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The Honorable Darrell Steinberg
President pro Tempore
California State Senate
State Capitol
Sacramento, California

Dear Mr. President,

Thank you for the opportunity to be of assistance to you, the state Senate, and the people of California through service on the Governor's Commission on the 21 St Century Economy (COTCE).

At your request, I have prepared the attached document. It provides you with my thoughts concerning the process, substance, and recommendations of COTCE. It also includes my thoughts regarding what set of tax reforms would be helpful in achieving the goals set forth in the Governor's Executive Order that established COTCE, but were not forwarded to the Governor and the Legislature by those commissioners who signed the final COTCE document. Both the group of signers and the group of non-signers include a broad cross-section of COTCE. Each group includes legislative and governor's appointees. Both include academics, the for-profit business sector, the not-for-profit sector, and elected officials. Therefore, both the COTCE report and other documents, such as that which is attached, are worthy of your consideration. The COTCE report alone, however, should not be the basis of the Legislature's starting point on this important public policy topic.

It is my opinion, which can certainly be countered by others, that COTCE missed the opportunity to present a well balanced set of recommendations. The Legislature, however, does not have to allow this to be a lost opportunity. In fact, the Legislature may see this as the start of a serious effort to modernize California's tax system in a manner that will be fair and allow California to be a national and international leader in many sectors of the 2l ' t century economy.

Again, thank you for this opportunity. I stand prepared to assist you in any manner that you deem helpful and appropriate.

Sincerely,

FRED KEELEY
Commissioner
Governor's Commission on the 2l st Century

COTCE: The Good, The Bad and The Ugly and How to Build on the Good

The Good

COTCE Staff

COME staff was professional in every respect and deserves very special thanks and recognition. Despite the challenging timeframe in which a great deal of work needed to be accomplished, the entire staff was thoroughly professional, responsive and tireless in their efforts. The website and support thereof was impressive, including the webcasting of meetings and easy availability of correspondence, presentations and other reports on the website. All of this represented a great service to the public and helped to achieve some transparency in the process.

COTCE Commissioners

While substantial disagreements exist amongst COTCE commissioners, there is no disagreement on my part that each and every commissioner was well motivated and advanced their belief system as it relates to tax policy in an earnest manner.

COTCE Speakers

COTCE heard presentations and accepted reports and correspondence on a wide-range of tax and economic topics by well-informed speakers. All-in-all, impressive efforts were made by an extremely large and dedicated group of people. The only complaint (expressed repeatedly) from the experts and other members of the public attending COME meetings, was a pattern of being unable to speak during the public comment periods, which were either postponed until the end of the day or truncated such that speakers were limited to one or two minutes each.

COTCE Recommendations

Several aspects of the recommendations are worthy of further study:

Rainy Day Fund. Creating a strong rainy day fund is the best solution for reducing the state's revenue volatility. Many good ideas have been advanced regarding the best design and mechanisms for a rainy day fund and it's possible that COME has seized on the right formula. Reasonable people can and do disagree on this point, but it is meritorious to argue that revenue volatility is best addressed as a budget issue, not as a tax matter.

Reducing Reliance on the Personal Income Tax. Reducing the state's reliance on the state's Personal Income Tax is an inherently good idea, but not at the expense of progressivity. Taxing consumption is better than taxing income, but since the Personal Income Tax is the only tax that allows effective distribution of tax burden (as contrasted with the state's more regressive taxes such as sales tax), it is extremely important to not

flatten the Personal Income Tax without specific and strong policy justifications for doing so. Reducing the state's reliance on the Personal Income tax and increasing tax revenues from commercial property taxes (split roll), if done in conjunction with an Oil Severance Tax, changes to the Bank and Corporation Tax, so long as there is not a net increase tax regressivity in the system as a whole, is an example of a package suggested in the previous sentence.

As fellow commissioner and former state Senator Becky Morgan pointed out, simplifying the state income tax is also a good idea. Flattening out the income tax schedule does little to achieve that. If an honest effort to simplify the state income tax system is undertaken, such an effort should also examine closely many of the tax expenditures contained therein, including potential limits on mortgage tax deductions. Any policy justification that exists for a mortgage tax deduction certainly never foresaw such a wide application of the deduction to upper income households.

Elimination of the Bank and Corporation Tax. Eliminating the Bank and Corporation Tax, given its current loophole-ridden condition and low revenue generation, and replacing it with other sources of tax revenue is worth further study. However, given the ease with which a fairly well designed corporate tax has come to resemble Swiss cheese, a major concern is why anyone should believe that the same slow base erosion won't take place with the proposed Business Net Receipts Tax (BNRT), particularly given the experience in the few other states where hybrid versions of the BNRT have been adopted.

Working Group on Pollution Tax. It was good that the Chair allowed the establishment of a working group of folks regarding the notion of a pollution tax. A pollution tax not only would support the state's greenhouse gas reduction targets under AB32, but would also raise much needed revenues for local and state transportation budgets. While ultimately the draft legislation for the pollution tax did not make it into the final basket of proposed reforms, the process revealed support within segments of the business and environmental communities.

Tax Court. The COTCE recommendation for a tax court to replace the current adjudication of tax disputes at the Board of Equalization is thoughtful, reasonable, and used as a best-practice in most states in the country, and is very much worthy of adoption.

The Bad

The COTCE process was problematic from several perspectives.

First, perhaps because of time, commissioners did not begin the process with a discussion about the COTCE's goals and the process used to reach those goals, despite several requests. From there, many aspects of communication were made difficult.

The agenda and course of discussion were closely managed. COME avoided discussing some basic aspects of the tax system. For instance, COTCE held no comprehensive discussion regarding whether or not the current level of progressivity of the state income tax was appropriate. Had that discussion taken place, more concerted opposition to the idea of making the state's income tax system more regressive would have developed early, pushing COTCE in a different direction.

Second, many commissioners made comments at various points in deliberations regarding concern about distribution of the overall tax burden. COME agendas, however, focused on the negative dimension of the current income tax system (i.e., volatility), thus focusing commissioners on the idea that the way to reduce the volatility of the income tax system was to lower income taxes on high income households whose capital gains incomes are inherently volatile (the 144,000 households who pay 50% of the state's income tax), and the proposed BNRT.

Third, requests by commissioners and outside experts on comparative data on tax incidence by decile were not responded to in a timely manner. When the requested incidence data was delivered twenty-two hours before the final COTCE meeting, it was too late in the process to change the COTCE's direction.

Third, an alternatve set of reforms, called the Blue Plan, accompanied by a set of . economic rationales tied to the Governor's Executive Order were submitted in mid-July (See attachment). The economic arguments in the Blue Plan referenced empirical work done by Public Policy Institute of California (PPIC,) and Center for Continuing Study of the California Economy (CCSCE) and other nonprofits and academics, concerning state demographic and economic trends. The Blue Plan reforms were at least as well-grounded in basic economic and tax theory as those being promoted by the Chair; but, unfortunately, most of the Blue Plan reforms and the economic and tax theory and data they were based on, were largely ignored by COTCE.

Unfortunately, when the process is bad, the results can be ugly.

The Ugly

Proposed Changes to the Personal Income Tax

Reducing taxes on the wealthy who, empirical evidence indicates, are not leaving the state, are not impacted significantly by recent cuts in social services, are most likely to save their tax break and not spend it, and, some of whom do not want such a tax break because of how it would be financed, is truly unwise.

Additionally, increasing taxes on lower and middle income households, who are leaving the state (See PPIC report on this topic), are deeply impacted by the recent cuts in social

services, are most affected by high unemployment and mortgage default rates, and whose decline in consumption has most contributed to the weakness in the state economy, makes little if any tax policy sense. It is a prescription for a potential economic disaster.

The widening gap in California between high-income households and low- and middle-income households suggests a need for a compassionate response (either tax cutting or rebuilding the social safety net), exactly the opposite of what COTCE proposes. The inflation-adjusted adjusted gross income (AGI) of the average California taxpayer in the top one percent increased by 117.3 percent between 1995 and 2007 - nearly 13 times the gain of the average middle-income taxpayer.' Currently, the lowest-income households pay a larger share of their incomes in state and local taxes than higher-income households. Substantial income gains among the wealthiest Californians mean that the top one percent of taxpayers has nearly doubled its share of AGI since the early 1990s. One-quarter (25.2 percent) of total AGI went to the wealthiest one percent of taxpayers in 2007, nearly twice their share (13.8 percent) in 1993, the earliest year for which data are available.[2] In contrast, taxpayers with incomes in the middle fifth of the distribution reported just 10.0 percent of total AGI in 2007, down from 13.0 percent in 1993.[3] National data, which are available since 1913, show that the share of income going to the wealthiest one percent in 2007 was the second highest in history; the only higher share was in 1928.

Proposed Business Net Receipts Tax (BNRT)

The proposed Business Net Receipts Tax Fails the Sound Tax Test on Several Dimensions.

Even in good economic times, California's tax system fails to provide sufficient revenues to support "baseline" program demands.[5] In bad economic times, like the present, the gap widens. Most of state's $60 billion budget shortfall this year stems from a shortfall in actual or anticipated revenue collections.

The state's persistent revenue shortfalls are exacerbated by the continued creation through legislation of tax expenditures, further widening the gap between revenues collected and government expenses. For instance, even in weak budget year such as

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[1] Franchise Tax Board

[2] 6 Franchise Tax Board.

[s] 7 The wealthiest 1 percent of taxpayers' share of AGI peaked at 27.5 percent in 2000 at the height of the economic boom, then fell to 17.8 percent in 2002, largely as a result of the drop in investment income due to declines in the stock market. As the economy recovered, the wealthiest 1 percent of taxpayers' share of AGI rebounded. In contrast, the share of AGI going to taxpayers with incomes in the middle fifth of the distribution has been relatively flat since 2000.

[a] Emmanuel Saez, Striking It Richer: The Evolution of Top Incomes in the United States (Update With 2007 Estimates) (August 5, 2009).

[5] Baseline or "current services" spending is generally defined as the level of programs and services required under existing laws adjusted for population, caseload, and/or enrollment growth and inflation. The Legislative Analyst's Office releases a multiyear baseline budget forecast each November as part of its Fiscal Outlook series.

2008-2009, where the state faced a projected budget shortfall of $60 billion, actions were taken in the Budget Act that resulted in a reduction of 2008-2009 revenue collections by $11.7 billion. As a result, California's tax system fails even in good economic times, the test of adequacy: to produce sufficient revenues to ensure a balanced budget. Despite these facts, COTCE's own estimates suggest that their proposals would result in a tax system that grows more slowly over time than the state's existing tax system.

Modeling done for COTCE clearly shows that the changes under consideration would lower the rate of growth of state tax revenues.' COTCE documents estimate that COTCE's recommendations would result in a tax system that would raise about $7 billion less at the end of the five-year period than the current system.

By way of comparison, California currently spends about $5 billion each year to support the California State University and University of California systems. In 1959, California adopted the Donohue Act, which clarified the roles of each of the three legs of higher education in the state. It also pledged that each element, the University of California, the State University system, and the 107 Community Colleges would be world class, affordable and accessible. While they each continue to be world class systems, it is certainly arguable that they are all less accessible and affordable than ever, and trending in the wrong direction on these counts. Making major changes to the existing tax system using a relatively untested keystone tax (the BNRT) and shifting the overall tax burden from the top down, seems unwise.

The BNRT Creates an Incentive for Business To Outsource Jobs Out-of-State.
Documents prepared by Commission staff suggest that the BNRT would look at business activities within the "water's edge," a concept that looks at activity within the United States and a limited number of other jurisdiction. [?] The use of a water's edge approach, combined with the questionable ability of the state to impose the BNRT on firms without a physical presence in California, would likely encourage businesses to outsource to firms outside of the United States that are not subject to taxation in California. The incentive to outsource takes place because wages are not taken into account for the purpose of calculating net receipts subject to tax, while purchases of services are taken into account. To the extent services are purchased from firms with a clear nexus in California, those firms would be subject to the BNRT. However, the state's ability to tax firms without clear nexus is uncertain and would likely be subject to lengthy and complex litigation. The negative implications of this are twofold: a potential loss of California jobs and a reduction in state tax revenues.

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[6] Commission on the 21st Century Economy, Tax Structure Options (July 16, 2009), downloaded from http://www.cotce.ca.gov/meetings/2009/7-16/testimony/documents/STAFFPRESENTATION 7-16-09.pdf on August 31, 2009.

[7] **Carl Joseph and Jeffrey Margolis, Analysis of Tax Nexus Issues Concerning the Commission on the 21st Century Economy's Business Net Receipts Tax Proposal (August 21, 2009), downloaded from http://www.cotce.ca.gov/documents/correspondence/staff_and_commissioners/documents/FTB%20Analys s%2Ofor%2000TCE520%208.21.09.pdf on September 8,**

The Business Net Receipts Tax Is a Risky Proposition. A letter signed by a number of prominent economists and lawyers highlighted the lack of experience with the BNRT, stating, "our concerns regarding the BNRT arise primarily from the numerous uncertainties relating to administration, compliance, legal challenges, and economic distortions of such a tax. [There is very little experience worldwide] to draw from with an apportioned business net receipts tax of the sort under consideration by the Commission."[8] The letter's authors note that the BNRT would likely be subject to legal challenge if the state attempts to impose the tax on entities without physical presence in California and that it will be subject to "aggressive tax planning" that could significantly erode potential revenue collections. Other states that have recently adopted consumption-based taxes, such as Texas and Ohio, have seen revenues fall significantly short of initial forecasts. The constitutional requirement that state tax increases be approved by a two-thirds vote of the Legislature could make it difficult, if not impossible, to remedy such a shortfall if it were to occur.

Building on the Good: Vision for a 21St Century Tax System in California

As referenced in the cover letter to this report, several groups have presented their vision of a more balanced set of tax reforms that respond to the goals laid out in the Governor's Executive Order that established COME. From these five or six plans (Professor Pomp's Red, White and Blue Plan', California Budget Project's document of September 21, 2009, the Blue Plan, Center for Continuing Study of the California Economy document of October 3, 2009), a basic set of tax reforms emerge that include the following:

Amending the Personal Income Tas to Create a New Allocation of Capital Gains to Offset Volatility. In addition to the Rainy Day Fund proposed by COME, if additional anti-volatility measures are deemed necessary, very serious consideration should be given to amending the state Personal Income Tax to provide for new allocation of Capital Gains revenue as follows: (i) One-third of the moving five-year average Capital Gains receipts will supplement the General Fund; (ii) One-third will pay for debt reduction, pension liability prepayment or other one-time expenditures; and (iii) The remaining one-third will be allocated to the Rainy Day Fund.

Lowering Sales and Use Tax Rate, Extending to Services. Extending the sales tax to selective services and lowering the sales tax rate, exempting both services that disproportionately impact lower income households and that lead to tax pyramiding for businesses would lower the burden of the tax on both businesses and lower income households. This would also cause the state Sales and Use Tax to more accurately reflect the contemporary composition of the California economy.

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[8] Letter to COTCE Chair Gerald Parsky from Joseph Bankman, et al. (September 5, 2009)

Taxing Internet Sales. Collecting sales and use taxes owed on electronic sales, given the growth in internet sales would result in $2 billion to $5 billion per annum. California should take the lead in enc aging Congress to overturn the 1992 US Supreme Court decision in Quill Corporation v. North Dakota. In the meantime, the state could increase collections by taking steps such as requiring businesses such as Amazon.com that enter into "affiliate" relationships with California-based entities to collect California sales tax and imposing the sales tax on digital downloads. The State of New York has set an example on this topic, and an initial test in court has verified the legitimacy of the tax.

Split Property Tax Roll. There have been many proposals to amend Propostion 13, yet the most frequently discussed has been the Split Roll. Given the evidence that approximately 20% of residential property sells each year, and thus is reassessed to essentially market value, and non-residential property sells much less frequently, an argument has been made that amending Proposition 13 relative to reassessment of non-residential property, makes sense. It has also been argued that to improve the business climate faced by new property investors who currently face higher property taxes than businesses already located in California, such a change would be appropriate.

Display Tax Expenditures in the State Budget, Sunset Tax Expenditures. Improving the accountability and transparency of the state's tax code through.greater disclosure of tax expenditures and beneficiaries should be undertaken. Tax expenditures have every bit as much impact on budgeting as do other more transparent expenditures. Displaying all tax expenditures in the Governor's proposal State Budget, and imposing a sunset provision in all existing and proposal tax expenditures was advanced very early in the COTCE process.

Oil Severance Tax. Imposing an oil severance tax should be seriously considered by the Legislature so that California can join the rest of the nation's oil-producing states. Currently, California is the only oil-producing jurisdiction in the world without such a tax.

Repealing Some Elements of the Bank and Corporation Tax. The Legislature should revisit and consider repeal of some of the most recently enacted elements of the existing Bank and Corporation Tax (making single factor apportionment mandatory, not elective; eliminating the NOL carryforwards and tax credit sharing provisions) and studying the possibility of lowering the rate, so that any gains from closing the loopholes can be shared by all corporate taxpayers, rather than a very small number of firms.

Pollution Tax. The Legislature should consider a properly structured pollution tax to support the goals of AB32 and SB375 and to raise critically need fund for local and state transportation budgets. Because the price of gasoline in California does not accurately represent its full social costs, costs associated with smog and global warming pollution from petroleum combustion are borne by society as a whole and not by the producers and users of petroleum fuels. A properly structured pollution fee could help address this market failure by creating the price signals necessary to drive change in this sector.

Blue Proposal

Note: This proposal, as submitted, uses the Governor's Executive Order S-03-09 as the rationale and goal of each and every item contained herein. Additionally, each and every item is further based on testimony and written material submitted to the Commission during public meetings and deliberations of the Commission.

1/ **Rainy Day Fund.** Amend California Constitution to require that all General Fund Revenues that exceed Department of Finance projections by 5% within the Fiscal Year, be placed in an account (Rainy Day Fund) that is restricted as to expenditure or appropriation by the Governor and the Legislature, to state General Obligation Debt reduction, or to remain in the account to be available for expenditure or appropriation for General Fund-supported purposes when the General Fund Revenues underperform Department of Finance projections by 1 % or more.

Rationale: The Rainy Day Fund responds to nearly every one of the objectives set forth in Governor's Executive Order S-03-09[1]. First and foremost, the Rainy Day Fund will force the state to commit more seriously to a basic business practice -a budget reserve- thus providing a greater degree of fiscal responsibility and bringing the state's tax and budget system into the 21 st century. Of the two main approaches outlined in the LAO Report[2], revising the revenue system or relying on budgeting strategies to manage volatility, a blend of both methods is proposed herein to manage the state's General Fund revenue volatility. To rely solely on revising the revenue system would mean a flattening of the income tax which represents a significant trade-off in terms of progressivity.

The Rainy Day Fund's main function will be to help stabilize state revenues and reduce volatility, thus insulating the state budget from vicissitudes of the economic cycle. A more stable state budget will improve the state's creditworthiness and thus, promote the long-term economic prosperity of the state and its citizens, and, as a result, improve California's ability to successfully compete with other states and nations for jobs and investments. As mentioned, establishing a Rainy Day Fund is not only a basic business principle, but also reflects principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration.

2/ **Amend State Personal Income Tax to Provide for New Allocation of Capital Gains Revenue.** Capital Gains Tax Revenue will be apportioned as follows: (i) One-third of the moving five-year average Capital Gains receipts will supplement the General Fund; (ii) One-third will pay for debt reduction, pension liability prepayment or other one-time expenditures; and (iii) The remaining one-third will be allocated to the Rainy Day Fund.

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[1] Link to the Governor's Executive Order S-03-09: http://www.gov.ca.gov/executive-order/I 1836/

[2] *LAO, Revenue Volatility in California, 2005,* COTCE website.

Rationale: The proposed reform addresses several of the objectives set forth in the Governor's Executive Order S-03-09. Specifically, by reserving equal portions of the capital gains each year for the General Fund, debt reduction and reserves (Rainy Day Fund), this proposed reform will stabilize the revenues flowing to the General Fund, by providing the discipline to allocate surplus capital gains revenues during strong revenue years to reducing the state's debt and building up the state's reserves; and, during weak revenue years, drawing down reserves, thereby reducing volatility of General Fund revenues. In turn, by providing a mechanism for debt reduction and healthier reserves, the proposed reform will help to improve the state's creditworthiness and thereby promote the state's long-term economic prosperity and enable the state to compete more successfully for jobs and investment.

3/ Business Net Receipts Tax will be Studied Further in a Process to Include Public Hearings and Informational Filings.

Rationale: The Business Net Receipts Tax is a VAT-style tax with a high potential in terms of helping to create a 21 St Century tax structure. The potential merits of a VAT-style tax are many: including reducing taxes on mobile capital; providing a more stable source of business tax revenue than corporate income tax; taxing all forms of doing business, not just corporations, thus broadening the base and allowing for lower tax rates; and providing an alternative and perhaps superior, way to tax services and cross-border sales.[3] However, Bob Cline of E & Y, Richard Pomp and Michael McIntyre [4], all experts on the business net receipts tax and variations thereof, all agree on the significant challenges associated with transitioning to such a tax.

Therefore, without further study, the Commission would seem to be unable currently to say with any certainty that the objectives as set forth in the Governor's Executive Order would be attained by implementing a net business receipts tax, either in conjunction with the elimination of the state sales and use tax and corporate tax or in conjunction with a reduction in the rates of those taxes.

4/ The State-Sales and Use Tax Rate Will be Reduced by X%[5], and the State Sales and Use Tax base Will be Expanded to Some Services, Exempting "Business Inputs". Many details as to implementation will need to be worked out both with respect to which services to include and which business inputs to exempt. Regarding the exemption of business inputs, one possibility is to follow the approach used for the manufacturer's sales/use tax exemption (1993-2003), but to broaden the exemption to cover all business purchases. To prevent abuse, there may need to be exceptions for items that could be converted to personal use.

E & Y presentation, June 16° 2009 COTCE meeting, COTCE website.

[4] Pomp, Richard, and McIntyre, Michael, *A Policy Analysis of Michigan's Mislabeled Gross Receipts Tax,* COTCE website.

[5] X% is a placeholder for the amount of rate reduction which can be achieved, while still preserving at a minimum the current level of sales tax revenue.

Rationale: The proposed sales and use tax reforms will put California at the forefront of pro-business sales tax reform, thus responding to many of the objectives set forth in the Governor's Executive Order S-03-09. Specifically, this reform directly responds to the challenge to establish a 21 St century tax structure that fits with the state's 21" century economy, by promoting the state's long-term economic prosperity and enabling the state to compete more successfully for jobs and investment. According to Charles McClure, taxing business purchases reduces California's competitiveness, employment, and income, and reducing taxation would increase them.

In addition, a combination of SUT base expansion and rate reduction is an ideal, pro-business and progressive, tax reform. The slow growth of the sales and use tax base is largely due to the increased consumption of services which are not included in the base, putting goods consumption at an unfair disadvantage relative to closely equivalent services. This is a widely recognized problem with the sales and use tax in California, where just 21 of 168 service sectors are currently taxed. According to the 2007 Federal Tax Administrators' survey, only nine states tax fewer services than California. Including additional services in the sales and use tax base will also make the sales and use tax more fair and equitable, since services which are currently untaxed are mainly consumed by higher income households.

51 Amend California Constitution to Reassess Annually the Market Value of Non-Residential Commercial Real Estate Property for Property Tax Purposes. The type of split role reform proposed herein involves a change in how the tax base for commercial property is calculated annually. Specifically, the proposed split role reform would leave residential property as-is under Proposition 13, but would require non-residential commercial properties' valuations to be reassessed periodically to reflect their market value for tax purposes and continue to be taxed at a rate of 1 %.

Rationale: According to the Federal Tax Administrators, "taxes should not only be fair and equitable towards individuals and businesses similarly situated... [and] businesses engaged in similar commercial activities should be subject to the same level of taxation." While Prop 13 provided many benefits, since its passage in 1978, there has been wide recognition of the unfairness and inequities and other issues embedded in Prop 13. Addressing some of these issues will help to establish a 21 st century tax structure that encourages new investment and job creation. In addition, the proposed reform of Prop 13 will increase property tax revenue, which is widely recognized as a stable source of tax revenue, thus helping to stabilize state revenues and reduce volatility. [7]

By evening the playing field between new and existing commercial property investors, the proposed reform will reflect principles of sound tax policy including competitiveness, efficiency, predictability, and stability. In a very direct way, the proposed reform will ensure that the tax structure is fair and equitable for all commercial property investors,

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[6] McClure, Charles, *How to Improve California's Tax System: The Good (But Infeasible), the Bad, and the Ugly*, Testimony at February 12, 2009 COTCE meeting, COTCE website.

[7] Sheffrin, Steve, *Economic Aspects ofA Split Roll Property Tax*, February 5, 2009 article, COTCE website.

whether they are new investors considering an investment in California or an existing investor. By making California more attractive to new investors, the proposed tax reform will improve California's ability to successfully compete with other states and nations for jobs and investments and thus, will promote the long-term economic prosperity of the state and its citizens. The downside is that the proposed tax reform will be more complicated to administer than the current system, but the economic benefits dwarf the additional costs associated with the proposed reform.

The proposed tax reform will support the goals of SB375, *Redesigning Communities to Reduce Greenhouse Gases,* as well as *AB32, Global Warming Solutions Act.* Reassessing commercial properties and land more frequently to reflect their true economic value will increase the cost of warehousing valuable land and will create pressures for highest and best use, a necessary condition for dense and efficient land use. The increase in property tax revenue that would result from treating all commercial property equally would lessen the reliance of local governments on. sales tax revenue and, thus, alleviate the 'fiscalization' of land use that has been one of the inadvertent and negative consequences of Prop *13.*

6/ Allow Local Governments (Cities and Counties) to Increase Existing Local Sales Tax by Up to 1.50% (or any .25% fraction thereof) by Majority Vote of Electorate.

Rationale: The proposed tax reform aims to restore some of the fiscal autonomy that local governments have lost, particularly since the passage of Prop 13 in 1978, thus ensuring a more fair and equitable tax structure that enables local governments to provide necessary services. Allowing local governments to access additional financial resources to provide necessary services will help to improve California's ability to successfully compete with other states and nations for jobs and investments. While the proposed reform does not address the main cause of the chronic tension in the state-local fiscal relationship (i.e. a lack of a separate, dedicated source of tax revenues for local government), it does acknowledge the impact, i.e. the smooth and efficient delivery of local services, and aims' to restore some fiscal autonomy and, thus, rebuild local officials' sense of accountability.

7/ **The Bank and Corporation Tax Rate will be Reduced by** 2% **and the Bank and Corporation Tax Base will be Expanded By Making the Single Sales Factor Apportionment Mandatory and Eliminating the NOL Carryforward and Tax Credit Sharing Provisions.**

Rationale: The proposed reform responds to the challenge to establish a 21st century tax structure that is fair and equitable. While an ideal tax system would eliminate a corporate tax, an interim step in that direction is to reduce the corporate tax rate, while improving the predictability, stability and fairness of the existing corporate tax structure. The three corporate income tax reforms proposed greatly reduce the predictability and stability of the corporate income tax. In addition, the reduction in corporate tax revenue that is forecasted from the changes to the corporate tax laws in September 2008 and February 2009 are estimated to be *$2.0* billion per year, and potentially as. much as *$2.5* billion, an

amount equal to nearly one-quarter of the income tax dollars currently paid by California corporations.. The benefits arising from these corporate tax reduction measures are poorly distributed. In particular, the benefiis.from single sales factor apportionment and credit sharing would largely go to a very few, very large `incumbent' corporations. A superior way to achieve the goals of the Commission, i.e. to promote the long-term economic prosperity of the state and its citizens; and to improve California's ability to successfully compete with other states and nations for new jobs and investments, is to lower the corporate tax burden for all businesses, new and existing, large and small. The proposed tax reform also reflects principles of sound tax policy including simplicity, efficiency, predictability, stability and ease of compliance and administration.

8/ Adopt a Pollution Tax on Carbon-based Fuels. The proposed pollution tax on fuels will be structured so that it moves inversely with the price of crude oil, effectively putting a rough floor under the price of gasoline. [9] This tax could be structured so as to combine a sliding gas tax with a severance tax, yielding a steady stream of revenues with little volatility. The intention also is that the tax is borne by California residents so as to promote more efficient use of energy (i.e. driving, home heating, etc.). Exemption certificates will be considered in the event that it is determined that the proposed tax will impact manufacturers and possibly lead to job loss (although this raises issues with respect to the scope of the exemption).

Rationale: Pollution taxes are widely accepted as an ideal type of tax in that they discourage `bad' behavior. (in this case, the consumption of fuel by high fuel-consuming vehicles and congestion). As such, a fuel tax would be the hallmark of a 21st century tax structure. Given the state's above-average reliance on passenger vehicles and its leadership in the clean energy and transportation industries, a fuel tax will support the state's 21st century economy. A fuel tax will also support Governor's Executive Order 5-03-05 and AB32, *Global Warming Solutions Act.*

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[8] California Budget Project, *To Have and Have Not,* June 2009, COTCE website.

[9] For instance, a tax that is only in effect when the price of crude oil is below $72 per barrel, and is equal to 2.5 cents per gallon for every dollar that oil is below $72, would roughly stabilize California gasoline prices at about $2.75 per gallon so long as the price of oil is below $72. It would have no impact on gas prices if oil was above $72 per barrel. (An equivalent approach that takes effect only for gas prices below $62 per barrel would stabilize' gas prices at about $2.50 per gallon.) The amount of revenue that the tax would bring in would depend on the oil price trigger level.

Any volatility of oil prices could be hedged with a tax on oil extraction (a severance tax) that is progressive in the price of oil. For instance, an oil severance tax could be zero so long as the price of oil is below $50 per barrel, but if the price rises above $50 per barrel the severance tax would take an increasing share of the incremental dollar of revenue. Revenue from such a severance tax would increase with the price *of oil* and would offset the loss in revenue from the gas tax. *If oil* prices fell, revenue from the severance tax would fall, but revenue from the gas tax would rise. Parameters *of* the taxes could be set so as to significantly reduce the volatility of the total stream of revenues from the two taxes. In addition, once the taxes were in place, remaining volatility of the total revenue stream could be hedged through financial transactions on the oil futures markets.

As proposed, the fuel tax will help to stabilize state revenues and reduce volatility by providing a steady source of revenue. By supporting the clean energy and transportation industry, which many investors view as the next growth industry, this proposed tax refor`rri will advance California's role as a leader in the clean energy sector and promote the long-term economic prosperity of the state and its citizens.. As proposed, the fuel tax reflects principles of sound tax policy including simplicity, efficiency, predictability, stability and ease of compliance and administration.

9/ Add to the Income Tax a Universal Tax Credit of $1.00 to $300 as a "universal rebate" of the carbon tax revenues, the exact amount depending on the amount of revenues expected to be generated by the carbon tax and the degree of offset of the carbon tax desired. Every state resident would receive the exact same refundable credit or "prebate" (to use the language of "Fair Tax" advocates).

Rationale: The proposed tax reform has several advantages. First, rebating the carbon tax revenues shows that such a tax is not about raising revenue for government, but changing the collective habits of the state's citizens. Second, the universality of the prebate suggests a certain "we're all in this together" attitude that is consistent with the principles underlying the tax. Third, a universal rebate/credit gets high marks on simplification grounds (and leaves ReadyReturn untouched). Some might suggest that a rebate should be means-tested-and that's certainly do-able, but any phasing out by income would reduce some of these advantages. The universal credit provides progressivity, since the credit of $100 to $300 is a significant amount to lower income households, but much less so to wealthy households. It turns out to be more efficient in many ways than a means-tested credit.

10/ Tax Expenditures:

i) Display all Tax Expenditures in Governor's Annual Budget;
ii) Require all Tax Expenditures (existing and future) to have a sunset date, in no case longer than five years;
iii) Require all Tax Expenditures to have estimated cost in the Budget Year; and, estimated/actuals for Fiscal Year displayed in Governor's Proposed Budget (including available demographic information);
iv) Require all Tax Expenditures, existing and future, to have legislative intent language, including, but not limited to, outcome purpose of Tax Expenditure, sunset date (not longer than five years).
v) Require in the statutory implementation of these reforms that all tax expenditures contain a performance-based metric.

Rationale: Transparency of government tax expenditures, while not called for explicitly in the Governor's Executive Order, is a principle of sound tax policy, as mentioned in ,2(e) in EO S-03-09. Transparency off government tax expenditures will also ensure that the state tax structure remains fair and equitable.

11/ Create an Independent, Pre-Payment Tax Dispute Forum. The only prepayment resolution tax forum for income taxes and sales and use taxes is the very entity that administers those taxes, thus creating the appearance of impropriety.

Rationale: Creating an independent, prepayment tax dispute resolution forum will help bring California's tax administration into the 21 St century and into conformance with the federal model.' °

[10] Rubin, Robert, Testimony at March 10, 2009 COTCE meeting, COTCE website.

Petroleum Fuels Pollution Tax: Rationale and Process

How a Petroleum Fuels Pollution Tax Fits into the COTCE Framework

The proposed Petroleum Fuels Pollution Tax responds directly to each and every one of the Governor's Executive Order goals.

(a) "Establish 21st Century tax structure that fits with state's 21st century economy."

This proposal directly addresses two features of California's 21st century economy that are not addressed by other proposals before the commission. One, transportation infrastructure is critical as a foundation for prosperity and growth in our 21 " century economy and testimony before the commission has documented that our present system does not come close to funding our identified transportation infrastructure needs. Two, the state has a goal of reducing greenhouse gas emissions while maintaining a strong 21st century economy.

(b) "Stabilize state revenues and reduce volatility."

This proposal will provide relief to the General Fund by allocating revenue to retire existing transportation and transit bonds. Debt retirement for these bonds currently draws down nearly $500 million in General Fund revenues each year. The funds from this tax source will be dedicated to road maintenance and smart growth activities consistent with Article XIX of the State Constitution and with the greenhouse gas reduction goals set out by SB 375 (Steinberg) and AB 32 (Nunez), providing some relief on the General Fund and reducing the costs to the state of implementing AB 32 and SB 375.

(c) "Promote the long-term economic prosperity of the state and its citizens."

The petroleum fuels tax avoids the economic distortions of other taxes. It recognizes and promotes California's role as a leader in green development and technology. It reduces pollution and urban sprawl, thus increasing the desirability of California as a place to work and live.

(d) "Improve California's ability to successfully compete with other states and nations for jobs and investments."

California's transportation and transit infrastructure is badly neglected, thus reducing California's ability to successfully compete with other state and nations for jobs and investment. This proposal would provide urgently needed funds to address the multi-billion dollar back-log of maintenance and construction. Additionally, this proposal would send very important signals to the investment community. First, for the broader investment community, the signal would be sent that California recognizes the failure to invest in transportation and transit infrastructure, and has an aggressive plan to address it. Second, it sends a targeted signal to those who assemble capital for new investment in products and technology, that California is moving on every front (Air Resources Board, California Energy Commission, Governor's Office of Planning and Research), including tax policy, to address the Global Climate Change issue and bring solutions to market.

(e) "Reflect principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration."

This proposal is simple. It is based on an existing tax, thus making it unnecessary to create new structures within the tax collection and administration. A petroleum fuels tax makes California more desirable to live, work and invest because it does not tax labor or income and because it gives the state a cleaner environment, all of which make the state more competitive. In terms of efficiency, the proposal uses existing law and administration. Furthermore, by correcting a known market failure, this

is one tax that actually improves the overall efficiency of the California economy. Given that "predictability" is important to investors, consumers, and to the Governor, this proposal allows predictability in terms of fuel taxes for a decade into the future. "Stability" is a close cousin to "predictability", and this proposal provides a stabile source of revenue for an area of state spending that is in serious need of a sufficient, dedicated funding source. "Ease of compliance and administration" is addressed directly through the use of the existing tax system regarding fuel taxes. The existing system is well understood by the entire chain of administrators, payers, and consumers.

(f) "Ensure that tax structure is fair and equitable."

This proposal is fair and equitable in the sense that it begins the important process of internalizing the cost of burning carbon-based fuels. Additionally, it provides the Legislature with a method of reducing the regressive nature of the tax by authorizing a refund of some portion of the tax for low and moderate income individuals.

Policy Rationale and Design Considerations

Because the price of gasoline in California does not accurately represent its full social costs, costs associated with smog and global warming pollution from petroleum combustion are borne by society as a whole and not by the producers and users of petroleum fuels. A properly structured pollution tax could help address this market failure by creating the price signals necessary to drive change in this sector. This paper provides some input regarding the best structure for a petroleum fuel pollution tax, from the standpoint of meeting the state's environmental goals.

Transportation and Environmental Policy in California

California currently depends on petroleum fuels for 96% of its transportation energy needs. This reliance on a single, high-polluting source of fuel presents many serious problems for the state, including poor air quality, climate change, and energy security concerns. The transportation sector accounts for approximately 40% of California's greenhouse gas emissions and nearly 50% of its petroleum usage.

Recognizing the severity of the threats posed by petroleum dependence and the need to transform the transportation sector, California set a target for petroleum reduction as part of the 2003 Integrated Energy Policy Report: "Increase the use of nonpetroleum fuels to 20 percent on on-road fuel consumption by 2020 and 30 percent by 2030." The state has also put into place a number of regulations and policies designed to mitigate the negative impacts of petroleum consumption and accelerate the transition to a cleaner transportation sector, including:

- SB 375 (Steinberg): creates GHG targets to drive land use planning
- AB 32 (Nunez): calls for economy-wide GHG reductions of approximately 30% by 2020. The transportation sector currently accounts for approximately 40% of GHG emissions in California
- AB 1493 (Pavley): created GHG vehicle standards (commonly known as the Pavley standards) and became the basis for recently announced federal auto standards
- Low Carbon Fuel Standard (LCFS): calls for a 10% reduction in fuel carbon intensity by 2020
- Zero Emission Vehicle (ZEV): mandates production of advanced, very low-emission vehicles
- Various air quality standards and programs

Pollution Tax is a Necessary and Valuable Complement to Existing Policies

Despite the many targets and programs designed to clean up the transportation sector, reducing the state's petroleum consumption has proven to be a difficult task, due in large part to the lack of a strong price signal. Policies such as the LCFS and the ZEV program are designed to make sure that alternative vehicles and fuels are available, but the low price of gasoline makes these cleaner technologies less attractive to both consumers and investors. Relatively low gas prices also complicate efforts to vehicle miles traveled. Though cap and trade legislation is expected to "put a price on carbon," experts have stated that carbon prices will be too low to drive investment and behavior changes in the transportation sector. Complementary policies, including a strong price signal, are essential.

A petroleum fuels pollution tax would complement the state's existing transportation policies and act as a "backstop," providing some assurance that those policies will actually deliver the petroleum and emission reductions that they are supposed to. Creating a strong price signal would ensure that people want to buy the cars that manufacturers must produce to meet the ZEV and Pavley standards. It would also serve to level the playing field for alternative fuels, helping the state's LCFS to deliver real emissions reductions. Finally, it would create a much-needed market signal to drive better land use decisions and reduced vehicle miles traveled, helping the state to meet or exceed the goals set out in the AB 32 Climate Change Scoping Plan and in SB 375.

In order to drive investment and behavior changes, the pollution tax would have to ramp up to a meaningful level by 2020, creating a price well above current levels. While there may be concerns about the costs this would impose on the state's businesses and consumers, the truth is that these costs are already being paid in the form of negative environmental and health impacts and huge payments to out-of-state providers of petroleum fuels. Furthermore, the current plan is to return some of the revenues to consumers, mitigating concerns about economic drag and regressivity

Tax Levels and Escalators

The most basic and most important consideration in designing a pollution tax is the level of the tax itself. Table 1 at right shows the minimum pollution tax that California would need in order to reduce petroleum consumption by various amounts when compared with consumption under the status quo. Note that a tax of over 30 cents is needed to drive even a five percent reduction in consumption over the long term. Aiming for a reduction of 20%, as called for in the state's Integrated Energy Policy Report, would require a pollution tax of nearly $1.25. For the sake of comparison, a $20 price on carbon emissions would only lead to an 18 cent increase in prices, leading to a long run reduction in consumption of slightly less than 3%.

Table 1: Minimum Pollution Fees Needed at Today's Prices to Drive Petroleum Reductions

To reduce long term petroleum consum tion b	*Would require a pollution tax of a roximatel .*
5%	*$0.31*
10%	*$0.62*
15%	*$0.92*
20%	*$1.23.*
NOTE: Assumes baseline gas price of $3.07 and long term elasticity of -0.5	

Given the state's environmental goals and the problems associated with petroleum consumption, it makes sense to aim for a minimum of a 20% reduction over the long term. However, it is clear that California should not impose a pollution tax of over $1 all at once, particularly given the current state of the economy. A more logical approach would be to phase the tax in gradually. Table 2 below lays out options that would create a strong price signal and make a meaningful contribution to the state's environmental goals. The tax structures presented here would create price signals that are modest in the near term (all options begin with a tax of 18 cents/gallon), and ramp up in later years as the economy recovers and alternative fuels and vehicles are more widely available. For each of the three tax structures, the table shows the per-gallon tax in 2010 dollars. Note that the tax would be adjusted annually for inflation. It also shows the degree to which a tax at that level can be expected to reduce petroleum consumption over the short term (1-2 years) and longer term.

Table 2: Pollution Tax Escalators and Impacts, Starting with 18 cents/gallon in 2010'

Tax and Impact' By Year	Annual Escalator	Conservative 5 cents / year (2010 dollars)	Moderate 7 cents I year (2010 dollars)	Aggressive 9 cents / year (2010 dollars)
	Per gallon tax	$028 / gallon	$0.32 I gallon	$0.36 / gallon
2012	Petroleum reduction: short term	0.9%	1.0%	1.2%
	Petroleum reduction: long term	4.5%	5.1%	5.8%
	Per gallon tax (2010 dollars)	$0.43 / gallon	$0.53 / gallon	$0.63 / gallon
2015	Petroleum reduction: short term	1.3%	1.6%	1.9%
	Petroleum reduction: long term	6 7%	8.2%	9.7%
	Per gallon tax (2010 dollars)'	$0.68 / gallon	$0.881 gallon	$1.08 / gallon
2020	Petroleum reduction. - sortte fill	2.0%	2.6%	3.2%
	Petroleum reduction: long term'	10.1%	12.9%	15.8%

NOTE: Assumes annual inflation rate of 2.5%, short term elasticity of -0.1, and long term elasticity of -0.5. All scenarios start with $0.18 in 2010 and all assume a 2010 gas price of $3.07 before the pollution tax. Taxes would be adjusted annually for inflation and increased by $0.07/gallon.

Experts have suggested that a pollution tax of $0.60 to $0.90 per gallon is necessary to drive change in the transportation sector. The three options outlined in Table 2 above would get to that level, roughly, by 2020. From the standpoint of meeting the state's 2020 petroleum reduction and emission goals, a $0.09/year escalation factor would be best, though even this would not be sufficiently aggressive to motivate a 20% reduction in petroleum usage by 2020. A more moderate escalation factor of $0.07/year, provides a reasonable middle ground. Given recent warnings on climate change from the scientific community, it makes sense to move more quickly than a $0.05 escalator would allow. Lower taxes may still make sense from the standpoint of improving economic efficiency and providing revenue for the state, but price signals and environmental gains would be small.

As noted above, all of the taxes outlined in Table 2 start with a $0.18 tax in 2010. The taxes would then be adjusted annually for inflation, and increased by the specified annual escalator ($0.05, $0.07, or $0.09 per gallon) every year for 10 years. This gradual ramp up allows consumers time to adjust, allows more alternatives to enter the market, and helps put to rest fears about delaying the economic recovery. Note that we have chosen to structure these increases in terms of annual inflation-adjusted Xcent-per-gallon increases in order to make the taxes easily understood, but you could also build in an annual percentage escalator and arrive at similar numbers.

Which Fuels to Tax?

Also important is the question of which fuels to tax. As currently written, this pollution tax would be levied on gasoline and diesel. However, in order to truly make this a tax on petroleum fuels, it may make sense to move one step up the production process and apply the tax to all petroleum fuel inputs. For gasoline,

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Elasticities and price assumptions come from Severin Borenstein, "The Implications of a Gasoline Price Floor for the California Budget and Greenhouse Gas Emissions." Center for the Study of Energy Markets WP 182, Dec. 2008.

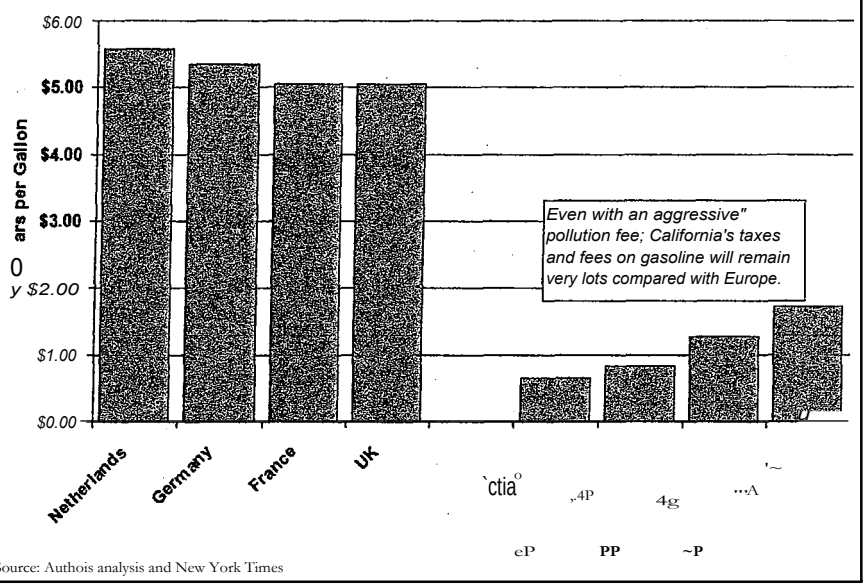
this would mean taxing California Reformulated Gasoline Blendstock for Oxygenate Blending (CARBOB) and not taxing the ethanol that is blended into gasoline. This would slightly reduce the overall cost per gallon increase at the pump, but would ensure that the tax is being levied on petroleum fuels, and would provide an incentive for higher levels of renewable fuel blends. An open question would be whether or not the state would want to tax the petroleum portion of blended renewable fuels, such as the 15% of E85 that is not ethanol, or the petroleum portion of biodiesel blends. These are details that should be worked out in discussions with stakeholders and the relevant state agencies.

Putting it All in Context: Proposed Taxes are Really Quite Modest

At first glance, the suggested increases may seem dramatic. However, that is only the case if you consider them in the context of current U.S. fuel taxes, which are among the very lowest in the developed world. Even the scenario labeled "aggressive" is actually quite moderate, with tax increases equal to less than one cent per month. The more conservative scenarios have increases equal to less than half a cent per month. The initial 18 cent tax proposed for 2010 would cost the average California resident less than $7 per month, not taking into account any refund. [2] This number would grow as the tax escalates, but the growth would be offset at least in part by a refund and by reductions in per capita petroleum consumption due to increases in vehicle efficiency and alternative fuel use.

Compared with other OECD nations, gasoline prices and taxes in the United States are extremely low. Figure 2 at right shows total (including state and federal) gasoline taxes in Europe and California. Even under the aggressive scenario, with a pollution tax that climbs by an inflation-adjusted $0.09/gallon per year from now until 2020, California prices would still be far below those Europe. The "cheap gas" policy in this country is fueling petroleum dependence, congestion, pollution, and a lack of energy security. Furthermore, the relative lack of domestic demand for efficient vehicles is putting domestic manufacturers of clean technologies at a disadvantage.

Figure 2: Taxes and Fees on Gasoline in California and Europe



Source: Authois analysis and New York Times

Shifting back to domestic prices, it is instructive to look at natural fluctuations in gas prices, which far exceed the changes that would be brought about by this pollution tax, especially in the near term. We have witnessed swings of more than $2 in just the past two years. This sort of volatility is a clear argument for reducing dependence on petroleum and shows how minor the pollution tax is in the context of overall volatility. Local prices can also vary substantially on a given day. These variations, even among stations sitting on opposite sides of the same corner, are often at least as large as the proposed pollution tax, yet many people pay the higher prices despite the availability of cheaper gas. Gas prices on one day in late August at three San Francisco gas stations lying within less than a mile of each other

[2] California's annual per capita gasoline consumption was 445 gallons in 2005, according to the U.S. Department of Energy (http://appsl.eere.energy.gov/states/transportation.cfm/state=CA) An 18 cent/gallon fee would therefore equal $80.10 over the course of a year.

along the same road ranged from $2.95 to $3.15 per gallon.[3] This is quite common across the country, yet the higher priced stations remain in business. It may be argued that those in lower socioeconomic classes tend to seek out the stations with the lowest prices, meaning that the difference of a few cents per gallon is significant, and that the pollution tax will hit this group the hardest. However, the proposed rebate (along with any tax cuts recommended by COME) should help address these concerns and offset the increased transportation costs. Furthermore, the only way to protect disadvantaged populations from high prices over the long term is to reduce our petroleum dependence, and strong price signals are necessary for achieving this goal.

Revenues Could be Used to Further Policy Goals

Revenues produced by a pollution tax on petroleum fuels would be subject to Article XIX of the California constitution, restricting their use to "research, planning, construction, improvement, maintenance, and operation of public streets and highways," or "research, planning, construction, and improvement of exclusive public mass transit guideways." However, even under the constraints of Article XIX, the revenues could be used to achieve a number of important goals. First, some portion of the revenues could be returned to taxpayers through a universal rebate, mitigating concerns about the regressive nature of this tax and the potential drag it may create on the economy. Given the current state of the economy, this is particularly important in the first year.

Pollution tax revenues could also be used to help pay for Article XIX transportation infrastructure expenses. California's excise tax on gasoline has remained constant since 1994, at $0.18/gallon, meaning that the state has actually seen a $0.08/gallon tax cut in real terms. This has hurt state and local transportation agencies that rely on these funds for vital infrastructure expenditures.

Finally, revenues could also be used to pay down transportation-related debts, easing the burden on the general fund and helping to address the budget deficit. The split between these different uses of pollution tax revenue is a policy decision that will require further discussion.

Proposed Expenditures of Pollution Tax Revenues

The funds in the Transportation Revenue Account would be spent as follows:

- First, for payment of current fiscal year debt service on general obligation bonds issued by the state for transportation purposes. An amount necessary debt service on these bonds would be set aside for this purpose each year. Currently, this is approximately $500 million. This allows for some General Fund relief, though a portion would effectively be rebated to consumers through the fuel tax rebate account. (See below for details.)

- Next, of the moneys remaining after funds are dedicated to debt service, 20% would be paid to the Strategic Growth Council and eligible entities for the planning and implementation of projects consistent with the policies of Chapter 728 of the Statutes of 2008, providing the planning and projects are consistent with Article XIX of the California Constitution."

- Thereafter, of the moneys remaining after debt service and allocation of funds to planning and implementation of projects consistent with Chapter 728 of the Statutes of 2008: 50% would be transferred to the State Highway Account to be used for eligible projects in the State Highway Operation and Protection Program and for mass transportation projects consistent with Article XIX of the California Constitution; and 50% would be apportioned to cities and counties for street and highway maintenance, rehabilitation, reconstruction, and storm damage repair, as well as for mass transportation projects consistent with Article XIX of the California Constitution.

[3] Author's observations, verified on CaliforniaGasPrices.com. Note that another station on the same block had a price of $3.32, though it offered discounts for gas purchased with a car wash. All four gas stations had many customers.

Furthermore, as noted above, the bill would create a Fuel Tax Rebate Subaccount. Each year, an amount equal to 35% (or some other amount, to be determined by the legislature) of the Transportation Revenue Account funds used for general obligation bond debt service would be transferred from the General Fund to the newly created Fuel Tax Rebate Subaccount. The revenues in this subaccount would then be used to make payments under a personal income tax rebate program to be established by the Legislature to offset, in part, the higher fuel taxes imposed by the bill.

Conclusion

California should implement a Petroleum Fuel Pollution Tax starting at $0.18 per gallon and adjusted annually for inflation with an additional annual increase of 7cents per gallon. A well-designed pollution tax with this structure would have many beneficial implications for California, including:

- Petroleum reduction due to increases in transportation efficiency and reductions in travel
- Improved air quality due to reduced vehicle miles traveled and accelerated fleet turnover
- Improved energy security
- Increased funding for smart growth transportation infrastructure
- Increased investment in clean technologies in California
- Reductions in payments to out-of-state petroleum fuel producers
- Progress toward the GHG reduction goals set out by AB 32 and SB 375

Higher escalators will generally mean greater benefits. The plan to return a significant portion of the revenue directly to the public through a universal refund should address concerns about regressivity and loss of purchasing power.

Petroleum Fuel Pollution Tax Working Group Process

Summary

Subsequent to the July 16th COTCE meeting at UCSF, Mr. Gerry Parsky, COTCE Chairman, sent out a memo to fellow commissioners describing the process going forward regarding the tax reform proposals that had been put before the Commission since its inception in January 2009. In his memo and attachment dated July 24th, Chair Parsky recommended that Commissioners participate in efforts that would add structure and detail to the major tax reforms which had been discussed at the Commission. By agreement amongst Commissioners, COTCE's report to the Governor and Legislature would include three parts.

The first set of recommendations will be statuary tax law changes that can be acted on by the state Legislature immediately (several conversations at previous COTCE meetings indicated that the intent is/was to have the specific tax reform in 'bill form'). The proposed pollution tax discussed herewith falls squarely into this first part.

After advising the Chair and pursuant to the guidelines of the Bagley-Keene Open Meeting Act, which covers all state boards and commissions, Commissioner Keeley organized three working group meetings to discuss the broad set of issues associated with implementing a new pollution tax on carbon-based fuels. Invited to these three meetings were all COTCE Commissioners, a broad cross-section of staffers from the State Board of Equalization, the Assembly and Senate Revenue and Taxation committees, the Legislative Counsel's office, as well as legislative leaders, academics, energy policy and transportation experts, and representatives from the business and environmental communities. [4]

Three meetings were held in Sacramento, of which one (August 12th) was held in one of the Capitol's Senate Hearing Rooms and the other two (August 18th and August 25th) were held at the Board of Equalization. Notice was provided by way of emails to all COTCE Commissioners and other interested parties. Commission Keeley relied on an extensive mailing list to spread the word about the meetings. Attendance varied from 15 to 25 at the three meetings.

From a process standpoint, the goal of the meetings was to be transparent and to develop draft legislation that reflected the input of all involved. This consensus-building process resulted in draft legislation that addresses the major goals that Commissioner Keeley set out to achieve, with the support and input of a wide variety of constituents. Most importantly, the process provided the public with the ability to monitor and participate in the decision-making process. While some efficiency was sacrificed for the benefits of greater public participation in this process, the end product, the attached draft legislation, reflects the views of those who were involved.

The following section turns to a discussion of each meeting, agendas for which are attached at the end of this document in Appendix B.

[4] Working Group List in Appendix A.

The Meetings

August 12' Meeting

The focus of the first meeting was to examine in detail any fatal flaws associated with the variable rate pollution tax with floor. Much of the initial discussion focused on Article XIX restrictions [5] on how the funds would be spent. Since the main objective of the proposed variable rate pollution tax was to create clear price signals for consumers and investors that encourage a reduction in petroleum consumption, to help launch a strong clean technology industry in California and to support the goals of AB32 and SB375, the initial thinking of the group was to accept the Article XIX restrictions and the flow of the revenues from this tax into the Transportation Revenue Account. However, as many staffers expressed their concerns both about the need for additional General Fund revenues and others voiced concern about funding smart growth initiatives and others expressed their concerns about the regressivity of the tax, the discussion veered towards a focus on the proposed tax revenues.

As the discussion about the revenue stream of the proposed tax progressed, it became apparent that the state's transportation sector was vastly underfunded. DeAnn Baker with California State Association of Counties (CSAC) noted that their organization had just completed a study co-funded by the League of California Cities indicating that the underfunding amounted to $7 billion per year. As a result, the discussion began to focus on how the proposed pollution tax could create a stable source of revenue for some vastly underfunded areas of local and state government, not to mention some initial funding for new smart growth initiatives, whose goals are consistent with the goals of the pollution tax, while offering some relief to lower income households, upon whom this tax would hit the hardest.

BOE, Assembly and Senate staff raised the issue of how the impact of the proposed Business Net Receipts Tax might complicate the revenue issues associated with a variable rate pollution tax. Prop 42 revenues from sales and use tax on gasoline, unlike the excise tax, are not Article XIX restricted and can be spent on any type of transit expenditure. However, the reduction in rate that a COTCE tax reform may propose in sales and use taxes will decrease Prop 42 revenues, unless some specific action is taken to dedicate some additional portion of either the SUT or BNRT revenues to transportation to make up the difference.

The group spent a significant portion of the time discussing the design of the tax, specifically what index should be used for recalculating the tax? How often? What coefficient of change? In examining these questions with legislative and BOE staff, it became clear that some of the objectives of the variable rate with floor version of the tax would be administratively challenging. Ideally, the tax would be adjusted . monthly based on oil futures prices at the end of the month. BOE staff indicated that this would be very difficult and suggested that the most frequent adjustments that they could accomplish would be quarterly adjustments. Furthermore, BIDE staff suggested that government and industry would need significant lead time for changes, with decisions about new rates being made three months in advance. Many meeting participants thought this might undermine the program. The academics and energy policy experts offered to look at oil price volatility to see if futures prices three months in advance are accurate enough for these purposes. Shorter time increments, it was observed, may be necessary to make sure the tax is acting as it should - increasing prices when they are low and phasing out when prices increase.

Many other aspects of the design of the proposed variable rate were also discussed, such as the appropriate floor price (oil price trigger level), the manner and how often the floor price should change, who would decide, etc. The actual price floor level is a policy decision with political factors at play. Severin Borenstein, University of California at Berkeley economist, suggested $3.00, and the Auto

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[5] Article XIX of the State Constitution stipulates that gas excise tax revenues can ONLY be used for research, planning, construction, maintenance, and operation of public streets and highways, or research, planning, construction, and improvement of exclusive public mass transit guideways. *"Revenues from taxes imposed by the State on motor vehicle fuels for use in motor vehicles upon public streets and highways, over and above the costs of collection and any refunds authorized by law. "*

Alliance has suggested $3.50. Meeting participants agreed that the floor should be adjusted annually for inflation but there was disagreement as to how this should be accomplished.

One of the major issues raised but not resolved at this meeting was what type of fuels to tax. The original idea was just gasoline, but the meeting left this issue in doubt. Jet fuel was definitely considered out, but the inclusion of diesel was left undecided. Joe Bankman, Stanford law professor, noted that excluding diesel would be good because it is a business input and you could minimize the economic impact and opposition from trucking companies and other businesses by excluding it. Professor Borenstein noted that this would cause a shift toward diesel. Encouraging a light duty shift toward diesel is "picking winners" to some degree, but encouraging a shift toward more efficient diesel vehicles might not be a bad thing. Furthermore, diesel is currently taxed at a higher rate in this country (the federal government has a higher excise tax on diesel) so having varying taxes would not be a departure from existing policy.

The long discussion on revenues in the beginning of the meeting followed by a discussion with some of the technical and administrative issue with the variable rate version of the pollution tax caused many in the meeting to question whether a flat tax increase might be preferable. The revenue discussion . increased the focus on one aspect of the proposed variable rate tax with floor that hadn't at first seemed to be a large issue, the lack of stability of revenues. Several participants, including Professor Borenstein, the author of the variable pollution tax with floor, began to reconsider whether a fixed rate version of the pollution tax would be preferable because of the stability of the revenue stream. This would provide a definite source of revenues and would allow for offsetting reductions in other taxes, which could help. generate support and would make the tax easier to link to other portions of the COTCE package. It would also help deal with the state's budgetary problems, which the more volatile and uncertain variable surcharge might not do. By meeting's end, the consensus was that a type of flat tax would be best at meeting the various objectives of the proposed pollution tax and would also address the administrative and technical issues associated with the variable rate version.

August 18th Meeting

Commissioner Keeley launched this meeting with a restatement of the goals of the proposed pollution tax (i.e. sending the signal to consumers and investors that more efficient and alternative fuel vehicles are a good choice and supporting AB 32 and SB 375 and thereby contributing to environmental goals).

Professor Borenstein_ provided his overview of variable tax proposal, followed by a critique thereof. The idea of the variable rate tax is to raise revenue and dampen declines in gas prices in a way that sends a signal that gas prices will not go very low. This incentivizes more fuel efficient vehicles. However, this is not the ideal way to address climate issues. The ideal way is to price externalities with a fixed tax. The main.problem is extreme volatility. Ten dollar swing in price of a barrel of oil translates to $6 billion. This issue could addressed by implementing an oil severance tax which moves up with price of oil, moving opposite this tax. However, in the last meeting, there was recognition. that the different restrictions on excise tax revenue and sales tax revenue flowing from gas taxes does not make these two taxes a good pair. Originally, Professor Borenstein said he came up with this idea because he thought it would be politically more feasible, but that he had always felt that a straight tax increase that does not phase out is actually preferable from an economic efficiency standpoint.

Considerable discussion followed Professor Borenstein's presentation and the conclusion was tentatively reached that some sort of flat tax would be preferable to a variable tax for a long list of reasons, economic, political, and administrative. Commissioner Keeley summarized the evolution of the gas tax from a flat tax, to a variable tax and now, seemingly, back to a flat tax. Professor Bankman agreed that a flat rate is better, all else equal, but 18 cents per gallon would have minor behavioral implications. Long run, elasticity is -0.5, so any behavioral changes would be minor. Michael Wara, Stanford Law School professor, commented that starting with a flat tax that grows quickly over time might be preferable to a constant tax or floor. With the variable tax, you would increase the floor. With a flat tax, or hybrid thereof, you could increase the tax. Professor Borenstein agreed that if you take AB32's 2050 goals seriously, $20 per ton is insufficient, but $70-100 per ton will yield the necessary changes (we need 60-90 cents per gallon, just for carbon).

Following on the notion that a flat tax needs to be higher to affect consumer and investor behavior, Mark Watts, a legislative advocate, said that 75 cents per gallon would be necessary for Caltrans for maintenance of roadways, roadsides, and modest increase in capital improvements. Also, the League of California Cities and CSAC just completed an assessment looking just at local maintenance needs. Including all rev streams, Prop 1 B and American Recovery and Reinvestment Act (ARRA), there is a $71 billion shortfall over next decade, which would represents a 38 cent tax increase (this is just local, not the freeway system). A Western State Petroleum Association (WSPA) representative indicated that they will oppose oil severance, but may be able to help with support on the gas tax if no severance tax is involved.

Again, the meeting discussion focused on Article XIX issues, with Eric Lange, Legislative Counsel, providing feedback as to what expenditures would comply with Article XIX. Much of this discussion focused on how to fund a rebate to address the regressivity of the proposed pollution tax. Commissioner Keeley averred that a constitutional amendment to Article XIX could not be part of this process and that the group needed to work with Article XIX. Gayle Miller, Principal Consultant Senate Committee on Revenue and Taxation, responded to the idea of crediting back some of the revenues to consumers by saying that according to Prop 13, it's not a tax credit even if it is given back to different people and that it may be possible to use a refund; but Legislative Counsel would need to opine on this. Eric Lange also indicated that Commssioner Keeley's idea of making the findings that Californian's pay some amount on average, thus enabling a refund of that same amount (maybe $150). Transit vouchers were another idea that was considered, but discarded.

The following allocation of expenditures was tentatively agreed upon under a flat tax of $0.18 per gallon. Assuming such a starting point for a pollution tax, Professor Borenstein estimates that first-year tax revenues would be $3 billion. If each household received an $80 rebate, that represents approximately $1.2 billion which could be split 66% split between Caltrans and locals, 33% eligible for rebates. The idea was discussed of using funds totaling about $400 million for 1 B debt servicing, then taking the General Fund revenues which would free up an equal amount of General Fund revenue for transit rebate.

Commissioner Keeley then requested that Legislative Counsel to draft up the current proposal on the table, specifically to construct a proposal for an 18 cent tax that increases at CPI plus x% (maybe 5% per year). This would yield about $3 billion in the first year, of which $2 billion for state and local Article XIX expenditures and $400 million for debt service payment and $600 million for rebate. Considerable uncertainty was expressed as to whether a 5% annual increase would be sufficient. Many wondered whether an absolute adjustment of up to $0.10 per year would be better in order to start off with larger increases that send a strong signal in the short term as opposed to a percentage increase of say 5% which would be smaller in the short-term and larger later.

August 2e Meeting

The Pollution Tax Working Group meeting on August 25 th began with the distribution of the agenda and Legislative Counsels' bill draft. Commissioner Keeley asked attendees if working from the bill draft to frame the meeting might be the most expeditious path to meeting the groups' objectives, a suggestion which was received positively.

Legislative Counsel indicated that there is a serious Article XIX problem with rebate/refund plan as discussed in their cover letter and so the group decided to focus on resolving that issue for the next bill draft. The problem was tackled as the group worked through the "finds and declares" (Section 1) of the draft legislation. An extended discussion ensued about refunds and rebates, with some consideration given to using the VLF to fund rebates instead of the PIT. It was agreed that "refund" would be preferred to "rebate" as Article XIX allows for "refunds authorized by law." Legislative Counsel reiterates that refund expenditure would be cleaner if it came from the General Fund as Article XIX is refund limiting in Legislative Counsels' view.

Discussion advanced to observe that tax imposition and refund are severable issues and therein may be a solution. Perhaps the findings should clearly separate the issues of reducing fuel consumption from

regressivity of the tax. The idea emerged to direct more of this new tax revenue to reduction of debt service (instead of refunds) clearly allowed by Article XIX. In this way, the refund could be a separate General Fund expenditure via PIT based on General Fund savings in debt service payments provided by the new fuel tax. Carrie Cornwell, Chief Consultant for Senate Transportation and Housing Committee and expert on Article XIX, noted that there is a 25% limit for debt service expenditures in Article XIX but this would not be a constraint based on current numbers. Also, there should be a "net benefit" to the General Fund for this to work. Professor Bankman estimated that $400 million in refunds could relieve the lowest three household income deciles of taxpayers.

Using the whiteboard, the group began the process of outlining how the tax revenues would be allocated. The initial thought was that the total of $3 Billion fuel excise tax revenue (based on 18cents per gallon) would be first allocated to transportation debt service retirement ($500m), leaving $2.5 billion, of which the next allocation would be to SB 375 and the Strategic Growth Council (SGC). After an intense discussion, it was agreed that $100 million would be set aside for SGC and regional blueprint planning for rural counties) and $400 million would be set aside for MPO/RTP (SB375). The remaining $2 billion would be equally divided (50% apiece) between locals and State for transportation system maintenance and repair (in keeping with Prop 42 concerns, though it was noted that current split of fuel tax is 65% state & 35% local). John Boesel, CaISTEP (California Secure Transportation Energy Partnership) Partner, and others raised the concern that SB 375/AB 32 make it clear that the current system is not our transportation future.

The group discussion then moved to how best to increase this fuel tax. After intense deliberation, it was agreed that the increase would be CPI plus an additional 7cents per year for 10 years, and estimates the revenue will increase from $3 billion to $12 billion by year 10. It was noted that such a revenue increase will require a recalibration for regressivity and increased refunds. As currently discussed, refunds from General Fund will be constrained by debt service reduction.

The final minutes of the meeting were devoted to a discussion of exactly how to allocate the $500 million for the SGC and MPOs, how to handle allocations for future years (i.e. should the draft language be expressed as percentages, not absolute numbers), and should any of this be subject to a "sunset" provision. The meeting closed with advisory that plenty of drafting would commence and the group should look for emailed items to mark up and feed back.

Some of the outstanding questions left at the end of the meeting were whether the proposed pollution tax would be better structured as a fee; whether the bill should include diesel; whether the tax should be collected farther up the chain; whether there are simpler ways of structuring the percentages for revenue allocation; and how to structure the rebate and determine what portion of the freed-up General Funds it should represent.

Appendix A:
Pollution Tax Working Group List

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Appendix B:
Agendas for the Three Meetings

Meeting with Commissioner Fred Keeley on Proposed Fuel Tax
August 12, 2009

I. Should the Legislature enact this tax, what can it fund?

- Given Article XIX considerations, how may the Legislature allocate revenues from this proposed tax? If restricted, are there general fund backfill opportunities?
- Can revenues be used to create a stable investment environment for clean transportation?
- What other options exist to fund priorities?

II. Is the Proposed Tax the Right Priority of Objectives for a Pollution Tax on Carbon-Based Fuels?

- Does the tax help accomplish or complement the goals set forth in AB32 and SB375?
- Will the tax reduce greenhouse gas emissions, dependence on oil, and VMT?
- What does the data show regarding increased gas taxes reducing VMT/Greenhouse Gas Emissions? At what price does behavior change? Are behavior changes constant or "sticky?"

III. Tax Policy Questions:

Who will eventually pay this tax? Upon whom will fall the incidence? Will this tax be regressive or progressive?

- Which economic actors win? Who loses?
- Will the tax create distortions? What are they and is the distortion worth it?
- What are the implementation considerations?

N. Establishing the Specifics of the Tax

- Who pays the tax? Does levying the tax at the production level make sense?
- Which fuels should be included (i.e. just gasoline or also diesel, jet fuel)?
- What variable should be used? What coefficient of change?
- What is the appropriate floor price (oil price trigger level)? In what manner and how often should the floor price change? Who decides?
- What process would be used to make floor price adjustments?
- Should the floor price vary by region? What factors should cause regional differences? Are different regional floor prices administrable?
- Should the tax be indexed for inflation?
- If revenue is an objective, then what to do when price surpasses floor?
- What do we call this tax?
- Does an oil severance tax complement the goals of this tax?

V. Running the Traps to Identify any Fatal Flaws

- Can we enact this tax without a Constitutional amendment? If so, who would support or oppose an amendment?
- If not, is a Constitutional Amendment necessary to fund priorities? Who would support or oppose an amendment?

  Is any tax on gas subject to special fund or other restrictions?
- Are there additional policy, political, or implementation constraints?

VI. Meeting COTCE's mandate

- Can we ensure that this tax that will meet the requirements of COTCE's 'first bucket, which are "recommendations of statutory tax law changes (revenue related) that can. be acted on by the State Legislature immediately and are hopeful endorsed unanimously by the Commissioners?"
- Could a Constitutional Amendment to change Article XIX restrictions be included in COTCE's `second bucket,' of recommended Constitutional Changes?

VII. Other concerns

Pollution Tax Meeting Agenda
August 18, 2009
10:00 a.m. - Noon
Board of Equalization Headquarters
450 N Street, First Floor Conference Room
Sacramento, California

1. Welcome and Introductions

2. Public Comment (Not Required By Law, But By Commission's Desire for Inclusion)

3. Briefing on Pollution Tax
   a. Severin Bomstien, University of California at Berkeley
   b. Joe Bankman, Stanford University

4. Briefing on Article **XIX** of the State Constitution Regarding Excise Tax
   a. Senate Revenue and Taxation Committee Staff
   b. Legislative Counsel

5. Briefing on Proposition **42** Regarding Sales Tax
   a. Senate Revenue and Taxation Committee Staff
   b. Board of Equalization Staff

6. Variable Rate Gasoline, Diesel, and Airplane Gasoline Tax Structure
   a. Rate, Base, Revenue Projections
   b. Collection

7. Oil Extraction Tax Structure
   a. Rate, Base, Revenue Projections
   b. Collection

8. Drafting Instructions to Legislative Counsel

Note: This is not an official meeting of the COTCE, but a working group meeting approved by the Commission Chair.

Pollution Tax Group Working Meeting
August 25, 2009
10:00 a.m. - Noon
Board of Equalization Headquarters
450 N Street, First Floor Conference Room
Sacramento, California

Agenda

I. Description of proposed pollution fee/tax:

A. Fee/Tax Rate:

1. Excise Fee of 18 cents per gallon

2. Adjusted for CPI

3. Plus an upward adjustment factor of 7 cents a year to be levied for 10 years

B. Fee Distribution:

1. $600 million shall be made available for a rebate program to be administered to either the VLF or VRF.

2. $500 million shall be made available to the General Fund for transportation related debt service

3. $100 million shall be made available to the Strategic Growth Council for grants and loans to eligible entities for planning and implementation projects consistent with SB 375

4. Remaining funds of approximately 2.1 billion shall be made available to the state and local governments according to a 50/50 split for the repair and maintenance of existing transportation infrastructure. No funds shall be used for increasing capacity.

II. Outstanding Issues

A. Shall the fmal proposal be drafted as a tax or a fee?
B. Is the rebate program and the SB 375 funds Article 19 compliant?
C. Will the timing be sufficient for leg counsel to `turn around' the fmal proposal in time for next COTCE meeting?
D. Other

LEGISLATIVE COUNSEL'S DIGEST

Bill No.

as introduced, _____.

General Subject: Fuel taxes.

The Motor Vehicle Fuel Tax Law imposes a tax of $0.18 per gallon on motor vehicle fuel, commonly referred to as gasoline. The Diesel Fuel Tax Law imposes a tax of $0.18 per gallon on diesel fuel. These revenues, after certain deductions for nonhighway fuel uses, are deposited in the Highway Users Tax Account. Approximately $\frac{1}{5}$ of the revenues in the account are apportioned by various formulas to cities and counties, and most of the remaining revenues are deposited in the State Highway Account. Article XIX of the California Constitution restricts the use of fuel tax revenues from highway fuel used in motor vehicles upon public streets and highways to specified transportation purposes.

This bill, commencing July 1, 2010, would impose an additional tax on gasoline and diesel fuel of $0.18 per gallon, which would be adjusted annually each January 1

by the State Board of Equalization based on the increase, if any, in the All-Urban Consumer Price Index for the most recent 12-month period for which data is available. In addition, the board would be required to increase the fuel tax rate by an additional $0.07 per gallon each January 1 for the period between January 1, 2011, and January 1, 2020. After deducting revenues attributable to nonhighway fuel uses, which would be used for purposes related to those nonhighway uses, the remaining revenues would be deposited in the Transportation Revenue Account, which the bill would create, and would be continuously appropriated for certain purposes. The moneys in the Transportation Revenue Account would first be used for payment of current fiscal year debt service on general obligation bonds issued by the state for transportation purposes. Of the remaining moneys, 20%, would be paid to the Strategic Growth Council and other eligible entities for the planning and implementation of projects consistent with the policies of Chapter 728 of the Statutes of 2008, providing the planning and projects are consistent with Article XIX of the California Constitution. Thereafter, 50% of the remaining moneys would be apportioned to cities, counties, and cities and counties pursuant to specified formulas for street and road maintenance and repair purposes and for mass transportation purposes consistent with Article XIX of the California Constitution, and the other 50% of the remaining moneys would be transferred to the State Highway Account to be used for eligible projects in the State Highway Operation and Protection Program and for mass transportation projects consistent with Article XIX of the California Constitution. The bill would delete provisions relating to increases in state fuel taxes if the federal government reduces federal fuel taxes.

This bill would result in a change in state taxes for the purpose of increasing state revenues within the meaning of Section 3 of Article XIII A of the California Constitution, and thus would require for passage the approval of $^{2}/_{3}$ of the membership of each house of the Legislature.

The bill would also require the Controller to transfer a specified amount from the General Fund each year to the newly created Fuel Tax Rebate Subaccount in the Transportation Revenue Account. The amount to be transferred would be computed by the Controller based on 35% of the amount made available from the new fuel tax revenues for transportation general obligation bond debt service. The money in the subaccount would be continuously appropriated to the Franchise Tax Board to make payments under a personal income tax rebate program to be established by the Legislature to offset, in part, the higher fuel taxes imposed by the bill.

The bill would also make legislative findings and declarations.

Vote: 2/3. Appropriation: yes. Fiscal committee: yes. State-mandated local program: no.

An act to amend Sections 7360, 8353, 60050, 60652, and 60653 of the Revenue and Taxation Code, and to add Chapter 3.5 (commencing with Section 2140) to Division 3 of the Streets and Highways Code, relating to fuel, and making an appropriation therefor.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. The Legislature finds and declares all of the following:

(a) It is in the public interest to encourage energy conservation through the use of fuel-efficient motor vehicles or reduced use of motor vehicles using gasoline or diesel fuel. It is well established that higher gasoline or diesel fuel prices, real or perceived, encourage energy conservation, the development of a more fuel-efficient motor vehicle fleet, and the use of alternative modes of transportation.

(b) It is the intent of the Legislature to encourage energy conservation, reduce petroleum consumption, reduce greenhouse gas emissions, make investments in important transportation infrastructure to reduce vehicle miles traveled, and maintain the existing transportation system.

SEC. 2. Section 7360 of the Revenue and Taxation Code is amended to read:

7360. (a) A tax of eighteen cents ($0.18) is hereby imposed upon each gallon of fuel subject to the tax in Sections 7362, 7363, and 7364.

~~(b) If the federal fuel tax is reduced below the rate of nine cents ($0.09) per gallon and federal financial allocations to this state for highway and exclusive public mass transit guideway purposes are reduced or eliminated correspondingly, the tax rate imposed by this section, on and after the date of the reduction, shall be recalculated by an amount so that the combined state and federal tax rate per gallon equals twenty-seven cents ($0.27).~~

~~(c) If any person or entity is exempt or partially exempt from the federal fuel tax at the time of a reduction, the person or entity shall continue to be so exempt under this section.~~

(b) (1) An additional tax of eighteen cents ($0.18) is hereby initially imposed upon each gallon of fuel subject to the tax in Sections 7362, 7363, and 7364, commencing July 1, 2010.

(2) The State Board of Equalization shall adjust the amount of the tax imposed under this subdivision on January 1 of each year commencing January 1, 2011, based on the increase, if any, in the All-Urban Consumer Price Index prepared by the Department of Industrial Relations for the most recent 12-month period for which data is available.

(3) In addition, for each year beginning January 1, 2011, and ending on January 1, 2020, the State Board of Equalization shall further increase the rate of the tax imposed under this subdivision by seven cents ($0.07) per gallon.

SEC. 3. Section 8353 of the Revenue and Taxation Code is amended to read:

8353. ~~By~~ (a) Except as otherwise provided in subdivision (b), by the 28th day of each calendar month, the balance remaining to the credit of the Motor Vehicle Fuel Account at the close of business on the 23rd day of the same month, after payments of refunds and administration and enforcement, as provided for in Section 8352.1, shall, on order of the Controller, be transferred to the Highway Users Tax Account in the Transportation Tax Fund.

(b) By the 28th day of each calendar month, the amount of the balance remaining to the credit of the Motor Vehicle Fuel Account at the close of business on the 23rd day of the same month attributable to the tax imposed pursuant to subdivision (b) of Section 7360, after payments of refunds and administration and enforcement, as

provided for in Section 8352.1, shall, on order of the Controller, be transferred to the Transportation Revenue Account in the Transportation Tax Fund.

SEC. 4. Section 60050 of the Revenue and Taxation Code is amended to read:

60050. (a) A tax of eighteen cents ($0.18) is hereby imposed upon each gallon of diesel fuel subject to the tax in Sections 60051, 60052, and 60058.

~~(b) If the federal fuel tax is reduced below the rate of fifteen cents ($0.15) per gallon and federal financial allocations to this state for highway and exclusive public mass transit guideway purposes are reduced or eliminated correspondingly, the tax rate imposed by this section, on and after the date of the reduction, shall be increased by an amount so that the combined state and federal tax rate per gallon equals thirty-three cents ($0.33).~~

~~(c) If any person or entity is exempt or partially exempt from the federal fuel tax at the time of a reduction, the person or entity shall continue to be exempt under this section.~~

(b) (1) An additional tax of eighteen cents ($0.18) is hereby initially imposed upon each gallon of diesel fuel subject to the tax in Sections 60051, 60052, and 60058, commencing July 1, 2010.

(2) The State Board of Equalization shall adjust the amount of the tax imposed under this subdivision on January 1 of each year commencing January 1, 2011, based on the increase, if any, in the All-Urban Consumer Price Index prepared by the Department of Industrial Relations for the most recent 12-month period for which data is available.

(3) In addition, for each year beginning January 1, 2011, and ending on January 1, 2020, the State Board of Equalization shall further increase the rate of the tax imposed under this subdivision by seven cents ($0.07) per gallon.

SEC. 5. Section 60652 of the Revenue and Taxation Code is amended to read:

60652. Notwithstanding Section 13340 of the Government Code, all moneys deposited in the account under this part are hereby continuously appropriated, without regard to fiscal years, as follows:

(a) To pay the refunds authorized in this part.

(b) ~~The~~ (1) Except as otherwise provided in paragraph (2), the balance shall be transferred to the Highway Users Tax Account in the Transportation Tax Fund as provided in this chapter.

(2) The amount of the balance attributable to the tax imposed pursuant to subdivision (b) of Section 60050 shall be transferred to the Transportation Revenue Account in the Transportation Tax Fund.

SEC. 6. Section 60653 of the Revenue and Taxation Code is amended to read:

60653. The Controller shall make the transfers to the Highway Users Tax Account and the Transportation Revenue Account in the Transportation Tax Fund pursuant to Section 60652 at the same time as the transfers of moneys received under the Motor Vehicle Fuel Tax Law are made.

SEC. 7. Chapter 3.5 (commencing with Section 2140) is added to Division 3 of the Streets and Highways Code, to read:

CHAPTER 3.5. TRANSPORTATION REVENUE ACCOUNT

2140. The Transportation Revenue Account is hereby created in the Transportation Tax Fund and moneys in the fund are hereby continuously appropriated for the purposes of this chapter.

2141. The moneys in the Transportation Revenue Account shall be apportioned or paid by the Controller, as follows:

(a) For payment of current fiscal year debt service, as determined by the Director of Finance, on general obligation bonds issued by the state for transportation purposes consistent with Article XIX of the California Constitution, the amount necessary for that purpose. These payments shall be in lieu of payments for that purpose that would otherwise be made by the General Fund.

(b) Of the moneys remaining after the payments of subdivision (a), 20 percent, or a larger percentage if provided for by statute, shall be paid to the Strategic Growth Council and other eligible entities pursuant to the annual Budget Act for the planning and implementation of projects consistent with the policies of Chapter 728 of the Statutes of 2008, providing the planning and projects are consistent with Article XIX of the California Constitution. Eligible projects under this subdivision shall include mass transportation projects consistent with Chapter 728 of the Statutes of 2008 and Article XIX of the California Constitution. An entity that receives funds under this subdivision may issue bonds backed by those revenues consistent with Section 5 of Article XIX of the California Constitution.

(c) (1) Of the moneys remaining after the payments of subdivisions (a) and (b), 50 percent shall be apportioned to cities, counties, and cities and counties pursuant to the formulas in subparagraphs (A) and (B) of paragraph (3) of subdivision (c) of Section 7104.2 of the Revenue and Taxation Code. These moneys shall be used for the purposes described in subdivision (e) of Section 7104.2 of the Revenue and Taxation Code and for mass transportation projects consistent with Article XIX of the California Constitution.

(2) Of the moneys remaining after the payments of subdivisions (a) and (b), 50 percent shall be transferred to the State Highway Account. These moneys shall be used for eligible projects in the State Highway Operation and Protection Program and for mass transportation projects consistent with Article XIX of the California Constitution.

2142. The Fuel Tax Rebate Subaccount is hereby created in the Transportation Revenue Account. The Controller shall compute an amount equal to 35 percent of the amount made available each year pursuant to subdivision (a) of Section 2141 relative to payment of current fiscal year debt service on general obligation bonds issued by the state for transportation purposes. An equivalent amount to the amount computed under this section shall be transferred by the Controller each year from the General Fund to the Fuel Tax Rebate Subaccount. The money in the Fuel Tax Rebate Subaccount is hereby continuously appropriated each fiscal year to the Franchise Tax Board to make payments under a personal income tax rebate program to be established by the Legislature to offset, in part, the higher fuel taxes imposed by subdivision (b) of Section 7360 of the Revenue and Taxation Code and subdivision (b) of Section 60050 of the Revenue and Taxation Code.

2143. The apportionments required under Section 2141 shall be made at the same time as apportionments are made from the Highway Users Tax Account.

2144. All of the accounting and reporting requirements applicable to agencies under the Highway Users Tax Account in Chapter 3 (commencing with Section 2100) and Chapter 4 (commencing with Section 2150) shall apply to funds apportioned under this chapter.

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