

**Informational Hearing  
Assembly Revenue & Taxation Committee**

**Tax Policy in a Period of Budget Crisis:  
An Examination of Revenue Options and Tax Expenditures**

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**Testimony of  
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Thank you for inviting me to participate in this informational hearing today.

My remarks on the California sales and use tax focus on the need to modernize this tax. Specifically, I'll discuss the need to modernize the base of this tax so that it reflects 21<sup>st</sup> century ways of living and doing business. Modernizing the base is necessary due to changes in how people consume goods and services today relative to when the sales tax was created in the 1930s. In addition, exemptions and special rules in any tax should be reviewed periodically to be sure they continue to make sense and are appropriately designed to meet their intended goal. Periodic review of a tax base should be done whether or not a state is in a budget crisis.

I want to emphasize two key points in any efforts to change California taxes:

1. California can and should improve its tax and budget systems without resorting to tax rate increases.
2. Benefits will arise from following the principles of good tax policy such as equity, simplicity and economic growth and efficiency.

Let me elaborate:

California income and sales tax rates are already high and should not be raised further. If California has a revenue problem it is not in the rates, it is in the base. In fact, broadening of the sales tax base should be accompanied by a rate *reduction*. If base problems are ignored and tax rates are increased to generate revenue, the base problems will be compounded and we will just be postponing fixing the base problems. And those problems will get tougher to fix the longer we procrastinate.

If additional revenues are needed, that can still occur with a broader base and a lower rate. Also, so as to not create new budget problems, any additional revenue raised should not be earmarked but should instead be part of our general tax revenues.

Here are ten reasons for broadening the sales and use tax base and the benefits to be obtained:

1. A broader base would allow our high sales tax rate to be lowered. That could make the state more attractive to businesses and make the tax less regressive.
2. Economically, there is no reason not to tax all consumption under a sales tax.
3. Exemptions for necessities of life, such as food and utilities, are poorly targeted, making them more expensive to the state than needed and making the system less equitable. For example, not only is milk tax exempt, but also soda and an expensive gourmet block of cheese.
4. Consumption patterns have changed yet the tax base has not. For example:
  - a. According to the Legislative Analyst's Office, in 1981, 48% of consumption was of items subject to tax. That figure dropped to 38% by 2005.
  - b. Many items previously purchased as taxable tangible personal property are today purchased as non-taxable digital goods, such as music, books and software. This erodes the sales tax base.
  - c. Last Thursday, Apple announced that iTunes had become the "top music retailer in the US."

Tax bases should reflect the current economy. This was well stated in a 1967 report of the Ohio Tax Study Commission. They said: "Insofar as possible, a tax or tax structure should be capable of growing with the economy of the state and should be revised from time to time so as to correspond with the true makeup of that economy as it develops and changes."

5. Changes in consumption are not consistent across income groups which makes the sales tax more regressive and unfair. For example, higher income households have greater access to broadband than do lower income households which makes it easier and more likely that the higher income households will buy certain goods in digital form rather than taxable tangible form.
6. A broader base makes a tax less volatile.
7. Broadening the base will bring California's sales tax more in line with other states that tend to tax more services. Some states have changed their tax base to include digital goods, such as New Jersey in 2006.
8. A broadened base may help cities make better land use and economic development decisions because they won't be incentivized as they are today to only want retailers selling tangible personal property.
9. Exemptions should be reviewed regularly to be sure they are still warranted and if so, that they are working as intended.
10. A broader base would better enable the sales tax to meet the principles of simplicity, neutrality, efficiency and fairness.

Certainly, there are challenges and costs of broadening the base. First, change in general is never easy. Broadening the base means that something that wasn't taxed yesterday is

taxed today. Needless to say, that's not popular. However, a rate reduction and education as to why the base was broadened should help.

Also, more businesses will have to collect sales tax which involves new compliance costs. These businesses should be given a refundable credit to help offset the start-up costs. Also, the changes should be implemented over a sufficient time period to give businesses time to get ready to collect and for the Board of Equalization to provide assistance. The recently failed services tax in Michigan was enacted in October and effective on December 1. That is not enough time for businesses newly subject to collection to get ready.

Compliance costs for vendors and administrative costs for the Board can be lessened with efforts to simplify compliance through the use of technology and fewer reporting periods.

Another cost is that vendors should be compensated for collecting sales tax – not only vendors newly subject to collection obligations under a broadened base, but even those already collecting sales tax for the state.

There could be adverse effects to some local governments – there are likely to be winners and losers. Depending on what is added to the base, the amount of the rate reduction and a city's current mix of taxable items before and after, some cities might see a reduction in sales tax collection. It would be helpful if some transitional relief could be provided to such cities.

Another cost would occur if the broadened base included items primarily purchased by businesses. This would make pyramiding in our system worse than it already is. It might also lead to a loss of business in this state. Broadening of the base should focus on items mostly used by individual consumers so as not to make the pyramiding problem in our system any worse.

Finally, depending on how the base is broadened, some of the revenue might be needed to provide targeted relief to low-income taxpayers. For example, if the base were broadened to include all food, a refundable income tax credit should be provided for relief for lower income individuals and to reduce the regressivity of the change.

I was also asked to note some of the sales tax exemptions that, in my opinion, are outdated or inefficient. Here are some items I think we should and could add to the sales tax base:

1. The digital equivalent of currently taxed tangible personal property – music, books, off-the-shelf software – items that are downloaded from the Internet but used just as we'd use the tangible equivalent;
2. Services that are primarily produced and consumed in the state by individual consumers, such as entertainment, lawn care services, health club memberships, club admissions, dry cleaning, pet care, and other personal services;
3. Bottled beverages unless prescribed by a doctor, or alternatively, non-dairy beverages not prescribed by a doctor; and

4. Household utilities (with a refundable income tax credit for low-income individuals).

It is important to note that there are other states that tax these items and we can learn from their experience.

While there are also specific and odd sounding exemptions for some businesses, such as ice used for transporting food, I would stay away from adding them to the base due to pyramiding.

After an initial base broadening, the base should be looked at again in a few years to consider: more additions, a further rate reduction and a larger refundable income tax credit should necessities of life, such as food, be added.

In summary, California has a sales tax *base* problem. It can't be solved with a rate increase. That would only make the system more unfair, volatile and inefficient. We should be strategic and methodical in making the base changes. For example we should not make all of them at once, but we should have an implementation plan. Any base broadening should be accompanied with a rate reduction. That combination makes it clear that we are modernizing the tax rather than just being desperate for revenue. Of course, the rate reduction and base broadening can be done in a way that raises revenue if desired. Finally, the principles of good tax policy, including equity, neutrality and simplicity should be followed in making any tax law change.

I have a longer document on this topic. I have some copies with me and it is also available on the 21<sup>st</sup> Century Taxation website that I maintain.

[[http://www.cob.sjsu.edu/nellen\\_a/TaxReform/21st\\_century\\_taxation.htm](http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm)]

Thank you.