What is the Tax Burden in California?

An important issue concerning California's fiscal system is the tax burden: are taxes high or low compared to other states, and does the distribution of the tax burden among types of taxes and taxpayers differ from other states? The most appropriate standard for evaluating the size of state and local government and the burden of the tax system is controversial. One widely used measure is per capita spending and taxation by all state and local governments, and by this measure California ranks among the top ten states in the size of government. But one reason that California spends and taxes more per capita is that incomes in California are above the national average. As incomes increase, state and local governments spend more, in part because citizens want more public services as their incomes grow and in part because the salaries of government employees are higher in states with higher salaries in the private sector.

The most commonly used measure of state income is gross domestic product (GDP), which is the market value of all goods and services (including government services) that are produced in the state. GDP includes all income that, in principle, could be taxed, so tax revenue as a fraction of GDP is generally regarded as a valid measure of the burden, or hardship, imposed by the tax system. Table 1 shows California's share of national GDP, state and local revenues, and state and local government expenditures for 2005 (before the recession) and 2008 (the start of the recession and the most recent comprehensive data that are available). California's share of GDP, 13.3%, is substantially above its share of the population, which is 12.1%.

Table 1 shows that in 2008 California's share of total state and local government revenues were almost exactly equal to California's share in GDP; however, in 2008 total revenue is misleading because California, unlike most states, includes the gains and losses in the asset value of pension funds as part of state revenue. California's pension funds suffered major losses in 2008 due to the fall in the stock and real estate markets. Here the comparison between 2005 and 2008 is especially dramatic. California pension funds had a net loss of $40 billion in 2008, compared to a net gain of $47 billion in 2005.

If both national and California revenues are recalculated to exclude gains and losses in pension funds, California's share of national state and local revenue was 13.9% in 2008. Total revenue from taxes and fees in 2008 was about $25 billion larger than it would have been if California's share equaled its share of GDP. State and local taxes in California were roughly 11.7% of personal income in 2008, compared to 11.0% for the entire U.S. That is, for every $10,000 in income, Californians pay about $70 more in state and local taxes than the average for all states. California does not have the highest tax burden in the U.S. The state with the highest taxes is New York, where taxes account for about 14.5% of personal income.

Table 1 also shows the composition of taxes and fees. While total tax revenues as a share of GDP are above average in California, some taxes are low by national standards. Californians pay less in property and sales taxes than the rest of the nation, but they pay more in income taxes.

Due to Proposition 13, Californians pay lower property taxes than the U.S. average. In 2005, property taxes were roughly 30 percent less than they would have been had Californians paid the same share of GDP in property taxes as the national average. In 2008, property tax revenues were closer to the national norm due to the fact that, because Proposition 13 limited the rise in assessed property values during the real estate boom, the reduction in assessed values after the drop in real estate prices was less in California than elsewhere. If housing prices rise during the recovery, California's share of property tax revenues will again fall for the same reason.

Sales taxes include the general retail sales tax plus an array of excise taxes on specific goods and services. California has one of the highest retail sales tax rates in the nation, but Californians pay a lower fraction of their incomes in sales taxes than the U.S. average for two reasons. First, California exempts more goods and services from its general retail sales tax than other states do. The retail sales tax in California does not apply to groceries, and nearly all services are either exempt from sales taxes or are taxed at a much lower rate. For example, insurance premiums are taxed at 2.35%. Second, excise taxes on specific products, such as alcohol, tobacco and motor fuel, are generally lower in California than elsewhere. If the share of sales tax revenue in state GDP equaled the national average, revenue would be about $8 billion greater.

The common perception that California is a high-tax state is due to the state's personal and corporate income taxes, which are the most important source of state revenue. Income tax revenues in California are nearly $24 billion greater (about 40% of total revenue from state income taxes) than would be the case if the share of GDP from these taxes equaled the national average. Income tax revenue is highly variable from year to year. Corporate profits are very sensitive to the state of the economy, so that during a recession corporate income tax revenue falls dramatically. California's personal income tax revenue also varies over the business cycle. An important part of the personal income tax is the capital gains tax, and capital gains revenue falls during a recession as prices of stocks and real estate fall. California's income tax also is highly *progressive* – that is, the tax rate is higher for higher income households. Consequently, during a recession personal income tax revenues fall faster than incomes.

Table 1 also shows how state and local governments spend the revenue that they collect. California spent about $44 billion more on all state and local government activities in 2008 than it would have spent had expenditures equaled the national average share of GDP. Over half of this difference is accounted for by two categories: government-owned utilities and public safety.

Over 25% of California's larger expenditures ($12 billion) are for government-owned utilities. The state water project and the Los Angeles Department of Water and Power rank among the largest utilities, public or private, in the nation. While government-owned utilities are much more common in California than most other states, taxpayers would still pay for utility services if they were privately owned. User fees pay about 75 percent of the cost of government-owned utilities, while taxes pay for most of the rest. More than half of the losses in the utility sector are in public transportation, where user fees pay only about a quarter of total costs.

Another 25% ($11 billion) of the excess expenditures is accounted for by police, fire and corrections. Four other areas account for the rest California's additional spending: public insurance, health care, public employee pensions and community development (including housing). Public insurance programs, including unemployment and workman's compensation, spend over $5 billion more than the national average share of GDP, which is more than 40% of total spending. These programs are paid from dedicated taxes and fees, so benefits and taxes must be changed together. In the other three areas California spends about $4 billion more on community development, $5 billion more on health care, and $6 billion more on public employee pensions than its share of national GDP. Californians spend below the national norm on most other programs, including education, welfare and public roads.

An important feature of a tax system is the distribution of the tax burden by household income. Table 2 shows estimates of the percentage of adjusted gross income on federal tax returns that non-elderly households pay in state and local taxes by quintiles (five groups that each contain 20% of all households) ranked by income. The highest-income group is further divided into those ranking between the 80th and 95th percentile, those ranking between the 95th and 99th percentile, and the top one percent of households. Table 2 shows that state and local taxes are *regressive* – that is, the portion of income that is paid in state and local taxes is higher for low-income families. California's tax system is substantially less regressive than the average for all states, primarily because personal and corporate income taxes are both larger and more progressive than in other states. Corporate and personal income taxes account for 7.5% of household income and over 75% of total state and local taxes paid by the wealthiest one percent of households in California (households earning more than $600,000 annually).

The most regressive major tax in California is the sales tax. The poorest 20% of households pay 6.5% of their income in sales taxes, compared to 0.8% for the top one percent. For the nation as a whole, poor households pay 7.1% of their incomes in sales taxes while the wealthiest one percent pay 0.9%. Thus, both nationally and in California, poor households pay about eight times as high a fraction of their incomes in sales taxes as the wealthiest households pay.

Table 1: State GDP and State and Local Expenditures and Taxes: Percentage of GDP in 2005 and 2008

Item	Fraction of Nation 2005	Fraction of Nation 2008	California $ Billions 2005	California $ Billions 2008
GDP	13.2	13.4	1629	1925
State and Local Revenues	15.1	13.3	381	354
Federal Transfers	12.5	12.0	58	55
Taxes	14.2	14.4	165	198
Property	10.1	12.9	34	53
All Sales	12.7	11.9	49	54
General Retail	14.3	13.5	38	41
Motor Fuel	9.4	9.0	3	3
Other (Alc., Tob., Util., etc.)	9.4	8.5	8	9
Personal Income	17.7	18.6	43	57
Corporate Income	20.0	20.4	9	12
Motor Vehicle	12.7	12.8	3	3
Insurance (Unemp., Disab.)	28.4	19.8	19	12
Fees	15.2	14.8	88	99
Higher Education	9.6	9.3	7	9
Hospitals	15.2	14.0	12	14
Government-Owned Utilities	19.4	19.2	22	27
Interest	12.9	13.3	8	12
Employee Pensions	21.9	*-48.6*	69	*-13*
State and Local Expenditures	14.5	14.6	339	415
Net State to Local Transfers	19.5	19.8	74	88
Education	12.9	12.6	89	104
Higher Education	12.8	13.2	23	30
Elementary and Secondary	13.0	12.5	62	71
Welfare	12.3	12.6	44	51
Hospitals and Health Care	15.0	15.3	26	32
Highways	9.7	10.2	12	16
Police, Fire and Corrections	16.4	17.1	27	36
Community Development	19.9	20.2	8	10
Parks and Recreation	15.2	15.3	5	6
Government-Owned Utilities	19.6	18.6	31	36
Public Employee Pensions	15.1	15.9	22	29
Insurance (Unemp., Disab., etc.)	22.6	22.2	11	12

Sources: U.S. Department of Commerce, Bureau of the Census, "State and Local Government Finance by Level of Government and State," and U.S. Department of Commerce, Bureau of Economic Analysis, "Regional Economic Accounts," both available annually and accessible on the web site of the U.S. Department of Commerce.

Table 2: Fraction on Income Paid in State and Local Taxes For Non-elderly Families By Income Ranking, 2007

Income Group	Fraction of Income Paid in Taxes			
	California		All U.S.	
	Gross[1]	Net[1]	Gross[1]	Net[1]
Lowest 20% (up to 20th percentile)	10.2	10.2	10.9	10.9
Next Lowest 20% (20th to 40th percentile)	8.7	8.7	10.0	9.9
Third Lowest 20% (40th to 60th percentile)	8.3	8.1	9.7	9.4
Fourth Lowest 20% (60th to 80th percentile)	8.3	7.7	9.3	8.5
Next 15% (80th to 95th percentile)	8.8	7.5	8.8	7.4
Next 4% (95th to 99th percentile)	9.2	8.2	7.8	6.7
Top 1%	9.8	7.4	6.4	5.2

1. "Gross" is amount paid, while "Net" is net payment after federal deductibility of some state taxes in calculating federal income taxes.

Source: Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems of All 50 States*, 3rd Edition, November 2009.