Time to Abolish California's Income Tax?

By George Runner

The last thing overtaxed Californians need is another tax. Yet the Legislature continues to churn out new taxes that, once enacted, rarely go away.

Our economy has been transitioning to a greater reliance on services. As a result, some tax reform groups have argued for expanding the sales tax to include services. On its own, a sales tax on services—like Senate Bill 8 by Sen. Bob Hertzberg—is a terrible idea. It would impose a massive, complicated tax increase on both businesses and consumers. In fact, a recent study found that fully taxing all services would cost California taxpayers as much as $123 billion more each year.

But what if shifting to a greater reliance on "consumption" taxes, like the sales tax, allowed us to eliminate taxes that destroy jobs, like the income tax? What if we didn't raise taxes, but instead shifted them, replacing income tax with an expanded sales tax—and abolished the Franchise Tax Board?

It might be difficult to imagine a California without an income tax, since most of us weren't alive during the Great Depression, when California first started collecting it. However, seven U.S. states seem to be doing just fine without an income tax. And by several key measures, they're doing far better than California.

According to financial publisher Bankrate, six of the seven states with no income tax—Florida, Nevada, South Dakota, Texas, Washington and Wyoming—are all considered better retirement destinations than California. (The exception being Alaska, for obvious, climate-related reasons.)

Retirees who have invested their lives in our state shouldn't be forced to move away from their kids and grandkids for financial reasons. Yet the Manhattan Institute cites retirement-related moves as a key ingredient in the "The Great California Exodus" of more than 3.4 million residents since 1990.

Another vital measure is poverty. California's so-called "progressive" income tax has done little to improve the plight of the poor. In fact, based on data from the Census Bureau, California has the nation's highest poverty rate when other cost-of-living factors, such as taxes, are considered.

The reason is simple. California's punitive income tax rates drive away the very jobs and investment that help low-income workers move up the economic ladder. According to the Tax Foundation, some small employers in our state face combined top marginal tax rates exceeding 50%.

The dramatic ups and downs of California's income tax create conditions ripe for new and higher taxes. Good tax policy is rarely formed in moments of crisis. Steep declines in income tax revenue led to Proposition 30, which increased both sales and income tax. Those drops also gave us the lumber tax and a controversial fire prevention fee. Tax increases, even when sold as temporary, rarely go away after the state's rollercoaster revenues rebound.

If California joined the growing number of states considering elimination of their state income tax, it might increase pressure to get rid of the federal income tax. A movement in favor of what is known as the "FairTax" seeks to repeal the 16th Amendment and replace federal income tax with a national sales tax. Sure, it's a long-shot, but who wouldn't be glad to get rid of the Internal Revenue Service?

A common objection to replacing the income tax with a consumption tax is that, unlike income tax, sales taxes are regressive—hitting lower income people the hardest. This objection can be answered in several ways. For instance, some economists have suggested making the sales tax "progressive" by excluding more basic necessities or providing a rebate for seniors and others with lower incomes.

If we eliminate the income tax, most workers would immediately experience an overnight increase in take-home pay. True, service-oriented businesses would have to collect and pay sales tax, but they'd also no longer be paying state income tax.

What's needed now is a serious study of the options before us. Which revenue neutral tax changes would improve California's economic competitiveness? Which changes would raise incomes, grow jobs and keep more retirees in our state? Which changes would produce the most stable revenue and spur the most growth?

Since taxes affect behavior, dynamic economic modeling would provide answers to these key questions. But first, California's leaders need to muster the courage to ask the questions.

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