. This tax would not be as effective at promoting production within the state, but it would be easier for an individual state to implement than a state-level value added tax.

In the following pages, we discuss the advantages and disadvantages of each option in terms of revenue volatility, economic distortions, equity, and ease of implementation and administration. In the end, reform of the existing tax structure may provide the most straightforward path to reform, particularly in light of the potential difficulties of introducing an entirely new tax system.

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