An Analysis of a Consumption Tax for California

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This report presents the authors' opinions and findings, which are not necessarily endorsed by the SOR.

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The report can be found at http://csus.edu/calst/frfp/consumption_tax_16.pdf.

Agenda

- Purpose of study
- Findings in brief
- Criteria for evaluating proposals
- Findings with more specifics:
  - Why California should not shift revenues from an income tax to a consumption tax + Alternatives:
    - Revenue-neutral modernization of the sales tax base
    - Addressing negative externalities
  - Addressing consumption through formula approaches:
    - Savings incentives
    - The formula approach to replace most of today's sales tax
  - Conclusion
- Comments and Q&A

Purpose of the study

To answer this question ….

Should California broaden its use of a consumption tax, and if so, how?

Findings in brief

1. Do not make a significant change in revenue generation from an income tax to a consumption tax that makes overall tax system more regressive.
2. Implement a revenue-neutral modernization of base of existing sales tax, with a rate reduction, to improve equity and efficiency.
3. Consider forms of taxation beyond conventional consumption taxes, to include ones that address negative externalities, such as pollution and consumption of environmental resources.
4. If desire greater use of a consumption tax (despite #1), do so through income tax structure.
    1. Add savings incentives to income tax system; or
    2. Shifting to a formula approach consumption tax using "income less savings" as tax base.
        - Allows for progressive rates.
        - Reduces non-compliance that can occur with a sales tax with a high rate sales tax and hard-to-collect use tax.

Evaluation Criteria - Principles of Good Tax Policy (Updated January 2017)

1. *Equity and Fairness*. Similarly situated taxpayers should be taxed similarly.
2. *Certainty*. The tax rules should clearly specify how the amount of payment is determined, when payment of the tax should occur, and how payment is made.
3. *Convenience of Payment*. Facilitating a required tax payment at a time or in a manner that is most likely convenient for the taxpayer is important.
4. *Effective Tax Administration*. Costs to collect a tax should be kept to a minimum for both the government and taxpayers.
5. *Information Security*. Tax administration must protect taxpayer information from all forms of unintended and improper disclosure.
6. *Simplicity*. Simple tax laws are necessary so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.
7. *Neutrality*. Minimizing the effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction is important.
8. *Economic Growth and Efficiency*. The tax system should not unduly impede or reduce the productive capacity of the economy.
9. *Transparency and Visibility*. Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
10. *Minimum Tax Gap*. Structuring tax laws to minimize noncompliance is essential.
11. *Accountability to Taxpayers*. Accessibility and visibility of information on tax laws and their development, modification and purpose, are necessary for taxpayers.
12. *Appropriate Government Revenues*. Tax systems should have appropriate levels of predictability, stability and reliability to enable the government to determine the timing and amount of tax collections.

https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/tax-policy-concept-statement-no-1-global.pdf

Additional criteria for evaluating proposals

- National Conference of State Legislatures (NCSL)
  - 9 principles – including
    - "Complementary elements including finances of both state and local governments."
- Also,
  - Legal Constraints
    - Consider restrictions in US and California constitutions.

Appendix A

1. Reasons not to expand consumption tax usage

1. Makes overall tax system more regressive.
2. Income tax already includes some consumption tax elements, such as retirement plans.
3. Advantages exist in keeping income tax system:
   1. Greater revenue potential; reality of the income gap.
   2. Administer certain welfare benefits tied to income, such as EITC and favored deductions.
4. Higher sales tax rate leads to:
   1. Reduced overall revenue (can't raise as much as with income tax).
      - High income individuals do not consume all of their income.
      - Some consumption likely to be exempted – housing, education, food
   2. Regressive system (greater burden on lower-income individuals).
   3. Collection issues.

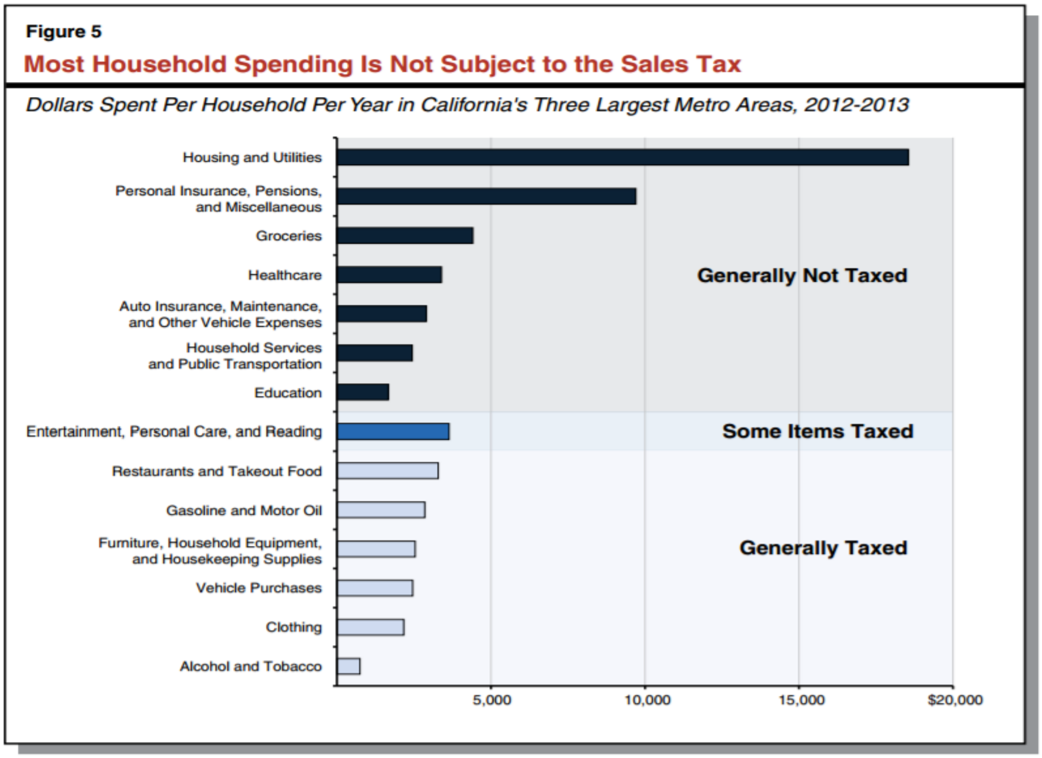
2. Implement a revenue-neutral modernization of sales tax base, with a rate reduction, to improve equity and efficiency.

1. A broader base allows for a lower rate and makes the tax more equitable and efficient.
2. Broadened base should not cover business purchases in order to prevent greater pyramiding in this tax.
3. Base of tangible personal property is similar to that which existed in 1933 despite growth in consumption of services, entertainment and digital goods.
4. Numerous exemptions exist; should re-evaluate in terms of equity, neutrality and simplification.

More on rationale for modernizing sales tax base

- Allows for reduction of today's high rates.
- Reduces regressivity (increase equity).
- Taxes high-end consumption currently exempted (entertainment, personal services, others).
- Improves neutrality.
  - Music CD and iTunes taxed similarly.

Rationale



Revenue potential of untaxed consumption is significant.

Services
~ $122 billion
(State and Local)

Current exemptions
~ $10 billion

Today, sales tax generates
~ $25 billion.

Implementation for modernizing the sales tax base

1. Public education
   - Rationale and benefit to state
   - How this implementation differs from failed efforts in FL, MA and MI
2. Lower the rate too
3. Transition in the changes
   - Allows BOE and businesses to get ready. Avoid MI problem.
4. Start with items people are used to paying tax on
   - Digital equivalents of TPP
   - Businesses that sell TPP and services (car repair, veterinarians)
5. Avoid consumption by businesses
   - Avoid pyramiding and issues in FL and MA.
6. Avoid definitional exemptions whenever possible
   - All or nothing approach is best; if exemption desired, find alternative manner.

     Example – rabies vaccine at veterinarian.

Implementation for modernizing the sales tax base

7. Avoid complexities and inefficiencies by using a single rate and not exempting sellers
   - Ensure follow principles of good tax policy.
8. Include any necessary relief for low-income individuals.
   - Such as via EITC or senior credit based on income.
9. Use new simplified compliance measures
   - Small vendors can file quarterly or with income tax return; collections go into estimated tax payments.
10. Compensate vendors
    - Provide refundable income tax credit for start-up costs of collecting sales tax.
11. Perform necessary legal analysis beforehand
    - Ensure there is no legally exempt item added to base.
12. Learn from other states that have broadened base.
13. Don't create or exacerbate tax and budget system problems.
    - Avoid earmarking any new funds
    - Avoid exempting certain sellers, such as small service providers (today, small retailers collect sales tax).

3. Consider non-conventional consumption taxes, such as those to address negative externalities, such as pollution and consumption of environmental resources.

1. Pigouvian type taxes.
2. Produces other benefits to the state beyond revenues.
3. Might be perceived by public as permissible/acceptable.
4. Can be assessed directly or indirectly.
5. Consider other taxes, such as severance taxes and reform of the property tax.

4. If desire greater use of a consumption tax, do so through income tax structure.

1. Savings incentives added to existing income tax.
   - Exempt all or a portion of investment income, or tax it at lower rate.

2. Replace sales tax with formula approach consumption tax.

Consumption = Income less savings

[details follow]

How to calculate consumption base of *Consumption = Income - savings*

Nicholas Kaldor proposed the following method:

1. Obtain the value of bank balances and cash at the beginning of the year.
2. Add the receipts of income, including gifts.
3. Include money borrowed and funds received in repayment of loans.
4. Add in the proceeds of sales of investments.
5. Subtract money lent or paid in repayment of previous borrowing.
6. Subtract the purchase of investments (including real estate).
7. Subtract the bank balance and cash at the end of the year to obtain gross expenditure.
8. Subtract exempted expenditure [such as donations and taxes paid].
9. Subtract an allowance for the spreading of expenditure on durable goods.
10. Add the proportion of expenditure on durable goods incurred in previous years and chargeable to the current year.

Kaldor 1955, p. 192.

How to calculate consumption base of *Consumption = Income - savings*

Example:

Beginning Bank Balance:	$60,000
Annual Gross Income:	+$100,000
Investment in Stocks:	-$10,000
Bank Balance at end of year:	-$60,000
Exempted Expenditures (tax):	-$30,000
Imputed Rental (house):	+$30,000
Tax Base:	$90,000
Taxes Due:	$5,400

- Step 1: Start with Beginning Bank Balance
- Step 2: Add Income
- Step 3: Borrowing – We assume none
- Step 4: Proceeds of Sale of Investments – We assume none
- Step 5: Loan Repayment – We assume none
- Step 6: Purchase of Investments
- Step 7: Bank Balance at end of Year
- Step 8: Exempted Expenditures
- Step 9: Durable Goods – We assume none
- Step 10: Imputed rental from Durable Goods

- Assume a tax rate of 6%

How to calculate consumption base of *Consumption = Income - savings*

Example:

Beginning Bank Balance:	$60,000
Annual Gross Income:	+$100,000
Investment in Stocks:	-$10,000
Bank Balance at end of year:	-$60,000
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Today:

Annual Gross Income:	$100,000
Investment in Stocks:	-$10,000
Exempted Expenditures (tax):	-$30,000
Available for Consumption*:	$60,000
Sales Tax Base:	$30,000
Sales Taxes Due**:	$2,175

*Assuming that 50% of consumption is currently taxable

**Assuming 7.25% State tax rate

S. 722 (104th Cong; 4/24/95) USA Tax (Appendix VIII)

- Gross Income (all income from whatever source derived including compensation for services, fringe benefits, distributions from business entities, interest, rents, royalties, alimony, child support, pensions, includible social security benefits, income from discharge of debt, and gains from sale of assets (other than savings assets); exclusions exist including, tax-exempt bond interest, some social security benefits, amounts received under accident or health benefit plans, gifts, inheritances)
- *plus* Deferred income (income attributable to withdrawals of previously saved/deferred gross income; referred to as *net includible withdrawal income*)
- *less* Alimony and child support deductions
- *less* Unlimited Savings Allowance (see explanation in appendix)
- *Equals* Adjusted gross income
- *less* Personal and Dependency deduction of $2,550 each
  less Family Living Allowance (for example, $7,400 for married filing joint)
- *less* Homeowner deduction (on up to $1,000,000 of acquisition indebtedness, no home equity interest deduction allowed)
- *less* Education deduction (up to $2,000/person for taxpayer, spouse and two dependents; limited to $8,000 deduction per tax year, generally for higher education tuition and fees)
- *less* Philanthropic transfer deduction (rules similar to current law)
- *less* Transition basis deduction (optional deduction for taxpayers with aggregate basis in qualified savings assets at 1/1/96 of $50,000 or less; purpose is to prevent later taxation of pre-USA tax system savings when they are later withdrawn and not reinvested; individuals with over $50,000 of qualified savings assets at 1/1/96 will have to follow special rules on tracking basis to avoid later taxation on this pre-USA tax system savings)
- *Equals* Tax Base

Advantages of formula approach

a) Progressive rate structure possible.
b) Broadens consumption tax base.
c) Can be calculated along with income tax.
   a) Reduced tax administration costs.
d) Eliminates problem of uncollected use tax.
e) No collection costs for businesses.
f) Eliminates sales tax for business purchases.

Challenges of the formula approach and solutions

Challenges	Possible solutions
"Savings" difficult to measure	• Exempt low-income individuals who also have low savings. (Lines 1 and 2 of the Kaldor calculation) • Provide worksheets and software.
Possible confusion among individuals in a system with both an income tax and a formula approach consumption tax, due to some similarities in calculation.	• Explain system and rationale. • Compare to what individuals previously paid as sales tax and advantages of new system to them and economy.
Local governments lose their sales tax base.	• Create system to enable local gov'ts to share in income tax. Better aligns state and local gov't goals of job creation.
Application to part-year residents.	• Create helpful forms and instructions.
Visitors/tourists won't pay.	• Might be an attraction to visitors. • State might add a TOT.
Won't reach underground economy as well as the sales tax.	• Broaden efforts to reach underground economy. • Remove vehicles from the new system (sales tax continues to apply and purchase is pulled from formula.
Determining revenue neutral rates.	• Consider transitioning in new tax and transitioning out the sales tax.

Implementation of formula approach

1. *Public education:* Find ways to help public understand why sales tax was replaced with a different version of a consumption tax and advantages expected to the state and its residents.
2. *Allow simplified methods for low to middle income taxpayers:* A complexity of the formula approach to taxing consumption is the need to measure net increase to savings during the year. Solutions:
    1. Allow individuals to use a table based on their income to obtain an estimate if they prefer not to track actual net savings.
    2. Exempt low-income individuals.
3. *Provide tools to aid in compliance:* Software tools can be created to help individuals track their net savings. Brokerage firms and banks likely to also offer services to help.

Conclusion

- Current system has weaknesses (Appendix A); so reform is justified.
- Do not move completely to a consumption tax system.
- Improve existing sales/use tax system.
- If desire greater use of consumption tax:
  - Consider taxes that address negative externalities
  - Consider adding more savings elements to existing income tax.
  - Move to formula approach as more likely to meet principles of good tax policy.

Comments and Q&A

Thank you!