

WHO PAYS TAXES IN CALIFORNIA?

The primary purpose of a tax system is to support public goods and services. State and local taxes are the way that Californians collectively pay for schools, public hospitals, the state’s transportation infrastructure, and various other public systems and services. However, these tax dollars are not collected according to individuals’ and families’ ability to pay. Contrary to the oft-repeated claim that high-income Californians pay an unfair amount of taxes, it is actually California’s low-income households who pay the largest share of their incomes in state and local taxes. Given widening income inequality over the last generation, and the ongoing economic challenges facing Californians in the aftermath of the Great Recession, policymakers could take specific steps to reduce the regressive nature of California’s system of state and local taxes and to promote economic security for low-income families.

Where Do the Dollars for State and Local Services Come From?

State and local government in California relies primarily on three types of taxes in order to deliver key services and perform necessary functions: property taxes, sales taxes, and taxes on personal income. In 2010-11, the most recent year for which both state and local government data are available, California’s state and local governments collected a combined \$185.2 billion in taxes.¹ (Local governments include municipalities, counties, school districts, and special districts.) While total tax collections in California are split about evenly between sales taxes, the personal income tax, and property taxes, state government tax dollars and local government tax dollars differ significantly in their composition (Table 1). Specifically:

- **Most state tax dollars come from the personal income tax and sales taxes.** More than four in 10 dollars (43.3 percent) of the \$116.7 billion collected by California’s state government in 2010-11 were from the personal income tax, and another 38.7 percent came from taxes on sales, including a general sales and use tax and additional taxes

Table 1: Where Tax Dollars Come From Differs Among California's State and Local Governments

Tax Source	Share of State Government Tax Revenues, 2010-11	Share of Local Government Tax Revenues, 2010-11	Share of Total State and Local Government Tax Revenues, 2010-11
Personal Income	43.3%	0.0%	27.3%
Sales	38.7%	20.5%	32.0%
Corporate Income	8.2%	0.0%	5.2%
Property	2.7%	73.4%	28.9%
Other	7.0%	6.1%	6.7%
TOTAL	100.0%	100.0%	100.0%

Note: Taxes on property include motor vehicle license (in-lieu) fees and the private railroad car tax.

Source: US Census Bureau

on tobacco, fuel, and other specific goods and services.² Taxes on corporate income represented 8.2 percent of total state tax collections.³ Other taxes, such as motor vehicle registration or some business license taxes, accounted for 7.0 percent.

- **Nearly all local tax dollars come from property taxes and sales taxes.** Property taxes accounted for nearly three-quarters (73.4 percent) of local government tax collections in 2010-11, and sales taxes accounted for an additional 20.5 percent.⁴ Other various taxes, such as some business license taxes, made up 6.1 percent of local government tax revenues.

An important characteristic of California's state budget is that many *local* systems and services are funded in part by the state, meaning that state dollars flow to local communities. One notable example is K-12 education. While California's school districts receive funding through local property tax revenues, school districts still get a majority of their funding through the state.⁵

Low-Income Families Pay the Largest Share of Their Incomes in State and Local Taxes

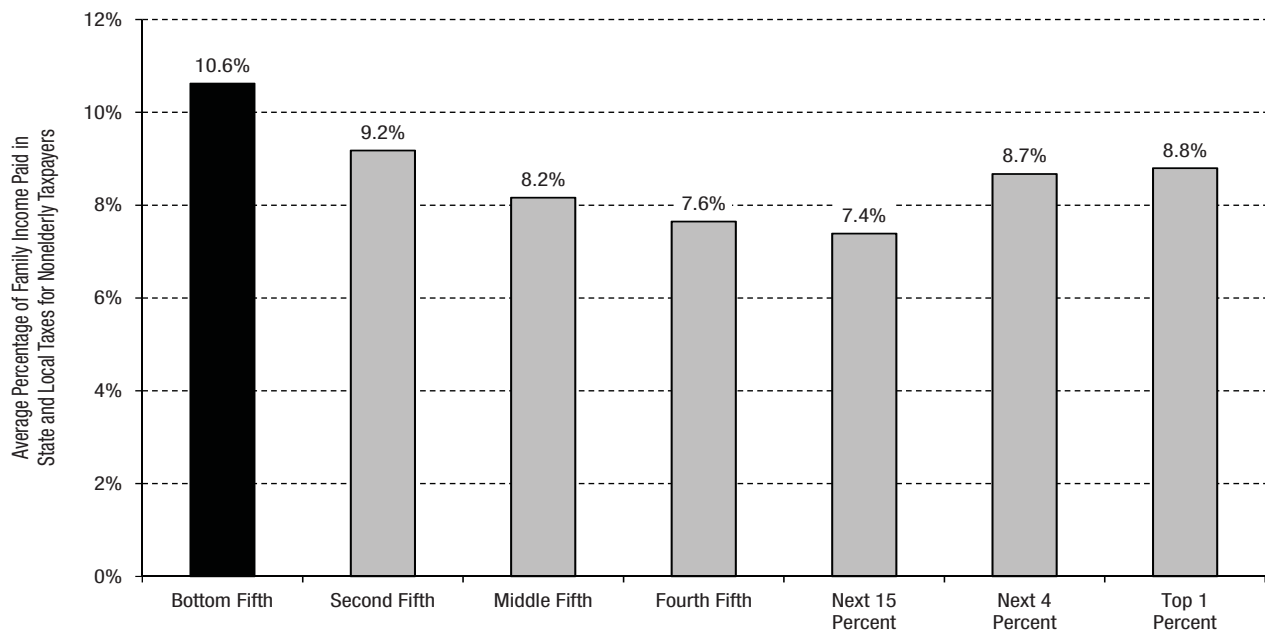
A fair tax system is one that asks individuals and families to contribute to public services based on their ability to pay. However, California's system of state and local taxes asks disproportionately more from lower-earning households. After taking into account Californians' ability to deduct state and local taxes for federal income tax purposes (discussed below), California's overall tax system is moderately regressive, meaning

that lower-earning households on average pay a larger share of their annual incomes in state and local taxes compared to higher-income households. The bottom fifth of California's nonelderly households, with an average annual income of \$13,000, spend an estimated 10.6 percent of their incomes on state and local taxes (Figure 1).⁶ In comparison, the wealthiest 1 percent of households, with an average annual income of \$1.6 million, spend an estimated 8.8 percent of their incomes on state and local taxes. These estimates include the overall progressive effect of Proposition 30, a ballot initiative approved by California voters in 2012. Proposition 30 temporarily increased the state's sales tax and added new, temporary personal income tax rates for very wealthy Californians.⁷

The share of income that California's households spend on state and local taxes is a function of relatively regressive sales and property taxes and the state's progressive personal income tax. Specifically:

- **Lower-income households pay a greater share of their incomes on sales taxes and property taxes.** Lower-income households spend all, or nearly all, of their incomes on basic necessities, including many goods that are subject to tax. In contrast, higher-income households tend to save a portion of their incomes or spend more of their incomes on services that are not subject to the sales tax. Moreover, low-income

Figure 1: Even With Proposition 30's Tax Rate Increases, California's Lowest-Income Families Pay the Largest Share of Their Incomes in State and Local Taxes



Note: Includes impact of Proposition 30 temporary tax rates and offset for federal deductibility of state and local taxes.
Source: Institute on Taxation and Economic Policy

homeowners and renters on average pay more of their incomes in property taxes, while the wealthiest taxpayers pay the smallest share.

- **Higher-income households pay a greater share of their incomes in personal income taxes.** California's personal income tax has a progressive structure, by which higher incomes are taxed at a higher rate. The state personal income tax also has a high income threshold – the level at which an individual or family *begins* to pay income taxes. This means that some low-income households pay no personal income tax at all. For example, a single parent with one child needed an adjusted gross income (AGI) of around \$43,000 to pay any state income tax for 2013.⁸ These characteristics of California's tax system mean that wealthy Californians pay a large share of the state's personal income tax. In 2011, the wealthiest 10 percent paid more than three-quarters (76.0 percent) of California's personal income tax.⁹

Other factors beyond tax bases and rates help make California's tax system moderately regressive overall. Federal income tax law allows taxpayers who itemize their deductions – meaning that they claim allowed expenses in order to decrease their taxable income – to deduct some state and local taxes paid. Because federal income taxpayers are allowed to deduct their California personal income tax payments, this federal deduction tends to disproportionately benefit high-income taxpayers. Moreover, other state income and business tax breaks, deductions, and credits can allow high-income households to reduce their overall income tax liabilities, and in some cases allow them to pay no tax at all. In 2011, 2,392 Californian taxpayers with incomes of \$200,000 or more paid no state income tax.¹⁰

How California's Tax System Can Work Better for Low-Income Individuals and Families

Key characteristics of California's tax system – and its moderate regressivity in particular – stand in stark contrast to recent economic trends. Over the last two decades, only high-income households on average have experienced gains in their incomes. Between 1987 and 2011, the inflation-adjusted average income of the top 1 percent of Californians increased by 78.4 percent. In that same period, the bottom *80 percent* of Californians on average saw declines in their adjusted income, with low-income households seeing the largest decline.¹¹ This disparity in income growth has led to a growing concentration of income at the top of the distribution. Between 1987 and 2011, the share of income held by the top 1 percent grew by more than half, jumping from 13.0 percent to 20.9 percent.

Moreover, Californians still face an economy with high rates of poverty and joblessness. In 2012, 15.9 percent of Californians

lived in poverty under the official measure of poverty, and California's unemployment rate in 2013 (8.9 percent) was one of the highest in the nation.¹²

Tax Policy Options to Improve Economic Security

Tax policy can be a powerful tool to improve economic security for low-income Californians. By taking steps to reduce the moderate regressivity of California's overall tax system, while maintaining or even strengthening its capacity to raise the revenues needed to support public services, state policymakers could provide a much-needed boost in economic security for low-income households. Such efforts could include:

- **Better targeting existing tax credits to low-income households.** Because some low-income households do not owe income tax, tax credits that are “nonrefundable” – meaning that taxpayers can only make use of them if they owe income tax – are poorly targeted for those who would most benefit from them. For example, state policymakers in 2011 eliminated the refundable portion of California's Child and Dependent Care Expenses Credit, thereby greatly reducing its benefit for low-income families seeking to offset the high costs of child or dependent care. Restoring the refundability of this credit is one way policymakers could help tax credits more effectively reach low-income households.
- **Creating a state earned income tax credit (EITC).** An EITC provides low-income workers and their families with a financial boost by lowering their tax liabilities and, in some cases, providing a refund for eligible households. The *federal* EITC – in conjunction with the federal Child Tax Credit – helped lift nearly 1.2 million Californians out of poverty in 2011, and a refundable state EITC that builds off the federal credit would reduce poverty even further.¹³ A well-designed EITC administered at the state level could help offset the current regressivity of California's tax system while expanding on one of the most powerful tools to boost incomes for low-income families.

Policymakers must consider important tradeoffs when implementing tax policies like the two mentioned above. Any tax policy change will have a direct impact on revenues, and policymakers must weigh the benefit of policies such as these against potential costs. Nonetheless, more can be done to promote economic security for Californians struggling in the aftermath of the Great Recession. A tax system that reflects today's economic realities is one that can expand opportunities for low- and middle-income Californians and foster widely shared economic gains over the long term.

For a comprehensive overview of California's tax system, see the California Budget Project publication [Principles and Policy: A Guide to California's Tax System](#) (April 2013), available at www.cbp.org.

Luke Reidenbach prepared this Budget Brief. The CBP was established in 1995 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

- ¹ US Census Bureau, Annual Surveys of State & Local Government Finance, 2011. These data do not reflect changes to the state personal income tax and sales tax as a result of Proposition 30, approved by California voters in November 2012. The US Census Bureau's definition of taxes includes business licensing and regulatory fees, which are classified differently depending on how tax liabilities are determined, such as a flat fee or a fee based on business sales or gross receipts. In Table 1, some business licensing and regulatory fees are included in the "Sales" category, while others are included in the "Other" category. See <http://www.census.gov/govs/local/> for additional information on how the US Census Bureau classifies tax sources.
- ² California's general sales and use tax is actually two separate taxes: a tax on the sale of tangible goods in California – the "sales tax" – and a tax on goods purchased outside of the state for use in California – the "use tax." Because sales and use taxes are complementary, they are typically referred to as the sales tax. This *Budget Brief* will use the term "sales tax" to refer to both taxes.
- ³ Census data for "corporate income tax" includes the three taxes that make up California's "corporation tax." These three taxes are California's franchise tax, the bank tax, and the tax on corporate income.
- ⁴ This analysis solely focuses on taxes and excludes charges collected in exchange for services, including public park, sewage, parking, and hospital services. In 2010-11, local governments collected \$43.6 billion in such charges, and the state government collected \$16.7 billion.
- ⁵ See California Budget Project, *How Do California Schools Get and Spend Their Money?* (May 2012) for more detail.
- ⁶ Institute on Taxation and Economic Policy (ITEP) Microsimulation Tax Model. These data apply current tax rates, including the temporary tax rate changes under Proposition 30, to 2010 income levels. Estimates also account for the federal deductibility of state and local taxes. For more information on the methodology behind the ITEP Microsimulation Tax Model, see http://www.itep.org/about/itep_tax_model_full.php.
- ⁷ Proposition 30 added three temporary personal income tax brackets – with additional rates of 1, 2, and 3 percent, depending on income – on top of the highest existing rate of 9.3 percent. These rates apply only to very-high-income Californians: single filers whose taxable income exceeds \$250,000 and joint filers whose taxable income exceeds \$500,000. The measure also temporarily increased the state sales tax rate by one-quarter cent. Overall, Proposition 30's tax increases are progressive, equal to 1.1 percent of the average income of Californians in the top 1 percent of the income distribution, compared to between 0.1 percent and 0.2 percent of the average income of Californians in each of the bottom four fifths of the distribution.
- ⁸ Assumes tax filers claim the standard deduction and the renter's credit.
- ⁹ Franchise Tax Board, *Revenue Estimating Exhibits* (May 2013), Exhibit A-10, and personal communication with the Franchise Tax Board.
- ¹⁰ Franchise Tax Board, *2012 Annual Report – Statistical Appendix Tables*, Table B-4A.
- ¹¹ Franchise Tax Board, *Revenue Estimating Exhibits* (May 2013), Exhibit A-10, and personal communication with the Franchise Tax Board. 1987 through 2011 is the full range for which data are available.
- ¹² Bureau of Labor Statistics and US Census Bureau.
- ¹³ Sarah Bohn, et al., *The California Poverty Measure: A New Look at the Social Safety Net* (Public Policy Institute of California: October 2013).