

OR CONTINUING STUDY OF THE CALIFORNIA ECONOMY

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DATE: October 12, 2009
TO: Legislative Committees on Revenue and Taxation
FROM: Stephen Levy
SUBJECT: Comments on the COTCE Report and Future Direction

Background

In November 2008 I was asked by California Forward to prepare a background paper on future trends in the California economy and the relationship of these 21st century economy trends to development of a new fiscal policy agenda. The objective of the paper was to inform California Forward's development of reform proposals with the understanding that the paper would be presented to the Commission on the 21st Century economy (COTCE), which occurred in February 2009 and is posted on the COTCE website.

After the California Forward paper, I followed all of the committee hearings and submitted additional comments and CCSCE reports to the Commission. Memos dated June 30, July 31, an August 5 email to Becky Morgan and a CCSCE memo on migration patterns are posted on the COTCE website.

An additional memo was sent to all commissioners on September 12, 2009 and is not posted on the website. I am forwarding all of these communications to the committee staff.

During the preparation of the paper for California Forward I met with Fred Silva of the California Forward staff and Commissioner Keeley who is a member of the California Forward leadership council. Following this meeting Commissioner Keeley invited me to continue talking with him of about the Commission's work in relation to the 21st century economic trends identified for California Forward. In addition I have had numerous emails and conversations with one or more of the nine commissioners who I knew previously or have gotten to know during the commission deliberations.

In addition I currently serve on the Economic and Allocation Advisory Committee tasked with making recommendations on the cap and trade component of AB 32 implementation and in reviewing the economic impact analysis of AB 32. At the end of this memo I will make some comments about the process we are

with staff and outside consultants and among commissioners so as to compare with the COTCE process.

ward

There are two main tasks going forward from my perspective—1) exploring a range of alternative reform proposals including the one proposed in the COTCE final report and 2) addressing the evidence, legal and economic theory issues that were only partially addressed by the commission.

The goals of the commission process (summarized below in my words) are a fine foundation for a fresh look at tax reform:

- Adapt the tax system to changing 21st century economic realities
- Support economic growth and prosperity
- Reduce volatility in state spending
- Address goals of fairness and simplicity
- Broaden the tax base and lower tax rates as possible

21st Century Economy Trends

Below are four trends that I identified in the paper for California Forward and which, I believe, command broad bipartisan agreement:

- The economy is moving from goods toward services in jobs, output and consumption. Goods production is more and more based on integrating new technology into new and existing products. As a result California's future is tied to our ability to compete for professional services, technology, innovation and design. The location decisions of these firms will determine our future economic prosperity in California.

Consumption patterns are changing as well with more spending directed to services and especially to telecommunications services reflecting the expanding use of Internet and mobile phone based services.

- The state has substantial infrastructure funding needs and no adequate long-term funding mechanisms. This is especially true for transportation where the LAO has pointed out this challenge for many years. Now the 2007 and 2009 Debt Affordability reports confirm the infrastructure funding challenge ahead. The Treasurer has called for a fresh look at these long-term funding challenges as they pose a substantial risk to the General Fund operating budget.

These infrastructure challenges detract both from our quality of life but also in many ways detract from our economic competitiveness, for example, from having inadequate water or port infrastructure.

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These infrastructure challenges detract both from our quality of life but also in many ways detract from our economic competitiveness, for example, from having inadequate water or port infrastructure.

- Local governments are increasingly critical participants in providing a solid foundation for economic competitiveness in the 21st century. The California Forward works points to the reform opportunities in this area and it may well command some bipartisan support. But California Forward's work and CCSCE's work also confirm a severe financing challenge faced by local governments over the next ten years.

California competes both as a place to work and as a place to live. We compete for families as well as businesses and local governments and schools are important in providing communities that talented people find attractive as places to live and raise their families.

- The state is committed to major reform in greenhouse gas emission reduction, including regional SB 375 mandates and guidelines. These new planning challenges add to the existing land use planning challenges affected by the state's tax structure as identified by SCAG representatives in testimony before the commission. Tax reform discussions should consider the implications of reform for meeting these goals.

How do Taxes Affect Economic Competitiveness?

From my perspective, the COTCE report and discussion accepted three major assumptions that merit review going forward. The testimony presented to the commission as well as in comment and publications from organizations throughout the state **offer strong alternative views**. The three assumptions that merit careful review are:

- Businesses and residents are "fleeing" California in response to high marginal tax rates on high-income households and firms—though these are the same rates in place during the dot-com boom. A modified version of this assertion is that high-income households bear too high a burden (share) of state tax collections.
- Volatility must be reduced on the revenue side because the legislature and Governor would never honor a rainy day fund.
- Economic competitiveness is primarily a question of the tax level and structure as opposed to public investment decisions and funding for the state and local governments.

From my perspective the commission summarily dismissed testimony and evidence from PPIC, CCSCE and their own March panel disputing this "everyone is fleeing California because our taxes are too high" assertion as well as the assertion that only the tax side of public budgets matter to economic competitiveness.

This fresh look by the Legislature can include a full range of voices and discussion on this lingering and often heated debate over what are the public

policies that support economic competitiveness and prosperity in California. Without some agreement on this issue, all discussion of tax and budget reform in California will merely reflect the current strong difference of opinion and, as a result, cannot lead to some measure of agreement.

Moreover, despite evidence from the California Budget Project and patient explanation from some commissioners, many on the commission continued to act as if the personal income tax was the only tax that residents paid. They continued to repeat that many residents do not pay taxes (clearly false) meaning that many lower-income households do not pay **state income taxes** although all residents pay sales, property and vehicle-related taxes as well as taxes on alcohol and tobacco products. Ongoing work should clarify this confusion and make discussion relate to the overall tax shares and not focus primarily or exclusively on the personal income tax.

Evidence Questions Left for the Legislature

There are three big evidence questions for the Legislature to clarify in reviewing and expanding the evidence foundation left by the commission. These questions relate to 1) revenue neutrality, 2) volatility and 3) incidence.

My understanding is that the status quo and commission proposal were compared for 2012 and that no longer-term revenue estimates were made because they were considered too uncertain. If true, the implication is that no evidence exists about the revenue neutrality of the proposed package past the first year. There is also no evidence that the package reduces volatility in the future and, if so, by how much.

Both measures—revenue neutrality and volatility-- require year by year revenue estimates for each component of the proposed package as well as the current tax system. Volatility is precisely a measure that requires year by year estimates and no evidence was presented to support the staff's assertion that the proposed package reduces volatility and whether this was based on future estimates or past trends.

The questions of tax fairness for the proposed package have been addressed by others and I will not add to their comments.

However, I do recommend that the commission seek detailed evidence, not presented to the commission, for the assertions about the distributional impacts of the proposed package. One specific is that the evidence presented asserts that \$6.8B of the cuts to high-income groups will be paid by out of state residents or the federal government. Another specific is the question of the incidence (who really pays) taxes on businesses. The legislature should seek testimony to clarify who will actually pay the BNRT as the tax is included in the prices of goods and services and passed on to purchasers.

The Legislature should seek the detailed Ernst & Young and staff analysis and have it reviewed by the tax experts here today and other voices. Second, if this is really a great idea it will be copied like tax credits for movies. Any change in tax structure that claims to get money from outside the state should be reviewed to assess what happens if other states follow our lead. Third, I believe that the analysis left out the higher federal taxes paid by households who have less state income tax to deduct.

Alternative Approaches to Meeting the 21st Century Economy Trends

I offer the following ideas **for purposes of illustrating how the above goals might be addressed by alternative approaches**. None of the ideas below, except the last one, are particularly new but as a combination they may offer a reform package capable of broad support.

- Broaden the sales tax to selected services
- Establish a new transportation infrastructure finance system through some version of tax disincentives for carbon-based fuels
- Reform assessment practices for non-residential property
- Address spending volatility through a reserve/rainy day fund
- Examine tax expenditures for efficiency and fairness
- As possible reduce tax rates for sales, corporate profits and income taxes
- Lower the vote threshold for passing local bonds and tax changes.
- I encourage consideration of addressing overall infrastructure finance in light of substantial research including the Treasurer's new Debt Affordability report issued last week. **One idea is to assess a small property tax for G.O. bonds similar to the self-funding mechanisms for schools and local governments.**

Broadening the sales tax to include services achieves many commission goals. It broadens the tax base in the direction of moving from goods to services—a 21st century trend. It simultaneously helps local and transit district tax bases as well as the state's tax base. The services added to the tax base are likely to reduce the regressive nature of the sales tax.

The Legislature now has two approaches to diversifying the revenue base to include services—the BNRT and broadening the sales tax base.

There is broad agreement that either approach should avoid taxing business inputs and would carefully examine the impact of taxing services where there were issues of competitiveness with out of state locations.

If the BNRT is studied further in the Legislature, **attention should focus also on making it applicable to the local and transit district sales taxes**. This was suggested in your earlier hearing by Mac Taylor from LAO. I believe this is a

good idea for two reasons. First it addresses the 21st century economy problems with transportation infrastructure and local government funding,

But, second, and this was widely overlooked within COTCE, having both a BNRT and sales tax increases administrative burdens. While under the BNRT proposal from COTCE the state portion of the sales tax would disappear, the local and transit district part would still be collected. So everyone who pays sales tax and files sales tax returns would still do so **AND** most would also now pay and collect a BNRT.

Revising assessment practices for non-residential property has several pluses going for it. It would help local governments as well as the state budget (through lowering K-12 obligations) and increase the collection on bond issues, thus allowing a lower rate increase for households.

It could raise substantial revenue and allow for rate reductions, if desired. It seems to correct an inequity in the existing system. There are also positive implications for land use planning and, perhaps, for meeting the SB 375 regional planning goals. This change could be the beginning of a package to reexamine the existing property tax structure to make it more favorable to new businesses and newly purchased homes as current practice places the highest property taxes on the new economic activity we hope to encourage.

Some version of the carbon tax plan developed by Commissioner Keeley and others addresses the 21st century challenges of funding transportation infrastructure and meeting the AB 32 goals. It has the potential for a small but positive impact on the state budget as well.

The rainy-day fund is the preferred choice for addressing volatility by the majority of analysts that I know, has been suggested before and is included in the COTCE proposal. The PIT reduction is not necessary to reduce the impact of economic swings on operating budgets.

It is true that the rainy day fund would not have been sufficient to cover the large recession-related budget shortfalls but 1) no system would cover the losses from a recession this deep and 2) the current shortfall was caused in part by the structural deficit, which residents and the Legislature have been unable to correct so far. The rainy day fund proposed by the commission would have handled all of the budget volatility before this extraordinarily deep recession.

The issue of reviewing tax expenditures (tax breaks to promote legislative goals) has been raised often in discussions about the state budget. The Department of Finance regularly compiles a list of tax expenditures and the LAO and other organizations point to tax expenditures that could be reduced to provide funds for other budget programs or tax reductions. Tax breaks that never met their

objectives or do not do so currently bring a measure of waste and inefficiency into the state's tax structure.

The property tax for G.O. bonds addresses the state's 21st century infrastructure funding problem, embraces key reform principles of PAYGO, will stop this nonsense where G. O. bond advocates allege it is free (no tax increase) and helps the General Fund by reducing debt service payments.

There were extensive legal issues raised in regard to the implementation of the BNRT. These issues are beyond my expertise by I commend the committee for hearing direct testimony from commissioners and other experts who raised questions about BNRT implementation.

The EAAC Experience

Our committee on AB 32 issues has sixteen members. We are working with the ARB and CalEPA staffs. They, in turn, work with a number of consultants. Our meetings are conducted with public notice, availability of materials and time for public comment, similar to the requirements that were expected to be met for COTCE. Our time frame is roughly the same as COTCE's and the committee's recommendations are on a tight time frame for decisions by the ARB.

The ARB and CalEPA staffs have been available at all times to us before our formal meetings as the committees and subcommittees. Issues and data brought to committee meetings have been discussed at the subcommittee level well in advance of formal committee meetings. The consultants are being made available to the committee members well before any reports are presented and our input is sought as to the direction of the consultant work. In fact our economic impact subcommittee has taken on the task of informing staff and the full committee about alternative approaches that can be considered by staff as well as topics and evidence we expect to see from staff and consultants.

Staff and the consultants are on notice from the committee that no evidence that is not fully documented and explained with time for review will be accepted.

Staff has provided committee members and posted publicly on their website a wide range of materials well before any meetings. To date there have been no "last minute" presentations from staff with new material not previously discussed,

Our meetings include time for public comment at the end of both the morning and afternoon sessions.

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DATE: September 12, 2009
TO: COTCE Commissioners
FROM: Stephen Levy
SUBJECT: COTCE Evaluation Questions

This is a follow up to the memo previously sent dated July 31, 2009 and attached.

I want to focus on the two traditional quantifiable evaluation measures described in the memo and widely discussed in commission meetings.

Understanding the Revenue Growth Potential of Proposed Tax Reforms

Some commissioners have discussed revenue neutrality of commission proposals as an important criterion. Whether revenue neutrality is required by the Executive Order or desired by the legislature, it remains a piece of information of interest to commissioners and other participants.

To determine revenue neutrality we need estimates of the revenue potential of each proposal over a reasonable period of time. No one would or should contend that if a proposed change is revenue neutral in 2012 or 2014 that it is revenue neutral over time. In fact much of the commission work documents how various components of the existing system have grown at very different growth rates in the past.

A simple starting point would be estimates of income, sales and corporate income taxes in the past (which have been presented) and in the future for purposes of comparison to the proposed changes.

A simple starting point for the future would be estimates of income and BNRT tax revenues for the next ten years.

Estimates for all years should be presented so that commissioners and other participants can see the impact of various starting and ending years on revenue neutrality.

I infer that some or all of this data is already available because the commission has been presented with estimates of the comparative volatility of different alternatives. I assume that the volatility estimates must have been based on data for each individual year.

One question of interest is how the BNRT would have performed for the past ten years as well as its projected growth over the next ten years.

I don't see how an informed decision can be made without this kind of evidence. Moreover, this kind of technical information gathering strikes me as something that the commission is better placed to do and review than throw the burden into the legislative hearing process without this information.

Understanding the Incidence of Proposed Tax Reforms

There has been a lot of discussion about the incidence of tax reform proposals at the commission meetings so I apologize if I am repetitive.

Although most of the discussion and information has related to the personal income tax (PIT), **distributional considerations relate to the proposed changes as a whole**. As a result no one can assess the impact of the PIT tax reductions without knowing the incidence/distribution of the replacement revenues. The same is true for the sales tax and replacement BNRT revenues.

As a result the key question would seem to be "who pays the BNRT?" I heard skepticism about knowing the incidence of the BNRT and I must admit my own response was "if you know so little, how can you recommend it?" but in fact I think the commissioners and staff can offer at least some more evidence and theory even if the answers are not 100% certain.

The commission has members and staff who are expert in both the theory of tax incidence and measurement issues. The incidence of the corporate income tax and sales tax has been widely studied in various contexts.

I hope that staff and commissioners can offer guidance on how the BNRT incidence compares to that of the sales and corporate taxes and on the layperson's question of whether consumers in fact pay most business taxes.

If, as is argued, residents are paying lower income taxes under the COTCE proposal under consideration, are they still paying lower taxes after the BNRT impact, sales tax impact and corporate changes are factored in? I imagine that the answer might vary by income group and so that information, which I believe was requested at the last meeting, is important.

I don't think the commission is arguing that its proposed package shifts the tax burden from people to businesses but does it shift the burden among various groups of people and why?

My understanding from the BNRT materials is that the BNRT tax is passed through and, I assume, eventually into the price. The materials explain that when business 2 buys inputs from business 1, that business 1's value added has been taxed and added to the purchase price charged to business 2 so business 2 gets to deduct the input purchases from its BNRT tax base. But the tax is still in its cost basis and price. Isn't it fair to assume then that the BNRT is passed on ultimately to consumers?

I will end with an example that might help make the abstract points come more alive.

I watched the incredible patience of John Cogan during the hours and hours of BNRT testimony as he tried to explain to a skeptical audience that they needed to look at what taxes were being cut or replaced by the BNRT. He argued cogently and persistently that you can't judge the package by looking at only one part. "Look he would say again and again, we are eliminating the corporate income tax, doesn't that sound like a good trade-off to you?"

The kind of information described above—detailed evaluation of the incidence and growth potential of each component on the table—can help sway skeptical minds and provide a solid foundation (or a disappointing but true answer) to the commissioners who said "I would support the idea of exploring the BNRT if I was convinced that its impact on distribution or revenue growth is not negative".

Three Personal Observations

1. No one will be eliminated from paying sales tax under the proposed changes. The sales tax will remain but at a lower rate at least initially. That point has two implications. One is that the tax compliance burden will probably be increased for businesses, many of whom will need to file BNRT and sales tax. No business who now files a sales tax return will be relieved of this responsibility as I understand what is proposed.

Two, and worth careful consideration, is that the incentive and ease for local governments to raise sales taxes (something which many are now doing) will be increased. They can say "look your sales tax rate was just lowered by 5%, let's take 1% to preserve city services".

2. This last point ties to my second observation repeated from before and addressed by the SCAG representatives on Thursday. COTCE should take local government tax reform considerations into account as they are

linked to state tax, budget and governance reform—a position argued convincingly by California Forward. This suggests a reconsideration of property tax reform issues as mentioned by SCAG and to the commission in earlier meetings.

3. I wrote twice earlier about the benefit of having COTCE address one of the state's well-documented 21st century economy tax issues—the declining support for transportation infrastructure investment at a time when I and many others think increased investment (perhaps in combination with private sector partners) is essential for California economic competitiveness.

I am glad that the issue was raised in Thursday's meeting and hope that the commission can incorporate this deficiency (well documented by the LAO and PPIC) into your recommendations to the legislature