Testimony for the Assembly Revenue and Taxation Committee

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Mr. Chairman, I appreciate the opportunity to testify before the Assembly Revenue and Taxation Committee today about the recommendations of the Commission on the 21st Century Economy. In my view, the Commission tackled one problem with the California tax system—its volatility—but its proposed solutions would be risky and I believe ultimately damaging to the State of California.

I was part of a group of nine economists and tax lawyers that signed a letter expressing reservations about the proposed business net receipts tax, suggesting it was too risky to adopt at this time for both economic and legal uncertainties. In our view, unlike a true value-added tax, it would penalize firms exporting from California to other states, create incentives to outsource production to entities not subject to the tax, be subject to legal challenges, and potentially be subject to gaming by taxpayers.

In my testimony today, I want to concentrate on four additional issues with regard to the proposed package by the Commission.

- Contrary to what the Commission suggests, I believe the proposal shifts the burden from high income to low income Californians.
- Eliminating the state portion of the sales tax while maintaining the local component is not sound tax policy.
- The business net receipts tax imports all the complexities of the corporate tax to many more taxpayers which would strain the limits of tax administration in this state.
- Finally, if California wished to experiment with the BNRT as a new tax, it should follow the Michigan model and adopt it as a separate, complementary tax and not use it to replace the state portion of the sales tax or the corporate income tax.

The Commission's report itself does not discuss the changes in tax burden associated with their proposed tax changes but only implies that it preserves the same degree of progressivity. Only by looking at a power point presentation prepared by the Commission can one see their claim that their proposal shifts an additional $6.8 billion of taxes to the federal government or non-

residents. No evidence in the report itself supports this claim. This is unfortunate because without a full accounting of their methods, neither the public nor the Legislature can critically examine the claims of the report.

Although economists disagree on many things, they do agree that assessing the ultimate burden of taxation is an extremely difficult matter and depends critically upon the assumptions built into the analysis. Based on my understanding of the analysis underlying these calculations, I believe they may be seriously incomplete and misleading. It appears to me that the methods employed by the staff and their consultant did not fully take into account how changes in tax structure will, even at a first approximation, affect baseline taxable incomes. For example, simply replacing a retail sales tax with a receipts-based tax like the BNRT would increase firms' taxable incomes along with their deductions and not lead to any additional federal tax deductions or "federal offset." To see this, suppose that a product sold for $100 before tax and a 6% tax sales tax were imposed. If the cost were shifted to consumers, prices would rise to $106, with the firm turning over $6 to the government, leaving its net sales at $100. Now, replace the sales tax with a 6% receipts tax. Prices still rise to $106 as before but now the firms' total receipts are the full $106. They are allowed a $6 deduction, leaving its net sales exactly at $100 as before. Just because firms can deduct the business net receipts tax from their income does not mean that they shift any of its burdens to the federal government.

If the calculations of the staff and the consultant are not correct and if some or all of the $6.8 billion is not shifted to the federal government or non-residents, then a substantial portion of the non-shifted tax will likely be borne by consumers. This is what we would normally expect from the Commission's proposal to shift from income taxes towards taxes more closely aligned with consumption. This would have the effect of shifting the overall burden of taxation in California from groups earning above $100,000 to those earning below $100,000. This would certainly not be a distributionally neutral tax reform.

Eliminating the state portion of the sales will create administrative complications for the state. Either cities counties, and special districts will have to create their own duplicative administrative structures to manage the sales tax or they will have to continue to rely on a state government that has virtually no long term interest in managing this revenue source. Either of these changes will inevitably lead to reduced efforts in auditing, monitoring and enforcing existing laws, as well as efforts to modernize the sales tax as through national efforts such as the Streamlined Sales Tax Project. Absent a consistent state presence, we are likely to see a balkanization of the sales tax across counties and the eventual spread of anachronistic practices that will impose additional costs of compliance for businesses. However, once the state no longer receives ongoing revenue from the sales tax it cannot be counted on to provide necessary oversight for local taxes as it does now.

In the Commission's own report, it bemoaned the fact that the existing corporate tax was expensive to administer because of apportionment, combination and unitary groups. Perhaps the Commission had not considered this part of their report when they proposed the BNRT. The BNRT expands the scope of these identical provisions to all business entities of sufficient size, not just corporations. This will sharply expand the number of taxpayers subject to the rather intricate rules of apportionment, business and non-business income, combination, and the application of the unitary business principle. It is well known that issues of combination and the determination of whether entities are part of a unitary group are often most difficult for smaller business entities. Many court cases document the difficulties of making unitary determinations in these settings. Flow-through entities such as LLCs, LLPs, S-corporations, partnerships and sole proprietorships will test the limits of the unitary business principle and the additional compliance burden will be significant. I would also anticipate many of these flow-through entities to be created and designed explicitly to test the limits of the reach of the BNRT by either exploiting limits to nexus or by locating outside the waters edge reach of the tax.

I believe the novelty of the BNRT and the expected, but unknown, difficulties that will arise in its implementation, would initiate a long period of instability in California's system of taxation. There is much to be said in favor of the maxim, that an "old tax is a good tax." Moving away from familiar taxes whose parameters have been established through litigation, such as the corporation tax and the state sales tax, to a new and untested tax will create additional uncertainty for firms and increased lobbying and rent-seeking on the part of special interests. The Commission's recommendation for including a Research and Development credit—despite virtually no evidence on its efficacy—and possibly even allowing deductions for employee health insurance—previews the types of interventions we would expect. I would also expect strong pressure from groups representing labor to push for deductibility of some forms of employee compensation, particularly if outsourcing becomes an important consideration. As a result of the inevitable changes that will be enacted to the tax, firms considering investing in California will not be able to count on a stable framework. This additional uncertainty can easily act as a punitive "tax" on doing business in California.

The one positive feature of the BNRT is that it potentially reaches sectors of the economy that are not being reached by California's existing tax structure, especially large parts of the service sector. The intention is to tax additional consumption services. Another approach to taxing additional consumption, would be to simply expand the scope of the existing sales tax. This is the course that I would recommend. However, if California wishes to experiment with a new tax, it should consider how Michigan—the only place with a similar tax—has incorporated it into its tax system. Michigan adopted a 4.95% income tax on all businesses and a 0.8%

“modified gross receipts tax.” The level of their modified gross receipts tax is less than one fourth of that proposed by the Commission.

California could experiment with a tax of that size and use the proceeds to either 1) increase revenue or 2) reduce other taxes possibly personal income, corporate income or sales taxes. And do so in a cost effective, deliberative and fair manner. But it is important to understand that no state has adopted the BNRT to replace sales and corporate taxes. Such a course is simply too risky.