

THE RED, WHITE, AND BLUE PLAN COMMISSIONER RICHARD D. POMP

I. Introduction

I share everyone's desire that the Commission act unanimously and reach a consensus on our recommendations. Unfortunately, at this time I will have trouble voting for key elements of the proposals we are discussing. (I remain agnostic on the net business receipts tax until I review the presentations at the workshops.) In a desire to move toward the goal of unanimity, I will share my misgivings. Now that we have abandoned the straightjacket of not writing to each other as a group, I invite a dialogue and encourage responses to my objections. I will happily reconsider my views in light of new information.

I also accept the Chair's invitation to me at the end of our last meeting to offer my own plan. The second part of this memo sets forth my Red, White, and Blue plan.

As we move toward our final recommendations, I hope we can avoid rigidity and be flexible enough to put together a plan that will allow a consensus vote. We all know a great deal more today than when we first met and should feel free to build on that increased insight and understanding.

II. My Misgivings

A. Eliminating the Corporate Income Tax

The California corporate income tax was adopted in the early 1930's. The tax is similar to that used by 90% of the states. Based on information provided to the Commission, the tax introduces an element of progressivity to the State's tax structure and to some extent falls on nonresidents who exploit the California market and benefit from the State's public services and infrastructure.

Those wishing to eliminate a hoary tax that is part of the national tax consensus have the burden of proof of demonstrating compelling evidence that the gains from doing so would outweigh the losses. This is especially true in California where the 2/3 vote requirement makes it unlikely that once eliminated, the corporate tax will ever be reinstated. I have reviewed our meetings and submissions and find nothing that even purports to make a credible case in support of eliminating the tax.

Because the tax has existed for more than 70 years, it has accompanied both periods of strong State growth and periods of weak growth. The tax can no more be given credit for the former than it can be blamed for the latter.

The California corporate income tax was once viewed as a model for other states and was emulated and replicated. California was looked to as a leading state on sensible corporate tax policy. California has now abandoned that role. Today, the tax has been emasculated and eviscerated through secret closed door deals. The solution is to reinvigorate it, not eliminate it.

Two recent illustrations capture the heart of a ubiquitous problem; unless we solve that problem, it will infect and undercut our attempts at adopting any new tax, such as the net business receipts tax (NBRT). Specifically, in 2008 and 2009, without any public hearings and no public testimony, between \$2 and \$2.5 billion reductions in corporate tax revenue were enacted by the Legislature, approximately 25% of the amount then being collected under the tax.

The Commission received information documenting the effect of three special provisions that were adopted during this period:

- One of the provisions results in nine corporations receiving reductions averaging \$33.1 million in 2013-14;

- Eighty percent of the benefits of another provision will inure to 0.1% of corporations with gross incomes over \$1 billion;
- Six corporation will receive tax cuts averaging \$23.5 million in 2013-14 from another provision; 87% of the total benefits from this one provisions will benefit 0.33% of corporations with gross income over \$1 billion;

I would have thought that given the magnitude of the amounts at stake, and the skewed distribution of the resulting benefits, the enactment of these special provisions would have been preceded by rigorous analysis. Yet in a candid exchange with a high ranking state official who testified before our Commission, we heard that there was no “rigorous cost benefit analysis,” there was no “scientific proof” that the changes would accomplish what the proponents hoped for, and that while there was “intuitive reason” to believe that there would be positive benefit, it was “hard to say” whether the benefits would outweigh the revenue loss. This official was admirably forthcoming in admitting that “[a]s a practical matter, when people sit down to make a budget, there are a lot of people who sit down and who need to be paid attention to. And so one set of interests is, if we're going to be raising taxes, let's do something to help business in this state.” Unfortunately, there is no reason to think that the lack of analysis was an aberration, rather than business as usual.

Tax policy should not be made in secret without empirical support or analytical rigor, just because big business lobbies for particular benefits. Indeed, why should we even bother debating a new tax like the NBRT, if it will come out looking like Swiss cheese once lobbyists finish their work.

I am not naïve enough to think we can repeal realpolitick, but we can restore democratic values of transparency, openness, and fairness into the legislative process. We have discussed various approaches to this problem under the heading of tax expenditures. I find each of the proposals we have discussed to be useful, but nonetheless do not go far enough.

My Red, White and Blue Plan discussed below proposes an approach inspired by Justice Brandeis' famous aphorism that "sunlight is the best disinfectant."

B. Personal Income Tax

1. Volatility

California has a personal income tax that raises a substantial amount of its revenue from a relatively small number of persons. This fact reflects the skewed income distribution of the State. Compared to other states, California is fortunate to have a relatively large percentage of the country's high income taxpayers.

The personal income tax is the major source of progressivity in the California tax structure. Because of the tax, the overall tax system is modestly progressive. A reduction in the income taxes on the upper income groups will reduce the progressivity of the overall tax structure unless it is offset with a tax that has a similar distributional impact. The Commission, however, is not considering any new tax that would be as progressive as the income tax. The NBRT, for example, is a regressive tax and if adopted and used to finance reductions in the personal income tax, the California tax structure would become less progressive.

Upper income persons tend to receive a disproportionate share of income that is volatile, such as dividends, interest, and capital gains. Earned income tends to be less volatile than unearned income. The Commission has expended much effort discussing volatility (or more accurately, the inability to predict volatility). From the outset, I have argued, and continue to believe, that volatility, which is a feature of every state's tax system, is a spending problem and not a tax problem.

To use a personal illustration, consider that my own income is also volatile. Not so much my teaching income, which (unfortunately) is

fairly predictable from year-to-year, but rather my consulting income. But rather than shun that volatility I welcome it. I look forward to tripling my consulting income next year, even if it subsequently returns to this year's level. I also wouldn't mind hitting the lottery some day, notwithstanding the resulting volatility and the likelihood of never hitting it again. I also don't mind receiving a large contingency fee upon winning a case, even if I will never receive one again. What I would not do, however, is to commit to a long term mortgage on the romantic hope that I will continue to receive such income every year. Yet that seems to be what the Legislature does.

Apparently, budgetary discipline needs to be imposed on the Legislature through constraints, such as rainy day funds, spending limits and the like. I have no particular insight or experience with the form that such constraints should take. But I know that if in my personal life I have overextended myself with a financial commitment, I do not solve that problem by stopping my consulting work so that my future income will be reduced. Obviously, that would make things worse. Yet that "cut your nose off to spite your face" describes viewing volatility as a tax problem whose solution lies in reducing the tax on upper income persons or on unearned income. I much prefer to dedicating tax revenue to a special fund, rather than the double whammy of not having that revenue at all, and reducing the progressivity of the tax system to boot. Moreover, the very volatility that some would eliminate will be most welcomed when the economy starts to recover and the State will need to address deferred needs.

2. Economic Development

I fully appreciate that some Commissioners support reducing the personal income not because of volatility, but for reasons of economic development. Apparently, the fear is that the personal income tax is discouraging the wealthy from coming to California, encouraging them to leave California, or discouraging them from working hard. (Similar questions have been asked about the federal income tax, without

conclusive answers.) I suspect that anecdotes can be offered to support each of these possibilities. The question, however, is how much the State should alter its income tax to reach these persons? Even at a lower rate, there will be persons falling into these groups, although presumably fewer than at higher rates. I do not know any way to fine-tune the income tax to reach persons at the margin, without needlessly reducing taxes simultaneously on persons who do not wear green eye shades and for whom the rates do not have any negative effect.

On the more general level of the effect of the personal income tax on economic activity, a number of studies exist. One study found that states that enacted significant tax cuts in the late 1990s and the early part of this decade fared worse in terms of job growth, personal income and employment, on average, than did other states. Another study dealt with the 1994-1996 period in which New Jersey cut its personal income tax rates by 30 percent as an economic development strategy. This study concluded that New Jersey experienced no additional job growth compared to its neighboring States of New York and Pennsylvania. A 1999 study found that high income tax states experienced more rapid economic growth than states with low income taxes during the 1980's and 1990's. A 2005 study analyzing data from all 50 states from 1977-2002 concluded that redistributive state taxes do not have a significant impact on interstate population flows.

Given the complexity of the inquiry, no one study can be viewed as determinative. I am sure that these studies will not convince those who wish to believe otherwise. But we should not be making major changes based on anecdote rather than empirical analysis. Nor should we be influenced by widespread assertions that disregard reality, such as the common story about how millionaires abandoned Maryland when that State raised its top personal income tax. True, the number of millionaires did indeed drop, but the number of returns with income just under \$1million rose. Presumably, the stock market had more to do with the drop in the number of millionaires than did a moving van. Millionaires moved, but it was to lower tax brackets, not to other states.

Having attended every meeting of the Commission and having reread the transcripts, I have not heard or seen any real evidence that would justify reducing the personal income tax on the grounds that it will have a positive impact on the State's economy.

3. Removing the deduction for medical expenses

So-called Tax Package 1 and 2 remove the itemized deduction for medical expenses but retain it for the charitable deduction (as well as mortgage interest and property taxes). I am baffled by this callousness.

As unemployment increases, more persons are finding themselves without health insurance. The country is currently debating this critical public policy issue. People who have lost their health insurance are paying for medical and dental services, and perhaps counseling, out of their own funds. I am at a loss to understand why the Commission would want to recommend that the State turn its back on the needy.

I have reviewed the materials distributed to the Commission and reviewed the transcript of our meetings and find no explanation for removing a deduction that would mitigate the hardship of those trying to maintain their medical, psychological, or dental well being without the benefit of health insurance. (To be sure, the California deduction tracks the federal deduction, and applies whether there is insurance or not, but those with insurance are unlikely to have the same non-discretionary out-of-pocket expenses as those without insurance.)

I can understand a decision that eliminated all itemized deductions as part of a general reduction in the personal income tax. But as long as itemized deductions are going to be allowed, even if ultimately phased out as called for under Tax Package 1 and 2, I cannot understand drawing a line between charitable deductions, which both Packages allow, and medicals, which neither Package allows. I have no idea how I could recommend to Legislators that they should subsidize residents

making charitable contributions to their alma maters in the East but not those having medical, psychological, or dental hardships.

III. RED, WHITE AND BLUE PLAN

A. Severance Taxes

In our discussion of the severance tax we heard that California is the only state with substantial natural resources that does not have a severance tax. In a country where every other state with substantial natural resources has a severance tax, it makes no sense for California not to also have one at a competitive rate.

Severance taxes have been proposed in the past at rates between 6 and 9.9%. In comparison with other states, that range seems acceptable. In the interests of compromise, I would be willing to have the resulting revenue used for reducing the personal income tax in a distributionally acceptable manner.

B. Corporate Income Tax

As the earlier discussion suggested, there have been numerous changes made to the California corporate income tax to encourage economic development. Apparently, these have been made without any cost-benefit studies and are the result of business pressure and politics rather than analysis. Unfortunately, a longstanding and robust literature suggests a weak, if any, correlation between economic growth and a state corporate income tax. In light of this body of learning, the burden of proof should be on those who would argue otherwise.

Much of the very recent changes in the California corporate income tax are arcane and technical, and made without the benefit of public hearings and testimony. The revenue cost of these measures will impact in 2010-11 and grow in subsequent years. My plan would eliminate them until proof of their effectiveness is forthcoming. The State should

eliminate elective single factor apportionment and revert to a mandatory double-weighted sales factor.

In the interest of compromise, I would be willing to use the resulting increased revenue from these changes to either lower the rate of the corporate income tax or fund distributionally acceptable reductions in the personal income tax.

C. The Creation of an Independent Tax Court and the End of Pay-to-Play

Surveys show that the degree of voluntary compliance with tax laws increases when taxpayers feel the system is fair and even handed. The Commission heard testimony and received a lengthy submission by the American Bar Association documenting extensive defects in the current administrative appeals process.

Taxpayers have two basic concerns when it comes to the adjudication of their California tax disputes: they want to contest alleged deficiencies without the heavy burden of prepaying the tax (pay-to-play), and they want a fair, impartial, tax-expert forum. The federal system satisfies both goals; California satisfies neither.

California has a complicated tax system. Taxpayers deserve a modern and fair adjudication forum—a tax tribunal or court that is both independent of the tax collecting agencies and staffed with real tax expertise.

Seventeen years ago, an expert on California administrative law stated that: "[T]o put it charitably, California's present arrangement for adjudicating tax cases is a patchwork that can only be understood as a series of historical accidents; to put it less charitably, the system is a mess." According to the ABA, things have not improved in the last 17 years, and California still finds itself among a steadily decreasing minority of states that place responsibility for collecting taxes and

adjudicating tax disputes in the hands of the same agency. Whatever the reality, the perception is one of bias and unfairness. As one of the tax lawyers who testified before us aptly stated, “Well, if you recommend a new tax structure and keep the old dispute system, it would be like putting a Prius engine into a Ford Pinto. It wouldn't make any sense at all.”

We are fortunate because the ABA has a *Model State Administrative Tax Tribunal Act*, developed over a four year period by the ABA Section of Taxation's State and Local Tax Committee. The Model Act reflects input from state and local tax litigators, state and local tax accountants and accounting firms, state tax department officials, state tax judges, taxpayer organizations, organizations of taxing officials, and academics. That Act should be recommended for legislative adoption, along with ending pay-to-pay.

D. The Disclosure of Tax Information by Name of Publically-Traded Corporation

The Commission heard much testimony on the topic of tax expenditures, that is, tax provisions that are not required by structural or normative considerations but are adopted to serve non-tax goals. The State publishes a tax expenditure budget, but it seems to have had little impact on the legislative process. Even excluding the recent corporate changes referred to above, the corporate income tax embodies \$4 billion of tax expenditures, the sales tax represents \$9 billion, and the personal income tax accounts for \$36 billion. These are annual figures.

The label “tax expenditure” does not mean a provision is necessarily bad, wasteful, or unnecessary. It simply represents a spending of money through a special tax credit or provision. The problem is that much of this spending escapes public scrutiny and analysis.

At a minimum, the names of publically-traded corporations receiving tax credits or tax expenditures in excess of \$5 million should be made public, along with the name and amount of the tax expenditures. This modest, simple step would allow the more costly tax expenditures to be evaluated. This disclosure would allow legislative and other researchers to analyze what California receives in return for its money. If a tax expenditure were implemented in the form of a spending program, normal budgetary questions would be asked. There is no reason why those questions should not be asked just because the spending takes place through a special credit or special provision. California devotes considerable effort in preparing a tax expenditure budget; it would be a small additional step to disclose by name of publically-traded corporation the major beneficiaries of selected tax expenditures.

The disclosure by name of corporate beneficiary raises a more general issue of disclosure: transparency and openness in taxation. The benefits of a broader disclosure were illustrated during the 1980's when Citizens for Tax Justice (CTJ), a Washington-based think tank, was able to utilize data from annual reports to shareholders and reports to the Securities and Exchange Commission (SEC) to document that some of the largest, most profitable corporations in the country were paying little or nothing in federal income taxes. The public outcry that resulted from the reporting of this information was one of the keys to the sweeping changes included in the Tax Reform Act of 1986, which broadened the tax base and lowered marginal tax rates.

CTJ subsequently shifted its efforts to the state level, documenting that 252 corporations in the Fortune 500 escaped state income tax on 2/3 of their profits. More shocking, 71 of these corporations paid no state income tax in at least one year from 2001 through 2003. Twenty-five of these corporations enjoyed multiple no-tax years. The 252 corporations avoided a total of \$41.7 billion in state corporate income taxes over the three years. Many of these corporations presumably did business in California. Unfortunately, because corporations do not report to the SEC

their corporate income taxes on a state-by-state basis but only in the aggregate, there is no way of knowing how much these corporations paid—or did not pay—in California. Yet fundamental questions about the California corporate income tax cannot be easily answered without knowing, by name of corporation, the amount of tax that it paid.

Certainly a change in the law that was limited to identifying the amount of tax expenditures received by name of corporation would be a starting point in increasing accountability and transparency in government. But that would be only a starting point. What is needed is a more general disclosure law.

This Commission, California Legislators, and voters have an obvious interest in California's corporate income tax. Large sums of money are involved both in the amount of taxes imposed and the amount forgiven through tax expenditures and other special deals.

As our Commission discussions indicated, the issue of how a state taxes, or exempts from tax, corporate activity raises fundamental value judgments about how the costs of government should be distributed. Both large-scale corporate tax avoidance and inefficient tax expenditures mean that California must rely more heavily on other taxes or cut spending. Part of the State's heavy reliance on the personal income tax no doubt reflects this fact. Those interested in reducing reliance on the personal income tax should want to eliminate waste and inefficiency in taxation, and disclosure facilitates that goal.

In addition to the question of how taxes are distributed between corporations and individuals, another significant issue is how the corporate tax is distributed among corporations and among industries within the State. California's corporate income tax is replete with provisions that discriminate between small and large corporations, in-state and out-of-state corporations, capital-intensive and labor-intensive corporations, and corporations that sell out-of-state and those that sell within the State.

Firm-specific data would facilitate the consideration of a full range of issues surrounding corporate tax policies. Disclosure encourages informed and critical evaluation of the distribution of tax burdens and of corporate requests for tax relief—requests that may be underscored by express or implied threats to abandon California for a more favorable tax climate, an issue of concern to the Commission. Disclosure allows the public to evaluate more effectively corporate claims that they are straining under an excessive tax burden. And disclosure would discourage corporations from misleading legislators and the media by taking public positions inconsistent with the facts.

To evaluate whether the tax system with its myriad special provisions is working as the California Legislature intended, the public must know, at the least, how much each corporation is paying in corporate income taxes. Only then can the public and legislators evaluate the tax system. Disclosure can restore public confidence by either showing that the current system is working well or by providing the information necessary for effective reform.

Compared with the extensive information already in the public domain because of SEC requirements, State disclosure is modest. Primarily because of the SEC, the public has been given a window into the financial affairs, including the income tax data, of publicly-traded corporations. State disclosure would open that window a crack more.

Disclosure is based on rather traditional values—the public as well as elected officials should be informed about the workings of our economic and legal systems; to the maximum extent possible, public policy should be made in an open and informed manner. Disclosure is just another reminder that as Justice Brandeis observed, “sunlight is the best of disinfectants.” Good government requires openness; the free flow of information is a remedy for poor policies and political ills. “Information is the currency of the ‘marketplace of ideas,’ the prerequisite for political self-determination, and a security against usurpation by secret

cabals.” Openness and accountability make it less likely that tax laws will be made behind closed doors, where special interests are more likely to prevail over the public’s interest.

IV. Summary of Red, White and Blue Plan Proposals

- Adopt a severance tax at competitive rates
- Adopt an independent tax court pursuant to the ABA Model State Tax Tribunal Act
- End Pay-to-Play, that is, eliminate the requirement that the tax must be prepaid as a precondition to challenging an alleged deficiency
- Eliminate the special corporate tax provisions adopted in 2008 and 2009 (elective single factor apportionment; new provisions on NOL carryback; tax credit sharing), until a rigorous cost-benefit analysis justifies them
- Reinstate the double weighted sales factor
- Publish the name of any publically traded corporation receiving more than \$5 million in tax expenditures and the amount and nature of those tax expenditures
- Publish the names of publically traded corporations and the amount they paid in California corporate income tax

These recommendations do not mean that I will not endorse proposals suggested by other Commissioners, only that these are my priorities. I encourage my fellow Commissioners to continue the process of frank and spirited dialog by critiquing these proposals in an attempt to reach a plan we can all support.