The Mercury News
MercuryNews.com

Sales tax not Schwarzenegger's only revenue option

By JUDY LIN Associated Press Writer

Article Launched: 11/07/2008 04:50:19 PM PST

SACRAMENTO—Eliminating tax credits for families with children, taxing attorneys' fees and raising business property taxes—these are some of the options Gov. Arnold Schwarzenegger could have proposed before settling on a 1.5 percent temporary sales tax increase.

None are easy choices in a struggling economy.

In laying out a proposal to increase sales tax for three years, the governor stressed an urgent need to raise revenue to maintain police protection and uphold California's education system.

"We feel very comfortable that this is the best tax to use," the governor said Thursday while revealing a $11.2 billion hole in this year's budget. "This is the best way to go and we have to not delay it. I think now is the time for action."

Economists recognize that the best form of taxation is the broadest one at the lowest rate. But California's budget fluctuates because it depends on a narrow segment of high-income earners whose fortunes ride with the stock market. About 50 percent of the state's personal income tax revenue comes from the top one percent of wage earners.

To complicate matters, the state's manufacturing-based sales tax has been shrinking proportionately because it hasn't been modified in decades to reflect service sector growth.

And a higher sales tax at a time when overall consumption is down may not do much to grow revenues.

But the idea for an income tax increase has been politically insurmountable of late. Democrats earlier this year proposed raising income tax on the wealthy but the plan was rejected by Republicans during a record-late budget battle.

Christopher Thornberg, principal at Beacon Economics, a California-based research firm said raising taxes on high-income earners may only exacerbate the boom and bust cycles of the state budget.

"We have high income taxes on people at the upper end of the income scale. Understand, these are the folks whose incomes swing most in a downturn," said Thornberg.

On Thursday, Schwarzenegger moved in support of broadening the sales tax in a way that would begin to match tax structures in New York, Texas, Florida and other states.

Starting next year, the governor wants to add the sales tax to certain services such as vehicle repairs, appliance and furniture repairs, veterinarian services and even greens fees for playing golf. By spring, the state will begin collecting sales tax on tickets to amusement parks and sporting events.

While car dealers and the golf industry countered the increase would hurt already-struggling businesses, some economists suggested the governor should tax more services.

"He's too afraid to go after lawyers and accountants. Now is the time to do what needs to be done," Thornberg said.

The Mercury News
MercuryNews.com

Currently, just a handful of states tax attorneys and accountants for the services they provide, according to the Federation of Tax Administrators. But more than not, the strong political pull of these professional groups have enabled them to remain exempt.

Another option for generating revenue is to reduce tax breaks currently being given to families with children and corporations.

Before stepping down as the Legislature's nonpartisan budget analyst, Elizabeth Hill suggested lowering the amount families can write off on their state income taxes for dependent children—from $294 per child to $94, which is the rate for mothers and fathers. It would generate an extra $1.3 billion for the state annually.

The idea never gained traction in the partisan Legislature because Republicans considered it a tax increase and Democrats said it hurt working families.

Hill also proposed—without success—limiting tax credits for companies that conduct research and development, and eliminating sales tax exemptions for equipment used in farming and timber harvesting. Those options for generating an additional $400 million or so a year are still available to the governor and lawmakers.

In the face of all these tough choices, Schwarzenegger has deferred to a tax commission to recommend ways for modernizing the state's tax system. The governor's office has yet to announce the members of the tax commission, but the group is expected to convene for the first time later this month.

One policy analyst suggested that any tax reform commission should review business property taxes since the current system is based on the value of the property when it was purchased, rather than market value. The situation has created an uneven playing field where longtime businesses pay significantly less than newer companies for office space.

Lenny Goldberg of the California Tax Reform Association, said changing the law would require voter approval. However, the Legislature could begin to close loopholes that allow companies to exchange ownership of properties without paying more taxes.

"If it's not a consideration of the new tax commission then they're not doing their job," Goldberg said. "The way we assess commercial property, it's bad economics, it's bad land use and it's bad law."