A Blueprint for a Californian Tax Reform

Emmanuel Saez (UC Berkeley)
Gabriel Zucman (UC Berkeley)

March 2017

I. Introduction

Income and wealth inequality have increased dramatically in the United States over the last decades, including in California. In the United States, the share of national income earned by the top 1% adults has increased from 12% in 1980 to more than 20% today (Piketty, Saez and Zucman 2016). In California, the increase has been even larger, with a rise in the top 1% income share from 10% in 1980 to 25% in 2012 (the latest available figure).[1] Despite the upsurge in inequality, Congress seems poised to pass legislation that would substantially reduce the progressivity of federal taxes (e.g., repeal of the surtaxes on high earners introduced by the Affordable Care Act; repeal of the estate tax; sharp reduction in top marginal federal income tax rates; large cuts in corporate tax rates) and would cut non-military government spending (e.g., reduction in Medicaid spending; cuts to subsidies for private health insurance; reduction in science and education spending, etc.). The combination of tax cuts for the wealthy and spending cuts is likely to exacerbate inequality, hamper social mobility, and increase poverty.

The State of California has the power to limit these adverse consequences by reforming its own tax policy. In this note, we describe a tax reform that would offset the

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1 See Frank et al. (2015). The above figures are available on the World Wealth and Income, http://wid.world. The numbers for California refer to the distribution of fiscal income across tax units.

decline in federal tax progressivity. The two pillars are the creation of a progressive tax on net wealth for the top 0.1% richest Californian residents (Section II), and a reform to the corporate tax that would tax the foreign profits of multinationals, which currently eschew taxation (Section III). In Section IV, we sketch a more ambitious proposal that would combine these new revenue sources with other sources to fund a Californian health care single-payer, modelled on the single-payers of European countries which provide access to high-quality care, at lower cost, and in a more equitable fashion than the current market-based U.S. insurance system.

II. A Progressive Californian Wealth Tax

What is wealth? Wealth is the sum of all assets net of debts owned by a given individual or family. It is very unequally distributed, much more so than labor income. In the United States, the bottom half of the population owns almost no wealth today, while the top 10% wealthiest families own over two thirds of total wealth (Saez and Zucman, 2016). US wealth concentration has surged in recent decades, with the share of wealth going from the top 0.1% growing from 8% in the late 1970s to over 20% at the national level today. The share of wealth held by the top 0.1% of families is now almost as high as it was at its peak in the late 1920s just before the Great Depression. There is no data on how Californian wealth is distributed, but given that income is even more concentrated in California than in the United States as a whole, wealth is also likely to be even more concentrated than nationally.

Why does California need a wealth tax? The main reason why a wealth tax is desirable is the sharp increase in economic inequality that has taken place over the last decades, a trend that is likely to be exacerbated if the progressivity of Federal taxes falls.

The second argument in favor of a progressive wealth tax is that existing taxes on income fail to tax the richest Californians effectively. To illustrate the limits of the current income taxes, consider the case of a Californian entrepreneur who becomes rich by creating a successful business. The wealth of the entrepreneur is the ownership of the business (Zuckerberg with Facebook, Brin and Page with Google are striking examples). As long as the business does not pay dividends and the founder does not sell shares, the individual income tax can be entirely avoided. If the shares are owned till death, the capital gain is never taxed. It is possible to build, maintain, and transmit huge fortunes without paying income taxes.

Our proposal: a progressive wealth tax for the top 0.1%. We propose that California creates a tax on net wealth (all assets minus debts) at a rate of 1% above an exemption threshold of $20 million dollars, which corresponds to the threshold to be part of the top 0.1% richest American families. Such progressive wealth taxation is the most direct way to make sure top wealth holders pay taxes commensurate with their resources. Two points are worth noting.

First, for wealth taxation to be successful, it is critical to have as broad a base as possible to prevent individuals from avoiding taxation by shifting wealth from taxable to non-taxable assets. Therefore, we envision a progressive wealth tax applying to all assets that can be owned and exchanged on a market, whether the assets are owned directly or indirectly through pension funds, trusts, or other intermediaries. Wealth would be measured at market value without any discounts to avoid shifting into preferential asset classes. All debts would be deductible from wealth.

Second, the tax directly targets top 0.1% wealth holders so its incidence falls squarely on this group. The tax would be based on the worldwide assets held by Californian residents, regardless of where the assets are located. To avoid the wealth tax, a family would have to move out of California. There are already significant differences in taxes across States today, yet the existing empirical literature does not find that tax-driven inter-State mobility is large (Bakija and Slemrod, 2004; Young et al. 2016). Mobility could further be reduced if all or most Western States jointly moved to taxing wealth in the context of a Western Union.

Impact on entrepreneurship. There is some evidence that State taxes matter more for the location of inventors (Moretti and Wilson, 2017). Relatedly, a concern about progressive wealth taxation (as well as progressive income taxation) is that it is a tax on economic success hence it might reduce the incentives to become a successful entrepreneur. However, the wealth tax we are proposing would only affect the top 0.1% wealthiest families with net worth above $20m, so that very few entrepreneurs would be affected. Further, the proposed tax at a 1% rate above $20m is far from confiscatory so that even extraordinary successful entrepreneurs would only have to give up a small fraction of their wealth to pay the tax.

A related concern is that taxes on business assets reduce the funds available for founders to grow their business. This concern arises only for cash-constrained businesses, which cannot obtain outside funding and must rely entirely on internal funding. The progressive wealth tax aims at taxing only wealthy families with assets above $20 million. These families have substantial funds that could be used to invest in their businesses or used as collateral for business loans. In other words, the top 0.1% wealthiest are the least likely to be cash-constrained.

Revenue estimate. Publicly available data do not allow us to precisely estimate the revenue that would be generated by a progressive wealth tax in California. However, we can estimate the revenue of a federal wealth tax. We find that a federal wealth tax at a rate of 1% above $20 million in net wealth would generate approximately $100 billion in annual revenue.

We use this estimate to project the revenue of a Californian tax as follows. From publicly available IRS tax statistics, we know that California had 16.8% of all the federal taxable income of tax units reporting more than $1 million in AGI in 2014.[2] So we assume that 16.8% of the US wealth above $20 million belongs to Californian residents.

[2] https://www.irs.gov/uac/soi-tax-stats-historic-table-2

Under that assumption, the Californian wealth tax would generate roughly $17 billion in annual revenue.

III. Reforming the corporate tax

<u>How the current Californian corporate tax works</u>. The corporate income tax aims to tax the profits of corporations regardless of whether they are distributed to shareholders or retained within corporations. In principle, the corporate income tax thus reaches wealthy individuals who own corporate stock. For example, although Facebook does not pay dividends, it pays corporate income tax, hence Mark Zuckerberg—Facebook's main shareholder—indirectly pays taxes this way.

California, like all other States with a corporate tax, uses an apportionment formula to determine what fraction of corporate profits are taxable in California. Since 2013, apportionment is based on sales only: if a company makes 10% of its U.S. sales in California, then 10% of its U.S. profits are taxable in California (at a rate of 8.84% currently). Before 2013, the formula was more complicated, with apportionment based not only on the fraction of sales, but also the fraction of employment and tangible capital assets used in California by the corporation.

There is, however, one big problem in the current system: only the U.S. profits of firms are apportioned and taxed in California. Foreign profits are not apportioned and not taxed. This is a big issue, because multinationals have become expert at artificially shifting their profits to foreign tax heavens. Google Alphabet is a case in point: in 2015, it made $15.5 billion in profits in zero-tax Bermuda, using a technique known as the "double Irish Dutch sandwich". This form of tax avoidance deprives California (and the US) from substantial revenue, as apportionment only applies to "US profits," and disregards the large and growing profits artificially shifted abroad. Nowadays, about 35% of all the profits of US firms are made outside of the U.S., of which close to 60% are booked in tax havens (Zucman 2014, 2015).

Our proposal: extending sales apportionment to global profits. Our proposal is simple: California should extend sales apportionment to the global profits of firms that are active in California.

In such a system, if Apple makes 10% of its global sales in California, then 10% of its *global* profits would be taxable in California. Global sales apportionment is a powerful way to tax corporate profits, because it removes any incentives for firms to move real production activities to low-tax countries or to artificially shift profits to tax havens. The taxes owed by Apple to California would only depend on its total worldwide consolidated profits and the fraction of its global sales made in California. Because Apple cannot move its customers across States or across countries, it would have no control on its tax liability in California. Global sales apportionment makes the tax base inelastic. California could thus tax corporate profits at a higher rate than 8.84% without reducing the tax base.

Previous attempts. Before 1986, California used to apportion the global profits of firms, not only US profits as it does today. Corporations challenged that system, putting forward two main arguments. First, they argued that maintaining records of sales, capital and labor employed all over the world was costly. Second, global apportionment discouraged investment in California and encouraged to move real activity (employment and capital) to low-tax countries.

It is important to understand, however, that global apportionment applied when California still used a three-factor formula (sales, employment, capital) to apportion profits. The arguments put forward against global apportionment are in fact mostly arguments against using employment and capital in the formula. With an apportionment based on sales only—as is currently done—there is no incentive to move real activity out of California, as the tax liability in California is only determined by the fraction of sales made in California—which is not something that corporations can control. Now that California has moved to sales-only apportionment, it is high time to reintroduce foreign profits in the tax base.

The United States Supreme Court has confirmed the constitutionality of California's apportionment of income on a worldwide basis, so there are no serious legal obstacles to reverting to global apportionment. Since 1986 the artificial shifting of profits to foreign low-tax countries has dramatically increased, so the revenue gains are likely to be substantial.

IV. A Californian Health Care Single-Payer

TBD

References

Saez, Emmanuel and Gabriel Zucman, "Wealth Inequality in the United States since 1913: Evidence from Capitalized Income Tax Data", Quarterly Journal of Economics, 131(2), 2016, 519-578.