

## STATEMENT OF COMMISSIONER RICHARD D. POMP

I endorse those Sections of our Report proposing the establishment of an independent tax forum and the end of pay-to-play. These are two independent proposals and the Legislature can adopt one without the other.

Whatever the nature of the tax system, taxpayers deserve to have their disputes heard by an independent body with tax expertise. Taxpayers should be able to have access to this body without having to pay in advance a contested assessment. These recommendations merely conform California procedure to both federal procedure and that of many other states and their adoption is long overdue.

I support the establishment of a rainy day reserve to deal with the issue of volatility. The Commission is well aware that I view our inability to predict volatility not as a tax issue but rather as a budget and spending issue. We should choose the taxes we prefer on their merits, and then take appropriate steps in the design of budget measures to deal with volatility.

Based on my 35 years of experience in the field of state taxation, and having participated in numerous tax reform efforts, I cannot agree with the other recommendations in the Report, but I especially disagree with the heart of our efforts, the Business Net Receipts Tax (BNRT). I am simply not confident that the BNRT will advance the welfare of California's citizens and businesses.

When it comes to tax reform, I subscribe to the equivalent of the Hippocratic Oath: do no harm. We are proposing sweeping and fundamental changes in the State's tax system. If the supporters of the BNRT are correct, the tax will impose new burdens on the consumers, with the burdens distributed to the detriment of lower and middle income groups. It is a crude and nontransparent way of

taxing services. If the critics of the tax are correct, the BNRT will put California businesses at a competitive disadvantage against producers elsewhere. The tax will also encourage firms to substitute capital for labor, to use independent contractors rather than employees (or misclassify employees as independent contractors), and to use out-of-state vendors of goods and services that do not have nexus with the State. By sending the BNRT forward, I fear we are acting more on the basis of wishful thinking. I prefer analysis and empiricism.

In that vein, I have submitted three memoranda to the Commission, which I now ask the Chairman to attach to our final Report. At our last meeting, there was a suggestion that there be no dissenting reports. But the Commissioners have an obligation to those who appointed them, to the Legislature as a whole, to California's citizens and businesses, to academics and analysts, and to the rest of the country that is following our work. We should openly and candidly express our views so that others can evaluate the merits of our respective positions. As Justice Brandies is famous for saying, "sunlight is the best disinfectant."

The combination of the proposed changes in the personal income tax, financed by the revenue raised from the BNRT, will shift the overall State tax burden onto the lower and middle classes and will provide a massive reduction in the taxes of a small group of high income taxpayers. Moreover, compared with current law, the new tax structure will generate revenue more slowly as the economy turns the corner, increasing California's already substantial structural deficit. And the BNRT is fraught with economic disincentives that I fear will harm California businesses.

What we are proposing is certainly bold. But boldness for its own sake is not a virtue. I have no confidence that our boldness is warranted.

Confidence is when we can point to other states (or countries) that have successfully adopted similar taxes at similar rates, and whose experience reinforces our boldness.

Confidence is when empirical evidence supports our boldness.

Confidence is when the leading experts in the country bless our boldness.

Confidence is when the business community embraces our boldness.

We have none of that.

To the contrary, the business community, economists, and leading academics have analyzed numerous flaws in the BNRT and found the tax wanting. Nine of the leading tax experts in the country concluded that “there are numerous reasons to believe that this is the wrong course for the state to take at this stage.” Michigan, the State upon which we have modeled the BNRT, has so little experience with its tax that no information even exists on how much revenue has been raised at its 1% rate.

We have “boldly” recommended that the corporate income tax, used for more than 70 years and by more than 90% of the states, be replaced by an unknown and untested new tax. Yet we heard no evidence that the corporate income tax, which has accompanied the good times and the bad times for seven decades, was having any negative effects on the economy. Nor did we hear any clamor from the business community to replace the tax.

Moreover, for reasons set forth in an earlier memorandum, I predict that the BNRT will devolve into a new type of income tax once the Legislature has responded to pleas that the BNRT should allow some relief for the payment of wages and interest, and

should not be applied to businesses operating at a loss. I question what will be gained by eliminating the existing corporate income tax and replacing it with a new tax that has many unknown effects yet replicates many of the features of the tax it is supposed to replace.

True, devastating changes that will gut the existing corporate income tax are scheduled to take effect in 2011. We heard testimony that those 2011 changes were not based on any studies or analysis. We have ignored an opportunity to recommend a reversal of those changes and to restore the corporate income tax as a model for other states. We should be rehabilitating and resurrecting the corporate income tax, not burying it. We should have adopted measures to implement systemic, institutional changes in the legislative process that will bridle future corrosive forces on the integrity of the tax and improve legislative decision-making. We have squandered a chance to raise revenue by eliminating waste and inefficiency in the corporate income tax.

What is not bold, indeed is brazen, is (mis)describing the BNRT as a value added tax (VAT), attempting to wrap it in the mantle of a tax widely used in the rest of the world, but poorly understood in the United States. The BNRT has one feature in common with a VAT: it is a regressive tax on consumption. In some key design features, however, the BNRT is exactly the opposite of what is done elsewhere.

The VAT used throughout the world would not put California producers at a disadvantage in competing at home with foreign and out-of-state producers, yet that is what the BNRT does. The VAT used throughout the world would not put California producers at a disadvantage in competing in other states and countries, yet that is what the BNRT does. Not surprisingly, therefore, is the opposition by the business and academic communities (not always allies).

What is “bold” is claiming that we are only asking the Legislature to “consider” the BNRT, when we are apparently presenting a draft bill to the Legislature. What is bold is attaching that bill to the Commission’s Report when we have never discussed the language of that bill or endorsed any of the policy decisions the bill incorporates. Indeed, at our last meeting we discussed the proper treatment of payments for health insurance, yet no one mentioned that the draft bill contained an explicit provision on this point. I suspect no one had read the bill because its discussion was not on the agenda.

The fact that a bill exists underscores my concerns. A bill will encourage the Legislature to take the BNRT more seriously than I think it deserves. Presumably, those that want to attach the bill to our Report are hoping for exactly that result. I note, however, that the Commission did not review, discuss, and certainly did not approve the bill.

I do not know how we can attach the bill to this Report. If we do, however, the Legislature should be told very clearly that the bill does not have our imprimatur or endorsement.

I fear that our Report, despite the many caveats and procedural safeguards attached to the BNRT, will nonetheless divert the efforts of the Legislature from other, more promising avenues of reform. For the reasons I have laid out in great detail in an earlier memorandum, I find these other avenues of reform more worthy to pursue than the flawed BNRT. That the proposed Report flags some known flaws for further consideration by the Legislature merely reinforces my fears, rather than allaying them. The Legislature has limited resources and limited time; whatever is diverted to the BNRT through hearings, studies, and drafting, cannot be devoted to other alternatives, such as dealing with the problems of the 21st century imposed by the Internet and the digitalization of goods and services.

I remain baffled at why in these hard times when people are losing their jobs and their health insurance, and stay-at-home parents are being forced into the job market, we are proposing eliminating the medical expense deduction and child-care credit. If those changes weren't callous enough, the BNRT will add to the plight of the afflicted by taxing child care, doctors, dentists, medicine, food, and utilities. And to pile on, Section 3 of our Report asks the Legislature to consider a minimum income tax that will fall on those too poor to pay the regular income tax. A recession may adversely affect us all, but those who suffer the most are the needy, not the rich. Yet the Commission repeatedly has proposed changes in California law that reduce taxes on the well-to-do and increases taxes on those less fortunate. I am baffled by this indifference to the needy.

Why are we embracing the BNRT with all of its known flaws? The only candid answer is because the BNRT can generate the revenue needed to finance the reductions in the personal income tax, reductions that benefit those at the high end of the income distribution. If, for example, revenues from the BNRT were to be pledged for debt service, the tax would be a non-starter. The Report proposes to give \$7.6 billion dollars of income tax relief to the top 3.2% of the taxpayers, financed by the regressive BNRT. The goal of tax relief for the well-to-do is not a sufficiently high priority for me that I can support a regressive, flawed, unprecedented tax, with the potential of harming the California economy.

If the goal of reducing taxes on the wealthy was to improve the California economy, my earlier memorandum referred to studies from other states indicating the fallacy in this approach. If the goal of this reduction was to reduce volatility, I feel the rainy day fund, as recommended by the Commission, is the appropriate mechanism and I endorse that approach.

In our early and enthusiastic embracing of the BNRT, I am reminded of a police department that latches on early to a prime suspect in a murder case, looking for a quick and easy arrest. By the time DNA testing shows the wrong person was arrested, all other leads have gone cold. We have ignored the equivalent of DNA testing and not pursued other leads. We have not pursued other avenues for fundamental reform that are more likely to achieve the goals of fairness and economic efficiency. I think in time it will be apparent that we have made a serious misjudgment, and have not served the people of California as well as they had a right to expect.