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Fred Keeley
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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 21st 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 21st 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 21st Century

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

### The Good

*COTCE Staff*

COTCE 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 COTCE 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 COTCE 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. COTCE 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. COTCE 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.[1] 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.[4]

*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

[1] Franchise Tax Board

[2] 6 Franchise Tax Board.

[3] 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.

[4] 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.[6] 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 jurisdictions.[7] 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/STAFF_PRESENTATION_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%20for%20COTCE520-%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 COTCE. 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 COTCE, 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.

[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 encouraging 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 21st 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/11836/

[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 21st 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.

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[3] 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 21st century tax structure that fits with the state's 21st 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.[6]

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.

**5/ 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 21st 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 of A 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.[8]. The benefits arising from these corporate tax reduction measures are poorly distributed. In particular, the benefits 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 S-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 reform 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 $100 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 of 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 21st century and into conformance with the federal model.[10]

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