STATE OF CALIFORNIA

COMMISSION ON THE 21st CENTURY ECONOMY

TAX OPTIONS
and
STRUCTURAL VARIATIONS

PUBLIC MEETING

Tuesday, March 10, 2009
9:07 a.m. - 4:27 p.m.

Clark Kerr Conference Center
University of California, Berkeley
2601 Warring Street
Berkeley, California

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A P P E A R A N C E S

COMMISSION ON THE 21ST CENTURY ECONOMY

Commissioners Present

GERRY PARSKY
Commission Chair
Aurora Capital Group

RUBEN BARRALES
President/CEO
San Diego Regional Chamber of Commerce

MICHAEL BOSKIN
Professor
Stanford University

JOHN COGAN
Professor
Stanford University

EDWARD DE LA ROSA
Founder and President
Edward J. De La Rosa & Company, Inc.

CHRISTOPHER EDLEY, JR.
Dean/Professor of Law
Boalt Hall School of Law

GEORGE HALVORSON
Chairman/CEO
Kaiser Foundation

WILLIAM HAUCK
Trustee, California State University
Director
Blue Shield of California & Blue Shield Foundation

JENNIFER ITO
Research, Training, Policy Director
SCOPE

FRED KEELEY
Treasurer, County of Santa Cruz
Professor, San José State University

A P P E A R A N C E S

COMMISSION ON THE 21ST CENTURY ECONOMY

Commissioners Present
continued

REBECCA MORGAN
President
Morgan Family Foundation

RICHARD POMP
Alva P. Loiselle Professor of Law
University of Connecticut

CURT PRINGLE
Mayor
City of Anaheim

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COTCE Staff Present

MICHAEL C. GENEST
Commission Executive Director
Director of Finance

MARK IBELE
Commission Staff Director
Board of Equalization

ASHLEY SNEE GIOVANNETTONE

LORI HSU

ANTONIO LOCKETT

JESSICA MAR

MICHELLE QUINN
Staff Writer

PHIL SPILBERG
Chief, Financial Research
Department of Finance

MARGIE RAMIREZ WALKER

A P P E A R A N C E S

Public Testimony

TONY FISHER
New United Motor Manufacturing Inc. (NUMMI)

Presenters

SEVERIN BORENSTEIN
Professor
UC Energy Institute
Haas School of Business
University of California, Berkeley

ROBERT R. RUBIN
Of Counsel
McDonough, Holland & Allen, PC

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BE IT REMEMBERED that on Tuesday, March 10, 2009, commencing at the hour of 9:07 a.m., at the Clark Kerr Conference Center, University of California, Berkeley, 2601 Warring Street, Berkeley, California, before me, DANIEL P. FELDHAUS, CSR 6949, RDR, CRR, in the state of California, the following proceedings were held:

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(The meeting commenced with Commissioners Morgan, De La Rosa, and Barrales absent from the meeting room.)

CHAIR PARSKY: On behalf of the Commission on the 21st Century Economy, I want to welcome everyone to this public session.

I want to thank our hosts at Berkeley for making this facility available to us and to the public. We very much appreciate it.

I can tell you from my own personal experience as a former Regent of the University of California, I have a special affinity for all of the UC campuses and, in particular, for Berkeley, where we had a number of interesting and somewhat heated discussions with the student body about a number of issues.

We welcome all students.

I'm going to let Fred Keeley just mention one group of students that are here observing this session before we proceed ahead.

I did want to indicate that we've had two public sessions, San Diego and Los Angeles. We have scheduled another public session for April 9th at Davis. And we'll talk a little bit about the work that we have underway and some of the issues surrounding what is proceeding ahead with respect to the agreement reached in Sacramento as we hear from that presentation.

We have an agenda that's been provided. For the Commissioners, unfortunately -- we have all of the materials for all of the people presenting in your book. And the big screen back here will have it on the screen. You'll have to turn your chair in order to see the screen, or you can work off of the materials that are in your book. Either way, I just would be careful as you turn these chairs. They slide a little bit.

Just a few comments that I would make before we ask for public comments, and then we can proceed ahead.

I just want to -- and I've done this at each of our sessions -- but I want to remind the public of the goals or the objectives that were established at the time that this commission was established. And there are six objectives that we, I think, need to see how close we come to achieving with all of the recommendations.

The first is to try to establish a tax structure that is consistent with or that fits within our state's 21st century economy.

Second, to attempt to provide stability to state revenues, or to reduce the kind of volatility that has existed in the past.

Third, to promote long-term economic prosperity for the state. It ties into the first objective.

Fourth, improve the ability in California to compete with other states for jobs and for investments.

Fifth, to reflect the principles of sound tax policy, including simplicity, competitiveness, efficiency, and predictability.

And, finally, to ensure that the tax structure is fair and equitable.

Said in another way, I hope that any of the recommendations that we come up with, we will attempt to test against all of those principles. In short form, make sure that we are making recommendations that foster economic growth in our state, make sure that those recommendations do address some elements of volatility, and make sure that they are fair and equitable; or, said another way, that we test against the elements of progressivity that have existed over time in our system.

We, as a voluntary commission, are not charged with making the policy decisions that need to be made in

Sacramento. If the elected leaders decide that they want to increase taxes or reduce taxes, that's certainly their prerogative.

What we've been charged with is to try to address the tax structure that's been in place for a long period of time and see how it might be modernized. And so with that in mind, we are going to try to come up with a set of recommendations and a report.

Certainly, my objective is that this report and these recommendations will be unanimous. I think from the legislative leaders' standpoint and the Governor, they are hoping for the same.

We have a broad cross section of very experienced experts that sit on this commission, none of whom, for purposes of their work here, have been elected. And so our work will end with the report we make; but the ability to affect policy, I think, could be very high if, in fact, we can come together and make recommendations that satisfy all of us.

And as I think has been indicated in the past, the legislative leaders have indicated that they will take our recommendations to an up-or-down vote in the Legislature. And that, I think, is a positive commitment on their part that, although the recommendations may not be in exact legislative form, they would give tremendous impetus to bringing about policy change. And so it reflects, I think, the legislative leaders' commitment -- first of all, their endorsement of the quality of the individuals on this commission; and second, their desire to listen to these recommendations.

The only other comment I'd make by way of introduction -- and we're going to hear about this on our agenda -- but as all of you know, since our last meeting with some strain and sleepless nights, the legislative leaders and the Governor reached agreement on a budget. And included in that agreement was a commitment to seek voters' support for a ballot initiative. And we're going to hear about that.

I think it's important that, as we listen to a recitation of what has been agreed, that we see it in the context of the recommendations we may make. I know that the legislative leaders and the Governor hope that we will do just that.

I think by way of introduction, I can say that they haven't solved all of the problems. And so what I think is important for us to do, is to see which issues they have addressed and which they haven't, and how our recommendations could fit within what they have accomplished. And that's one of the purposes of the early presentation this morning.

So with that -- and I will give every commissioner that would like to make a comment to do so -- I'd just like to welcome the public.

I think we have one public speaker this morning. And we have announced, and the agenda has reflected, the fact that we invite the public to come in and make comments at the beginning of our session rather than ask the public to wait until the end since, as we move to the afternoon, sometimes we go a little bit longer. So I'd like to keep to that and invite the public to speak at the beginning of our session.

One public speaker, Tony Fisher, has indicated a desire to speak.

If you'll come forward to the microphone and give us your comments, we'd appreciate it.

MR. FISHER: Thank you, Chairperson Parsky and Commissioners. I'm Tony Fisher, representing NUMMI.

As you may know, NUMMI is a Toyota/GM venture in Fremont, California, that employs about 5,000 team members and produces, on average, over 300,000 vehicles per year. Also, NUMMI has attracted to California 26 affiliated major part-supplying companies that employ a total of approximately 3,500 additional team members.

We appreciate the opportunity to share with you our comments regarding an important economic stimulus needed to retain or expand relocatable manufacturing jobs in California.

Our proposed economic stimulus is a sales-tax exemption for manufacturing machinery and equipment. Its justification is based on:

One, moving towards an even playing field with other states and countries;

Two, providing an incentive to fund capital projects which retain or expand jobs in California;

Three, generating approximately $5,000 per year in state revenue for every type of manufacturing job like those at NUMMI;

And fourth, adhering to the economic competitive principle of not taxing business inputs.

We are familiar with the two main objections to a sales-tax exemption for manufacturing machinery and equipment. The first one being that it initially causes an adverse budget impact on the state. The second one being that a similar incentive, the California Manufacturers' Investment Credit, MIC, did not increase manufacturing jobs from 1994 to 2004.

Our response to the first objection is to enact a deferred credit for the sales tax on manufacturing machinery and equipment, which would remove the initial adverse budget impact on the state.

Our response to the second objection is a decrease in manufacturing jobs in California from 1994 to 2004 was due to any one or combination of significant overriding conditions that existed in many other states and countries, like overall lower sales-tax rates, additional incentives, lower employment costs, reduced regulatory burdens, favorable exchange rates, and a more reliable electricity supply.

While California cannot override many of the incentives offered by others, from our experience and the benefit that the MIC provided us, a sales-tax exemption for manufacturing machinery and equipment, along with no additional taxes on business inputs, would help manufacturers in this state achieve a more even playing field with other states and countries.

Thank you for allowing me to give NUMMI's perspective. If you have any questions, I'd be glad to answer them.

CHAIR PARSKY: Before we turn to the Commission, any questions?

Michael, you'd like to ask --

COMMISSIONER BOSKIN: Yes, we've heard and there's a general discussion that among the reasons why manufacturing jobs, in particular, in California have suffered in recent years, in addition to general overall climate for manufacturing, has been very expensive electricity. You mentioned the lack of reliability with brown-outs and things of that sort. But what about the cost of electricity? Is that a concern for you?

MR. FISHER: The cost of electricity is a main concern. And, you know, at least my understanding was that the latest figure is that we're kind of around -- at least 30 percent, maybe 35 percent over -- now, this was done just two years ago of manufacturers -- on average, the electricity rates here. So we are definitely higher here.

As you mentioned, too, there was a reliability situation here in the beginning of the 2000s. You know, in 2000, 2001, I mean, the electricity crisis and some of the manufacturing facilities were hit with little blackouts. And, boom, they just said they couldn't take it because their whole place was down and they lost millions in a day or two of production. And so all of a sudden they started to move out, you know, wherever they had other facilities. So electricity is a particular problem.

But I would say this, that we are at least in a more reliable situation now in electricity. I can tell you that, okay. Our costs are high, but the thing we're trying to do is go after one of the biggest uneven playing fields that we see. And that is when you're taxing -- especially now we're close to 10 percent sales tax on machinery and equipment, where you have other states that don't even have any of that -- and I'm talking with the new increases coming about. I'm saying, unbelievable.

And it's not uncommon for NUMMI -- because every couple years -- because we've got two lines. You've got to do something with one of those lines every five years. So about every two to four years we're spending money -- a lot of money on machinery/equipment to get that here to stay competitive.

Now, we'll spend $100 million to $200 million on machinery and equipment every couple years. Well, the parents look at us and say, “Wait a second, you know, $100 million to $200 million, let's just look at a $100 million. I'm spending an extra $10 million on taxes, and I can move that into plants that I already have.” Like, they got one they built down in Tijuana that builds the same truck we do, in essence; and they've got one in Canada that builds the Corolla. And those places, with their exemptions, where they don't pay anything. So I'm just saying, wow, they start looking at that -- do you see -- and we could get up, more money. So I just wanted to mention, that we're looking.

There's also other plants back in the Midwest --

you people are certainly familiar with sales tax on machinery and equipment that -- I think it’s about 47 other states don't charge or have some sort of an exemption, too.

So I just wanted to give you that perspective -- do you follow me –- of what we're trying to do. This is the most important tax issue for NUMMI as a manufacturer in California.

COMMISSIONER BOSKIN: Thank you.

CHAIR PARSKY: Any other questions?

Curt?

COMMISSIONER PRINGLE: Just if I may, briefly.

When did you establish your manufacturing line in California, the present operation?

MR. FISHER: Yes, it was started 25 years ago.

COMMISSIONER PRINGLE: And the present relationship with Toyota and General Motors started when?

MR. FISHER: Twenty-five years ago.

COMMISSIONER PRINGLE: And manufacturing cars, did you establish the plant after the MIC was put in place?

MR. FISHER: No. When we came in in '84 -- and I was one of those that helped get it going -- the MIC was not in place at that time. But one of the things we did work on, NUMMI, with people here and in Sacramento was the

MIC. And it's been extremely helpful to -- do you follow me –- it’s been extremely helpful to NUMMI in order to move to a more competitive level.

COMMISSIONER PRINGLE: So when that was established, that was 1994 or 1995; right?

MR. FISHER: Well, yes, I think it started in '94. I think the bill went through in '93. It was an Alquist --

COMMISSIONER PRINGLE: Authored by Willie Brown, I think?

MR. FISHER: Well, Willie Brown helped get it going; but the author was, I believe, Senator Alquist.

COMMISSIONER PRINGLE: Okay, I just want to make sure we state who was behind creating that sales-tax credit for manufacturing equipment at the beginning.

MR. FISHER: Yes, yes.

COMMISSIONER PRINGLE: Very good. Thanks.

CHAIR PARSKY: Thank you very much. We really appreciate your comments.

If there are no other public comments, we’ll turn to any of the commissioners.

Fred, you might introduce the group that is in our audience and any other comments you'd like to make.

COMMISSIONER KEELEY: Thank you, Mr. Chairman. Good morning.

For those commissioners who were not able to attend the reception last evening, I'm very fortunate to have -- we are very fortunate to have with us today the students from Pacific Collegiate School in Santa Cruz, which is a public charter high school. And for two years in a row, *U.S. News and World Report*, which tends to rank things, has ranked Pacific Collegiate School the number-one public charter high school in the nation. And they are a wonderful group of students who I have the pleasure of being their teacher early on Tuesday and Friday mornings, from 7:30 to 9:00 a.m., which is way too early for both the students and me, but we get through the day, anyway -- or through the morning.

The particular thing I wanted to draw to the attention of the commissioners is that as we began our task back in January, we were just starting a new semester at the school. And I gave the students a choice: They could continue on with their curriculum that we had set forth for the spring semester in contemporary California government and politics or, in the alternative, they could jump in with both feet into working with me on the work of this commission. And it was their choice, and they chose unanimously to do this. And so they have been, for better or worse, for their young minds, they have been reading all of the transcripts of our hearings, watching the video of it, going into depth.

And, Mr. Cogan, you might want to watch out here, we've been going into depth about each commissioner and finding out who they are and what they're up to, and really thinking these things through.

And it is quite interesting, Mr. Boskin --

COMMISSIONER BOSKIN: They could be vetters for the Obama Administration.

COMMISSIONER KEELEY: They will be.

COMMISSIONER EDLEY: Be nice.

COMMISSIONER KEELEY: And, Mr. Boskin, you'll be interested to know that it's really quite something to see a group of high-school seniors sitting in a classroom, debating whether a particular proposal has distortion in it for the taxes and whether the base is broad enough and so on. But, anyway, it's actually a wonderful thing that they're doing.

And when the meeting was scheduled for here, they were very excited about coming to this hearing and observing all of you in real life.

So, Mr. Chairman, thank you for the opportunity to introduce them.

If you would just all raise your hands so they know who you are.

There we go. There they are. Okay, yeah.

(Applause)

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

CHAIR PARSKY: Having spoken to a number of them last night, I will tell you that they will be writing their own report about the work of this commission. So we'll have a chance to compare the quality of it. And any of you that have taught classes will be able to grade both reports before we're finished.

Any other comments that commissioners would like to –- Michael?

COMMISSIONER BOSKIN: Yes, I just want to say, having -- maybe the best way to say it, having spent some of the best, on balance, years of my life as an undergraduate here, at a time when Clark Kerr was president of the University of California, I'm particularly pleased to be back in the Clark Kerr Conference Center.

CHAIR PARSKY: Chris?

COMMISSIONER EDLEY: And just on behalf of the Berkeley campus, I want to add my welcome, and apologize for the chilly weather.

We did form a bipartisan weather committee, but we're waiting for two designees from the academic senate to get going.

CHAIR PARSKY: Chilly weather should only be compared to the warm welcome. If they want to talk to any of the Regents, they can get the other side of the picture at any time.

Okay, with that, I think we can move right into our agenda.

The first item on our agenda is the California budget developments and the impact on the Commission.

And I'll ask Mike Genest and Phil Spilberg to come forward and lead us through this important discussion.

MR. GENEST: Am I live? Okay, good.

CHAIR PARSKY: You are definitely alive.

MR. GENEST: Barely, after this budget. Barely alive.

Glad to be here. Thanks for having me.

I think the purpose that I'm here to perform is just to bring you up to speed with what happened with the budget. It was a monumental budget, a far-reaching set of proposals that were adopted. So it changes rather substantially the underlying situation that you have been convened to address.

So with that, I would like to go to my presentation, if I can. Hit the black button. There we go.

So I'll just take a little time to go through this, and then we have plenty of time for questions. And Phil Spilberg, who has been working and testifying several times, will also talk later this afternoon, is going to help me out with some of this.

I think the first thing to address is why we had a problem. And really, maybe this is mislabeled. It's really sort of how the problem appeared or how it took shape. I'll get more into the "why" later.

This chart shows that we had a revenue decline of 31 points -- basically, $31.3 billion.

Whenever we talk about budget numbers, the $41.6 billion budget gap, the way we talk about that is essentially a three-year number. We look at the past year, because sometimes that changes a little. We look at the current year, even though there's been a budget enacted. Often, things change and you have to update that. And we look at the next year, in this case 2009-10.

So when we say there is a gap, what we mean is that if we did nothing this winter and just let current law run and current policies go on and on, we would have spent, actually, $31.6 billion more than we had. And, obviously, not being the federal government, not owning a printing press, we're not really able to do that. So we had to make some adjustments, we had to make some changes.

The 41.6 is just the 39.6, but you have to have some sort of reserve. So we put in the idea maybe of a $2 billion reserve. It's a little meager, especially in times like this. But the Constitution does require us always to have a, quote, “prudent reserve.” It doesn't define what "prudent" means. Arguably, $2 billion is a little less than prudent in these troubled times; but that's the target number we put in. And so when you add it all up, we lost, in those three years, 31-plus in revenue.

Our workload budget grew. The expenditures grew by $6.6 billion relative to what we had originally anticipated. And when I say a "workload budget," there is actually a constitutional requirement that the Department of Finance estimate what all state programs will cost if we make no policy changes. So sometimes a program just started in the middle of the year. So if you're going to figure out what it's going to cost next year, you have to essentially double the amount because you only paid for half of it in its year of inception.

Sometimes programs have automatic cost-of-living adjustments in statute. Those are taken into account.

Other times, there aren't automatic cost-of-living adjustments, but there is a policy of funding for the increased costs of gasoline or the increased costs of telecommunications, rent, and so forth.

And so we add all of those things up.

We also take into account increased caseloads when we get into a recessionary time, we do have a tendency to see caseloads go up.

But caseloads don't just involve health and human services, they also involve population in the prisons. Prison population goes up -- and it's not just a matter of the actual count going up. Sometimes costs change because of the behavior. You may not get any new people on Medi-Cal or very few new people, but you're getting -- replacing sort of the cheaper-to-take-care-of people, young families, with the sicker people that cost more, older people or disabled people.

And all of those trends are taken into account every time we do a budget estimate. And it's called a "workload budget," and we're required to do that.

Now, no one thinks that the State of California is automatically required to fund the workload budget. Obviously, we're required only to fund what we have enough money to pay for.

But as we start the process, we identify the full extent of that workload budget and the full extent of our revenue, whether it's a loss or a gain. And we add these things up, and we come down to a budget gap if we're in a bad year, and sometimes it's a surplus.

This time, unfortunately, it was a gap of $41.6 billion, once you count in a reserve. So that's more or less what the gap is about.

The way we solved it was somewhat -- I mean, we went to a lot of different solutions. I've often joked -- and it's really not much of a joke -- that this was the easiest budget for anyone to decide about that we've ever had. Because we took every idea we could think of, listed them down, they still weren't enough -- we had to do them all -- and we came up with some things that we really wouldn't want to do in even the best case, and that's that borrowing number there. You can see we proposed, and we are going to propose, borrowing some money. The biggest single piece is the Lottery. I'll talk about that later, the Lottery securitization.

But we couldn't make the $41.6 billion number without borrowing. We did every tax increase we thought we could do. We did every expenditure solution, which is pretty much always a budget cut, although sometimes that means shifting a program's cost from one source of funding -- the general fund -- into another, which doesn't count on this, because these are only general-fund numbers. But mostly it's reducing programs relative to that workload budget that I've described.

So how did we do it? We had 38 percent of our solutions were on the spending side of the ledger; 30 percent were revenue increases. Virtually all of that is tax increases. We count on some federal stimulus funds -- and I'll speak a little bit more about that. And then we had the borrowing I spoke about.

The federal stimulus funds, you may all have read numbers in the paper, $45 billion, $50 billion is coming to California, and that's true. But in our budget, we have a thing called the *“trigger mechanism*.” Some of those cuts –- about almost a billion, that are shown up there -- and some of the revenue, about $1.8 billion, is going to take effect unless we get enough federal stimulus money to offset general-fund costs to add up to $10 billion. And if we do, then those cuts, the trigger cuts and the trigger revenue source will not actually take effect.

Right now, we're estimating about $8 billion. That's a tentative estimate. We have a statutory obligation to have a public meeting with the Treasurer and go over the numbers later this month, and before April 1st, determine whether that number is really 10. If it's 10, those cuts go away and the revenue increase, the $1.8 billion, goes away.

At the moment, it doesn't look like that will happen; but we haven't completed our analysis yet, and we don't have the final numbers on the federal stimulus package.

But I remind you, this is not the large package, the $45 billion or the $50 billion that you sometimes read about. Much of that goes directly to local governments. Some of that is in the form of tax increases to citizens. Some of it comes to the state but cannot be used in a way that would benefit the general fund. And only a bit of it comes to us in a form that we can use to reduce general-fund spending. That's the part we're counting here in this trigger mechanism.

Before I go on to a discussion of some of the propositions that are on the ballot, I thought I'd give a sense; this is one of my favorite, in a way, charts because this year in the budget we had a terrible cash-flow situation. Many of you know that there is a difference between the budget numbers, which are on an accrual base, and the cash flow, which is essentially just how much money is in the bank. And sometimes you can be okay on the budget numbers and still be in trouble on the cash numbers.

Well, we were not okay on either set of numbers -- far from it.

And you can see here that if we had done nothing, that $26.3 billion negative number on the far right is how much the general fund would have been underwater by the time we got through the end of July.

Now, clearly, you can't be 26.3 underwater; but you can be a little bit underwater on cash because we're allowed to borrow from internal sources, special funds and the like. We do have a pool of money that is available for our temporary borrowing. And we use that to get through some of the low months. But as you can see here, we would have run out of money -- and this is where our situation really got desperate, if you look at that -10.4. What that July figure translates to, it is easiest to understand this way. If we had done nothing in the month of July, the State would have had $12.5 billion of bills to pay just for that month -- not counting the bills that we may not have been paying up until then. And by the time we paid back our old bills and counted in the new money, we would have had about $2 billion with which to pay $12.5 billion of bills.

Any private company or any other person looking at a month like that would be headed straight to the bankruptcy court. And that's certainly where we would have been headed, A, if we hadn't done anything and, B, if we were allowed to. The State cannot declare bankruptcy. We don't have access to that -- it's often called "bankruptcy protection." I don't know how much protection it gives, but it certainly gives you instant solutions to those kinds of liquidity problems.

We didn't have that access to that bankruptcy solution, so we had to come up with budgetary solutions that also addressed the cash problem.

I can tell you, I think we just completed our cash analysis. The State is still going to be struggling with cash next year. We're going to have to do some more temporary cash-flow borrowing. But at least at the moment, the budget solution solves the budget problem as well as the cash problem.

(Commissioners De La Rosa and Barrales entered the meeting room.)

MR. GENEST: But I wanted to mostly just use this chart to convey the sense of almost desperation that at least I felt and I think others were seeing that the State was really headed for a cliff. And if we had gotten to the point of denying payments to that many people who we owed money, I think it would have been a terrible, terrible situation. Happily, it looks like that's not going to be happening.

So as I said, a key part of this budget solution are a variety of ballot measures.

Now, let me point out, as a state official, it's illegal for me to advocate any of these ballot measures.

I can certainly explain to you why they were chosen and how they work, and that's what I'll be doing.

The first one is budget reform. I'm going to go into that in more detail on the next chart. So why don't we skip that one first? That's 1A.

1B is supplemental education payments. This gets a little complicated. If you've read the Legislative Analyst's analysis, you may be somewhat confused by it. What happened in Proposition 98 is that revenues declined so precipitously that under the Proposition 98 formula, the guarantee for the current year, 2008-09, dropped by over $7 billion. If you could imagine a total of fifty-some -- fifty-four, depending on what year you're talking about -- billion dollars, and all of a sudden in the middle of the year you lose seven, that's a pretty terrible situation for anybody to find themselves in. And that's where Proposition 98 found itself.

So we had really no choice but to fund that lower guarantee.

In Proposition 98, there's something called the "maintenance factor." And all this means is that in a normal setting, if you underfund the long-term trend line for Prop. 98, you may do that under certain circumstances -- the Legislature may -- under two circumstances. But if that happens, we keep track of that, and over a period of time we have to add back spending into the Proposition 98 amount so that we rise back up to that old trend line. And that trend line, by the way, has been growing over the years. So this maintenance factor is a way of bringing us back to where we would have been if we had never underfunded Proposition 98. And it's built into the Constitution. It is anticipated.

So normally, we would think that when Proposition 98 loses over $7 billion in a single year, that we would be creating a maintenance factor.

Now, the problem with the maintenance factor is that this money gets added back into the State’s spending base based on a formula that has a lot to do with state revenue. So in some years, if you have a maintenance factor to pay off -- I think in one year, we had to use 92 percent of the year-over-year revenue increase to the general fund to pay a maintenance factor. In other years, it can be as low as 50 percent. But it's difficult to plan around. And because of a technicality that no one really understood until we found ourselves in this situation, there was a legal question as to whether we even created a maintenance factor.

And I won't go into that, unless somebody wants to get into the details of that. But we sort of agreed --

the Legislature agreed to disagree. We didn't decide whether or not we create a maintenance factor this year. That legal question was left open. What we did instead was we changed the Constitution to say, no matter what we may have thought about what happened this year, this year's piece won't be a maintenance factor. Instead, we're going to put it in what you might think of as an easy payment plan. We're going to add it back into the Proposition 98 guarantee over a longer period of time and in a more phased-in, gradual fashion. And that phasing in is directly connected to budget reform. Because one of the provisions of budget reform is that we take out 3 percent of general-fund revenue and put it in a rainy-day fund.

Under the 1B, one-half of that amount. So 1½ percent of general-fund revenue every year, beginning two years from now -- beginning two years from 2009-10 -- will be given into this supplemental education payment to act as if it were a maintenance factor, but more on an easy payment plan.

That may seem kind of technical; but I think when you see the numbers, as we put it out in the future, you'll see that it makes it a little bit more palatable to address this huge loss in education.

I should say that recognizing what a big loss it was, the Governor and the Legislature did a lot of things to make the actual impact on the schools a lot less than the full $7 billion. There was a lot of accounting, that things got moved around. And so they didn't really, actually, lose nearly that much. Probably more like $2.5 billion. Still a lot, but we managed to dampen the blow. But on the Proposition 98 guarantee side, it was over $7 billion.

The next proposition is 1C, and the budget does rely on this for $5 billion. 1C is the Lottery. There are essentially two things we want to do with the Lottery. One, it hasn't been growing, the revenue source hasn't been growing. The education community is generally not so happy about the Lottery because every time they talk to their friends and they say, "We're underfunded," which they always say, people respond, "Well, you've got the Lottery. What's wrong?" Well, the Lottery has never really grown. It's never really been a very dynamic revenue source. It's actually gone down several years. It went down this year. It's been up as high as $1.2 billion. It's been down to $800 million, I think is the last estimate I saw.

So it's an unreliable revenue stream for education. And part of the reason is, there's really been no incentive and no effort to get the Lottery to grow at a more reasonable pace, to have a lottery that's closer to what other states have.

Our Lottery returns about half per capita what the average, the nationwide average is. And for states with really good-performing lotteries, it's more like a third. So we think there's plenty of room for the Lottery to grow. And we propose to take the Lottery revenue away from education, replace it with the same amount of Proposition 98 guarantee. And that grows, that grows essentially at the rate of general-fund revenue. So it's a better deal, in our opinion, for education, I think probably in their opinion as well. And it gives us, the State, a stake in the growth of the Lottery.

And we think, with some modernization, we can get some better growth. This doesn't mean, you know, that we'll be vastly changing the culture of California so that everybody plays the lottery, but we think we can do a somewhat better job. And that incremental revenue growth, we believe, will justify securitizing that increment over the next 20 or 30 years. So what that would mean is we would get a payment of $5 billion next year, late next year. And whoever paid us that would then have that revenue for some length of time to pay them back.

It's kind of like borrowing. Technically, it's not exactly borrowing. We call it that because it's on a commonsense basis, it is borrowing.

The other two things -- the First 5 in mental health. These two initiatives. The First 5, you may recall, is the Rob Reiner initiative. It was a 50-cent tax on cigarettes. It was used to pay for children's services. Mental health is the so-called millionaire tax. This is the incremental 1 percent surcharge on people who make more than a million a year. And it was intended for expanding the mental-health system.

What we have found with First 5 is that the money isn't being spent -- it's certainly not being spent consistently throughout the state. We think that without really damaging the underlying program, we can go in there for a few years, about five years starting next year, and pull out a little of the money and still use it for children's services, but use it for children's services now being paid for by the State general fund. So it gives us a general-fund benefit. And that's $608 million next year.

The reason the number is so much larger next year than it is in the ongoing years is there is a balance that's built up, and we would sweep some of that and use that to the advantage of the general fund.

Mental health, the millionaire tax: This is something that, in the long run, will probably be able to spend all of its revenue. But it is going take it a while. It has been a fairly slow-starting program. They're fundamentally changing the approach to mental health, and they're doing it in a ground, up fashion. So it takes a while for the local communities to really get this thing going. And they are going, but they're not going so fast that they need all the money. We think for a few years we can use some of that to pay for mental health services again but that are already being paid for by the general fund now. Which we need voter approval on both of those, because we weren't able to do that substituting without the voters' approval.

And then there's something that's really not directly related to the budget. For some, it might be regarded as the "feel-good" proposition. If you're a legislator, I don't know if you feel good about it or not. The Governor feels fine about it. It just says that if a future director of Finance determines that we're in budget deficit -- and as you can see, that I did that this year -- then state elected officials wouldn't receive a pay raise. There is a commission that gives their pay raises, and it would just be prohibited from giving one in that situation.

So that's how the ballot measures for May 19th tie into the budget, some of them very directly. The budget is heavily dependent especially on C, D, and E for direct funding.

But I think the thing that the Governor is most focused on is budget reform. And this is also something that's probably very useful for the Commission.

It's a little hard to see -- and I know the chart is a little busy -- but there's a lot of information on this chart. And I can provide you with the background data on it so that you can study it yourselves.

Let's first look at actual revenues, which is this line right here. And this is what our actual revenues have done over the years. You can see, when the Governor said the revenues are volatile, he sure wasn't kidding.

Now, Phil will talk to you later, more about this -- Phil Spilberg. But that's the volatility we now have, at least over the last ten years, in our revenue.

Our spending, of course, tracks our revenue. And I said earlier that I told you how we had a budget deficit, and I was going to get to why.

There are two reasons why we have a budget deficit. This chart tells the tale of both of them, but most of the years tell the first tale.

If you look at when revenues go up, look at what spending does. One economist, several years ago, said that the State Legislature and Governor always chase the revenues up the hill and then get stranded at the top when the revenues come back down. That's exactly what we did. We had really large increases in revenue in these years under Gray Davis, Governor Davis; and the Legislature and that governor committed a lot of spending based on those revenues.

Well, those revenues clearly -- we all thought they were unsustainable. I think even the Legislative Analyst, the Governor himself back then, Director of Finance at the time, a lot of people in the Legislature all said we shouldn't be committing these revenues to permanent spending because we can't expect this to be sustained.

Having said all that, we went ahead and did it, anyway, because the pressures in Sacramento are really huge to spend the money that's on the table.

So we spent the money that was on the table, and we ended up with a level of state spending that was simply unsupportable. And as the revenues plummeted in 2001, and stayed pretty low for a few years after that, we had massive budget shortfalls because we were trying to get our spending numbers back down.

Now, it looks like we really did drop our spending a lot between these years; but there's a more complicated story there. A lot of that was temporary, sort of one-time adjustments that could work for a year, maybe two. We, for example, took some money from local governments; but some of it we took, and we prevented ourselves from being able to do that again with a prior Proposition 1A. So that was a temporary solution that we no longer have access to, but it helped us for a few years.

Some of it we borrowed. We borrowed money from local government in something called the VLF gap loan. I won't bother to explain that. But there was a lot of borrowing, a lot of -- well, I hate to say the word, but some people call it "*gimmickery*" that occurred in through here, where we were able to make ends meet through things that couldn't last and that were destined to go away. And when they did, you can see what happened to our spending: All the way from 2003-04 until 2006-07, we got sort of back on a rocket ride.

Now, the revenues, fortunately, for us at the time -- or maybe unfortunately -- we were also back into a very high-growth revenue period between 2003 or so, and something like 2005-06 or 2006-07; there was really ample growth.

The problem with that was, we should have been cutting the budget, and we should have been raising taxes, or some combination of the two, depending on your perspective. But we should have been closing the long-term structural budget deficit in those years.

We didn't do it. We didn't do it because we didn't have to do it. We had this money coming in unexpectedly, and it prevented us from having to make the very difficult choices that we should have been making. And in our defense -- because I was certainly there in those years -- in our defense, I would say, again, when there is money on the table in Sacramento, you can't pretend it's not there.

We couldn't say to the Legislature, nor could the Legislature say to itself, "Let's pretend some of this money isn't there, because we all know this rate of revenue growth is too high to be permanent and supportable. Let's just not spend a bunch of it." You can't do that in Sacramento. The politics don't work that way.

If I put that money behind us and say, "Don't look over here," they'll say, “No, I want to see that on the table, it's on the table, we'll talk about the whole pile of money.” And we ended up, therefore, spending it all.

Now, in the defense of our administration, I would say there's almost no -- in this high rate of spending in here, when you see the actual spending here going up at a fairly substantial clip, there's virtually no expansion of government in there. That's just replacing these one-time measures, the borrowing that we could no longer do. We had to not only pay it back, because now we don't have that solution to keep the spending artificially low and other mechanisms of that sort that just went away.

So we didn't really expand government. What we should have been doing is shrinking it or, alternatively, raising the taxes so that we could afford the higher rate of government. But, instead, we didn't because we had the money coming in that we didn't have to. So, unfortunately, we ended up at about this juncture. And you can see spending now -- this is the spending right up until the current year 2008-09. And you can see, it's very low. In fact, if you go all the way back to 1998-99 and look at the actual spending that we have in the current budget for the current year and take one more year out because we already know the numbers for the next year -- at least we have them in law right now -- this rate of growth is about 3.7 percent a year. That's on an average annual percentage basis. That's a very low rate of growth.

So you could say we've paid for all of our sins.

We've had these high rates of growth in a couple of different periods, but now we've gotten back to where we're on track with a very conservative low rate of spending growth in state government.

Of course, you could also say it hurt a lot to do that. And it also necessitated, at least in our opinion and in the Legislature's opinion, this rapid increase in taxes, which is the only reason that the revenues are up that high at that point. Otherwise, they would be down substantially from that peak or that higher point you see in 2008-09. So as I showed you earlier, we had to raise taxes, we had to cut spending.

If we had been on a steady path, it wouldn't have been nearly so bad. And so here's what budget reform does: These darker lines. The green one is revenues. And you see that the revenues are not -- they're not exactly flat, there is some variation, but it's not very substantial, especially compared to what we actually saw.

And this is a model -- obviously, these are not real numbers. But if we went back to 1998-99 and put budget reform into effect and said, "What would have happened?" Well, in many of these peak years of revenue growth, we would have taken the money away. It's not in that green budget-reform revenue line because we've taken it away, we've put it into a rainy-day fund.

On the other hand, in these years where revenues plummet, you'll see that the modeled revenues from budget reform don't plummet at all. They may slow down a little, but they don't plummet.

Over here -- I'll get to the second part of the story -- they do go down a bit. But the reason for that isn't that we had to raise taxes in these years; it's because with the budget-reform model, we would have built up enough reserve to backfill the revenues.

And the rules of this budget reform are that you can backfill with your rainy-day fund, but not just because everybody thinks it would be nice to not have a tough year. There's very specific conditions on when we can take the money out of the rainy-day fund. And those conditions are essentially whenever next year's revenue, the actual revenue, is not enough to support this year's spending number with population and inflation growth attached to it, then you can take enough money out.

So we take this year's number of spending, whatever it may be, and we grow it by the increased percentage of population and inflation, both. And that forms a new target. And we say, if your revenue is lower than that, you can take money out of your rainy-day fund to at least build up to that point.

You can't take any more out. So it's a rather stingy, by some historical standards -- certainly, some of the rates of growth we see in here are far more than population and inflation. So it's a rather stingy rule that says: “You can't just take your rainy-day fund money when you feel like it. You can take enough out to kind of tide you through some tough times.”

There's another rule, and that is if there is an emergency. But the emergency isn't just, for example, a Proposition 58-style declaration of fiscal emergency. These are earthquakes, fires, floods. It's real emergencies. And you can take it out for those reasons with a two-thirds vote one time, one at a time for those kinds of emergencies. But it's a stingy take-out rule designed to be able to support a reasonable level of spending during tough times with a little infusion of money from the rainy-day fund, which is the purpose of the rainy-day fund.

Actually, the main purpose of the rainy-day fund is to take that money off the table in those good years, so we don't build a spending base higher than we can afford. But having done that, you have it available in the lower-growth years to help you out.

So that's the way, roughly, budget reform works.

Now, you'll see in here another reason for -- this is an anomaly. This isn't just -- this downturn here is not just -- I mean, in the revenues -- it's not just that we had some fluctuation. We're having one of the worst recessions we've had. So, obviously, no budget-reform mechanism is going to be enough to survive a really terrible recession.

What our modeling showed is that at the beginning of 2008-09 -- and I think I should go to the next chart to make sure I've got these numbers right -- we would have had, if you look at this third bullet -- the 2008-09 deficit would have been $5 billion instead of 15. The portion of that 41.6 that I mentioned earlier, that we just solved for, that was attributable to 2008-09, is about $15 billion. That's how short we were in the current year.

If we had budget reform in place, we would have had $9 billion in revenue, and our spending base would have been a little different. So it would have netted out that instead of having to solve a $15 billion problem this year, we'd still have to solve a $5 billion.

So I think there's two lessons in that: Budget reform as it's structured is really good for your budget, it helps you survive even a tough downturn like this one, but it's not a panacea. It's not enough to solve the entire problem because you're still going to have, in tough times like this, you're still going to have some tough budget times.

We would have also had $13 billion to spend on infrastructure or tax cuts. And that's another rule of this budget-reform proposal. It says that we won't build up the rainy-day fund past 12½ percent. So when it gets to 12½ percent of general-fund revenue, the money goes to pay off budget borrowing -- for example, the Economic Recovery Bonds that we owe money for now dating back to several years ago –- you can pay that off, the excess money. But after that, you can use it to pay off -- I mean, to provide tax cuts –- one-time tax cuts, or you can use it to provide infrastructure investments.

So we would have had $13 billion of infrastructure. We would have had $9 billion in the rainy-day fund coming into this year, as I mentioned before. The deficit this year, as a result, would have been substantially less. And arguably, we would not have had to raise taxes or cut programs, at least not nearly as much.

I don't know who would have won the argument if we were arguing about $5 billion instead of 41.6. Would the people who say “no tax cuts no matter what” or the people who say “no program cuts,” who would have won the argument. It would have been a lot easier argument to have. Maybe we would have had some of each, maybe just all cuts, I don't know. But it would have been a lot better situation if we had budget reform in effect.

The next couple of slides deal with the taxes. And I think it's probably important for you to see these as you consider what you may want to do about our overall tax system.

The top line shows total revenues that are projected out. Now, no one really knows what revenues are going to be in 2013-14, obviously. These are baseline revenues without any of the additional money below being yet reflected.

So we just essentially used something like the long-term average rate of growth, because no economic model has much validity out that far. But you want to see how things would perform. So you need to set up some sort of a structure to compare it to.

So we think we will grow to about 109, of these basic revenues. But then we did some things. We made policy choices in this budget or in the previous budget, the 2008-09 budget that we enacted last September, involving revenues.

Borrowing comes in, to some extent, we count it as a revenue. So let's just ignore that. That's really borrowing.

The first real revenue thing is in the income tax, you can see we increased income tax substantially, but that increase virtually disappears by the year 2013-14.

The sales tax, the one percent sales-tax increase starts out slow because it's starting late in the fiscal year at $1.2 billion this year. But it grows at a pretty good clip. And then it goes away entirely by the time you get to 2012-13.

There are some corporate tax changes, quite a few them. And as you can see, initially they raise the corporate tax revenues, but they start to reduce -- it becomes a net tax cut for corporate tax by the time you get out into the subsequent years.

The VLF, that was mentioned, I think, earlier -- maybe it was just mentioned in conversation -- but that's the vehicle licensing fee. And we are proposing to raise that fee. And that stays in effect for quite some time and produces substantial increase in revenue.

This is only the general-fund portion of it. There's a little bit for public-safety programs that's not reflected here.

Finally, that shows you the total tax increase. So in this planning period, we've increased taxes rather substantially. But we get back down in 2013-14 where it's a net tax cut in that year. These are not cumulative numbers. So it would take some time for that $1.5 billion tax cut to wipe out the budgetary impact of all those tax increases prior. But you do get to a negative number in the end.

So this in the bottom line just shows you what we think our revenues will be with all this in effect.

I think it may be worth -- and I'll just put these up, and you have them in your binder, and if you want to talk about specific issues, that's one reason Phil is here, because he probably has a much better handle on this than I do. But more complicated pieces -- everything else on there is sort of one thing. But when I showed you the personal income tax and the corporate tax numbers, it wasn't that simple. There are lots of different pieces to that, to both of those.

This one here, the 0.25 percent personal income-tax rate add on, meaning, we just add, if you're at the top rate of 9.3, you're now going to be at 9.55. So you add the 0.25 on to the existing rate structure. And that lasts until the middle of -- and it lasts until the end of calendar year 2012. So you see it disappearing or being cut in half and then disappearing in 2013-14.

Part of that is in that trigger side that I was talking about. Half of that will go away if we get enough federal revenue to offset general-fund costs.

Then we have these other changes. And I won't go over them. You're free to ask questions if you want to get into them. The corporate tax stuff is pretty hard to describe briefly. But any of it that you want to talk about, we can do that.

And I think that does conclude the presentation.

CHAIR PARSKY: Okay, let's step back. Everyone will have a chance to have an exchange of questions.

Let me just start, Mike, just so that we are politically neutral. If I look at the chart you put up on the impact of budget reform and where expenditures got kind of out of control, I would just say it cuts across all administrations in this period and not just one administration.

I think the point is well taken. But since this group is politically neutral, I think it's at least an appropriate chart to make that comment about.

My basic question then and we'll go on.

One of the main reasons for this presentation at this point in time is to get the commissioners focusing in on the relationship between our work and the budget reform that will be on the ballot. And I think it is quite difficult to come up with meaningful reform proposals on the revenue side if we don't know one way or the other whether or not the budget reform will be enacted. So much of what Mike has said is impact, assuming it's enacted. And I'll come back to that.

Your analysis, though, of the impact on the 2008-09 deficit doesn't extend it out when some of the changes would happen. In other words, assume for the moment that the budget reform is enacted, and yet there are certain things that are in place going out in years.

And I think it's important to know -- not necessarily today, but it's important for the Commission to know -- well, okay, if the budget reform is enacted and the changes happen in the 2012, 2013, 2014 period, what impact might that have in terms of the magnitude of the deficit if no changes are made on the revenue side. I didn't see it kind of extended out, but I think -- if you have any comments on that, I would welcome it.

And then the second question I had was on the real impact of this rainy-day fund concept. A number of commissioners in the past have raised that issue. And I want to be sure that, at least from your perspective, everyone understands that assuming for the moment the budget reform is enacted and assuming for a moment a rainy-day fund concept, as agreed to, is enacted, does that solve all of our problems? Or do we need to just kind of package all of this up and go home and basically leave everything alone; or not?

So if you could kind of comment on both of those.

MR. GENEST: Sure. Well, clearly, it doesn't solve all the problems and it doesn't even solve one of the problems entirely. Because your charge is not just relative to volatility, because there are other things that you're trying to accomplish. And budget reform doesn't address things like the business climate or the relationship of our tax system to our current economy as compared to its relationship to the economy when it was more or less devised several decades ago. So those things, obviously, are unaffected. But on the volatility question, it certainly does have an impact.

I think the interesting point here is to compare budget reform, which allows for a rainy-day fund of 12½ percent, to what Phil Spilberg said at the first meeting, when he looked at variability over time and said, if you wanted to survive a two-year recession based on having a reserve, at the 95 percent confidence interval based on the variability that he observed in the period of time he looked at, you would need something like a $30 billion reserve.

Well, 12½ percent of $98 billion, roughly, isn't anywhere near $30 billion.

So clearly -- and I think we've made this clear to the Legislature -- and the Governor always acknowledges it -- budget reform is not a panacea for future fluctuations in revenue.

And I think Phil touched on why that might be. Putting away that kind of a reserve, $30 billion, roughly 30 percent, putting that away has a lot of opportunity costs. And it's not so clear that the public would support having their monies stashed away at that magnitude. I think they'd rather take the risks that we might have some budgetary fluctuation in the future than having such a large reserve.

We think 12½ percent is a reasonable number. Like I say, it doesn't solve all the problems, but it does help buffer.

I looked at other states' rainy-day funds, a lot of states have funds and they actually call them rainy-day funds, and they sometimes call them something else. And it's a little difficult to compare state to state because it's never quite clear if their general fund is the same as ours. For example, one of the states -- I think Massachusetts -- has something they call something like the general education fund, and there's a 15 percent reserve in that. But I presume it's only for education, so I don't think it's directly comparable.

Other than that, there were a few states at

12½ percent; and all the rest of the states that have one, had smaller rainy-day funds.

So we think at 12½ percent, we've named the right number. And, again, that doesn't wipe out all the variability problems.

There is some advantage to some variability. I don't know that a perfectly flat-tax system would necessarily be ideal. Some up and down is good, especially if you have budget reform, because it's those peak years that generate most of the income that goes into the rainy-day fund to protect you against the bad years.

I suppose in a perfect world, if you had absolute certainty going forward forever, maybe that's better; but we know that can't ever happen.

I think that the charge to find -- in addition to the other charges of the Commission -- a tax system that has less volatility is still a very valid goal for the Commission to pursue.

It is quantitatively different with or without the enactment of Proposition 1A. It seems to me now, that is kind of a game-changer for you. If 1A were to fail, I think your charge would look a lot different than if it passes. But it's not going to take it away, if that answers that question.

COMMISSIONER HALVORSON: Mr. Chair?

CHAIR PARSKY: Chris, do you want to follow that on the rainy-day fund, since I know you were one of the outspoken commenters about that?

COMMISSIONER EDLEY: First, Mr. Genest, thank you very much for this. This has been terrifically helpful.

First, just quickly, I take it, that in the next slide, your point about the fiscal 2009 deficit being reduced to $5 billion had we had budget reform, but then for -- that's for fiscal 2009. But for fiscal 2010, I take it, you're saying that the 12½ percent simply wouldn't have provided enough of a cushion to make a meaningful impact on the size of the problem next year, that following year?

MR. GENEST: If it had been in effect and if the numbers had performed as we modeled them, there would be very little --

COMMISSIONER EDLEY: Very little left?

MR. GENEST: -- very little rainy-day fund left for next year.

However, the other side of that is the spending base, because it's one thing to have the spending grow somewhat slower than you might otherwise, and maybe there will be pressure to grow it faster. But it's quite another thing to have to drop it precipitously as we've had to do on several occasions. And so we wouldn't be faced with that. We would still have to drop spending a bit or raise taxes or some combination for the 2009-10 year.

We haven't modeled it out exactly; but there would be a big problem next year, even had budget reform been in effect since 1998-99.

COMMISSIONER EDLEY: But you still have some moderating impact?

MR. GENEST: Yes, you’d be in a far better situation.

COMMISSIONER EDLEY: On the next slide, 8, I think it is, on the total revenues with policy out there, just looking at the bottom line there, where you've got 107.9 in fiscal 2014, I've got to say, that seems crazy to have that little revenue growth over that extended period of time.

What am I missing here? I mean, obviously, you're not showing the expenditure period, but it seems hard to believe that there wouldn't be --

MR. GENEST: Well, I think the better comparison -- probably the best comparison would be to go back to 2008-09, at the top, baseline revenues.

COMMISSIONER EDLEY: I see. Very good, okay.

MR. GENEST: So our baseline revenues this year would be 80.12. Look at how big of a drop that is.

COMMISSIONER EDLEY: Okay, that's very helpful.

MR. GENEST: And so since there's virtually no impact of the tax policies by the time you get to 2013-14, maybe that's a better comparison. That's a fairly substantial amount of growth.

COMMISSIONER EDLEY: Okay.

MR. GENEST: I don't know the exact percentage, but it's probably like 5 or 6 percent per year, in some of those years.

COMMISSIONER EDLEY: Okay.

COMMISSIONER BOSKIN: High thirties cumulatively over four years, five years.

MR. GENEST: I didn't hear.

COMMISSIONER BOSKIN: High thirties percent over five years.

MR. GENEST: Right. So on an average annual basis, maybe 5 or 6 percent growth, which is roughly what we've seen in the long, historical trend.

It may well be that the growth is faster. A lot of times, as you're coming out of a recession, you do experience –- because the last one, we experienced 14, 15 percent growth.

If that should happen, that extra money, until it builds up to 12½ percent -- which it would do rapidly -- would go into a rainy-day fund under the proposal.

COMMISSIONER EDLEY: Yes, it's interesting, though, I'd actually have to think about whether the more useful comparison is -- you're sort of taking from the trough up to, let's call fiscal 2014, in the middle of the business cycle.

MR. GENEST: Right.

COMMISSIONER EDLEY: And I don't know whether thinking about revenue growth from the trough to the business cycle as opposed to -- but I take your point, I'm much more comforted on the --

MR. GENEST: And I think if we, say, looked at the ‘91 recession and looked at the six years after and said what was the rate of spending, we'd have much higher numbers in ‘13-14.

COMMISSIONER EDLEY: Okay, right.

MR. GENEST: We're not really making any prediction what it will be. We're just saying if it's at the average rate.

You could certainly come up with a scenario that says it would be higher than that. Hopefully, you can't come up with one that says it will be any lower, but I guess it's always possible.

COMMISSIONER EDLEY: The last question is, we've been talking about a rainy-day fund. I'm sort of interested in complementing a rainy-day fund with a drought facility, if you will. That is to say, a mechanism whereby, after you've exhausted the rainy-day fund with the constitutional change, if necessary, you've got an ability to go to the market for five- or six-year bonds, that you then repay with some dedicated revenue source or what have you.

Have you thought about that at all yourself personally or has there been any discussion of that?

MR. GENEST: Yes. In fact, that's pretty much what we did in Governor Davis’s last year, he authorized something called the Fiscal Recovery Bonds. And they didn't quite work out. Governor Schwarzenegger came in and got a constitutional amendment to authorize the Economic Recovery Bonds. Roughly, the same amounts of money and for the same purpose, which was to pay off the accumulated debt from the previous recession.

At the time, we thought it was ongoing; but it turns out that we had hit the bottom already and we were on our way up. But you can't usually see that when it's happening.

So at that time, the State did engage in borrowing. As a fiscal guy, I have to tell you, I go to National Association of State Budget Officers all the time, and when they hear that we actually went to the bond market to borrow money for current operating expenses, they look at me like a pariah. And I do feel guilty and bad about it. It's what we did.

COMMISSIONER EDLEY: But let me ask, what was the term on those bonds?

MR. GENEST: It was somewhat variable, because we set aside one-quarter cent of the sales tax. At the time we did it, it was worth about $1.5 billion a year. And the bonds, the initial tranche would have paid back in six or seven years; but we allowed 20 years in case there was a downturn. Well, now, there's been a downturn, so it may take a little longer than the seven years. Plus, we've also borrowed two additional tranches, one of 2, and one recently of 3.3. So it will be -- I don't remember the exact year, something like 2012-13 or 2013-14, somewhere out there, when we finally do pay off the Economic Recovery Bonds.

They're paying them off as part of our expenditure base.

CHAIR PARSKY: Chris, as you look at all of this data, bear in mind that there may be one way to prevent a drought from happening at all based on a change in the revenue system that we have, or the tax system that we have.

Second, please bear in mind that borrowing always has to be repaid, always has an impact; and the cost of interest is borne by future generations.

COMMISSIONER EDLEY: Yes. Although if the term is short enough, it would be this generation rather than a future generation.

But also, what are we this week, the seventh largest economy in the world? Let's say, we're the seventh, okay, largest economy.

MR. GENEST: The way the rest of the world is going, we may be the first.

CHAIR PARSKY: Everything is relative.

COMMISSIONER EDLEY: Yes. So if we're the seventh, my bet is that the sixth largest economy in the world and the eighth largest economy in the world do have an ability to go to bond markets to smooth their expenditure and income flows over the business cycle.

MR. GENEST: I think there are -- may I say, I think there are two problems that I see with that.

One is, we have a very aggressive program of infrastructure-building in the state, where schools, universities, highways, transit –– hopefully, water soon to be added to the equation, and flood control -- and a variety of other things -- courthouses and so forth -- even correctional facilities. And the interest expense of those is all built into our numbers. And it accounts for a very substantial increase in ongoing general-fund costs. And that increase is increasing over time. We think it's well worth it, it's an investment in the future; but we will be paying a lot of debt service as it is.

The other downside is that it would probably be fine to borrow money in a downturn if you had certainty that you were coming back to the same place. But you never really know that. And so if you borrow money, you don't do the more difficult thing, which is either to cut program size or increase taxes, or some mixture of the two. In other words, a permanent solution.

And we saw this in the early years of the 2003-04, 2004-05, 2005-06 years, when I said we should have been cutting programs and/or raising taxes; but we had so much money, we didn't have to. When you put off making the difficult choices that put you back into an ongoing balance, not only do you have the debt service to pay for, but somewhere down the road you're going to have to make that choice, anyway.

CHAIR PARSKY: George?

COMMISSIONER HALVORSON: Thank you. A comment and then I've got a couple of questions.

My own strong belief is that we need a multiyear financial plan for the State and that running the State from budget period to budget period as we do makes very little sense from any kind of an operational, financial, logistical perspective. And I think we need to get to multiyear budgets to really know what we're going to spend in out-years, and start working with those in advance and down the road. That's the comment.

The question -- and I think we need full transparency -- the question is, we're in an economic downturn, and it's pretty ugly. And there's every prospect that it's not short-term, that we're at least going to go through this year. There are very smart people that think we're going to go through next year; that it's going to be a couple of years. And instead of rebounding, it's likely to move into a recovery period and a slow rebuilding period, but not anything resembling a quick rebound.

So if we were to anticipate that that were true and that we're going to stay in financial bad times for a couple of years, how much damage would that do to us relative to these kinds of revenue sources? And how bad could it get? How deep could the hole get?

And I think you answered part of that a minute ago. But how deep could the hole get if the economy stays in this sort of status for a couple of years? That's the first question.

The second question is, what revenue sources are most protected and immune from an economic downturn? What would give us the most stability when you look through the array of revenue sources that we have, which of them are most likely to give us insulation over a multiyear period against that sort of an economic situation?

MR. GENEST: If you don't mind, I'm going to ask Phil Spilberg to think about that question and answer it as soon as I'm done answering your first question, which is, I'm afraid I'd have to say, I don't know. And it's a little difficult to speculate.

I never would have guessed from what our economists were telling me two years ago that we'd be where we are today. Although there were economists, they were outliers who were saying there were major storm clouds on the horizon. There was no mainstream economists -- and by that, I don't mean to say mainstream, but the majority of economists were not predicting a recession two years ago. And as recently as a year ago, we're still not -- in fact, a year ago, I believe the majority of economists were saying we are not in a recession.

COMMISSIONER HALVORSON: Right.

MR. GENEST: And it turns out we probably already were. So it's hard --

COMMISSIONER HALVORSON: Well, I'm not asking you to predict whether or not we're going to stay in the recession. What I'm saying is, assume that we will be in a recession for two years, what will the impact be on these numbers?

MR. GENEST: Well, it would take a lot of money out of the 2010-11 year. We've got a very substantial growth there. And if you didn't have any growth there at all, it would be devastating. I mean, our budget situation would get far worse. You know, two years is bad enough; three or four --

COMMISSIONER HALVORSON: If you attached a number to "far worse," what would that be?

MR. GENEST: I hate to say a number because I know there's at least one press person here. I don't want to establish the new floor. I don't know what the floor is. Hopefully, we're at the floor now, but I don't know that, either.

All I can tell you is -- maybe the best way to answer it is the way I semi-jokingly said, this is the easiest budget we ever had to decide about, because we took everything we could think of and put it on our options list, and we realized we had to do it all.

So somebody asked me the same question, maybe in a different way, they asked me what if the Lottery proposition doesn't pass and the other two, and so we're out almost $6 billion this year from what we plan, what's our fallback plan? We don't have a fallback plan. Every option that we could think of, we put in front of the Governor in November and December.

And, of course, we'll come up with something. But I think if it gets much worse, the things you come up with, I would rather not give voice to at the moment. Hopefully, I'll never have to, but it would be very, very harsh.

COMMISSIONER BOSKIN: I think it's fair to say that the economic assumptions underlying this budget are not nearly as dire as the ones you're talking about.

COMMISSIONER HALVORSON: Right.

COMMISSIONER BOSKIN: I think it's also fair to say that whether it's right or wrong, the consensus of economists -- more the mathematical average economists never come to a consensus about anything -- have been --

CHAIR PARSKY: Except the ones that --

COMMISSIONER BOSKIN: They're not as dire as you say, but they've been heading more in that direction month by month by month.

And so, for example, when President Obama drew up his budget blueprint, he made economic assumptions he thought were reasonable at the time, but they're now a recession that's only half as shallow as this month's blue-chip forecasters are predicting in a recovery that’s twice as strong. He may turn out to be right, but the consensus now is it’s more dire. So Mike may be back in this business next year, as much as he doesn't want to hear this.

The second point I think it's fair to say, which did not really come out -- I think Gerry kind of alluded to this in this presentation -- is that this gets us through the next couple of years under the assumptions, but there is still a longer-run structural problem that is sizable.

Now, that's not our job to decide how to deal with that, but we ought to come up with a tax structure that can handle that situation or a better situation or whatever.

So I think just clarifying the economics a little bit.

CHAIR PARSKY: That was exactly the point I was trying to make. So thanks for clarifying that.

Ruben?

COMMISSIONER BARRALES: Thank you, Mr. Chairman.

Mike, I had a couple questions. One related to the budget reform. I know Colorado experimented with a budget cap. I forget what they called theirs. But how does this relate to the Colorado model, the similarities and differences?

MR. GENEST: Colorado, as I recall, I'm pretty sure, it was population and inflation. I'm not exactly sure how they measured inflation.

It was a fairly stringent cap. There are some differences.

As I understand their cap, it didn't allow for solving any part of a future problem by raising taxes. Our cap allows for that. It doesn't encourage it or discourage it. It's neutral on the point. And so what that means is that under their cap, if they experienced a problem, and even if they could get a consensus that part of the solution was to raise taxes, they weren't able to spend the money from the tax increase.

And we've had some proposals for similar true, hard -- they have been called recently *"hard caps."*

One of the arguments against such a hard cap is what happened in Colorado. As soon as they got into a fairly tight corner, the people saw that they didn't want to be in there, and they suspended, I think for ten years, their ceiling or their cap.

COMMISSIONER BARRALES: Right.

MR. GENEST: We're very aware that that is a possibility. And that's why we've given this a little more flexibility. So that, heaven forbid, if a future Legislature decides with a two-thirds vote, and a governor who goes along with it or is overridden by the same two-thirds if he doesn't, that they want to raise taxes, well, they can do that to solve a future problem.

Under this budget-reform proposal, what happens is, you only get to have into the general fund what the ten-year trend suggests you should have. And if your revenues come in higher than that, you sweep away the excess revenues and put it in the rainy-day fund, as long as it's not full.

That's based entirely on the history of what has come before. They are just the revenue numbers from the prior years.

But if at the same time you raised taxes or lower them, that trend line is adjusted according to those policy changes for the next three years, so that you kind of capture -- if you want to raise taxes, you're still working with a trend line, but plus the tax increase. Or if you want to cut taxes, you're still held to the trend line but minus the tax increase. So it's adjustable.

As I understand the Colorado one, it didn't have that adjustment feature. And I think that's one of the reasons that the citizens got rid of it, or at least suspended it for a long period of time.

COMMISSIONER BARRALES: Right. And the same question relates to the economic stimulus, maybe you covered this.

As I understand, the budget compromise basically had a threshold if the state receives 10 -- I think the number was $10 billion, then it would basically be a threshold to eliminate some of the tax increases and some of the cuts.

And you did cover that? Great.

And if that's the case, then what's the status of that?

MR. GENEST: The tax cut that would be eliminated is the second half of the 0.25 percent rate increase on --

COMMISSIONER BARRALES: No, I'm aware of that. I guess my question relates to -–

MR. GENEST: What's the status on the –-

COMMISSIONER BARRALES: -- consensus on the $10 billion.

MR. GENEST: Well, right now, we have a number that we scored, but not in any legal official sense of $8 billion. So we fall short. But we have a statutory obligation to have a public meeting with the Controller --

I mean, with the Treasurer and to agree -- and I don't know what happens if -- there's only two of us, there's no tie breaker, so presumably we will agree on something at some point -- but to agree whether or not we've gotten the $10 billion.

It's not such an easy number to calculate. I believe there's a hearing in Sacramento right now, going over all this. And there's a little bit of controversy involved because there's sort of a three-step process in determining that number.

First is, we have to look at what the federal government has allocated. Well, that's pretty straightforward. We can do that. Those numbers are out there, more or less. Some of the stuff is competitive, so you're not sure. But generally, we can figure out what the federal government has allocated.

Then we have to decide how much of it is available to the State of California. A great example of why that's a question is if you look at -- the biggest piece of it is FMAP, which is the federal matching rate for Medicaid -- in our case, Medi-Cal. And by increasing FMAP, we get more -- well, we spend less general fund in our Medi-Cal program just automatically. So you could say that's available because we know that the federal government has made that available.

The problem is, in California, before we can receive the money, we have to change a law. We enacted a law a year ago that prevents us from having that money. It has to do with the frequency with which Medi-Cal recipients are reevaluated for their eligibility. We made it biannual. And now under the new federal law, if you want the increased FMAP, you have to go back to annual.

We haven't done that yet. Presumably, the Legislature will do that because there's so much money involved. But as a bureaucrat, as a functionary, I'm not sure it's appropriate for me to try to guess what the Legislature may or may not do. So under current state law, that money is not available. But without that money, the $8 billion would be $1.5 billion. So there is that complexity.

The final complexity is that it says it has to be allocated by the federal government, it has to be available, and it has to be available to offset general-fund costs. Well, there's a bunch of money that we haven't yet accounted for in our $8 billion that's for education. There are those who say the revenue numbers are going down. If the revenue numbers go down, the Proposition 98 guarantee will go down. That would mean the Legislature could constitutionally reduce further the Proposition 98 appropriation. And if they did, they could say that federal money is why I feel comfortable because it's coming in to offset. But is that really what *"offset"* means, or does it mean something more mechanical as it does in FMAP, where when we get the federal money, automatically the state spending goes down?

So those are complexities in operationalizing our estimate. We will figure out what we're going to say about all of those before April 1st, because we and the Treasurer have to say, yes or no, there's $10 billion or not.

Right now, we're at eight. I'm sure our number will change. That was the very first-cut thing. We had to score something just to get a summary out. But we'll keep looking at it, we'll keep working with the Treasurer. I don't know if we're going to get to 10 or not, but we'll look.

COMMISSIONER BARRALES: Thank you.

CHAIR PARSKY: Curt?

COMMISSIONER PRINGLE: Well, thank you.

There's probably just way too much information to narrow down my questions.

But first off, I would like to get back to Chris' point and making sure I fully understand the drought fund that had been created.

And, in fact, what is the total borrowing capacity under the Economic Recovery Bonds?

MR. GENEST: There's none left now. We started as 15.

COMMISSIONER PRINGLE: So the total amount was 15?

MR. GENEST: $15 billion.

COMMISSIONER PRINGLE: We've borrowed all $15 billion; right?

MR. GENEST: We have now. And we've paid back a lot of it. I don't know exactly how much. But paying it back doesn't mean we can go borrow more. It's a sinking fund. We can borrow the 15 and we're done. So we’re done with that.

COMMISSIONER PRINGLE: But is it $9 billion or $10 billion that's still -- that we have not repaid?

MR. GENEST: I'm not sure, I think it might be a little less than 9 or 10. I don't have that number.

COMMISSIONER PRINGLE: So what is the general-fund cost to those dollars?

MR. GENEST: When we first did it, it's a quarter cent on the sales tax. And the way we did it, it ends up costing money in the education budget. It's complex. And it was worth about $1.5 billion.

Now, with the slumping sales in the state, it's not $1.5 billion; it's probably more $1.4 billion,

$1.3 billion, something like that, per year.

COMMISSIONER PRINGLE: So the general-fund cost of that remaining $9 billion is $1.5 billion?

MR. GENEST: I'd probably call it $1.3 billion at this point. I don't have the exact number. It's less than $1.5 billion now.

COMMISSIONER PRINGLE: Okay, I was actually thinking it was more than that; not only in terms of what we owe, but what we’d pay out of the general fund for those dollars. But I guess my point is that that is a cost to the general fund that otherwise would be in this two-year cycle, dollars that would be scored twice?

MR. GENEST: Right.

COMMISSIONER PRINGLE: In the 2009-10 and --

MR. GENEST: Well, for example, if we hadn't done that, instead of cutting $15 billion out of state spending, we could have only cut 13 and a half, because we would have had that one and a half in there.

COMMISSIONER PRINGLE: Right.

Could you go back to the one chart, which seems a little confusing to me on page 6, please?

Now, I get what this says. This says if somehow Proposition 1A's spending cap was imposed in 1998, this is what we would see; right?

MR. GENEST: The dark lines, yes.

COMMISSIONER PRINGLE: Is there this chart going forward?

MR. GENEST: No. We're working on it, but it's a little difficult because of the way the spending proposal works, the budget-reform proposal works. Before you know how it works going forward, if you project a problem, you have to also know what the solutions are, because it will work differently if your solution is all taxes or if your solution is all cuts. So modeling it forward is pretty difficult.

COMMISSIONER PRINGLE: So if it's all taxes, it raises the cap is what you're suggesting?

MR. GENEST: Right. The cap goes up if you raise taxes.

COMMISSIONER PRINGLE: Right. So the spending level would go up under that scenario; otherwise, you're living within the spending cap itself if you just rely on cuts, predominantly; is that right?

MR. GENEST: Right. And when you ask the question in a future downturn, can I take money out of the rainy-day fund to soften the blow of the downturn, you have to know what the inflation in population-adjusted figure is from that first year --

COMMISSIONER PRINGLE: I'd be surprised, though, as smart as you are, Mr. Genest, and that of your department, that you don't have modeling. I mean, I just all of a sudden saw the budget modeled in 2014.

I would assume you have assumptions every single year. So I would assume I would be able to -- somewhere in the dark recesses in the Department of Finance, I'm sure there is some model done that shows really what the spending cap would be based upon all assumptions -- not the Legislature raising taxes in the future but based upon the assumptions that you made in projecting a 2014 budget?

MR. GENEST: Well, we don't really -- we don't have the model. It doesn't exist. We are talking internally about how to do it, but there are these mechanical problems.

One of them is, if you're projecting future revenues based on long-term trends -- say, 5 percent or whatever the long-term trend is -- which is what we do when we get out a little distance -- then there's no variation in your projection. And, therefore, there's no excess revenue going into the rainy-day fund.

COMMISSIONER PRINGLE: So, you see, I would like to see it, because I don't understand -- I understand that K-through-12 education is exempt from the spending cap; is that right?

MR. GENEST: Proposition 98 is unaffected, yes.

COMMISSIONER PRINGLE: So Proposition 98. And with 1A and 1B, the maintenance factor is reestablished under 98; is that correct?

MR. GENEST: Well, as I said, it's different than the maintenance factor in that it's sort of like the maintenance factor on an easy payment plan.

COMMISSIONER PRINGLE: So the cuts that were made this year would be reestablished under the maintenance factor, therefore, 98 would grow based upon that reestablishment of those; is that correct?

MR. GENEST: Right.

COMMISSIONER PRINGLE: And then 1C basically also puts all the Lottery funds -- the billion dollars a year that's been historic since 1992, I think, is about when they were at a billion, and they stayed that way, give or take, ever since -- that would put that billion dollars under 98, too; is that right?

MR. GENEST: That goes into the 98 account, yes.

COMMISSIONER PRINGLE: So we know that we would get a pretty good understanding of what K-through-12 spending would be; right?

MR. GENEST: Yes. But even then, it's dependent upon assumptions which we make. We make the assumptions. We project it out, they could be up or down, we don’t know.

COMMISSIONER PRINGLE: Sure. And all I'm saying is that I would really like to know, even with the spending cap imposed -- and I'm a big fan of spending caps that work -- that it would be interesting to see the divergence of where we may be even under this spending cap with those elements as a part, and one of which is Prop. 1C, just so I understand that a bit.

The borrowing that you have listed in the available funds that would be brought forward under one of the first charts, you said, "How We Solved the Budget Deficit," so there's borrowing in the 2008-09, which is relatively insignificant, $268 million. So the $5 billion -- 5.1 in 2009-10 is mostly reliant upon the Lottery borrowing?

MR. GENEST: $5 billion is Lottery, and 135 is some other internal types of borrowing.

COMMISSIONER PRINGLE: Therefore, the assumption is made that all of the $5 billion available on borrowing against the Lottery would be available in the next fiscal year; is that right?

MR. GENEST: Yes, except we think it's more than $5 billion. It depends on how many years you want to securitize and it depends on what trajectory you assume we can get to in terms of increased revenue.

We think you can --

COMMISSIONER PRINGLE: Or what someone else thinks, because it's not based upon what you're willing to sell it at.

MR. GENEST: Right.

COMMISSIONER PRINGLE: It's based upon what someone's willing to buy it at.

MR. GENEST: Well, the reason we're comfortable with the $5 billion -- we actually think we could conceivably do another $5 billion in the next year. We haven't programmed that in or decided to do it, but we think there's room. The reason we're comfortable with the $5 billion is even if we don't grow the Lottery revenue stream at all, it securitizes out easily at $5 billion, the existing revenue stream.

Now, we actually think we're going to grow it fast enough to cover that, and maybe even faster. But, you know, we're going to need a little experience with it before you can go to the market with the next tranche. We think this tranche is easily justifiable under normal conditions.

COMMISSIONER PRINGLE: On the current $800 million to $1 billion annual return?

MR. GENEST: Yes.

COMMISSIONER PRINGLE: I see. So if 1C did not succeed, it would be this $5 billion hole would be there; is that right?

MR. GENEST: Right.

COMMISSIONER PRINGLE: And then the rest of the elements -- I think I understand 1D and 1E, because those are raw dollars you're taking from other programs and other revenue streams.

But could you tell me under 1A and 1B, if those did not pass, what the economic impact would be in the next two years?

MR. GENEST: Under 1A and 1B?

COMMISSIONER PRINGLE: Yes, in the next two years.

MR. GENEST: There wouldn't be.

COMMISSIONER PRINGLE: Okay.

MR. GENEST: In the next two years, neither one of those has an effect directly in the next two years.

COMMISSIONER PRINGLE: Okay, that's what I had thought. We understand the elements of the trigger in 1A or the trigger in the tax increases that would come about under the passage of 1A. But under 1A and 1B, you don't see any immediate shortage from the general fund?

MR. GENEST: Not a shortage.

I should mention, if we're all surprised and revenues grow really dramatically in the next two years, which is possible, then 1A would take some of that revenue and put it in the rainy-day fund. That would happen.

COMMISSIONER PRINGLE: That's one I wouldn't really hold my breath on.

MR. GENEST: I'm not holding my breath, unfortunately.

COMMISSIONER PRINGLE: Thank you, Mr. Chairman.

CHAIR PARSKY: Just to follow that one and see if we can relate the comment you made to George and the comment here; I know you haven't projected out, but if you look back at this Impact of Budget Reform chart, I want to make sure that you were clear about the impact of a prolonged downturn/recession on that chart. If that were to occur, how would those lines look?

MR. GENEST: Well, they would just go down. I mean, there's no --

CHAIR PARSKY: But together or --

MR. GENEST: You mean, historically, if there had been that, or in the future?

CHAIR PARSKY: No, let's just say all of that was in place. The current tax system is in place. That's what these lines project.

MR. GENEST: Right.

CHAIR PARSKY: And we don't make any changes. This commission basically steps back and says, "We don't need to make any changes." I just want to make sure -- I thought one of the things you were saying is that the reforms, without changes in our revenue system, would create a problem if, for two years, three years, the economy didn't recover, under the current system would create a much bigger problem.

Is that not what you were suggesting or --

MR. GENEST: You mean, the budget reform? No, I don't think it would create a bigger problem.

If, heaven forbid, the economy stays down and goes down even farther for several years, I don't think budget reform is relevant, I mean, at that point. I think at that point, you're just into doing the best you can.

Now, had you had budget reform in effect, you may still have some reserve to fall back on.

CHAIR PARSKY: Right. But we can only talk about what may be in place now going forward and what we should be recommending, on whatever contingency we want in terms of where the economy may go.

MR. GENEST: I think I have some hope that the other parts of the charge of the Commission can yield some fruits.

CHAIR PARSKY: Right.

MR. GENEST: In other words, maybe we can improve the business climate or you can recommend something we can adopt or the Legislature can adopt and improve the business climate and turn the tide.

I think there's certainly an argument that we were going into this budget a relatively high-tax state, depending on whether you measure it by per capita or by the percentage of personal income.

On a percentage-of-personal-income basis, Mac Taylor, the Legislative Analyst, said we're 14th in the nation. On the other hand, he said we're very close to the median, even though we're 14th and not 25th.

I think with these changes, we're certainly higher than 14th, and I don't think we're very close to the median anymore, unfortunately. So if there's something that can give us the same revenue but with lower marginal rates and better impact on the economy, that would be a ray of hope, I think, for the scenario of a bad revenue picture for the next several years, to hopefully turn that around. And that may well be what we're facing. I don't know.

COMMISSIONER BOSKIN: In view of our competitive discharges, it’s worth adding to your statement of where we are, we're at the top of our marginal income-tax rates, personal income-tax rates, and state sales-tax rates.

MR. GENEST: Right. And I don't mean to -- I mean, I've listened to the Commission and, of course, I've read a lot of economists, like we all have, and I think it's generally agreed that the broader-based, lower-rate tax system is the best way to go for a lot of reasons. And that's clearly not where we are.

We may, in fact, on a per personal-income basis have been near the average; but at the margin on those three taxes, we were way over the average.

COMMISSIONER BOSKIN: Can I just ask one technical question? I'm still a little confused on how all this works if it passes. And there's two parts to the question.

If we had had this in effect, the Legislature, in effect, signed by the Governor, your presumption with these lines is, they would have refrained from a sizable amount of spending that we now have on the books --

MR. GENEST: Right.

COMMISSIONER BOSKIN: -- and is in our baseline.

MR. GENEST: Well, and I think it's a reasonable presumption because the Legislature can't actually spend more than it has. And if you look at history, with one or two exceptions, they haven't actually spent more than they had.

What they did was, they spent more than they had a reason to believe they would continue to have. And so they raised the base to a point where they had to do something about it later. And I say "they," legislatures, governors, it's been a pattern.

So it's not so much that we think -- it's not so much that the problem is the Legislature spends more than it has; it's a matter of how much of that money stays on the table to be spent. Because if it's on that table, it will get spent.

COMMISSIONER BOSKIN: Okay, so now what if this is going along and we have a little bit of a rainy-day fund and we have some good growth years and there's a little bit of it swept into the rainy-day fund, and the Legislature, for whatever reason -- demography, their views about policy, et cetera -- decide we should spend more. What does it do?

MR. GENEST: They would have to raise taxes to do that.

COMMISSIONER BOSKIN: That’s right. So they could raise taxes, right? Okay.

MR. GENEST: Assuming they could get a consensus.

COMMISSIONER BOSKIN: And counterfactual to what you said earlier was, they could have raised taxes if they needed to, to spend more if they desired to. That's kind of -- we don't know what they would have done. Your assumption is they would not have got -- and certainly, because it's difficult to raise taxes because of the two-thirds rule, they probably would have had some constraints on explicitly raising taxes. But they might have raised taxes as well in the previous year?

MR. GENEST: That's right. We could have modeled it that way, yes.

MR. BOSKIN: All right. So I'm just trying to get an idea. There's sort of a lot of variables floating around. And you've chosen the -- kind of the "they spend whatever's in the bucket" kind of idea?

MR. GENEST: Right.

COMMISSIONER BOSKIN: All right.

CHAIR PARSKY: Bill?

COMMISSIONER HAUCK: Thank you, Mr. Chairman.

There's a lot of information, Mike. And I'm no expert on any of this. But I want to back up out of these numbers to the question George asked you earlier related to a multiyear financial plan for the State.

The way I see this process right now, the Legislature, once a year, enacts a budget which they know 30 seconds later is out of balance, and they don't look at it again for about 12 months.

When you have a hundred-billion-dollar-plus general fund, I don't know any other entity, public or private in the world, that approaches spending and revenues in any kind of enterprise that way. It seemed to me, given the volatility of the economies of the world today, that that's an impossible proposition; and I think that's partly why we got into the kind of trouble that we're in, in addition to spending what we'll call nonrecurring revenue, revenue which we knew it was not going to continue.

In fact, I'd give Governor Davis credit for proposing a budget, particularly when we had the $12 billion dot-com capital-gains windfall, let's call it. He initially proposed the budget that did not propose to spend that, you know, all on ongoing programs, and three months later he let the Legislature change that. I think that was a real mistake. And then on top of that, we had the energy crisis, which people seem to forget, but that is still costing us an awful lot of money.

To me, at least on the budget side, a multiyear plan or a multiyear budget which provided for review of spending and revenues in much shorter time periods -- say, three months, four months, five months, even -- where, if it's out of balance, you require the Governor to propose a rebalancing measure, and you give the Legislature a certain amount of time, maybe use the 45 days that's in Prop. 58 to act; and if they don't act, you give the Governor some authority to reduce spending and perhaps use some reserves to rebalance the budget. It seems to me that if you have a system like that, you would never get to the point -- or you shouldn't ever get to the point -- where you're so deep in a hole that politically you can't get out. And that's exactly where the Legislature and the Governor found themselves, it seems to me, this year. A $42 billion budget is not going to result in any acceptable political solutions. I mean, that seems -- I mean, that's the way I would summarize the points that you've made today.

I mean, do you agree with my premise? Do you see the need for a multiyear budget or a multiyear budget plan with much shorter review periods and much -- and rebalancing in much shorter periods of time?

MR. GENEST: Well, it's hard to deny. It would be a good idea, in my opinion, to have that.

We're not as far from that, though, as some might think. Proposition 58, which you mentioned, was used three times since September when the Governor signed the budget.

Now, it didn't do any good the first two times, but at least it laid the groundwork for the third time. The third time's a charm, I guess.

COMMISSIONER HAUCK: But Prop. 58 doesn't have the kind of teeth in it that I'm speaking of.

MR. GENEST: No, it doesn't. And I think that would be a good feature to have those kind of teeth.

However, this budget reform proposal does have a midyear reduction authority associated with it. There is a statute that was enacted last September which allows the Governor, in a fiscal crisis, to cut all state operational budgets by up to 7 percent, and to suspend the action of any cost-of-living adjustment or to take the cost-of-living adjustment back.

In some years, that would give the Governor the ability to trim spending by a couple of billion dollars, general fund, which isn't as much as we lost, but it would be a good start. And that statute does not take effect until and unless Proposition 1A is enacted.

So with that, and with Prop. 58, the ability to call a session, you're getting closer to what you're talking about. I don't think it's exactly what you're saying. But the elements would be there with 1A and the statute that's laying dormant at the moment and the existing provisions of 58.

COMMISSIONER HAUCK: Okay, and then just one other question or point backing up on 1A and the tax increases. It's my understanding, at least, that the tax increases that are in 1A are, if 1A passes, they are good for four years; if it does not pass, they're good for only two years; is that correct?

MR. GENEST: Yes. It's only one specific tax increase. This chart, page 9 shows that. It says “0.25 Percent PIT Rate Add-on.” That is actually two 0.125 PIT rate add-ons. And we combined them here together on the assumption that 1A is enacted. And then you see they are in effect for a full three years, and they drop off later.

They would only be in effect for two years, both of them, if -- I'm sorry, that is subject to the trigger, I had that wrong.

The trigger piece goes away if there is $10 billion or more of offsetting federal stimulus money.

The other pieces here are all assuming -- all these other proposals assume that Proposition 1A is enacted. And there is a variation of what happens if it's not enacted.

COMMISSIONER HAUCK: Does everybody understand that?

MR. GENEST: Well, I actually have a list of the specific things. It would take me a moment to get them out.

COMMISSIONER PRINGLE: Is it all of them?

MR. GENEST: Then I’m going to my list unless Phil knows off the top of his head.

COMMISSIONER PRINGLE: Well, but just "yes" or "no," though? Is it all of the increases that would only be a two-year life as opposed to a four-year life?

MR. GENEST: No, it's more complicated than that. It's variable.

The one-cent sales tax -- Phil, help me out. It's not contingent; is it?

Let me see.

Yes, the one-cent sales-tax if the budget reform is not approved, if 1A is not approved, then it goes out of effect on June 30th of 2011.

COMMISSIONER HAUCK: So that's two years.

MR. GENEST: Otherwise, it goes until June 30th of 2012.

COMMISSIONER PRINGLE? So the income tax and the sales tax which are the principal increases here --

COMMISSIONER PRINGLE: And VLF.

COMMISSIONER HAUCK: And VLF are two-year increases unless 1A passes. If 1A passes, they're four years?

MR. GENEST: The sales tax goes from --

COMMISSIONER HAUCK: You have it here for four years.

MR. GENEST: Well, it's partially also because these are fiscal years.

COMMISSIONER HAUCK: Right.

MR. GENEST: And the income tax is on a

calendar-year basis.

Do we have the list or do you have the list?

DR. SPILBERG: I believe that what it is, is that on the personal income tax, the surcharge would be just if 1A does not pass, it will be just for two years; otherwise, it's three years. On the sales tax increase, it would also be for two years if 1A does not pass, three years if it does pass. And the VLF would be in place longer if 1A passes than if it doesn't pass.

COMMISSIONER HAUCK: Okay, well, I think that answers the question.

So, I mean, if 1A doesn't pass, your forecast here with respect to the State's budget position is considerably worse under those circumstances; correct?

MR. GENEST: Oh, absolutely, yes. And that, I'm clear of.

COMMISSIONER HAUCK: I thought you might be.

CHAIR PARSKY: John?

COMMISSIONER COGAN: So, Mike, the way you think about what the Governor and the Legislature have offered the voters is, if you want a rainy-day fund, you've got to accept the tax increase and some spending increase for education, essentially; right? That's kind of the political compromise?

MR. GENEST: I think those are the components of it. I don't want to presume what he's telling the voters, but those are the elements of it; right.

COMMISSIONER COGAN: Okay, all right.

First, Ruben, you asked about the Colorado limitation. One provision in the Colorado limit or cap on spending, which I found interesting, was that the excess revenue would be rebated automatically back to the people. And they had a schedule, as I recall, where low-income individuals got the money back first, and then it went up the income ladder. And it was valuable in one respect, and that was that you didn't end up with this pot of money building up and becoming more of a temptation over time. The money quickly and automatically went out of the treasury.

On the other hand, when the 2001 recession hit, there wasn't any pot of money around. And that was ultimately the undoing of the proposition. And as I recall, the political debate was really around education cuts as being really what drove the voters to say, "Let's suspend this for a while."

On this drought fund, Mike, I have a question for you.

How much outstanding debt does the state have now, total general-fund obligation debt out there now?

MR. GENEST: Well, for G.O. bonds and including

Lease-Revenue Bonds, I probably have the number written down here somewhere, but it's on the order of 50-or-so billion.

COMMISSIONER COGAN: $50 billion?

MR. GENEST: In that general area.

COMMISSIONER HAUCK: In annual debt service.

MR. GENEST: But then for the Economic Recovery Bonds, it's probably, I'm going to guess, 7 or something like that.

COMMISSIONER COGAN: Right, right. So $50 billion, roughly, would be a subpart?

MR. GENEST: I can actually get the correct number.

COMMISSIONER COGAN: That's all right. I just want to get a general idea to make a point.

$50 billion, and then we now have $7 billion in addition to that.

If you add on top of that the State unfunded liability for pensions, what would that be?

MR. GENEST: Well, the unfunded liability from pensions, when we had the pension commission, was more or less under control -- what was it, around -- it was in the high eighties as the part that was funded. So it was in the low teens or so, the unfunded amount.

The performance of the stock market recently has probably changed that. I don't think we've seen new actuarials on it. But I've got to believe it's terrible at the moment.

COMMISSIONER COGAN: Right, right.

And then, of course, we have unfunded retiree health-care benefits for state workers.

MR. GENEST: Right.

COMMISSIONER COGAN: And I can't remember, Mr. Chairman, what the estimate was.

CHAIR PARSKY: That amounted to, I think, $47 billion, not including UC.

COMMISSIONER COGAN: Right.

CHAIR PARSKY: And then probably another $11 billion, including UC, at the state level.

COMMISSIONER COGAN: Right, right.

So the point here is, it seems to me, before we start going down this road of having a drought fund that might go alongside of a rainy-day fund, we should recognize what the consequences of having borrowing authority to a legislature is, and it's a recipe for higher spending and unfunded liabilities.

So, Mike, on your report to us -- and thanks very much for coming by -- I have a question about Prop. 98 and the rainy-day fund.

On page 3 of your presentation you have some numbers on education. And I thought you said at one point that you have managed to -- did I get the right page?

Yes, expenditure solutions. I guess part of that is education?

MR. GENEST: Right.

COMMISSIONER COGAN: I thought at one point you said you had a $7 billion problem that you managed to get down to a $2.5 billion problem. Could you elaborate on that?

MR. GENEST: I'm not sure I can remember all of the components. But the Proposition 98 guarantee is one step. And so one of the things we did was, we deferred a payment to the schools from late 2008-09 to early 2009-10. So that took the funding out of being counted against the guarantee, so it dropped the guarantee. But the schools got the money within a similar time frame, just a few months late.

COMMISSIONER COGAN: I see.

MR. GENEST: So that helped buffer -- because they still had the same -- really, the same amount of money. But the amount that was going towards the guarantee for 2008-09 went down.

There is also something called *“settle-up,”* which we had budgeted, which is general-fund money. And it is for Proposition 98 debts that we owe from the past, where we inadvertently -- truly inadvertently -- just didn't appropriate enough. And so you accumulate those deficits. And at some point, you pay for them. It's a one-time payment.

So what we did was, we took a portion of the guarantee money for 2008-09, and said instead of using that for a guarantee, we're going to move that into the category of settle-up. So we reduced the guarantee, but the schools still got the money. So there's a difference between reducing the guarantee and reducing the overall budget.

COMMISSIONER COGAN: Right, right.

MR. GENEST: There were a few other things of that sort that we did.

Plus, we gave the schools a lot more flexibility in how to use their categorical funding stream, so that they could move money around to accommodate the loss.

COMMISSIONER COGAN: So if I were to ask you the Prop. 98 applied would have resulted in what kind of cut in education again?

MR. GENEST: If we hadn't done any of those things to ameliorate it, it would have been around in the mid-seven-billion-dollar range.

COMMISSIONER COGAN: $7 billion.

MR. GENEST: Actually, it may have been in the high sevens.

COMMISSIONER COGAN: Right. And then because of the changes you were able to make, the cut ended up being --

MR. GENEST: We think the effective cut was about $2.5 billion for 2008-09.

COMMISSIONER COGAN: For 2008-09? Okay.

And that's all current year?

MR. GENEST: But that does mean -- the importance of cutting the Proposition 98 portion of the appropriation down to what the guarantee requires and no more, is that that forms the base going forward for a period of time. And that did save money out in the future, substantial amounts.

COMMISSIONER COGAN: Right, right.

But I guess I'm wondering, where does the $4.5 billion difference, let's say, between $7 billion and $2.5 billion --

MR. GENEST: Well, I told you the two components that I recall off the top of my head, which is the settle-up and the deferral -- and there is another component, I just can't recall it. I'd have to go look in my notes. But it adds up to the difference.

COMMISSIONER COGAN: Okay, all right.

I guess what's bothering me, here we have a constitutional provision that says the State shall reduce education expenditures by $7 billion, or whatever it is. That's sort of what Proposition 98 as literally applied would say.

MR. GENEST: I wouldn't say that.

What Proposition 98 does, is it establishes the minimum funding level. It doesn't establish the maximum funding level.

COMMISSIONER COGAN: Right.

MR. GENEST: That's at the discretion of the Legislature and the Governor.

COMMISSIONER COGAN: Why did then the State allow for, in the unusual circumstances that we're in, under Prop. 98, to not restore the spending automatically, which is what I thought you had said? That is, the maintenance is waived. Is that so the rest of the budget doesn't get devastated by a recession? That is, that education has to share in the total; is that why they did that?

MR. GENEST: Right. I guess that would be one way to characterize it.

You try to put the whole thing together so it sort of holds together. And if we allowed the Proposition 98 maintenance-factor formula to be in effect -- and, by the way, I don't think it was, so I'm not sure that that was really an option, I guess we could have been sued and then settled and agreed to lose; but I don't think the Constitution said that there really was a maintenance factor created. But there was no agreement on whether or not Prop. 1B simply comes in and says, "Regardless of what it used to be, here's what it is now," and it goes on to an easy payment plan instead of into this harder-to-finance maintenance-factor formula which, in our opinion, wouldn't have applied, in any event.

COMMISSIONER COGAN: Right.

MR. GENEST: I think the point of Proposition 1B in the whole scheme of the budget, is that the Governor and the Legislature felt that the hit to education was really strong. And even though they didn't know exactly how to deal with it in the short run, they wanted to get the money back into the education budget over time. Regardless of whether it was constitutionally required or not, Prop. 1B comes in and says it is required, but we're going to do it slowly.

COMMISSIONER COGAN: Got it. Got it.

And then as we go out into the future now with a rainy-day fund, you said that Prop. 98 would still be in effect, so education would still get its money.

And then the amount of money that goes into the rainy-day fund would be what's left over after education has been taken care of; right?

MR. GENEST: Right, right.

COMMISSIONER COGAN: Good, good. And then --

MR. GENEST: Well, except for -- well, even with the trend -- if we were above trend, yes.

COMMISSIONER COGAN: Yes, if you were above trend.

MR. GENEST: Right.

COMMISSIONER COGAN: So there's no impact on Prop. 98, really, as you're out in the long term. Proposition 98 doesn't have its funding, education doesn't have its funding reduced when we set up this rainy-day fund?

MR. GENEST: No, the rainy-day fund does not cut Proposition 98. You could argue, and I think the Legislative Analyst's ballot pamphlet does argue that the combination of 1A and 1B increases the amount that education would get. But that's on the theory that we didn't have to pay them to begin with. And I actually agree with that theory, but that was never decided legally.

COMMISSIONER COGAN: Right, right. Okay, good.

And then on withdrawals of the rainy-day fund, just to make sure I understand this, if the fund gets above 12½ percent, then how can the money be used?

MR. GENEST: Well, the first call on it after it's over the amount, is to pay off budgetary debt, like the Economic Recovery Bonds. Or I don't know if we still owe some money to the road funds. But whatever those kinds of -- we certainly did just borrow $268 million from special funds in this last budget, plus a little more in the 2009-10 year. So we would be paying that kind of budgetary borrowing back.

COMMISSIONER COGAN: Right.

MR. GENEST: And then after that, it gets used for infrastructure. You can use it for tax cuts. One-time kinds of things.

COMMISSIONER COGAN: One-time things? Good, all right.

MR. GENEST: Or you could leave it in the reserve and just have a bigger reserve. That would be up to the Legislature to decide that.

COMMISSIONER COGAN: Right, okay.

And then on the stimulus package and its effect on the budget, you mentioned that there were some strings with respect to Medi-Cal that the federal government had attached to the money.

Are there any other strings in other programs that you're aware of that would affect the ability of the State to get the money?

MR. GENEST: I don't think so with respect to the portion of the stimulus that's likely to count as a general-fund offset.

There are some other areas. I think our legislative group has come up with about four statutory changes that they feel are urgently needed in order to get all of the federal money. But I think there's only the one that's directly related to the part that offsets general-fund costs.

COMMISSIONER COGAN: Okay, good.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

MR. GENEST: Oh, excuse me, you know what? I need to clarify that there's one little piece of that, since we're sitting here at the university. There was some federal money that would have come to the State one way or the other. It either would have gone to local school districts or community colleges, that's one thing it could have done; or if we had reduced our University budget by a certain amount, it could go to replace that reduction. The budget actually made that reduction so that the federal money would flow to the benefit of the budget.

We don't regard that as being for the purposes of offsetting the general-fund cost because that's in the budget. We're working from the budget document and moving forward.

COMMISSIONER COGAN: Got it.

MR. GENEST: Offset from the point of enactment of the budget on, not looking backwards, right.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you.

Mr. Genest, good morning. You used the term "budget reform" in reference to 1A. And I think there's folks who would agree, and I would agree, that there is a substantial element of budget reform in 1A. Among other things, I think that are very positive, is that it would reduce to some substantial degree the revenue-volatility questions that have been in front of the Commission over the last several months. And it is at least a significant, if not an entire solution to that problem. It's a significant step towards addressing that issue of revenue volatility, as revenue volatility to the degree that it is a problem in the budget, this helps reduce that in the budget.

I do think, however, that when people speak about budget reform, at least the contemporary conversation in California includes many other aspects as well. And some of them have come up here today. There's some conversation about multiyear budgeting that comes up, there are issues about the budget process itself which are raised, not the least of which is whether or not the two-thirds vote requirement deserves examination; and if so, what kind of solution might come out of that.

So I imagine that the Governor does not believe that budget reform consists of 1A exclusively; that there are other elements which are necessary in order to achieve budget reform.

Would you agree with that?

MR. GENEST: Probably. He, for example, is supportive of the proposal that was put on the 2010 ballot for open primaries.

And I think he is in favor of that partially because he thinks some of our budget problem that we have today is because the Legislature has become so polarized. And he feels that that might allow for some -- you know, a little bit more moderation and blending. So I suppose you could call that a kind of budget reform.

And he's spoken in favor of other concepts. But it's one thing to sort of mull things over and to have some proposals. He's had prior proposals. Proposition 76 was a Governor Schwarzenegger proposal. Proposition 58, as he originally envisioned it had, as I think Bill Hauck said, a lot more teeth than what we ended up with. So he's been working on the overall question of budget reform for a long time.

I think the Governor is very happy with this particular piece of it.

Is this the end? Maybe not, but it's what we have right now.

COMMISSIONER KEELEY: Right, thank you. I agree that it is. It's hard to argue whether it's what we have right now or not. Of course, it's what we have right now. But I do think that in the contemporary conversation, there are many other aspects; and I think this is one, and one important piece of that.

Earlier in the conversation, in an exchange -- I believe it might have been with Commissioner Boskin, I believe -- that there was a bit of a back and forth about where California ranks in terms of tax burden and that kind of thing. We've been over that ground. It seems like we're destined to go over that ground every single time we meet; and then we discuss whether that's a total tax burden, whether that tax burden -- which particular taxes get included in that issue, what the effects of those tax burdens might be on the business climate and so on.

I do know that Commissioner Barrales and I had an opportunity to visit the Silicon Valley Leadership Group at their invitation a couple of weeks ago. And it was within days after the adoption of the budget.

And I know that in that conversation with them, that although heroic efforts went into putting this budget together so that everyone was mutually dissatisfied with it and able to then adopt a budget, that there was not a lot of cheering about what that did relative to California's position in competitiveness and so on.

I know that a number of the business leaders that we met with, although they were happy at some level that there was a budget, the idea that California, with regard to K-12 and higher education, where that put us relative to other states and the reliance on business in California of the public education system, both K-12 and higher education, that there was no celebrating in that room about what that trend line looked like for California relative to the other states with whom we compete.

I think that that's a fair statement. I think it is also fair to say that the business leaders with whom we met were also not satisfied that what was contained in the budget relative to either taxation or spending gave them a lot of reason to be in a celebratory mood, and that it may be that this commission has an awful lot of work still left to do in that regard.

And I will tell that you at least I didn't detect that the business leaders with whom we met felt that tax increases were necessarily the enemy of competitiveness. It depends on which taxes, for what purposes, restructuring the tax system for what purposes, towards what end, managing towards what objectives were of equal interest to them to the overall tax-burden question.

And so the reason I want to raise that is that I feel duty-bound every time we go into this territory at these meetings to point out that the rankings issue, about where California ranks in terms of total tax burden, oftentimes we are competing with states in that ranking who rank better, if "better" means less. And, you know, some of those states are relevant and some of those states are irrelevant in terms of ranking with us in our comparison.

If you're a monocultural economic state -- meaning, that your state's economy hasn't changed in 175 years because it is basically an agricultural state and it hasn't changed in 175 years and it isn't going to change in the next 175 years, then how that competes with California in terms of a ranking may or may not be relevant.

It may be more relevant to compare us to states who have even anything approaching the mix of economic component parts that our state has. So if you are New York, Florida, Ohio, or other large states with complex economies, that might be a more relevant comparison.

Let me ask this question about school deferral funding. It is something that I think is worth examining. The deferral, as I understand it, the apportionment is a three-month deferral; is that correct?

MR. GENEST: I think that's right. I don't have that in front of me, but it sounds about right.

COMMISSIONER KEELEY: So the county offices of education and the school districts receive apportionments from the State which, among other things, is property taxes coming up and going back down based on a formula and so on, and revenues that are due to the school districts and to the county office of education.

When the Legislature and the Governor agreed upon a deferral strategy, the school districts are now left to figure out how to deal with their ongoing expenses between the time they would otherwise receive those apportionments and the time the apportionments arrive; is that correct?

MR. GENEST: Right.

COMMISSIONER KEELEY: Okay, so the school districts are now trying, in many instances, to shift the risk of the deferral, which they have now assumed that risk; they have a risk. And it is that the State has essentially handed them an IOU: We owe you an apportionment. We were supposed to pay it in April. We're now going to pay it in June. We're going to pay you in May, we're now going to pay you in July. We were going to pay you in June, we're now going to pay you in August on those deferrals, as I understand it. And they have now assumed that risk, and they are looking to shift that risk and seeing if they can monetize somehow those IOUs.

They go to people like me, county treasurers, and ask if we will accept the State's IOU and give them cash and step into their shoes and assume the risk that's been shifted to them.

I understand how that helps the State in terms of the State's budget. I'm not as clear how that doesn't seriously affect the school districts and legally how they can -- unless they can monetize that IOU –- how it is those folks can do anything in April, other than lay off teachers because of the legal requirement to notify teachers whether or not they're going to have a job. And if you've deferred payment and handed them an IOU, how they can do anything except lay off teachers.

Is that the situation they're left with?

MR. GENEST: Well, I think given the nature of the budget, there will have to be teacher layoffs. And I've heard about them up and down the state already being planned and implemented. I just think that's the way it is.

The other way to look at that deferral is the alternative to it, constitutionally, would have been simply to not give them the money at all.

COMMISSIONER KEELEY: Right.

MR. GENEST: And that was a decision the Governor made initially and the Legislature agreed to on the basis that he felt that was too draconian a cut, even though it was constitutionally permitted.

COMMISSIONER KEELEY: Right.

MR. GENEST: Or as Mr. Cogan said, maybe even required. I don't think it was quite required, but we certainly had every right to do that and chose not to. So I think what you're describing is an unfortunate situation. It's kind of a game of shuffling the risk around.

COMMISSIONER KEELEY: Yes.

MR. GENEST: The State stopped making payments all together for months, and we may end up having to do it again if things get any worse, as somebody said they might. So I think everybody is on the hook on how to figure out how to deal with this diminishing revenue. And

I don't know if we've unfairly given some of that burden to various parts of local government or not.

Initially, you may recall, we had proposed a seven-month deferral of certain payments to counties. And we got an earful on that, and we went back and relooked at the numbers and decided we could drop that down to 30 days, maybe longer, but hopefully only 30 days. So there's plenty of pain to go around on this budget, I'd certainly acknowledge that.

COMMISSIONER KEELEY: Right, right.

Let me ask -- and stay with this issue of the deferrals. That's one thing, the deferrals for counties, because counties are essentially your creature. They're a creature of the Legislature and the Governor, and they're your delivery system for health and human services. And if you choose to defer payments to counties as your branch offices out in the state, that's your choice. I'm actually less concerned about that. Even though I'm a county treasurer in my day job, I'm less concerned about that because I think it is the State's -- the State has the jurisdiction to do that. And if that's what they choose to do, their branch offices may not like it; but we're your branch offices in that regard, not somehow a separate part of government, which I would argue the schools fit in a different category.

Did you just say -- and I think you did -- let's assume for a moment that on May 19th the voters -- any single component part, whether it's the securitizing of the Lottery or any of the other elements -- if any one part of this falls out -- and let's assume for a second that it's securitizing the Lottery -- there's a $5 billion hole in the budget. You come out with your May Revise on May 25th, or thereabouts. I know there's at least discussions in Sacramento that that's going to have another five- to ten-billion-dollar hole in it, irrespective of what happens on May 19th.

But on May 25th, there could be something between a ten- to fifteen- to twenty-billion-dollar new hole for the Legislature and the Governor to wrestle with for the 2009-10 fiscal year. And it doesn't seem like people who are observing all of this think that that's unlikely to happen.

Is one of the items on the table further deferral of school payments, school apportionments?

MR. GENEST: At the moment, there's not an item on the table. There is no table.

From my perspective, our planning is that the initiatives or the propositions will be enacted and that our current revenue numbers will hold.

I certainly see the same writing on the wall that everyone else does. The economic news since we did our revenue numbers has not exactly been great. And we have heard that the Legislative Analyst's office, they're always preparing their next estimate, and that's likely to come out relatively soon. And I don't know what it will hold. But for the moment, even if they come out with a negative number, I'm going to defer judgment until we see our new revenue number. Maybe things will have gotten better by then.

So we don't have -- as I said earlier, we don't have a fallback plan. But I can tell you, if things get worse, everything has to be on the table because there's just no room to wiggle, even with everything going the way we expect it to. If things get worse, it's going to be even worse.

COMMISSIONER KEELEY: Thank you.

Thank you, Mr. Chair.

CHAIR PARSKY: Just one follow-on comment. I think all of the commissioners would welcome Ruben in your view of how the Silicon Valley economic community or business community might view our current system of taxation. But I think it's important that the Commission hear from a broad group of the business community before we are finished with this discussion on the impact of our current tax system.

And I, for one, don't think a debate is helpful or not helpful as to whether or not we are a higher-tax system or a lower-tax system. What's important, though, is that whatever we recommend, we pass through the screen that basically says, are we recommending something that has the potential to hurt or help economic growth in the state, and take into account what the 21st century economy will look like. That, it seems to me, all of us need to kind of continue to keep in mind.

COMMISSIONER KEELEY: Mr. Chairman, if I might. A couple of thoughts on that.

I hope you didn't think that what I was trying to do was characterize the opinion of all of the business community in California. I was careful, I think, to say that we were appearing at the invitation of the Santa Clara Valley -- the Silicon Valley Manufacturers' Association which, because there's virtually no manufacturing left, now calls itself the Silicon Valley Leadership Group. And they lead certain things, but it's not manufacturing anymore.

Secondly, I do think that this commission has had in front of it, and we had at the last meeting, a panel of folks who asserted that they represented the business community in many of its very various combinations, ranging from Cal-Tax to the Howard Jarvis

Group, to many, many business organizations. And I recall that they provided testimony which essentially said California taxes business too much, supports business too little, and went on at great lengths for hours. And your admonishment to them at the end was that that was not sufficient. And what they needed to do, if they wanted to provide a positive impact on this commission, was to provide written recommendations to this commission of about how we could -- if they desired that the business climate be improved, how that could be done, and that you wanted positive recommendations from them for action.

I would make an inquiry to you about how many of those entities that you admonished to do that have provided the Commission with such written recommendations. Can you advise us?

CHAIR PARSKY: It's, they're coming.

COMMISSIONER KEELEY: So that would mean none to date?

CHAIR PARSKY: Well, we'll talk a little bit about how we collect the information. The main point --

COMMISSIONER KEELEY: That's fair enough. But to date, they haven't provided any?

CHAIR PARSKY: Well -- and they may not be the only organizations that we want to hear from.

COMMISSIONER KEELEY: No, and we've heard from a lot. But you specifically admonished them to provide us with written material; and a month later, we don't have any; is that right?

CHAIR PARSKY: That's true.

I also admonished another group that presented to us, who basically took a little bit of the opposite point of view, to also come forward.

COMMISSIONER KEELEY: Right.

CHAIR PARSKY: And we haven't heard yet from them.

COMMISSIONER KEELEY: Fair enough.

CHAIR PARSKY: But we will.

COMMISSIONER KEELEY: Thank you.

CHAIR PARSKY: Okay, one more comment and then we'll take a little break here.

But, Richard, you may ask the last question, if you will.

COMMISSIONER POMP: All right, I will try to be briefer than all the preceding speakers combined.

CHAIR PARSKY: I will switch chairs with you, and I would welcome that. That would be good.

COMMISSIONER POMP: And I, too, need a break.

Again, just to pick up, your exchange with Fred on rankings. I mean, Wyoming and South Dakota that always do better than California, should not be our role models in terms of the business climate. And I believe you phrased it as I would: Do we have a tax system that is hurting particular segments of the economy and, if so, what can we do to alleviate that? And that's the meaningful question. Not whether, on some abstract ranking, we're higher than South Dakota.

So I would like to ask some questions on page 9. I will be brief.

You know, the devil is always in the details, but so is Santa Claus. So if we could just go up to page 9.

I guess the next thing I don't understand is, we have a corporate tax 20 percent underpayment penalty that shows a loss of revenue in three years. And I'm just curious -- not much, but why a loss in revenue from a penalty?

DR. SPILBERG: Well, the revenue is coming basically through an acceleration of amounts in dispute that would have otherwise come in, in future years. But it's an ongoing penalty. So in the first year, what you receive is amounts that would have actually been coming in over the next several years. But you then have a continuing acceleration into the future because it's an ongoing penalty. So the reason that you have these reductions is because of the acceleration aspect of this penalty.

Does that make sense?

COMMISSIONER POMP: No.

DR. SPILBERG: Okay, so in other words, if the money is not just coming in from the penalty amount but actually from the principal -- so in other words, people are coming in and paying a disputed amount, and the disputed amount may be, let's say, a billion dollars, let's just say, and there is no penalty, really, involved with respect to that billion dollars that is paid. It's revenue because it's coming in, in that year. However, it is an expectation that during its normal process -- the Franchise Tax Board in this particular instance -- would, in fact, have this kind of revenue come in, in later years, through its examinations.

So to the extent that that money is coming in earlier, it's a revenue in that year, but it's a loss in future years because that same money would have come in but later.

COMMISSIONER POMP: But in the aggregate, it would be a positive amount on this chart?

DR. SPILBERG: Yes, it will be a positive amount on this chart because this acceleration is going to continue to occur because corporations are going to be making payment of these disputed amounts earlier with respect to all future tax years.

COMMISSIONER POMP: So that -5 that I see becomes a +5 in subsequent years?

COMMISSIONER BOSKIN: I don't think that's quite the way to look at it.

DR. SPILBERG: No.

COMMISSIONER BOSKIN: I think the proper way to look at it, if I might intercede for a second, is the $1.4 billion when it was enacted took money that would have been paid over the subsequent few years and moved it forward. And, hence, relative to the preexisting baseline, instead of having numbers like -- so some of this decline and these lower numbers are lower than they otherwise would have been because it was moved forward.

COMMISSIONER POMP: Because it is in the 1.4.

COMMISSIONER BOSKIN: It's already –- it’s front-loaded. It’s a low-interest loan --

COMMISSIONER EDLEY: You've incentivized them --

COMMISSIONER BOSKIN: -- that business provides to the State is what it amounts to.

COMMISSIONER EDLEY: -- is what it amounts to.

COMMISSIONER POMP: Got it, okay. Thank you.

There were things that were changed that I don't see on the chart, and I don't know if that's because they were difficult to cost out or they were considered white noise, but the State has moved to an economic nexus standard. And you would think that's a revenue-raiser. I don't see it here. So why is it not here?

MR. GENEST: Economic nexus standard?

DR. SPILBERG: Oh, that’s it down below, okay.

MR. GENEST: That's the single sales factor?

DR. SPILBERG: Yes.

It's built into that -- that, in fact, is built into the revenue numbers for the single sales factor. The single -- it's farther down on that same table. It's next to the bottom. It's that row of numbers. In it, there are actually more than one provision.

COMMISSIONER POMP: I see. Because single sales factor will have an impact on a company manufacturing here in California for which economic nexus is a totally irrelevant issue.

DR. SPILBERG: Yes, yes.

COMMISSIONER POMP: But yet it's rolled in somehow?

DR. SPILBERG: Right, yes.

COMMISSIONER POMP: I would like to see it rolled out to really get a feel for this. I assume you could do that because you must have it.

DR. SPILBERG: We'll try to get you those numbers.

COMMISSIONER POMP: Okay, and similarly, you're changing cost-of-performance standard to a market or audience factor. Do you have numbers on that?

DR. SPILBERG: That's also that single sales factor. And we'll try to get you those numbers, too.

COMMISSIONER POMP: Okay. The single sales factor, just so I think everyone understands what this means, if I manufacture in California and sell everything outside of California -- all right, so despite my benefitting from the services, the infrastructure of California, despite any costs I might be imposing on California through congestion or whatever, pollution, I would pay no California corporate income tax, is that correct, under a single factor where you assume all my sales are made outside the state?

DR. SPILBERG: Yes, that's right. It is elective under this provision. So if you elected to be taxed in that fashion and all your sales were outside of California, you would pay no income tax in California.

COMMISSIONER POMP: The election, of course, makes it even worse in terms of a revenue impact?

DR. SPILBERG: Yes.

COMMISSIONER POMP: So I assume before you made a change that had nearly $800 million and had this really astounding consequence to it, there was a rigorous cost-benefit analysis of what the State was going to get in return for this kind of change?

MR. GENEST: I don't think "rigorous cost benefit analysis" is quite right. I think there was a weighing of some factors that are hard to quantify. But the positive side of this is that it incentivizes businesses to provide high-paying jobs, manufacturing jobs tending to be higher-paid. And not all of these jobs would be manufacturing. But it incentivizes businesses to have their jobs located in California.

COMMISSIONER POMP: That's the hoped-for benefit, although we have not seen that actually be fulfilled in other states have made the change. So I'm just curious about the way things are done in this day. We've heard some amazing things earlier, and now I'm looking at $800 million, really on a hope and a prayer. And I just find that baffling.

MR. GENEST: The single sales factor has been an active issue in other states and in this state for many years, and I don't know that anyone has got scientific proof that it does or does not do exactly what the proponents hoped for it to do.

And certainly there is intuitive reason to believe that there would be positive benefit; whether that’s more than outweighed by the negative revenue loss is hard to say.

As 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. And I think that set of interests got listened to, as did many others.

COMMISSIONER POMP: And there's a lot of people, including the average working Joe, who maybe isn't exactly sharing that conversation. So there's a lot of ways to spend $800 million. And I don't know that this is the most cost-effective way. And what you're telling me is, well, there really wasn't any serious study that this was the most cost-effective way.

I'll say this: If you've looked at the work of organizations like Center on Budget and Priorities out of Washington, you'd have every reason to be rather skeptical and pessimistic that this is, indeed, going to have the positive effects that one would hope in spending $800 million.

But, Mr. Chair, I know you want to take a break, so I can continue after the break.

COMMISSIONER EDLEY: Gerry, I'm sorry, I know you want to stop, but this guy is so handsome and tall.

CHAIR PARSKY: Let's not get carried away.

COMMISSIONER EDLEY: But I'm wondering --

CHAIR PARSKY: He is our executive director. He's available to us totally. And in the afternoon session, he will be available with our staff.

COMMISSIONER EDLEY: Okay.

CHAIR PARSKY: And I would not lay too many compliments on him because it will get out of control.

MR. GENEST: Besides, they're not believable.

COMMISSIONER EDLEY: Okay. Well, I just wanted to ask him the vision question. But we can -- you know, the economic vision, what will the economy look like, does he think. But we can do that later.

CHAIR PARSKY: The vision thing, that's not his thing, generally. But you can ask him, anyway. You can ask him. It's okay.

We have two more very important items that I would like to make sure we cover before lunch. My suggestion is we take a ten-minute break and then we keep going and maybe delay our lunch a little bit. But I promised that we would get these two items covered before lunch. So let's take ten minutes and then come back.

Thank you.

(Recess from 11:47 a.m. to 11:58 a.m.)

CHAIR PARSKY: Before we move on, I just wanted to just make one comment and ask the commissioners to think about something.

First of all, I think the presentation that Mike did, at least from my perspective, was certainly helpful in seeing the interrelationship between the budget reform ballot initiatives and the work that we have been asked to do.

I would just ask the commissioners to think about and let me know if you would be supportive of my requesting of them, in light of this and in light of the fact that we won't know until May whether or not these initiatives will be adopted or not, whether or not the commissioners would support the notion of my requesting of the Governor and the legislative leaders that we extend the date by which our report and recommendations would be offered. That, obviously, would be after the May ballot initiative.

And I'm not a big proponent of postponing things; but, it seems to me, that it's very difficult to make recommendations without knowing exactly what will happen in May. And I certainly wouldn't want our recommendations to in any way be utilized inappropriately in the political process of trying to have these ballot initiatives adopted.

COMMISSIONER HAUCK: So moved.

COMMISSIONER HALVORSON: Second.

CHAIR PARSKY: So is there any objection from the commissioners to that? I would be more than happy to -- I just want to make sure that everyone is in agreement.

COMMISSIONER PRINGLE: Mr. Chairman?

CHAIR PARSKY: Yes.

COMMISSIONER PRINGLE: If I could. I completely agree; and I actually have always felt that the time-line, one may be the time we started, let alone the time we are supposed to end, is way too short. And I'd actually like to hear, maybe in April or in May, whatever the case may be, even more of the level of specific examples or ideas on the table than we have.

And I don't think we can be very well informed on next directions if, in fact, we meet -- you know, we could have an April meeting, but certainly our May meeting should be after the 19th, to be able to understand what palette we are to work on. So I would certainly feel if we were to continue an additional month or two, it would probably have value to me, Mr. Chairman.

CHAIR PARSKY: Thank you for those comments.

My thought to all of you would be that we have a scheduled April meeting. We would schedule -- and I'll try to coordinate it with all of your schedules -- a meeting after the vote of the initiative in May; and then we would put on, if necessary, a meeting in June, and our final report would be done in the last week of June, something like that, if that.

And as I said, I'm not a big one for postponing indefinitely; but I think in that time frame we can have heard some really specific alternatives, and we will be able to take into account the initiatives.

Chris?

COMMISSIONER EDLEY: Gerry, just a slight, friendly amendment to your comment in case there happen to be any journalists present.

I think in our role as commissioners, we ought to be agnostic about what should happen on May 19th. In other words, we're not postponing in order to help win adoption of these. Maybe they should pass, maybe they shouldn't pass. We might have disagreements here about that. But do you see my point?

CHAIR PARSKY: 100 percent. In fact, at the heart of this recommendation is so that this commission and the individual members as commissioners wouldn't take a position and allow the voters to proceed ahead, and then we would be able to come up with some recommendations in light of whatever action was taken.

In other individual capacities, people can express their views; but as a commission, as commissioners, we wouldn't be doing that.

COMMISSIONER COGAN: Mr. Chairman?

CHAIR PARSKY: John?

COMMISSIONER COGAN: Mr. Chairman, on the final date, you might want to think about, to make sure that we would have enough time following the vote in May. So you might want to think perhaps sometime in mid-July or something like that for a final report, just to give yourself a little bit of time to wrap things up appropriately here and not ask for another extension.

COMMISSIONER BOSKIN: And I would just say that the sooner we get that schedule worked out, the better, because people have travel schedules in the summer.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

Mr. Chairman, I completely support the recommendation that you're making. And I think that in addition to the May 19th election, and wanting to understand what happens on that date, about six days later, as I understand it, the Department of Finance will be -- they have delayed -- chosen to delay the date of the May Revise, so that it also comes out subsequent to the May 19th election.

And, Mr. Genest, am I right, that your current target is May 25th for the May Revise?

MR. GENEST: We're thinking more of the 28th and even as late as June 2nd. We haven't nailed it down yet.

COMMISSIONER KEELEY: Have a May Revise in June? Okay, sounds good.

So I think that it might be, Mr. Chairman, in keeping with the spirit of your recommendation, perhaps we should -- if we have the -- we would have the meeting at the University of California Davis in April, because there's a lot of work we can do regardless of what the outcome is. And then we would have a meeting -- perhaps it could take place subsequent to both the election and the release of the May Revise, that we have a June meeting.

So maybe there's no meeting at all in May. We have a June meeting instead, where we can benefit from the outcome of the information that results from the outcome of the election and the May Revise, if that would make sense, Mr. Chairman.

CHAIR PARSKY: Rather than try to address schedules in this meeting --

COMMISSIONER KEELEY: Schedule against those documents.

CHAIR PARSKY: -- I definitely think we need to have a meeting after, at some point after. The only question is, is there work that we could do in May that would advance the cause of our report; but then make sure that we schedule a meeting in June.

COMMISSIONER KEELEY: Great, great.

CHAIR PARSKY: Okay, if that's the consensus -- or I should say unanimity of this group, we'll proceed on that basis.

Okay, let's turn to our next subject. And, Fred, maybe I'll let you introduce our professor who is going to speak to us about energy taxes, carbon taxes, and the federal policy.

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

Mr. Chairman, as you know, at previous meetings of this commission, there has been discussion of a variety of ways to look at the economy of the 21st century. And one way to look at it is that in California, it may be that a combination of Assembly Bill 32, which was enacted by the Legislature and signed into law by the Governor, and at least in my opinion, is the most significant action taken by any state in the union relative to global climate change and putting California on a path to be a serious policy leader in that regard, that a combination of that in California as public policy and what appears to be emerging as a very major component part of a three-part strategy for the Obama Administration with regard to the national economy, and looking at what it might be going forward, that it makes sense for us to hear from Severin Borenstein with regard to his work here at the University of California at Berkeley and the Energy Institute that he heads up here on this campus, relative to the variety of subjects that can be called either carbon taxes or energy taxes or cap-and-trade system, or whatever the variety might be. But they go to what is emerging, anyway, as a body of thinking concerning how we externalize or not the effects of carbon in our economy and in our society.

And so I appreciate it, Mr. Chairman, that you were kind enough to extend an invitation to Mr. Borenstein, who is the director of the UC Energy Institute and has been a professor at the Haas School of Business here for a considerable period of time. And it's a pleasure to introduce him to the Commission today.

Thank you, Mr. Chairman.

Thank you, Professor.

DR. BORENSTEIN: Thank you. And thanks for that kind introduction.

I am director of the UC Energy Institute, where we've been doing quite a lot of work on climate policy and economics. And I'm going to just try to go through, particularly to keep stomachs from grumbling too much, fairly quickly the set of slides you have here.

To just cover some fundamental issues, I'm not going to lay out a policy proposal, I'm not going to do too much in the way of numbers, but I am going to try to clarify some of the debates that go on around carbon and energy taxes.

To get a couple numbers on the table to start with, let me just say, California emits by most accounting, about 500 million metric tons a year of CO_2 equivalent greenhouse gases. At $20-a-ton valuation, if there were a tax, that would raise about $10 billion a year.

$20 a ton at the pump would raise the price of gasoline about 18¢ a gallon.

$20 a ton in electricity would raise prices about 1¢ a kilowatt-hour, just to give you a rough idea of what we're talking about.

I'm not sure this slide was really necessary, but I'll just whip through it quickly, what the fundamental goals of taxation are. You've been talking about them. Besides raising revenues, minimizing regressivity, achieving fairness across sectors in regions where fairness doesn't necessarily mean equality of contribution across sectors and regions. And then on the ones the economists spend more time worrying about, minimizing economic distortion, recognizing that taxes can destroy economic value by stopping -- reducing trade between individuals where that trade is taxed.

And the one that gets very little attention in tax policy, which is that taxes can also be used to correct market failures, because the market itself has mispriced some good or service. And that's the one I'm going to spend most of the day talking about.

And that leads to the concept in economics of distortionary versus corrective taxes. "Corrective" are, among economists, usually known as Pigouvian taxes. They are taxes that actually seek to correct some mispricing that's going on in the economy. Those sorts of taxes are not necessarily -- and, in fact, generally not economically distorting. In fact, they can be corrective. They can move the economy to a set of goods and services that is actually a better set in terms of the total economic value that the economy produces.

And the classic example of this is a tax on pollution. Pollution is a negative externality that is underpriced. It's generally priced at zero and as a result is overconsumed. And so our economy produces more of it than we would if people actually had to face the direct costs of it.

There are other negative externalities that do occasionally get priced, though, even in those situations it's probably more coincidental. Tolls on roads could be thought of as congestion pricing, but they generally aren't actually designed that way. Traffic tickets could be thought of as trying to internalize the externality of unsafe driving, though others might argue they're more a revenue-raiser as well.

But the concept is out there. Unfortunately, in my mind, it's not very often applied. Corrective taxes, even if you just took the money and rebated it on a per capita basis, would be likely to improve the economy. But there's an additional advantage, which is, if those corrective taxes can be used in place of what we know to be distortionary taxes -- the best example is, obviously, taxes on labor, on wages -- then we get what is commonly known as a double dividend. And that is, that not only do you raise the revenue and correct the negative externality by discouraging certain behavior; by using that revenue, you actually get an improvement in the -- or a reduction in the distortion that was coming from taxing whatever that -- in a way that didn't reflect a negative externality. So, for instance, in taxing wages, if we could reduce the tax on the wages, we would encourage more labor because people would be able to collect the full value of their work.

I'm going to talk generally today about taxes, but I'm going to spend one slide on taxes versus tradeable permits, partially because I am on a mission these days to correct a widespread misperception that economists all favor taxes over tradeable permits.

There is a set of economists who I think are not actually dealing with real-world implementation very seriously, who, on a theoretical basis, would argue that taxes dominate tradeable permits. And I think that argument can be made in certain circumstances. So can the opposite.

I think in practice, though, the directions we're going with all of these policies, the two approaches are melding into one.

Taxes are not going to be a forever-set price on carbon, and a tradeable permit system isn't going to be a forever-set cap on greenhouse gas emissions. And, in fact, all of the suggestions I've seen on tradeable permits generally have some sort of escape valve or banking and borrowing or something to mitigate price variation. And, in fact, in the extreme, they start to look a whole lot like a simple tax at whatever the cap is.

They have exactly the same enforcement issues. Both can be used -- both will raise energy prices, a fact that the State of California is desperately trying to mitigate while at the same time reduce greenhouse gas emissions, which I don't understand. And both can be used to raised revenue or not. That is, both can be used -- the permits can be auctioned off and quite a bit of revenue can be raised, probably on the order of $10 billion with the number I gave you, or the tax revenue can be kept.

Alternatively, the permits can be allocated so that no revenue is raised from them, or the tax revenue can be rebated on some basis. So they really don't differ that much.

There is currently a debate, because it is commonly thought that auctioning -- or that the tradeable permit system would be implemented with some degree of allocation, not 100 percent auctioning. And the debate that is going on right now is about how much allocation versus auctioning should go on.

There is a widespread misperception that is, I think, being pushed by many in the business world that most of the incidence of these taxes -- that is, most of the cost of these taxes -- will be paid by the shareholders of the companies that have to actually directly pay for the greenhouse gases.

I think there's no evidence for that. And, in fact, I think there's strong evidence in the opposite direction. The vast majority of that $10 billion that I mentioned, if it were $20 a ton, would come out of consumers. The price of gasoline would go up, the price of electricity would go up, the price of cement would go up, the price of all energy and greenhouse-gas-intensive goods would go up.

That's the reality. The fact is that those sorts of energy sources create greenhouse gases; and we have come to the conclusion that those greenhouse gases are a negative externality. So most of the burden would be borne by consumers. Some of it would be borne by companies, particularly in the short run, probably less over the long run.

When we talk about carbon and energy taxes, it's interesting because the discussion almost immediately turns to targeting the revenues. I find this puzzling since, when we talk about, for instance, income taxes, it generally doesn't turn to targeting the revenues towards helping income; whereas targeting the revenue from energy taxes do tend to get discussed in the context of supporting alternative energy or some other worthy goal.

I think that is an unfortunate direction the public policy debate has taken; and I think it would be wise for this commission to at least put forward the idea that targeting revenues from taxes, in general, and particularly from energy taxes is bad policy. Now, it may be necessary politics to get certain things passed. But on an economic basis, it really is bad policy.

This morning, there was plenty of discussion of Prop. 98 and other sorts of restrictions on budget use that may sound like a good idea at the time they're passed, but the world changes, and then suddenly you're hitting restrictions that actually are not ones that lead to good public policy.

And there's no particular argument -- there's no good argument that the tax level necessary to correct a negative externality raises an amount of revenue that is in any way appropriate for allocating to that public policy problem. It could be greater or it could be less. So I would argue that pursuing carbon or energy taxes should be coupled with the recognition that that revenue shouldn't necessarily be targeted towards any specific program.

From an economic point of view, I'm aware from a political point of view, and from perhaps a budgetary control point of view, people might have different opinions.

People worry about the regressivity of energy taxes. They are regressive. They're probably a little more regressive than sales taxes. Possibly not. There is conflicting research. I think probably the best guess is they're somewhat more regressive than sales taxes. They're clearly more regressive than progressive income taxes.

The standard economist’s response to this, I think, carries a lot of weight, which is, if you're worried about that sort of regressivity, you have all of the instruments of taxation to deal with, not just that one tax. And so increasing this tax and then offsetting the impact on lower-income people through reducing income taxes, raising the standard deduction, reducing sales taxes, or many of the other instruments, is certainly possible.

I know one of the things that this commission is worried about is revenue stability. I think this actually makes energy taxes or carbon taxes quite attractive if done right. Unfortunately, we're doing it pretty much wrong right now in California.

We do have an excise tax on gasoline. And that actually is a fairly stable source of revenue because gasoline consumption varies fairly little, despite the news reports, over business cycles.

We also have a percentage sales tax. And that has become clear over the last 12 months -- my life has become much easier in explaining this to people -- is a fairly unstable source of revenue.

I think that if we impose energy or carbon taxes through a per-unit fee or through an auction for tradeable permits, that would actually be quite a stable source of revenue through economic good times and bad.

I don't think anyone seriously is proposing -- and I hope no one would -- a percentage sales fee on energy or carbon beyond what we already have through the sales tax. And, in fact, one direction this commission might want to consider is recommending removing the sales tax, regardless of how much revenue you want to raise, removing the sales tax on gasoline and replacing it with a larger excise tax that's revenue-neutral. That would make the revenue stream more stable.

It's important to recognize that revenue volatility over the business cycle is a separate issue from concerns about competitiveness and leakage. "*Competitiveness*" is a phrase I've already heard here this morning. "*Leakage*" is not one that gets discussed too much outside of the greenhouse-gas and energy-tax area. But it's basically the idea that if you tax a specific energy source, the economic activity associated will move out of state.

It's also important to recognize that revenue volatility is separate from another issue that, over the long run, this commission or the State will have to worry about, which is a secular trend away from fossil fuels. That, by the way, is not occurring right now; but with luck, it may occur in the future.

So let me finish up and talk about competitiveness.

Whenever we tax an activity at the state level, or at any level, even the federal level, we worry about "*competitiveness*" as it is called, among tax folks -- or "*leakage*," as it's called among the energy and climate-change crowd. And that is that those sorts of costs will cause the economic activity to move elsewhere.

It's true of sales taxes. It's true of corporate and personal income taxes. It's true of property taxes.

Energy and carbon taxes raise exactly the same set of issues. Some of them are pretty avoidable. And one of the reasons leakage, I think, has become such a common term is because of electricity transmission. That makes it a much bigger issue than in most other areas because electricity can be very easily transmitted across state lines. And so the ability to move that activity out of state is higher than we think of for most other commodities. And that's where we have significant concerns.

Contrast that with transportation fuels.

There's actually very little problem of leakage with transportation fuels. If you raise the tax, excise tax on transportation fuels, there's very little change in economic behavior that's going to take place for transportation within California.

One worries a bit about what's called "*tankering*" in the airline industry, where airlines actually bring in fuel on flights into the state. I've talked to a couple of the members of the Commission about that and how I think that could be avoided through a somewhat altered monitoring process.

The harsh reality is that taxes do raise the cost of doing business, they raise the cost of living. That's the cost we pay for living in a society where we have public services. And the idea that simply because taxes raise the cost of doing business, they shouldn't be imposed is, I think, in general misguided. I think it is doubly misguided when we're talking about taxing a negative externality. Because we're actually trying to improve -- or we would be able to improve -- the overall performance of the economy by imposing those sorts of taxes.

The pleasant reality, of course, is that government services actually lower the cost of doing business. Having police protection, having good roads, all of those things lower the cost of doing business. And what this commission is obviously trying to do is help the State strike that balance, not just with the size of government, but also between sectors of the economy. But I think what's very clear and is rarely disputed by anyone in economics, is that these sorts of corrective taxes are the first place that government should be going to raise revenue. This is where the money is, if not free, at least a whole lot cheaper than it is in all the other areas, because this is actually correcting an inefficiency in the economy while raising the money.

Make no mistake about it, somebody still has to pay the taxes. But in the process of paying those taxes, it moves the economy towards a different type of economic activity that we think is actually a better sort of economic activity. By taxing pollution, it moves the economy away from polluting activities, and we think that's good for the economy and for the health of individuals or whatever at the same time.

That all sounds wonderful until we start talking, I think, about where the taxation should be going on. There is a discussion in the energy and carbon area of layering of taxes and how that could create excess costs.

I think it has devolved into a discussion from some people using terms like *"regulatory chaos"* and *"conflicting standards."* I mean, let's get serious about this. When you have to pay 5¢ a gallon -- or 18¢ a gallon for excise tax on the state level and 19¢ on the federal level, that might be excessive taxation, but it is not regulatory chaos. It's pretty simple to add the two numbers together. That's what we're talking about here. There are certainly cases in environmental regulation where we have had conflicting standards. This is not one of them. This is simply adding more tax on to this behavior.

Now, should California be in this business of correcting these externalities, this would be a much easier case to make if we were talking about NO_x or SO_2 or particulate pollution. Those are local pollutants. And the damage that's being done is local. And the State, for the benefit of the people who live in the state, have very good reason to be trying to correct that.

It's harder to make that argument when you get to climate change. It's a worldwide pollutant. And, in fact, I think it's widely agreed that you can't really make this argument that we should be reducing greenhouse gases because the direct effect of California reducing greenhouse gases is large enough to justify the cost to Californians. It's just not. That's not a reason we shouldn't be doing it, but I think we have to understand what the arguments are.

I think the strongest argument is to demonstrate leadership because there has been very little action on the federal level. One could argue that maybe this is not as strong an argument as it was before November. But so far, we still haven't seen much. And given the way the federal government moves, California is pretty far out ahead.

I do have to say, though, California is way ahead on back-patting right now relative to actual action. We've been doing a lot of telling ourselves how great we are in meeting greenhouse-gas challenges. And so far, California really hasn't been reducing our greenhouse-gas footprint. We've been talking about how we're just about to do it.

I hope we're going to move forward on this, I hope as a country we're going to move forward, and I hope internationally we will. But California has clearly been pushing for it on this faster. We are further down the road; but I don't want to get too far out ahead of ourselves and say we're actually instituting change very rapidly.

I think besides showing leadership, there is a good argument that California moving ahead on this would be able to show that it can be done at a fairly small cost to the economy. That is, if you take away the negative externality -- addressing the negative externality, how much is it actually hurting our economy to move towards a more energy-efficient and low-greenhouse-gas economy? And I think California could be a leader in demonstrating that could be done at a fairly low cost.

I am not one of the economists -- and I think they are actually fairly few in number -- who will tell you that this is actually a boon for the California economy, the California economy will actually grow faster because of it. I think that the fact is, when you put another restriction on economic behavior, it tends to reduce the value of economic output somewhat. But I think, if you look at the numbers and the low-hanging fruit that exists, it's going to actually be a fairly small number. We could make a great deal of progress on greenhouse gases at very little cost to the economy.

The leadership value of that, I think, is very important. And California is a big part of the world -- of the state -- of the national economy.

I don't think that -- some people have argued we should do this to move the California economy ahead so that we will be where the rest of the world has to go.

That is, we'll have the high-tech industry, we'll be investing in whatever it is because we'll have forced our economy in that direction.

That's possible. I'm a little less certain on both the view that that's definitely where the world economy will go and on the view that it will give us that big of an advantage. The fact is, most of the solar panels aren't going to be made here; most of the wind turbines aren't going to be made here. But we do have some real technological advantages. And I think investing in those makes a great deal of sense.

That was not a plea for money for my institute; but it is a plea, I have to say, for funding for the scientists who work on these areas who have been greatly underfunded.

This is a great challenge for the world, I think, dealing with climate change. California can do a part in it. I think we have to be reasonable about what part we can do in it.

The argument that we should, in general, be taxing these sorts of negative externalities as a revenue source is just overwhelming. Economists have been saying this for years. We, as a group, are terribly frustrated that there aren't more congestion taxes, that there aren't more pollution taxes. And regardless of what end of the political spectrum you're on, that those shouldn't at least be substituting for the very distortionary taxes that we do have.

And that concludes my views. Thanks.

CHAIR PARSKY: Thank you very much.

Questions?

George?

COMMISSIONER HALVORSON: Fascinating topic.

As someone whose long been an advocate of increasing cigarette taxes because I know what the massive impact on health-care costs result from cigarette smoking, I think making a change in human behavior by using the tax laws makes a lot of sense.

My question is, there are issues where this might be perceived as being regressive. If there was an approach where half of the money that was collected went back to low-income Californians, either as a direct rebate or as subsidy for the purchase of high-energy appliances or high-energy cars, then the regressiveness of the thing could be balanced a bit, and you would also still get the behavior at the pump that we really want to encourage because it would be an asynchronous set of decisions. And, in fact, the rebate could even prime the California economy a little bit because the people who would get it would not be likely to save it, they would be likely to spend it. If they're low-income, that money is going to go right back into the economy.

So some kind of a cycling process that involves a rebate for low-income people, and then aim the tax directly at energy-usage areas where we would expect a behavioral change as a result. Not something like the generation of electricity because it's too far removed from decision-making, but heating homes, maybe.

So wouldn't it make sense to make it a package rather than just an individual tax, than think of it as a total --

DR. BORENSTEIN: That was a larger package. It expanded as you went along. So let me parse it a bit.

First of all, I think there would be widespread agreement that one should offset the regressivity of increased carbon or energy taxes by changing income taxes or through per capita rebates or some sort of process that is tilted more towards helping low-income people. I think that there are certainly some people who might not agree, but the vast majority of economists would agree with that.

The idea of using the taxes to boost particular energy programs always makes me a little nervous. It's well-known that I'm not a booster of all alternative energy sources for implementation right now. I think some of them aren't ready. And, unfortunately, you get a lot of lobbying in that area.

And you made a third point right at the end, and I forgot it already.

COMMISSIONER HALVORSON: Well, the basic question is, can we change behavior of people?

DR. BORENSTEIN: Oh, behavior, right.

I worry about trying to target these at certain behavior that certain people think is more amenable, because everybody will argue a car is a necessity, a large car is a necessity, a large television is a necessity -- everything is a necessity, so you shouldn't tax it. And the fact is that all of these things have some elasticity. And the people who said driving would never respond to gas prices seem to be quieter now after last summer.

But what we've learned actually is that they respond both directions. The price went up, people started driving less, people started buying more fuel-efficient cars. Prices have gone down, people are driving more again now.

COMMISSIONER HALVORSON: Exactly. And that's why I think we ought to pick a couple of things and tax energy use in those areas.

DR. BORENSTEIN: But I think electricity is another one. If you don't tax electricity, you are essentially undercutting energy efficiency. I think we need to recognize all of these costs.

And to the extent that it offsets -- that it hurts poor people more, we can offset it through some other mechanism. But I would not take any greenhouse gases off the table. I would say we want all of them in. And that gives us a broader tax base in that sense. And all of those are negative externalities.

CHAIR PARSKY: Chris?

COMMISSIONER EDLEY: Thank you, Gerry.

Severin, and thank you very much for the testimony, of course.

First, I want to declare, I'm really for this. However --

CHAIR PARSKY: You need to say what "*this*" is.

COMMISSIONER EDLEY: You know, "*this*," "*this*."

However -- and I think it's also important to remember that while there are problems with this, it's not a question of, are there problems with the carbon tax; it's a question of comparing the problems with this tax with the problems of other taxes. So we have to keep that in mind.

But my question is this -- I'm just trying to -- I'm just a country lawyer, and…

CHAIR PARSKY: Uh-oh, we've heard that before.

DR. BORENSTEIN: A very dated reference.

COMMISSIONER EDLEY: But it does strike me that the argument in favor of this as a Pigouvian tax runs into trouble once we acknowledge, which I believe we should, that the impact on climate change, the impact on greenhouse gases will be negligible to nonexistent, because you don't get the benefit of the reduction in the externality, if indeed we don't believe it's really going to contribute to the global problem.

But is it fair to try to rebut that by pointing to the likelihood of both federal policy and global policy involving greenhouse-gas reduction? Because it can't be the case that no greenhouse-gas tax/cap-and-trade mechanism could be Pigouvian just because any specific measure would be too incremental. I mean, we're getting into kind of a commons problem.

DR. BORENSTEIN: Right.

COMMISSIONER EDLEY: Do you see what I mean? You could make the same -- what are there, 200 countries in the world? You could make the case that with the exception of two or three economies, that none of them should bother acting because that particular country's contribution to greenhouse-gas reduction would be so minimal, that the tax wouldn't be Pigouvian.

So how do I --

DR. BORENSTEIN: I think you're going towards exactly the right argument, which is, obviously, if the State of California were the only actor on this and everybody else were committed to never doing anything about greenhouse gases, it would be impossible to argue that this is a corrective tax in the sense that we're going to move our economy to better direction.

COMMISSIONER EDLEY: I see. But if we just waited and made everybody else do it, we'd be free riders?

DR. BORENSTEIN: Right. But if we recognize that what we're going for is full participation, probably in the medium run, full-developed world participation, then everybody has to be willing to sign on.

Now, the United States has a record over the last decade of being way behind the rest of the world in signing on. And so signaling that we are now catching up or willing to get ahead of the world in signing on has real value to it.

You're not probably going to get here by a one-time meeting of all the world's governments sitting down and saying, "Okay, here's the answer," and we all agree to go implement it. We're going to have to get there incrementally.

California is a non-trivial increment. It's small, but it's not a trivial increment in that, in the actual output or in the leadership in content. And I think that the argument has to be made -- somebody has to move first, and California has interest in doing this, and that there's real demonstration value. And California being, I think, a very technologically advanced state and known for innovation is probably as able or more able than anywhere else to implement these policies in ways that have fairly low costs to the economy and lead to a lot of innovation.

I don't want to get too far down that road. I don't think this is going to, three decades from now, make California the center of all alternative energy. I think California might be a major player in that one way or the other. But I think one can overstate how this is going to lead to huge economic advantages in the long run.

COMMISSIONER EDLEY: If there were more funding for your center, then perhaps…

DR. BORENSTEIN: Thanks. Thank you for saying that.

CHAIR PARSKY: Michael?

COMMISSIONER BOSKIN: Severin, thank you for your excellent presentation. It's good to see you again.

I just wanted to make a couple of kind of technical questions relating to California as opposed to the general desirability of carbon tax nationally or some global reduction in greenhouse gases enabled by joint carbon taxes or whatever they happen to be.

First, you said that the U.S. has lagged behind signing on. And I would certainly agree with that if you mean signing some piece of paper.

It turns out that, for example, almost all the European countries have fallen not just behind, but considerably behind their Kyoto commitments.

So what signing on would have meant, given we tend to actually honor our treaty commitments relative to some other countries, perhaps more often than others -- but even if we would have done the same, I think signing on shouldn't be taken as a synonym for actually constructive behavior that actually does something.

The second point -- so would you agree that that's a generally fair characterization?

DR. BORENSTEIN: I think that is a fair -- I think the countries that have made more aggressive commitments than the United States to reducing greenhouse gases have not met those commitments. And partially, that's a learning process, I think, that they're shocked to find out that --

COMMISSIONER BOSKIN: There were costs.

DR. BORENSTEIN: -- things didn't go quite the way they expected.

COMMISSIONER BOSKIN: And there were costs.

DR. BORENSTEIN: Yes.

COMMISSIONER BOSKIN: The second is just a very technical kind of tax administration question. I mean, there are a variety of ways to take the existing energy taxes and deal with them. But a carbon tax would be a new administrative structure to literally have a carbon tax.

And so you're bearing the fixed costs of administering a carbon tax in California to have your own, new carbon tax; whereas if there was a national carbon tax, for example, California could piggyback on that administrative structure.

Is that conceptually correct?

DR. BORENSTEIN: I think it's conceptually correct.

I think in practice, we're never going to have a carbon tax or a pure carbon permit system because different sectors are going to have to be treated differently.

So carbon, by the way -- or greenhouse gases, by the way, are harder than all other pollutants, in that there are significant sinks as well as sources. And this just makes life very, very hard. That is, there are trees sucking up CO_2 and there are ways of disposing of CO_2, and that has to be measured as well. And it's going to be very industry-specific.

In gasoline, it actually turns out to be very easy. You can do a straight carbon tax by simply taxing gasoline because the ratio of gasoline into the car, to carbon coming out, is fixed. You can't do that with a lot of other processes. You certainly can't do that with electricity, as we recognize there are sources that have massively different CO_2.

So I think you're right, it's going to be difficult to do. And the administration costs are going to be something that -- there will certainly be a great deal of overlap in the technology for monitoring, for instance.

COMMISSIONER BOSKIN: Let me just ask --

COMMISSIONER EDLEY: Michael, can I just ––

COMMISSIONER BOSKIN: Sure.

COMMISSIONER EDLEY: On that specific point, though, I think, Severin, that the connection with AB 32 and any kind of cap-and-trade system would, for example, in the case of the electric-generation issue -- we already have people in the state trying to figure out how a state-level cap-and-trade system would figure out ways to impute carbon contact to carbon content to the electricity flows. So, yes, it's an analytical problem, but it's not a new analytical problem for California policymakers.

DR. BORENSTEIN: I think that's right. And I think we also have to recognize that one can do part -- we're not going to do -- the end of my point about sinks and sources, we're not going to do 100 percent taxation, we're not going to get this right. We're going to do it industry by industry, we're going to address transportation fuels, we're going to address electricity, we're probably going to address concrete -- cement production, and a few other areas. And then we're probably going to probably just leave a lot of the residual untouched. Apparently, we're not going to tax cows, even though agriculture is a major source of greenhouse gases.

COMMISSIONER BOSKIN: That was my last question, about other gases, like methane.

DR. BORENSTEIN: Yes, and so I think, again, we're going to do this incrementally.

I suspect your next question will be: Well, is incremental really a good idea? And the answer is, no, it's not, relative to full implementation, but it probably is still a big improvement over not doing it, which, of course, on an economic-theory grounds isn't necessarily the case. But I think in practice, it is.

And, yes, there are a lot of other gases that we probably have not taken as seriously as we need to in addressing greenhouse -- in addressing climate change.

And the first place that pops up is in the ag sector. And that is one of the hardest places politically, apparently, to address it. But it's a major issue in the agriculture sector.

CHAIR PARSKY: Yes, Edward?

COMMISSIONER DE LA ROSA: Thank you very much.

I mean, upon listening to this, my first reaction is that I can see a tax like this being used to mitigate the effects, externalities of activity that has a local effect, like diesel bus fumes near schools and urban centers or something like that, but where you expand the concept to something like greenhouse gases, I have a tougher time imagining a future when we actually get to a position where we would make the first sacrifice if others didn't. And I think you got to that point.

Moving on, though, I've got another question. That being said, I think the concept is worthy of consideration. When you have an auction system, I imagine that you have certain credits for emissions and then you sell those and then they become tradeable in the future.

Has there been any debate about whether an auction system like that causes barriers to entry in certain industries because the larger, more established firms that have their infrastructure, their manufacturing infrastructure in place can pay for these, can buy the credits in the auction every year and the price gets bidded up, whereas a new entrant might have a tougher time?

DR. BORENSTEIN: This argument gets made, but I actually don't think there's much economic content to it because it's a cost of doing business. You are paying for an input. One of the inputs you need to make cement is a tradeable permit because you're going to put out a bunch of greenhouse gases.

It's a cost for everyone, but it's not a cost that disproportionately falls on new entrants. It falls on everyone. And it's like -- I mean, yes, when the price of fuel is high, the airlines that are less well-capitalized are hurt relative to the ones that are well-capitalized. But we don't think of that as a barrier to entry, we think of it as a cost of doing business. And so I think it is tough in almost all implementations to argue that this disproportionately hurts new entrants relative to incumbents.

One could argue in some cases that it may benefit new entrants where there is new technology that is available. And the new entrant by waiting has not sunk money into the older technologies.

But, again, that argument, I think, in a sort of dynamic sense doesn't hold, either, because that's a sunk cost at that point.

CHAIR PARSKY: Yes, Richard?

COMMISSIONER POMP: One argument I'm sure we will hear if we go down this path is that we will simply drive business out of California. And we hear that in different incarnations.

In other areas, however, one response is, well, you can't go somewhere and avoid a corporate income tax. Almost every state has it. You can't avoid a sales tax. Almost every state has it.

So unless the emulation effect is going to be so strong that this will start a groundswell, if California is out there by itself for a while, do you worry about the effect it will have?

DR. BORENSTEIN: Well, I worry about it on a sectoral basis. I don't worry about it with transportation fuels. The fact is that people will still drive in California and will still fly to California. To be realistic, it will cost a little more to drive in California and airfares to California will go up. The airlines will adjust their airfares to reflect the fact that fuel costs a little more.

COMMISSIONER POMP: But manufacturing, let's say?

DR. BORENSTEIN: Manufacturing, it would raise the price of energy. But going back to the numbers I gave you, it would raise the price of electricity 1¢ a kilowatt-hour if it's $20 a ton. The average price differential between California electricity now and the rest of the country I think is about 5¢ a kilowatt-hour. It has varied over time.

It does have some impact. But, of course, the question is the elasticity, how much of that effect it is. I think over the range we're talking about, the impact would be fairly small.

I have to caveat that, though, by saying, I don't think $20 a ton is where the price will eventually have to end up for us to make real progress. I think $60 or $80 a ton is where the price is going to have to end up.

$20 a ton is 18¢ a gallon at the pump, and that's not enough to significantly change consumption behavior. $20 a ton does not change the dispatch order for electricity generation. The cheapest way to make electricity at $20 a ton is by burning coal in current technology. It still beats natural gas at $20 a ton. So I think the vision that $20 a ton actually gets us major changes in greenhouse gas emissions just isn't there.

Now, that said, if the point of California doing this is leadership and showing what the economic impact would be, this is a way to move in that direction. I mean, I think one can argue that it's not worth it for leadership purposes, but I think it is certainly the case that we recognize that there is going to have to be something done on a worldwide basis. And moving at this level will have incremental effects and will show that it will have a fairly minor effect on our economy.

COMMISSIONER POMP: Unless you're wrong and it has serious negative consequences, in which case you've discouraged any other state from doing it in isolation.

DR. BORENSTEIN: Yes, I think at the level we're talking about, the risk of that is extremely low. I mean, you can't make a plausible argument on transportation fuels. It's just not enough money.

I don't think you can make a plausible argument on electricity. Given the noise between California and other states already, the numbers we're talking about are not big enough.

Yes, it's incrementally an effect. But given all the differences -- you know, we do have to remember that, well, tax burdens are, I guess, higher here than elsewhere. Service amenities are different here, too.

I draw a parallel, which is very unpopular with my colleagues -- though Dean Edley might like it -- that universities are excessively focused on matching salaries when faculty get outside offers, because there's this whole array of amenities that is going on. And for some reason, we feel that number has to be just the same.

Well, likewise, when we start talking about tax burden in one place or another, we have to think about service amenities in one place or another. And, of course, the elasticity of businesses moving out of state is an elasticity with respect to that whole package. And so then you have to ask the question, how big is that, this and that package.

In the business world, I think this is a fairly small number. Not zero, and that's where the cost-benefit analysis comes. But the idea that you get sort of an economic fallout -- to be honest, the idea that you will ever be able to identify an economic impact from a $20-a-ton greenhouse-gas tax I think would be difficult.

CHAIR PARSKY: But a $60 to $80 would have an impact?

DR. BORENSTEIN: $60 to $80, I think, nationally is about what's going to be necessary if we're going to actually change our greenhouse-gas footprint.

I think if California went to a $60 or $80 tax right out of the box by itself, then you would be talking about a much more serious impact. I would --

CHAIR PARSKY: That's leadership, though.

DR. BORENSTEIN: That would be leadership, but it might not be leadership that succeeds.

CHAIR PARSKY: And just to follow on your question, if we assumed the outlines of the cap-and-trade proposal that has been sketched out --

COMMISSIONER EDLEY: Nationally, you mean?

CHAIR PARSKY: Nationally occurred -- then how would you feel about California having its own carbon tax in addition to that?

DR. BORENSTEIN: Well, yes, so it depends on whose outline you're looking at.

The outlines that I think are surfacing these days generally do envision a price of about $20 a ton. $20 a ton isn't going to fundamentally change the way we produce carbon. I suspect if we do that five years from now, we'll be just as shocked as the Europeans are right now that it hasn't worked.

And so at that point, we have to revisit the question, okay, what's the value of California going a bit further? Maybe adding another $20 a ton onto a price. Well, everybody else's costs have gone up from the first $20. So in terms of competitiveness, that hasn't changed things.

Is it worth it for the leadership value? Is it worth it for demonstrating what the impact would be?

CHAIR PARSKY: Getting closer to leadership, though.

DR. BORENSTEIN: Pardon?

CHAIR PARSKY: You were getting closer to leadership, if you’ve set the $60 to $80 as kind of real --

DR. BORENSTEIN: You are getting closer to leadership. But at some point, you -- I mean, it's a trade-off. And as we teach in economics, you've got to go to the optimal point where the lines cross.

CHAIR PARSKY: The last question, Michael.

COMMISSIONER BOSKIN: Yes, would you be at all concerned, Severin, that if we did something like a $20 tax, that it would create a concern, not just among existing businesses here but, say, existing businesses in their expansion plans, when we get back to a growing economy at some point -- which hopefully will be not in the too distant future -- but also other new businesses forming, that they be worried that this was a signal that it's likely to be higher in the future?

DR. BORENSTEIN: I don’t think so ––

COMMISSIONER BOSKIN: I mean, going from zero to 20 has to be more unnerving to people worried about this than keeping it at zero, that's for sure.

But do you see ways to guarantee that it stays at 20?

DR. BORENSTEIN: That's, I think -- the political side of guaranteeing, I'd have a hard time with. But I think a rational company that looked at this would probably -- their best forecast should be that it will revert back to the national policy over time. Not that it will get more out of line with the national policy.

So if California gets ahead in the form of leadership, I think the best guess is, the national policy gradually catches up and California's gap gradually narrows. Not that California gets further out of sync.

COMMISSIONER BOSKIN: So your view is that California would eliminate its carbon tax in the future, once there was the equivalent of a federal --

DR. BORENSTEIN: Or it certainly wouldn't expand it further. It would probably wind down.

And I think --

COMMISSIONER BOSKIN: If we do that, I hope you're right.

DR. BORENSTEIN: On a public-policy basis, I think the argument is definitely stronger if there is no federal policy. And the argument, in my mind, goes away if there is a federal policy we think that's actually getting the prices to the right level, which in my mind, would probably be $60 to $80 a ton. It would be very hard for California to argue we should do even more for greenhouse-gas purposes.

I want to keep on the table, because I want you folks to keep on the table, congestion taxes and all of the other negative externalities that we are not picking up that much-cheaper money than the money that you've had to grapple with through other tax sources.

CHAIR PARSKY: One final, just a clarification. But I think at the heart of your presentation was that you would not look at this in isolation; that you would look at it in the context of coupling it with reducing a tax -- personal income tax, some other form -- together.

DR. BORENSTEIN: Yes. But, I mean, I'm not trying to set the entire state budget priorities.

CHAIR PARSKY: Go right ahead. I mean, any number of people do.

DR. BORENSTEIN: No, I'm the one who's not going to try. But I think that it certainly makes sense at any given level of government expenditures to do more of the financing with this tax, with these sorts of corrective taxes, and less of it with the distortionary taxes that the State now relies on. So whatever level of funding we come to for the state services, more of it should be done through these corrective taxes.

CHAIR PARSKY: Thank you very much.

Bob, are you okay if we pick your presentation up after lunch.

MR. RUBIN: Yes.

CHAIR PARSKY: We didn't quite get there, and I had said we'd -- I really appreciate your waiting.

With that, let's take a half hour break for lunch and then come back and pick up with the tax appeal process.

(Lunch recess taken from 1:00 p.m. to 1:46 p.m.)

(Commissioner Pringle left the meeting room for the day.)

(Commissioner Morgan entered the meeting room.)

CHAIR PARSKY: Next on our agenda, we have -- when I look at your name, Robert Rubin. You're a special Robert Rubin?

MR. RUBIN: You thinking of my brother, Bob.

CHAIR PARSKY: Yes, that fellow, who I know, but doesn't carry nearly the expertise that you do in the tax area.

We're going to talk a little bit about the tax appeals process in California. It's a specific issue that has been raised a few times. And Bob Rubin is going to lead us through this discussion.

MR. RUBIN: Thank you, Mr. Chairman and Members.

Thank you for allowing me to be here today.

I worked for IRS for about ten years, mainly trying tax-court cases. And for the last 23 years, I've been in private practice in Sacramento, mainly representing people and businesses who have disputes with taxing agencies, including the Franchise Tax Board and the Board of Equalization.

One of your principles is to establish a 21st century tax structure that fits with the State's 21st century economy; and another principle is to ensure that the tax structure is fair and equitable.

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.

I deal with a lot of clients who are from out of state. They do business in many states. And uniformly they perceive the Franchise Tax Board and the Board of Equalization to be very aggressive, and they view California as a difficult place within which to do business. And they perceive that the lack of an independent tax-dispute forum contributes to that negative view.

The income tax in California -- and we're talking about the personal income tax and the bank and corporation tax -- is administered by the Franchise Tax Board. The Franchise Tax Board is composed of the director of the Department of Finance and two members of the Board of Equalization. The Board of Equalization is composed of four elected members from districts and the State Controller. And the Board of Equalization and the Franchise Tax Board administer the sales and use tax and the income-tax programs of the State.

So in that capacity, the members have day-to-day contact with staff. They're involved in decisions about hiring and firing and evaluating and promoting employees, promulgating regulations and rules, publishing manuals, managing the audit program, sponsoring legislation, analyzing all relevant legislation to their activities, and collecting the tax.

So if I am a senior manager of FTB or BOE or a senior attorney managing those programs, I'm going to have day-to-day contact with the members about all of these issues. And I would be a poor manager or a poor attorney if I wasn't able to convince the members that I could be trusted, that I had good judgment, that I was competent.

Well, let's say that you or your business got audited for income tax or sales and use tax, and you came to me. I would explain to you that you can go through various administrative processes within the FTB and the

BOE. But ultimately, if you're dissatisfied, your only chance for a prepayment review would be a hearing before the State Board of Equalization, those very people who administer the program, who, on a day-to-day basis, have contact with our opponents -- because I'm representing you or your business now before the BOE.

It is not a fair and independent review. And it's not because the members and the staff of the BOE aren't trying to be fair and impartial; but it's impossible to have such day-to-day contact with the tax people who administer the programs, and then put on another hat and try to fairly review a case.

About half of the states have independent tax-dispute resolution forums, and that's the direction that people are going. There's nobody going from being independent to a non-independent situation.

The federal model is the United States Tax Court. The United States Tax Court used to be a part of the Internal Revenue Service. As a matter of fact, the courtroom used to be in the IRS headquarters building at 1111 Constitution Avenue.

In the forties, that lack of independence was perceived, and the Tax Court became an independent court. In the Tax Court, your trials are always to one judge. And the judges ride circuit around the country. There are tax-court procedural rules that are simplified compared to the Federal Code of Civil Procedure or the California Code of Civil Procedure because most tax cases result from a full audit, where all the facts become known. So there isn't a need for as much detailed discovery as in a civil case. And many times, in tax cases, there are no facts in dispute. It's a question of legal interpretation.

In the Tax Court, there are simplified procedures for small tax cases, cases in which the amount in dispute is less than $50,000. And in those cases, the taxpayers almost always appear pro se or representing themselves.

In contrast, at a BOE hearing, it's always before a full board of five people, whether the case is a billion-dollar case or a $250 case. And there are $250 cases that actually come before the Board. The time that is allotted for each case is 30 to 60 minutes. Usually no more than 30. It doesn't matter if there's $10 million in dispute.

And as a practitioner, in order for me to be sure that the members understand my case, I have to meet with them or their staffs or both of them, each member, before the hearing to explain my case to them.

I don't have any confidence that -- if I don't do that, the only thing they will have seen is the BOE staff summary of the case. And as distasteful as that is -- because if this were a tribunal for purposes of the Code of Professional Responsibility, it would be unethical for me to do that. But the Board of Equalization, when it sits in its adjudicative function, is not a tribunal for State Bar purposes. So it's something that I do in all the cases.

There's a paucity of published decisions, which means that there isn't much guidance out there for taxpayers or for the Franchise Tax Board. And in income-tax cases, if the Franchise Tax Board loses at the Board of Equalization level, that's it; they cannot appeal an adverse decision.

The advantages of conforming to the federal model would be that you had an independent, trained tribunal. All of the judges in the Tax Court are tax experts.

There would be no ex parte contacts. It would be like any other trial. There would be a trial to one judge instead of to a five-member board, which seems much more efficient to me.

There would be an opportunity for a full evidentiary hearing. I'm not telling you that every judge would give you as much time as you wanted every time, but you certainly got more time than 30 minutes to put on your case.

There would be precedential written decisions that would provide guidance to both the government and taxpayers on a statewide basis.

In the long run, that would probably minimize disputes. Because in a lot of cases now, you don't know how the Board is going to rule. They may have had the same issue three years ago, but it's a different board, there's no decision that you can rely upon, that either side can rely upon.

It would be possible to have a simplified procedure for small tax cases, so that the costs of litigation wouldn't be burdensome for taxpayers with a small amount in dispute. And both sides would have appeal rights.

Now, a state tax court is not a novel idea. There have been several tries at a tax court over the last 15 years or so. And there are political issues. We've got the Board of Equalization, it's been there since the 1850s. A lot of people are used to it. But an alternative to an independent state tax court would be to eliminate what's referred to as the pay-to-play rule.

Right now, in order to get into court, where you could get an independent review of your case, you have to pay the tax and penalty at issue, if there is any penalty at issue. This makes it impossible for some taxpayers to pay the tax and penalty, and also afford to litigate the case. So allowing taxpayers to go to court on a prepayment basis would be a major improvement over the current system.

And we heard today about a carbon tax. I can tell you that right now there is something called the "*environmental fee*" that is imposed annually by the Department of Toxic Substances Control on corporations based on the number of employees they have. Any appeal of the environmental fee is to the Board of Equalization. And the Board of Equalization doesn't have a clue about that law. They defer to the Department of Toxic Substances Control.

There haven't been many cases. But, I mean, if there's a carbon tax, if there's cap-and-trade, somebody's going to have to go out and audit emissions, and there's going to be disputes. And where are those disputes going to be heard? And I think it's got to be in an independent forum.

Thank you.

CHAIR PARSKY: Questions?

Chris?

COMMISSIONER EDLEY: Thanks very much.

In my real life, just before I turned into a fund-raiser, I taught administrative law. And once upon a time, I even taught tax for a few times. And I have to say, that this is one of the things that goes on my list of “I wish I had known before I moved to California.”

This is really bad. I mean, I don't know whether this falls within our charter. But just in terms of the legitimacy of the whole system and building broader public respect for the revenue system and giving people a sense of basic fairness -- there are ways to design this that would not be bureaucratically cumbersome; that would not introduce untoward delays in revenue collection and that I think could go a long way in giving the public a sense that they can get a fair shake when they’ve got a dispute with the government.

I mean, if it is within our purview, I would very much support voicing some support for a move in this sort of direction.

CHAIR PARSKY: John?

COMMISSIONER COGAN: I would echo what Chris said. It just seems profoundly unfair as a legal matter, the system.

What kind of arguments do you get in return when you offer this, from the Board of Equalization or the Franchise Tax Board? How is this system defended?

MR. RUBIN: Well, one issue has been fiscal.

It costs money, and anything that costs money is bad.

The Judicial Council has voiced opposition because they don't want an independent court.

The Board of Equalization members are understandably protective of their turf.

COMMISSIONER COGAN: That's it?

MR. RUBIN: That's pretty much it.

COMMISSIONER COGAN: Are there any empirical studies that you're aware of, that might provide evidence that the outcomes are affected by this system that we have? That those who appeal end up being denied at a higher rate and so forth?

MR. RUBIN: No.

COMMISSIONER COGAN: Okay. It's not an easy thing to tease out the data, so I'm sure that --

MR. RUBIN: Correct.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you.

A couple quick questions, Mr. Rubin.

On the -- in Item 10.d, in your testimony on the Board of Equalization hearings where you mentioned that there's a paucity of published decisions. That issue really intrigues me, because it would seem that a -- especially where the Board of Eq. is an elected body, they're all elected officials -- for them to essentially not have a pretty substantial body of published opinions would even erode further public confidence.

I know a number of the members of the Board of Equalization. I think many of us do. And I think to a person, they are honorable, good people. But an elected official who sits in a quasi-judicial position and year after year can render decisions and virtually none of which have to be published, seems to me not to be even close to a good situation.

What are the circumstances under which they do or don't decide to publish a decision? And does that carry -- I'm not a lawyer so I don't know, does this carry the kind of -- when they publish something, does that carry additional weight, like it would in a normal judicial setting?

MR. RUBIN: I really don't know how they decide when to issue a published decision.

In the eighties and early nineties, they issued many more published decisions. They're very rare now.

Certainly, if there was a case decided six months ago that was similar to my case, and I knew how the Board was going to decide the case, and if it was adverse, there's a good chance my client wouldn't pay to go back before the Board.

So in that sense, it is very inefficient that neither the Franchise Tax Board nor taxpayers know what the BOE is going to do. And to the extent that you have the same board, those decisions would be precedential.

From a legal point of view, there is a California Supreme Court case called *Yamaha* that talks about what deference a court should give to, for example, a BOE decision.

Now, if I had won the case at the BOE, I'd never be in court. If I lose the case and I'm before the BOE, the Franchise Tax Board is going to argue, "BOE is the expert, Judge. You have to give that written decision a lot of deference."

The *Yamaha* case says you have to take all the facts and circumstances in dispute. I, representing the taxpayer, would argue, it shouldn't be given deference; that this is a trial de novo, and the judge should make the decision. But in some cases, judges have given great deference to BOE decisions.

COMMISSIONER KEELEY: My last question -- or my second and last question is you mentioned that the Judicial Council has in the past not looked favorably on this concept.

What is the substance of their objection? I didn't hear what that was.

MR. RUBIN: They would oppose any kind of independent court, something outside of the California judicial system.

There's a way to remedy that --

COMMISSIONER KEELEY: How have the other states remedied that? Because they must have had their equivalent judicial councils not looking favorably on this. What's the solution?

MR. RUBIN: Well, it varies from state to state. Some states have the independent tax court as part of the administrative-law-judge system. Other states, such as Maryland, has an independent tax court.

There are ways to remedy all of the objections that have been brought up if there was a will to have an independent dispute-resolution forum. For example, right now, venue is proper in any of the superior courts in the counties in which the Attorney General has an office. There could be one judge trained in taxes appointed to the superior court in each of those counties. When there were tax cases, the judge could hear tax cases; when there weren't tax cases, the judge could hear non-tax cases. So there are ways around all of the objections that have been raised in the past.

COMMISSIONER KEELEY: Thank you, Mr. Rubin.

Thank you, Mr. Chairman.

CHAIR PARSKY: Richard?

COMMISSIONER POMP: These are honorable people, Fred. They're just honorable people who run for reelection that have ex parte communications.

In a system where a law firm -- and correct me if I am wrong on this, Bob -- but where a law firm can set up a PAC, encourage contributions to the PAC, and that PAC money finds its way into the reelection coffers of the member who will be deciding the case or who has decided the case, you know, it's very hard to tease out of the data whether this leads to biased decisions. It certainly leads to the appearance of bias, and that's so important to correct against.

And this is what we did in New York: We created an independent tax court, not because anyone could prove the decisions were biased, but it was the appearance. No one thought they were getting a fair shake. So this is a system which really sits in the craw of every taxpayer, unless you're a taxpayer who feels you're manipulating it and getting the advantage of it because you know how to play the game, then you have access. But that's no way to run government.

Bob, the federal system, you don't have to pay to play to get into the Tax Court; is that correct?

MR. RUBIN: That's correct.

COMMISSIONER POMP: Is it also correct that, oftentimes, the auditor will hit you with a very large assessment just to keep you from being able to litigate it?

MR. RUBIN: Well, there was a case decided, actually, in 2007 where the Franchise Tax Board issued a notice of proposed assessment which was paid by the taxpayer. The taxpayer filed a refund action in court. And then the Franchise Tax Board issued subsequent notice of proposed assessment of large amounts of money, and then argued that the taxpayer couldn't maintain the refund action until they paid the tax determined in the subsequent notices of proposed assessment. FTB lost that case.

COMMISSIONER POMP: But this is the kind of club that is often used that does not exist in the federal system?

COMMISSIONER EDLEY: I think you ought to elaborate for the benefit of the nonlawyers. For example, in the federal system, the idea is you can go to the U.S. Tax Court and contest without paying up first. But if you want to go to federal district court rather than to the Tax Court and get sort of a real Article III judge with the fancy, expensive black robe, then you have to pay first and then file a refund action with the federal district court. So that's sort of the distinction.

COMMISSIONER POMP: Right, and get a jury.

COMMISSIONER EDLEY: Correct, and you get a jury.

COMMISSIONER POMP: Which is what you really sometimes want.

But, that’s right. You don't have to pay first in the federal system. And most states don't have pay-to-play. So this is a minority position by California.

CHAIR PARSKY: Michael?

COMMISSIONER BOSKIN: Yes, I want to just explore a little further.

I agree with everything all of my colleagues have said, and I especially give deference to those who are -- like Richard and Chris, who have great legal experience and their sense of this as being, at a minimum, just an atrocious appearance problem, if not an actual serious administrative problem. It hits me very hard. And I would strongly support their positions on this.

But I'm just trying to get an idea for what actually goes on in other states. Like, how large are these systems that have developed relative to total tax collections? Are they kind of modest-sized operations and aren’t all that expensive, that wind up offloading -- part of which is offloaded from other administrative actions? Are they big and bureaucratic? Has any state decided they made a mistake in doing this and undone it? Or has it generally been what Richard said about New York, that basically people are at least pleased that they've cleaned up at least an appearance problem?

MR. RUBIN: I know of no state that has gone from an independent system, to a system that isn't independent. And it seems that every year, more and more states are going to an independent system. I'm unaware of any statistics regarding numbers of cases or dollars.

COMMISSIONER BOSKIN: To your knowledge, there is no outcry that it's become big, expensive, and bureaucratic, and we never should have done this in the first place?

MR. RUBIN: No.

COMMISSIONER BOSKIN: My own experience with the Franchise Tax Board, by the way, getting 12 or 15 extra notices a year from my estimated taxes, is that they’re kind of random and equally likely to be refunds and requests for payments. Maybe that will change with the State's budget problems. But I get a lot of notices, and I teach public finance at times and know something about the tax laws, and I find them kind of somewhat incomprehensible and often random but symmetric.

COMMISSIONER MORGAN: My only comment would be in agreement with what's been said about addressing this in one of our charges as a commission, is a 21st century tax structure. And it seems to me the organizations that collect taxes are part of that structure and, therefore, we should be addressing this.

CHAIR PARSKY: I do think that -- first of all, thank you very much, Bob, for doing this.

I think that we certainly have the prerogative for including a recommendation addressed to this. I think we probably ought to step back and ask, are there any other areas of the administration of the tax system that we would want to also take a look at, so it just isn't one -- maybe this is the only issue that would appropriately come to a series of recommendations. But my guess is, it may not be.

So I think the staff ought to consult with Bob and other tax experts on how the system is administered, and see if there are any other items that we ought to deal with.

Bill?

COMMISSIONER HAUCK: One quick question.

Looking at your memo, Bob, you point out that if we allow taxpayers the option of going to court on a prepayment basis, that would go a long way to remedying the problem.

Has that been suggested? Has anybody introduced legislation on that? And if so, what was the BOE’s or the FTB's position on it?

MR. RUBIN: I don't recall any pay-to-play legislation. It was always tax-court legislation.

COMMISSIONER HAUCK: But listening to you earlier, it sounded to me like if we took that as the approach here and we used the existing trial courts of California for this purpose, we'd be going a long way to helping taxpayers get some judicial review. And if we combined that with a simplified procedure for smaller disputes, we would not have to create any new system or new court system, but we would be going a long way toward a more equitable treatment for taxpayers.

MR. RUBIN: That's correct.

COMMISSIONER HAUCK: Okay, thanks.

CHAIR PARSKY: Okay.

MR. RUBIN: Mr. Chairman, at the risk of going somewhere where nobody wants to go --

CHAIR PARSKY: Oh, with this group, you might find that you can go anywhere you want. It's all right.

MR. RUBIN: I mean, I think everybody needs to know this. You've got the Franchise Tax Board that administers the income tax, basically, okay. You've got the Employment Development Department that is responsible for what I'll call *"employment taxes,"* which includes personal income-tax withholding, state disability insurance contributions, unemployment contributions, and disability contributions. So you have the FTB, you've got the BOE -- or you've got the EDD, we've got the BOE who administers the sales and use tax programs. So at the end, you've got property-tax disputes, which is way beyond what we're talking about now. But you've got property tax, which is administered locally and at the state level by the Board of Equalization. Because so-called unitary companies, who have properties in many counties, like railroads and public utilities, their property taxes are determined at the Board of Equalization level. And all of these entities have historical roots. And if you're on the FTB, you're not really interested in seeing your authority taken away. The same thing with the Board of Equalization.

And there have been numerous attempts to combine the agencies; and there's always been great political opposition that has, to date, been successful. But if you're blowing up the boxes and starting over, I mean, that's one thing to think about.

And maybe -- I mean, there's a lot of political reasons why maybe you don't want to bite off that much.

CHAIR PARSKY: Well, we don't want to blow up as we blow up the boxes. So let's take them one at a time and see if we can't come up with some meaningful recommendations.

Thank you. Thank you very much.

Okay, let's move on now. We saved most -- all of the rest of the afternoon for a discussion about tax-reform options, and then we'll talk a little bit about how, the next steps that the staff ought to be doing. And so we ask the staff to come forward and kind of lead us through a discussion of various approaches we can take.

COMMISSIONER KEELEY: Mr. Chairman?

CHAIR PARSKY: Yes?

COMMISSIONER KEELEY: While the staff are changing, could I ask a very quick question of the gentleman from NUMMI just before we get going?

Would you give me just one minute? Would you be kind enough?

CHAIR PARSKY: Sure.

COMMISSIONER KEELEY: Thank you very much.

There we go, great. Thank you. This will be very quick.

We had a bit of a conversation during the break, and I wanted for the Commission to have the benefit of the conversation.

So thank you for coming back in here for just a second.

In your testimony earlier, in your public comment earlier, you were talking about how NUMMI makes substantial investments in one of their two lines almost all the time, and it costs several hundred million dollars to do that. And one of your concerns is the sales tax and so on, on those business inputs.

So your general testimony is that from NUMMI's perspective, it is not a good idea to tax business inputs; correct?

MR. FISHER: Yes.

COMMISSIONER KEELEY: Okay. Let me ask you about what NUMMI's view would be about the later discussion that happened here with regard to carbon taxation, the way it was discussed here, where it was discussed largely in the context, during the questioning, of fuels.

Does NUMMI have a view on that, either as a public-policy matter or in any other way?

MR. FISHER: Let me start my -- you know, let's say, a high level. NUMMI's position is this, is that if the reasonable efforts to minimize the waste in government spending has been put in motion, then any needed tax increase should be broad-based, and in line with what I testified this morning; it should not tax the inputs of business.

Now, getting to your specific question about the carbon tax. I will mention -- I'll start from, in line with that, is that NUMMI -- and they have gone on record on this -- we feel it's detrimental to charge, let's say, a cap-and-trade tax or a tax on permits or allocation fee or allowance fees. All of those things are cost drivers, and they're inputs to business, okay. And they can become very expensive, especially when you're trying to compete with –- do you follow me -- anywhere else.

So in that aspect, with the carbon tax, those are the input taxes that we think are counterproductive, especially for manufacturing.

Now, on the side of, okay, what is in the carbon-tax business, what would qualify as a broad-based tax that would not tax, you know, business inputs. One type I'm just going to mention now is like the gasoline tax. It's not the only one in the carbon tax, but there is something that is broad-based, gasoline, mostly to the people and from that standpoint.

So does that answer the question?

COMMISSIONER KEELEY: Yes, it answers it.

Thank you very much, Mr. Chairman.

Thank you for your kindness in allowing me to ask the gentleman a question.

MR. FISHER: Thank you.

CHAIR PARSKY: All right, Mark and Phil, why don't you start us through this discussion?

MR. IBELE: Certainly.

Mr. Chairman, Members of the Commission, Mark Ibele with the staff, and with me is Dr. Spilberg, who by this time you know well. He plays first base, third base, shortstop. An all-utility player.

So we're going to go through some options and alternatives for you on the personal-income-tax side and the sales-and-use-tax side.

Before we do that, we're going to spend just a few minutes going over some of the issues, background issues that we spent some time talking about, but we thought it would be important to sort of revisit those, however briefly, to keep those in mind when we're going through some of the alternatives. And we're going to tag-team this.

Phil is going to talk about the volatility issue once more. I'm going to talk a little bit more about tax rates and tax burdens. Phil is going to talk about the revenue neutrality, and then we're both going to discuss the distributional issues a little bit. So I'll turn it over to Phil.

DR. SPILBERG: Thank you, Mark.

Once again, let's talk a little bit about volatility. It's an issue that we went over in the first session, and Mr. Genest went over earlier today. But I think it's worthwhile to just go through it quickly, once again.

As Mr. Genest said, the language in Proposition 1A would substantially reduce our volatility problem. But volatility continues to be an important principle of a tax system. And the reason for that is the reserves, if they are established, will not protect against all downturns.

A reserve could be thought of like an insurance policy. And the larger your level of volatility, the larger should be your policy. And there is a cost, there is an opportunity cost to maintaining these policies. Or saying it in a different way, that for a given size of reserve, high volatility offers less protection. And you need more protection with higher volatility.

This is a chart that I did show in the first session. And the important, I guess, line over here or statistic, is that green line which shows the coefficient of variation in California over several decades. And what it shows -- and the way to interpret the coefficient of variation, it can be easily interpreted. That is, if that factor, if that number is twice as large than in the previous period, the volatility is twice as large as in the previous period.

And what this shows is that volatility in California has increased quite substantially over the last several decades. And in the decade 1979 through 1988, it was .75. Now, it's about 1.66. So volatility has more than doubled from that decade. It has gone up by about 50 percent since the last decade.

So volatility has substantially increased, producing the problems that we have right now with deficits which are substantially larger.

COMMISSIONER DE LA ROSA: Can I ask you a quick question? I apologize.

What you're saying, what this chart says is that volatility has increased and is not just the same level of volatility just based on a larger revenue number?

DR. SPILBERG: Right, yes. The degree of volatility has increased.

COMMISSIONER DE LA ROSA: Thank you.

DR. SPILBERG: Okay, the next chart compares us to other states. And, frankly, it's difficult to compare California to other states because we are so much larger than any other state and so much more diverse. But we tried to pick some states which are comparable to California. And of those states, we are the most volatile in terms of our revenues.

There are states which do have higher volatility than we have. And I will list, I have four states, really, over here which have higher volatility.

The state with the largest volatility by far is Alaska. Of course, Alaska has a population of less than 800,000, and most of the revenue is from extraction.

The next state is Wyoming, then New Mexico, and then Michigan. California is the next highest state in terms of volatility.

So we do have a system which is more volatile than other states.

So how does one reduce volatility? Really, there are two ways. One is that one of our most volatile revenue sources is the personal income tax. And if we reduce the volatility of the personal income tax, we will reduce the volatility of our tax system.

The second way to reduce volatility is to reduce our reliance on volatile tax sources. And in terms of volatility, in declining order of volatility, the chart that you see in front of you starts off with transaction taxes. Really, the most volatile source, really, is income taxes.

Below income taxes would be transaction taxes. What is a transaction tax? Our sales tax is a transaction tax.

Just below that is consumption taxes.

What differentiates, really -- or what makes our sales tax a transaction tax, is about one-third of the revenue sales tax comes from business inputs. So a consumption tax would sort of reduce the base. And consumption is less volatile than transaction in total.

Just below that, in terms of volatility, would be taxes on asset values. Assets would include property, it would include wealth, it would include basically stocks rather than flows. And the least-volatile tax would be what economists refer to as a head tax, which is a tax which is just based upon presence in the state. It's not based upon any economic basis beyond that.

COMMISSIONER MORGAN: So, excuse me, if you had the head tax, all those people that moved to Nevada to avoid personal income tax wouldn't get a head tax, either?

DR. SPILBERG: Well, if you had a head tax, everyone in California would have to pay a certain dollar amount. The same dollar amount for every person.

COMMISSIONER MORGAN: Who resides here, how much of the time?

DR. SPILBERG: Well, now you're making this a little bit more complicated. Those would have to be established as to those kind of rules. But basically, I think that the important principle over here would be that the amount of tax would not be based upon either income or your wealth -- some economic condition that creates that tax. So it would be just a presence tax.

COMMISSIONER MORGAN: I understand that, but that didn't answer the question about whether you'd have to be here a month or nine months, or would that be part of any legislation that would institute something like this?

DR. SPILBERG: Right, it would be part of the legislation.

COMMISSIONER MORGAN: I'm not sure we're going to do that, but it was instituted in my home state.

MR. IBELE: Phil, I'm a little disappointed there weren't any *New Yorker* cartoons this time, but perhaps next time.

I'm going to open myself up here a little bit. I know we've talked about the issue of marginal tax rates and average tax burden and so forth, so I'm not going to spend a lot of time on this.

I did want to mention a couple things that I think are important and maybe to make the connection here. And one is that I don't think any economist or tax analyst would argue that the tax rates are the most important thing in location decisions and additional investment.

But the marginal tax rate, that is the tax rate for the next dollar spent, to the next dollar earned is an important consideration I think in most people's minds.

The second point is that, as we increase the marginal tax rate, as we increase the tax rates overall, you're not only increasing the tax revenue, you're also increasing what economists term *"excess burden."* And it's disproportionate with the amount of revenue that's raised. So that's another concern with high marginal rates.

And I think that the final point here -- and this goes to the four charts in this section, State Tax and Revenue Comparison, Comparison of State Marginal Tax Rates, is that we can end up being an average tax state that has an overall tax burden like we have now. We can be a slightly higher tax-burden state and actually have lower marginal rates. And this really goes to the sort of -- one of the common points of interest, I think, that the Commission has addressed, which is broadening this base of taxes and lowering the overall rates. And I think that can have an impact on competitiveness and investment decisions and so forth.

If you go past the next chart, this is the -- we won't spend a lot of time here, State and Tax Revenue Comparison. Again, California, average. Some days, some years, it's a little bit higher than average. Some years, it's a little bit below average. Over time, over the last ten or 20 years, it's been around the average and clustered in the middle.

If you look at the marginal tax rates, again, we're now at 10.3 for a marginal rate which is the highest, and that's going to be increasing.

The corporation tax rate among the highest. And the statewide sales-tax rate, which is 7.25, will go to 8.25 on a statewide basis. In San Francisco, it will go to 9.5.

So average tax state in terms of tax burden, a high tax state in terms of marginal rates, to put it simply.

CHAIR PARSKY: Are there any questions on that?

COMMISSIONER DE LA ROSA: I have one.

Mark, a quick question.

What happens if you remove the top 1 percent of taxpayers? Where would California's average tax rate be relative to other states? Because it strikes me that Colorado, Minnesota, Nevada, Ohio, Oregon, Texas, Utah, and Washington maybe don't have so many really wealthy people living in them as California does. And with 50 percent of the tax being paid by people that are in the top 1 percent of the income bracket, would their removal change California dramatically relative to other states?

MR. IBELE: I'm going to defer to my colleague here.

DR. SPILBERG: Well, in terms of marginal tax rates, on the personal income tax, the tax rate would drop down to 9.3 percent on the margin because that additional 1 percent is for taxpayers with income over a million dollars. And I think that the breakpoint for the top 1 percent is about $335,000, something like that. So that would drop.

The corporation tax, that wouldn't change. You know, the marginal tax rate would stay at 8.84, because that's not really affected by the personal income tax. And the same --

COMMISSIONER DE LA ROSA: On the personal income tax?

DR. SPILBERG: Yes, that would drop from 10.3 percent to 9.3 percent.

CHAIR PARSKY: Any other questions on this concept of marginal tax-rate burden created?

Okay, George?

COMMISSIONER HALVORSON: Actually, I am curious about the answer. If the top 1 percent were taken out of each of the states, if you take out --

MR. IBELE: The top 1 percent?

COMMISSIONER HALVORSON: -- California the top

1 percent, how do our taxes for the other 99 percent of the population compared to other states for the other 99 percent?

I think that was a question.

CHAIR PARSKY: Are you trying to get at the revenue impact or --

COMMISSIONER DE LA ROSA: You often hear people say that we're in a high-tax state. Are we in a high-tax state for everybody or just for the top 1 percent or the top 5 percent? That's another way of asking the question I was getting to.

COMMISSIONER HALVORSON: I literally would be interested in knowing exactly that. If we take out that top percent, then how do we stack up next to other states relative to how everybody else's taxes go.

COMMISSIONER BOSKIN: I think the general answer to that -- no one has that specific data right now –- is that we're a bit above average –- not far, but a bit above average in percentage of personal income or per capita. We have very high marginal-tax rates.

While our top personal tax rate would come down from 10.3 to 9.3 if you excluded the top 1 percent, we still have a very progressive income tax where people at very modest incomes get very high up the income tax very quickly relative to other states.

COMMISSIONER HALVORSON: That's what I was curious about.

COMMISSIONER BOSKIN: Yes, so if you looked at what our income tax burden was for a family of $60,000, it's very high relative to other states, because we're very progressive, very rapidly.

COMMISSIONER EDLEY: I'm confused. Isn't this what's on the tax-distribution-by-quintile charts that are later in the package?

MR. IBELE: Well, there's a couple different issues here.

In terms of the tax structure itself, as Commissioner Boskin indicated, it's quite a progressive tax until you hit a certain ceiling, about $100,000. And after that, it's basically a flat tax, aside from the additional rate for millionaires. But I had a chart in here that sort of indicated the average tax and the marginal tax rates. But it's steeply progressive and then basically flat. So you have a situation where a household earning $100,000 in taxable income is paying approximately the same rate as a household earning $600,000 or $800,000.

DR. SPILBERG: On the margin.

When you look at the tax rate, you should also take into account the other properties of the tax system, which includes credits and deductions. And in California, actually, just not taking into account the temporary reduction or exemption credits.

We have a system where a family with two children doesn't pay any tax until their income rises, let's say, about $47,000. And then, of course, it rises at the marginal tax rate, which is at 9.3 percent.

So people with income of, let's say, $60,000 or $80,000 with two children still don't pay very much tax. And we should think about that when you think about what is really sort of the effective tax rates on their entire income, the average tax rate that they pay.

So we do have a progressive tax structure.

And so you can ask really two questions, and both of them are of interest. One is, what is, in fact, our tax burden? And we can look at the personal income tax and other taxes relative to other states. And the second, which is, again, equally important, is, what are our marginal tax rates? Because marginal tax rates do matter for economic decisions.

MR. IBELE: Actually, that's a good point. And Phil will talk about this a little bit more when we talk about the income-tax options. But for this sort of middle spectrum of households, say, between $100,000 and $300,000, the credits and deductions begin phasing out. So once you hit that -- I'm sorry, they start phasing out at $300,000. $300,000 they begin phasing out, and you get less and less of a benefit from those deductions, until they basically disappear. And the only remaining amount you get is 20 percent. So I probably had my strata a little bit wrong. But after you hit a certain point, it's sort of a flat tax, and you have the average tax basically asymptotically 9.3 or 10.3 percent. You have an approaching equivalent.

CHAIR PARSKY: Chris first.

COMMISSIONER EDLEY: Just to press this a little bit more, though, I guess marginal rates are important, but most of life is inframarginal. Did that make any sense?

MR. IBELE: Yes.

CHAIR PARSKY: If you assert it definitively enough, it will make sense.

COMMISSIONER EDLEY: Okay. I guess that -- yes, it's sort of like you worry about what you're going to be thinking on your deathbed. But most of your life, there's the other 25,000 days.

DR. SPILBERG: Only the death part is marginal.

COMMISSIONER EDLEY: Right, exactly.

So, I mean, as I look at the charts that you have, it looks like the effective tax rates in California are kind of middle of the road. That there are a lot of states with more effective tax rates over most of the range -- I'm sorry, with higher effective tax rates over most of the range than California. So I agree with you that we need to think about effective tax rates as well as marginal tax rates. But the burden is not the margin. The burden is the effective tax rate. The incentive issues are the marginal questions.

DR. SPILBERG: Right, yes.

COMMISSIONER EDLEY: But that then begs the question of what else is happening at the margin to affect and influence people's behavior from the weather to the -- personally, I'm desperately afraid of earthquakes, and think about that more than I do my marginal tax rate, but…

COMMISSIONER COGAN: What are you doing here?

COMMISSIONER EDLEY: I didn't say I was rational.

MR. IBELE: Commissioner Edley, do you want me to --

CHAIR PARSKY: Do you have a comment?

MR. IBELE: I think that's an excellent point. I think in most of the business-location-decision literature, taxes is not one of the top concerns. And there are obviously other labor costs, labor quality, transportation, so forth.

I think it is one of the few things that, you know, decision-makers, policymakers can directly affect, and they can say, "Oh, we're going to change this tax rate," as opposed to more sort of the indirect or long-term decisions.

And in terms of the overall tax burden, that's clearly important for companies, for individuals, as is, you know, deciding where to put the next dollar of investment.

I guess the point I was trying to make is that we can come to a point where we can replicate this sort of average tax burden here with a different tax structure.

COMMISSIONER EDLEY: You know, here's another way of thinking about it analytically given our concern about volatility. Suppose you took one of these charts that you have that looks at tax burden by quintile. Not at the marginal rate, but by tax burden by quintile. It would be interesting to try to think about where along that curve most of the volatility is.

And I assume that the answer would be at the top; right?

DR. SPILBERG: Yes.

COMMISSIONER EDLEY: And the reason I phrased the question that way is, because if we thought about introducing a new revenue source, be it sales taxes or carbon taxes or tweaking Prop. 13, whatever, and then you wanted to use that added revenue to displace some current revenue source, if the goal is exclusively in terms of reducing volatility, that tells you that you ought to be substituting this new revenue for the revenue that's currently coming from the top quintile, top decile, et cetera.

DR. SPILBERG: Yes.

COMMISSIONER EDLEY: If, on the other hand, you think that the tax burdens are appropriate at the top of the scale, and we'd be more interested in using the new revenue in order to reduce tax burdens, either across the system or for the middle class, say, then that would suggest a different strategy for what revenue we swap out for the new, but it wouldn't give you the same bang in terms of reducing volatility. So I don't know where that leads me, but I guess I don't have any theological objection to reducing marginal rates at the high end, but I don't particularly care for reducing -- for making the tax burden less progressive.

CHAIR PARSKY: Just hold that thought until we get into a discussion of progressivity.

COMMISSIONER EDLEY: Yes, I'm sorry.

CHAIR PARSKY: I think that's certainly a very legitimate position.

And I know, Chris, you've expressed it at several meetings. It's very important. But I think it's important that -- the first kind of subject matter is volatility -- all of these have got to be melded together in some way. The first subject is this volatility issue, but we will get to progressivity. And also, we want to talk about neutrality.

But I would really urge everyone to not focus on one single point in time, given the fact that we've got to look at a system over a period of time; and the fact that our tax laws have been in existence, in basically its current state, for a long period of time. So just bear that in mind as we get through each of these.

COMMISSIONER POMP: Mr. Chairman, I have a comment to make. Because Mark said something very important, and I hope it doesn't get lost, and that is that legislators want to do good, and they run for office in order to do good. And you have a fairly limited set of tools as a legislator. One of them is taxes. And so there is just the human tendency to perhaps put too much weight on what you can achieve through a tax system. It's part of the natural –- things you can only control so much.

I can't control -- no legislator can -- Chris's fear of earthquakes. It's a reality out here. Not much you could do about it. Maybe better detection and all that. The climate. You know all the things that are basically outside the control of a legislator.

And so taxes tend to be focused on -- and we have to be careful about statements like “Marginal rates make a difference.” Well, you know, as I’ve suggested before, even at the federal level, with high marginal rates, much higher than California's, we cannot answer basic questions like: Do higher taxes discourage people from working or encourage people from working? Do higher taxes encourage more savings or discourage savings?

And you can't answer them at higher marginal rates, you certainly can't answer them at a lower state rate. Nonetheless, appearances can be important.

And I sort of share Chris' perspective that to the extent without doing undue harm to distributional concerns, if we can lower a top rate -- I think when *U.S. News* does the simple-minded ranking of states by marginal tax rates, you pick up a little bit of advantage. Not for anyone sophisticated. No sophisticated person is going to be fooled. I mean, I pay 5 percent in Connecticut. Would I be better off coming to California and paying 8 percent? Maybe. You know why? Because my 5 percent is on adjusted gross income.

Well, I'm not going to be fooled by our low rate. It's on a very broad base, and I get no deductions.

Tax managers aren't going to be fooled, but some people will be fooled.

COMMISSIONER EDLEY: We may not want them.

COMMISSIONER POMP: You may not want them. That's right, you may not want the green-eyeshade types, either, who know the cost of everything, the value of nothing. Maybe you don't want those as neighbors. That's a legitimate question to ask.

CHAIR PARSKY: That’s why Connecticut is not close to California, you know.

COMMISSIONER POMP: The other thing I find interesting is that most of the surveys show -- and, again, this is at the federal level -- most people cannot tell you what they paid in the federal personal income tax. They can tell you what their refunds were and they can tell you what the check they wrote in April or October, whenever you file your extension; but they can't tell you what they actually paid in the aggregate. And I find that very interesting. So it's sort of --

COMMISSIONER BOSKIN: Is that a plea to repeal withholding?

COMMISSIONER POMP: What was that?

COMMISSIONER BOSKIN: Is that a plea to repeal withholding?

COMMISSIONER POMP: No. Nor is it a plea to exempt the top 1 percent in this state to solve the volatility problem.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

We've been over this ground before, and we're destined to go over it again, I'm sure; but the issue of volatility I think can be looked at a couple of different ways. And one is, we're treating the issue of volatility -- first of all, we've said it's a bad thing, and we sort of value-judged volatility. And that, I guess, it may be yes, may be no. But then what we've done is we've focused mostly on, well, this volatility issue manifests itself when there's either too much revenue, called a "*surplus*," or too little revenue, called a "*deficit*." And then we focus in on the sources of those revenues. Well, it's the personal income tax. It overperforms in good times and underperforms in bad times. We know all of that. So that's well established. But it seems like it is equally as important to say, from a budgeting point of view, when you're managing the fisc of the state, why is this a problem?

It's only a problem, it seems to me, because until May 19th, when the voters adopt 1A, if they do, then arguably, is this any longer a problem? Or if so, to what extent?

Now, let me just finish. I'm not trying to campaign here. I'm just trying to say --

CHAIR PARSKY: No, that's okay.

COMMISSIONER KEELEY: Just whatever they do, they do. But if they pass that, where is the problem then? Because the problem isn't, it seems to me, whether we bring in too much tax money or don't bring in enough tax money, surplus and deficit; the issue is, does the Legislature and the Governor have the tools to manage those in such a way as to take the volatility out of the budgets? Not take the volatility out of the revenue. They're completely different issues.

I understand the problem when you're sitting there and you're on the downside of the business cycle and the two big sources of the general fund are underperforming in the economy significantly, and the Leg. and the Governor are sitting there, saying, "How do we deal with this deficit?" Because when they were on the upside of the business cycle and the two major sources of the general fund were overperforming in the economy, and they -- and I count myself among them when I was in the Legislature -- don't have the discipline to take it and either spend it on one-time purposes or take and put it in a rainy-day fund but once you establish that rainy-day fund, once you say we're going to go to 12½ percent of the general fund, and you discipline yourself through the constitutional amendment or statutory initiative and do that, why is it a problem then?

CHAIR PARSKY: Well, just pause on that.

I thought part of our discussion this morning was to try to give a little insight into just an answer to that question.

And what I heard -- correct me if I'm wrong -- what I heard is that the 12½ percent rainy-day fund could address elements of volatility but couldn't solve the volatility issue entirely.

COMMISSIONER KEELEY: Okay, now, I think that's fair. I think that's fair because -- but I would also say that over every downturn we've had in the economy in the modern era of the state of California, since there's been a full-time Legislature, which I will call the modern era -- that's what we call the modern governance era in California -- there has never been a deficit that would not have been solved by the 12½ percent general-fund problem. Am I right?

If you had 12½ percent general-fund reserve, would you still be in deficit?

CHAIR PARSKY: I think we should get an answer to that question. But what was made clear, Fred, was that a subsequent continuation of this downturn -- again, we can't redo the past. What we can do is to make some changes that will attempt to address the future.

COMMISSIONER KEELEY: No, I totally understand that, Mr. Chairman.

CHAIR PARSKY: It was pretty clear from this morning that a continuation of the economic downturn would create the need for about a 30 percent rainy-day fund --

COMMISSIONER KEELEY: I understand that.

CHAIR PARSKY: -- to address the issue.

That's not feasible.

COMMISSIONER KEELEY: Okay, well, Mr. Chairman, I understand that. I'm not debating that issue, because I fully understand that. But what I'm saying is, it seems like where this is going is to say that somehow, you need to bring in less revenue when you're going on the upside of the business cycle, and you need to bring in more revenue when you're going on the downside of the business cycle so that you get rid of volatility. I mean, is that where this argument goes when you focused in on the revenue side of the picture, the personal income tax of the picture?

CHAIR PARSKY: No.

COMMISSIONER KEELEY: Where else does it go?

CHAIR PARSKY: Well, no, I think it's saying, in part, that the current system of taxation, the reliance that there is on the personal income tax as opposed to other taxes that may create a more predictable revenue stream over a trend line ought to be considered. Because even with the budget reforms that have been created, if we leave in place the current system, we don't change it at all, we haven't solved the potential problem that could exist if we had a continuation of downturns.

COMMISSIONER KEELEY: Okay, Mr. Chair, I'll just conclude with this. I don't disagree with that and I'm not a defender of the current system. I agree. I think as we move along over the next couple of months, there will be all kinds of proposals for changing the current system. But I do find it curious that there is this sort of bashing on the personal income tax which has been a part of the history of this country, and part of the history of this state ever since it's been in place. And it's a progressive income tax.

And I don't know anyone who seriously argues that it should be dramatically changed. Maybe there is, maybe there isn't. But I think the heart of the issue here is that revenue volatility as a problem from a fiscal-management point of view is less about this issue of what's in there than it is, what kind of state do you want to have? What do you think the government ought to be doing? What kind of budget do you think we ought to have? Are you satisfied that when they adopted the budget at 4:20 in the morning a few weeks ago and we went from 44^{th} to 50^{th} in per-pupil spending in the United States, that it's a celebratory occasion? No. And that's revenue volatility.

How does this solve that issue? I mean, because budgeting isn't about trying to erase revenue volatility, it seems to me. I understand why the Governor put it in there. And my guess is, how much of a fix do you think we need to put to this problem? Because there is a fix that's on the ballot now that alleges to solve this problem -- or in the main, solve this problem.

But, anyway, thank you very much, Mr. Chairman.

CHAIR PARSKY: We'll continue this discussion. I mean, the purpose, one more time, of bringing up these issues now is I think it will be very difficult for us to come up with responsive recommendations unless we understand the dynamic of these issues.

So any other comments on the volatility question?

Mark, do you want to make some other comments before we move on?

MR. IBELE: Not particularly.

CHAIR PARSKY: No, no, you can keep -- your head is now in a noose. We can let it go in a little farther.

That's okay.

Phil, any comments --

MR. IBELE: If there's something -- we don't have the numbers right now. We couldn't respond directly to Commissioner Keeley's question about where we would be if we had done this in the past.

We will, no doubt, revisit this again. And we'll --

CHAIR PARSKY: Well, I do think that my friend, Curt Pringle -- I probably ought to interject this now, since I would before this session is over -- he, for one, wants to have a discussion and a presentation to us of a more transforming reform to go to a -- not a loan, but to go to a flat-tax system.

And as with all of the requests from the commissioners, we'll try to get that presented to everyone, so we can see exactly what might happen if we made some major changes in the tax system, and how that might affect volatility, progressivity, and all the other factors.

COMMISSIONER MORGAN: Gerry, because you're talking volatility, before we move on, is there any way -- you know, we've just put in a new gas tax for two years for revenue.

Pardon?

COMMISSIONER HAUCK: That came out.

CHAIR PARSKY: That was --

COMMISSIONER MORGAN: That was the 12¢, as far as the negotiation. You're right, I'm sorry.

CHAIR PARSKY: By 4:00 a.m.

COMMISSIONER MORGAN: I went to bed at midnight. I'm sorry.

One of the suggestions that came to me as I've asked around Silicon Valley, is what would happen Prop. 1A were to pass and we wanted to speed up the collection, and the biggest piece of volatility in the personal income tax is capital gains. What would happen if, for one or two years, the capital gains tax was reduced to 1 to 5 percent? Is there any way of estimating how much revenue would come into the state? Because people are holding out on their capital gains because everything is in the tank. But if they knew that they could sell something now and only be taxed 1 or 5 percent, would it kick-start the gap in the budget?

COMMISSIONER EDLEY: Who has gains? Raise your hands.

COMMISSIONER MORGAN: It's not December yet.

COMMISSIONER BOSKIN: Everybody that has mutual funds is going to be taking capital gains taxes. They have a large net loss. But there was trading throughout the year. And when they start paying their taxes in the next few weeks, they're going to be freaked out that they're paying capital gains taxes.

CHAIR PARSKY: Do you want to make a statement, Phil?

DR. SPILBERG: Yes, what you're referring to is what's described as *"unlocking,"* unlocking of capital gains when the capital gains tax rate is reduced. That is, in fact, something that revenue estimates do take into account.

It obviously does depend upon the stock of unrealized capital gains. So in this kind of environment that we have right now, the unlocking would be substantially lower than it was in some previous years. But there is some of that effect, and it includes -- and it's not just due to stocks, but it also can take into account the sale of businesses and the sale of real estate. But all of those are affected, obviously, by the market, by the present valuations.

COMMISSIONER MORGAN: And I was just putting that on the table as one possibility for a source of revenue.

CHAIR PARSKY: Okay, Mark, why don't you go ahead?

MR. IBELE: We'll go on to the next topic. This is actually Phil's, too, on the revenue neutrality. It's going to just touch on that a little bit.

DR. SPILBERG: Yes, now, that's something that we also went through, to some extent, in the first session. And so, therefore, this is sort of a review of what we did at that point.

And in the first session, we saw that there seemed to be a remarkable stability, at least during this historical time period, 1973 to 2008 in terms of the amount of revenue that was brought in to the general fund. And it stayed generally around 6 percent during that time period. In fact, during that time period, a 10 percent change in personal income would tend to be a 10.2 percent change in general fund revenues.

What this implies is, one way of thinking about revenue neutrality is to establish a system that also brings in approximately 6 percent of personal income into the general fund. If that system was to be less volatile than our current tax system, then it would bring in a bit more during downturns, it would bring in a little bit less during economic booms; but overall, it would wind up being somewhere around that 6 percent.

And this is sort of the statistical relationship which I presented at the first session. And it lays out the equation that derived this relationship.

I'm not going to go through this anymore. But this, basically using that statistical relationship, this is sort of the relation to personal income that was derived. And as you can see, during that time period you have general-fund revenues of somewhere around 6 percent. A little bit less than that during the beginning of that period and a little bit more at the end of that time period.

CHAIR PARSKY: Just stay with that for one last second, because I just want to make sure that that is clear.

If we decided to adjust the current tax system, change this, change that, but wanted to achieve this trend line, a trend line over X period of time, and it was applied, it would result at this downturn period in a tax increase?

DR. SPILBERG: Yes. Yes, if that system was less volatile.

CHAIR PARSKY: Less volatile?

DR. SPILBERG: Yes.

CHAIR PARSKY: So in one sense, attempting to achieve less volatility in a revenue-neutral way, different elements of the tax system applied -- or the same elements applied differently?

DR. SPILBERG: Uh-huh, yes.

CHAIR PARSKY: You would be effecting a tax increase during this downturn period?

DR. SPILBERG: Yes. If what you were intending to do was put in place a tax system that was revenue-neutral in the long run; in the short-run, it would be a tax increase.

CHAIR PARSKY: And it might, in another period, result in a tax decrease or cut?

DR. SPILBERG: Yes.

CHAIR PARSKY: Okay, I just want to make sure everybody kind of has that perspective.

COMMISSIONER POMP: Can I ask a question about the chart, Mr. Chairman?

The definition of personal income, Phil, is what?

DR. SPILBERG: Well, I think that this was personal income for economic purposes. This is NIPA personal income for California.

COMMISSIONER POMP: And which means what?

DR. SPILBERG: National income and product accounts.

COMMISSIONER POMP: I know the acronym. But I'd like you to explain to people what it means.

DR. SPILBERG: For economic purposes, it would be the measure of personal income. It is related to adjusted gross income that one would see on the tax return. But it would take into account income that is not reported on the tax return. It would include, for example, transfer payments --

COMMISSIONER POMP: Transfer payments. So we're talking welfare payments?

DR. SPILBERG: Yes. It would not include capital gains because that's not included in NIPA. So there would be some adjustments to AGI.

COMMISSIONER POMP: So it's a little different definition than what we think of in terms of taxable income?

DR. SPILBERG: Yes, it is.

COMMISSIONER POMP: All right.

MR. IBELE: Okay, the next topic. Tax burden distribution, which has come up frequently. And there's a lot going on here. In the interest of time, I'm going to skip the first two charts, the one that compares California to other states because we've compared California to other states, and we're not going to do it again right now. But we can come back to those if we have time.

CHAIR PARSKY: You learn from previous discussions. That's pretty good.

MR. IBELE: So we'll skip the spaghetti balls.

This you've seen before, this somewhat gaudy chart here. But it basically shows the contribution of revenues by source for general fund. And the results here are pretty stark. We're going from, roughly, in 1950-51, sales and use tax about 60 percent of general revenues, and the personal income tax was about 11 percent. Today, the personal income tax is about 55 percent, and the revenue from the sales and use tax is just about a mirror image of what it was previously.

And even in the last 25 years, the difference is fairly stark. In 1980-81, each of those major revenue sources, sales and use tax and personal income tax, was about 36 percent. And in the most recent year, it's dropping in the 25 to 30 percent range for the sales and use tax.

So this demonstrates one of the things that's going on. We're shifting, the State's portfolio is shifting quite dramatically.

And if you look at the next chart here, this you've also seen. Actually, this is from Phil's presentation at the first meeting.

The reasons for the decline, increasing consumption of services relative to tangible personal property, increase in intangibles, remote sales, and to a limited extent, additional tax-expenditure programs on the sales-and-use-tax side.

COMMISSIONER BARRALES: So what you're saying is the Internet and the like are causing a reduction in the sales-tax revenue?

MR. IBELE: Well, this is a relative decline in the contribution of the sales tax. The sales tax has grown fairly consistently over the years if you look over in the long term. But relative to personal income, it's declined.

COMMISSIONER BARRALES: Relative to the personal income. Okay.

COMMISSIONER BOSKIN: And it actually predates the Internet. It's basically the shift of services.

COMMISSIONER BARRALES: Uh-huh, okay.

MR. IBELE: You can see the steep --

COMMISSIONER BARRALES: Yes, it did look as though -- I mean, it's changing, looking at your other chart, your previous chart, before the Internet really came online. But it's related to services. You mean, we have less stuff and we're buying more --

COMMISSIONER BOSKIN: But more and more of our spending is on services and less and less on goods.

COMMISSIONER BARRALES: Okay, thank you.

MR. IBELE: Now, the reason this is important, how does this relate to distribution?

The next chart shows the distributional impacts of the sales and use tax. And I should say that in putting this together, there have been a certain -- some assumptions we've heard before that, really, the denominator in something like this should be total consumption, it should be taxable consumption as a proportion of total consumption. This is based on income, not consumption. And it's also based on annual income as opposed to lifetime income or permanent income.

And the argument here is that if you were to use a consumption comparison, you'd end up with a much less regressive tax. It's almost flat. And if you were to use annual -- I'm sorry, if you were to use permanent income or lifetime income, you'd end up with a less regressive impression of the sales and use tax.

And the reason for that has to do with basically what people call transitory income. You might be in a situation where you sell a business or you receive a gift, and for one year, you don't work, you don't have income, and yet you spend at the same rate or in the same sort of manner that you might have in a previous year when you did have income.

And I would indicate that your tax rate -- your effective tax rate, on the sales and use tax is higher than it would be if you measured against your sort of wealth or what you have available for spending.

COMMISSIONER BOSKIN: I think it's also reflecting kind of natural life-cycle things. I was in the bottom decile when I was a student at Berkeley, for example. So people -- I mean, there's a lot of fluctuation, there's this transitory component you're talking about, including especially for labor market and health incidents. But as you go through time, basically incomes tend to rise and then they peak, and tend to fall during retirement.

COMMISSIONER POMP: I have a question, Mr. Chair.

I have heard it said that as income goes up, the composition of consumption shifts from tangible to services. Is that borne out by your work in things you have seen and read?

MR. IBELE: I think that's going to come out in our later discussion on the sales-and-use-tax options. Because we have one of the options or alternatives being taxing a limited number of services such as really household services, like entertainment and so forth. And we can look at the effective tax rate there.

COMMISSIONER POMP: Okay, I will wait.

MR. IBELE: So that's essentially what this means, is that we've moved away from a sales-and-use-tax base, which is at least based on the measure that we've used here to be consistent with our other comparisons, annual income, which is largely regressive, moving from a rate at the low end of about 3.5 percent, to the highest decile, a little less than 1 percent. And we've basically shifted over to the personal income tax, both for reasons that we've adjusted the marginal tax rates to make up for the loss, but also because of the income shift that's gone on.

And Phil is going to talk about the implications on the distributional side for the personal income tax.

The important thing and the main sort of point that I want to get across, that we would like to get across, is that the distributional notion is a -- it's not a static concept. It's moving, it's shifting. It was different ten years ago. It was different 20 years ago. And it's based on our current, sort of the way the economy moves. It could be different ten years from now.

So there have been changes that have occurred over the decades, and Phil will talk about the personal-income-tax side of that.

DR. SPILBERG: I'm actually going to skip the next two charts and go to that chart that has just the blue lines on it -- the blue bars on it, that is.

And when you think about distribution, we think about tax burden along the distribution, what I would call sort of the distributional neutrality that we are sort of thinking about over here and why that's a moving target.

One of the properties that would change, let's say, tax burdens across time is the distribution of income. And the common sense of this is that the greater is the portion of income, let's say for the high-income people, the greater would be the amount of tax that you would expect them to pay. And that is what these bars are sort of indicating: That if you just look at that period of 1980 to 2006, you see that the portion of income for the top 10 percent has gone up. It's gone up from roughly 35 percent in 1980, to about 50 percent in 2006.

So this, in and of itself, would result with sort of an increase in the tax burden borne by the top 10 percent because their income has gone up.

Also, what would change the distribution of tax burden is basically the mix of taxes, or the progressivity of taxes that people are subject to. And this is basically what this next chart is trying to demonstrate.

We know that there has been this change in the portion of general fund coming from the sales and use tax and the personal income tax. And we also know that the sales and use tax is less progressive than the personal income tax.

Now, Mark has said that when you look at the sales and use tax, the progressivity of the sales and use tax, it's a little bit complicated because on the personal income tax, well, that's the tax divided by income is a fairly simple concept. But on the sales and use tax, we have this problem with life-cycle income and permanent income and transitory income. And those are much more difficult issues to deal with.

What this chart basically does, is it just takes the annual progressivity of the sales and use tax and the personal income tax. And then for 2006, it showed that about 25.3 percent of the sales and use tax was borne by the top 10 percent and 78.5 percent of the personal income tax was borne by the top 10 percent.

And then what it looks is, what if in 2006 we had sort of the distribution of our taxes, the sales and use tax and the personal income tax, as it existed during those historical time periods: 1950-51, all the way down to 2007-08. What would be the tax burden distribution in 2006 if, instead of the actual distribution of taxes between the personal income tax and sales and use tax that we had in 2006, it was as though it was in these historical time periods?

And what it shows, what this chart shows is that the tax burden distribution in 2006 would have been dramatically different if the distribution of our tax composition was substantially different.

If our distribution of taxes in 2006 was similar to what it was in 1950-51, then the tax burden for the top 10 percent would have been 33.8 percent. But for 2007-08 it would have been 60.9 percent.

So what it shows is that with respect to tax distribution, we do really have a moving target. We have a change in the income distribution that was sort of shown separately in the previous slide, and we have this change in the composition of our tax system between the sales and use tax and the personal income tax that is resulting with changing in our burden distribution. And these changes have really occurred automatically. There hasn't been any process in place, political process or otherwise, that has moved our system toward a more progressive system; and it just happened over time.

COMMISSIONER POMP: Can I ask a question, Mr. Chair, on this?

Are you suggesting that because the percentage paid in the aggregate of, let's say, the top 10 percent increases over time, that is an indication of the system becoming more progressive?

DR. SPILBERG: To the extent that the portion of your general-fund revenue shifts to the personal income tax from the sales and use tax, the system becomes more progressive because you are moving from a less-progressive tax source to a more-progressive tax source.

COMMISSIONER POMP: Okay, but it doesn't follow because your top 1 percent is paying a higher percentage of the PIT, the system is necessarily progressive?

DR. SPILBERG: Right.

COMMISSIONER POMP: That could happen under a flat tax, if I just have so many more wealthy people than poor people?

DR. SPILBERG: Right, right. And that was --

COMMISSIONER POMP: Okay, as long as we're clear on that.

DR. SPILBERG: Yes. That’s exactly what we were --

COMMISSIONER POMP: And I want to keep that clear as we go through this.

DR. SPILBERG: Yes, and that was basically what I tried to show in that chart, that this chart shows that the system would tend to show a higher tax burden for high-income people just because the income distribution has become more concentrated. And so this, what we've tried to do is basically isolate those two components. This basically focuses on the income distribution. And this, in a sense, is independent of the income distribution.

CHAIR PARSKY: And I think also your point, or what you want us to bear in mind, is that, going back to your point about not taking a static point in time, that you could look at tax-burden distribution, progressivity, regressivity, over a trend line, just the same way you could look at revenue neutrality over a trend line; right? Is that part of what you're suggesting people think about?

MR. IBELE: Yes. I mean, I think what we're trying to point out is that that's –- just to put it in slightly different words -- the distribution of the tax burden has changed going back to 1950. And it's largely become more progressive but for a number of different reasons. Changing from one type of tax to another type of tax, but there have also been shifts in income.

COMMISSIONER POMP: All right, and just so I understand, this is meant to be a descriptive statement rather than a normative statement?

MR. IBELE: This is intended to be descriptive.

COMMISSIONER POMP: Okay, thank you.

COMMISSIONER COGAN: So to get at, I think, the point Richard's going to and Chris is going to as well, if you looked at the average tax rate by income group, let's say, for the top 10 percent, what would have happened to the average tax rate, say, PIT tax rate? What would happen to the share of their income that's getting taxed? Has that gone up or has that gone down?

DR. SPILBERG: You know, it probably -- the PIT tax rate has really not changed all that dramatically -- the personal income tax rate has not changed all that dramatically.

COMMISSIONER COGAN: Not the rate. I'm thinking of the share of their income which they pay in taxes, which is equivalent to an average rate but not a marginal rate.

Another way to think about the burden, if you've got two things that are going on at the same time, one thing is that the incomes are becoming more and more unequal and therefore the share of income -- of total income taxes that are being collected, that are collected from the upper-income group, is going up. That's one concept; right?

Another concept is that you've got that burden on those is also going up.

So which is it? Which is dominating here? Or maybe -- you don't have to answer that now, but it's a good thing to come back to.

MR. IBELE: I think we'd like to spend some time looking at that.

COMMISSIONER COGAN: Yes. It's a different way to measure the burden that Chris and Richard are getting at and it would be very helpful, I think --

COMMISSIONER EDLEY: The effective tax rate of the median taxpayer would be another way to think about it.

MR. IBELE: And you just mentioned the personal-income-tax rate.

COMMISSIONER COGAN: Yes, and then do it for both.

DR. SPILBERG: Right. The average -- let's do the average because it's just easier to compute.

COMMISSIONER BOSKIN: Yes, that would be very, very helpful. But while you're doing that, it would be good if you also gathered information on capital gains, because you're including it in the taxes but not in the income. And on transfer payments, because what we really care about is the after-tax and after-transfer payment distribution of income. So if we raise taxes on different groups but raise transfers to them or something of that sort, we might consider offsetting it or something. So we'd want to make sure that we're looking at the net change in their post-tax and post-transfer.

DR. SPILBERG: Probably the easiest way to make that calculation, if you think that that would be adequate for this, is calculate the ratio of personal-income-tax liability divided by adjusted gross income. Because the adjusted gross income is obviously the base. It does not include capital gains -- I'm sorry, it does include capital gains. So we could make that kind of computation.

COMMISSIONER BOSKIN: I'd like to get transfers also, not just taxes. Most of our transfers aren't taxed. Many of them are excluded from both personal income and adjusted gross income.

DR. SPILBERG: Okay.

COMMISSIONER BOSKIN: Some are included and some are excluded from adjusted gross income.

CHAIR PARSKY: Jennifer?

COMMISSIONER ITO: I'm just wondering, unfortunately I didn't drag all my binders with me to this meeting, but I remember seeing a chart at the last meeting that I'm wondering if it was -- that it looked at I thought the tax burden, but it was based on a percent of the burden by quintile based on the adjusted gross income.

Does anyone remember that chart? Because I remember looking at kind of the percentage rate. And, actually, it showed that, towards the bottom, the lowest quintile paid a larger share of their income in taxes versus the other quintiles. And so I'd be curious to see kind of that type of analysis, looking at the trends of that analysis dating back to 1950 to the present.

COMMISSIONER HALVORSON: It was the blended chart sales.

COMMISSIONER DE LA ROSA: That was the California Budget Project that had that.

COMMISSIONER ITO: Yes, right.

COMMISSIONER POMP: I think Jennifer is referring to the one that included property taxes, sales taxes, income taxes.

MR. IBELE: Was this staff presentation?

COMMISSIONER EDLEY: California Budget Project, maybe?

CHAIR PARSKY: It's a group in Sacramento.

COMMISSIONER KEELEY: California Budget Project.

CHAIR PARSKY: Yes, California Budget Project. It may have been in there.

COMMISSIONER POMP: And it goes back to Citizens for Tax Justice that put out that “Who Pays” periodically.

MR. IBELE: Right, I’ve seen that.

CHAIR PARSKY: Well, it blends in with what John was saying. I think it is important to recognize the kind of dual development that has happened, namely, that incomes are becoming less equal but the burden is also being shared disproportionately. You have to kind of see both at the same time.

MR. IBELE: And we've tried to separate that, perhaps not as successfully as we would have liked. But that's exactly right, there are these two things that are going on simultaneously.

CHAIR PARSKY: John?

COMMISSIONER COGAN: One more thing on data. As Michael said, as individuals age, their income changes fairly significantly as you move up the income ladder for a while, at least.

So I'm wondering, is it possible to link up tax returns, has anybody done that, over time? So you can answer the question for us, if we take a group of people, say, ten years ago or 20 years ago, and ask how much were they paying in taxes, look at the lowest quintile, and then ask now how much are they paying in taxes, and where in the income distribution are they. That is, can you get those data for us?

DR. SPILBERG: The same person, right?

COMMISSIONER COGAN: The same person, right. So you can look at income mobility and, hence, tax mobility to get a better feel for the distributional tables that we're looking at.

MR. IBELE: I think -- I'm not familiar with the literature. I don't know if the Michigan longitudinal study does something like that or --

COMMISSIONER COGAN: You know, at the federal level, the IRS, actually, the Treasury has done this, at the federal level, where they've literally taken tax returns and linked up the same individual over a ten-year time period. I'm wondering whether that's been done at the state level or not.

DR. SPILBERG: It's more difficult to do at the state level because of cross-state mobility. It is certainly possible to match returns over time, but there is a substantial amount of fallout. And the problem is, what do you do about new entries, what do you do about exits?

It's something that certainly the Franchise Tax Board has done in the past. It's doing it over a ten-year time period is something that hasn't been done. And it really is -- there's problems. Let me just say that there are just mechanical problems. Some of it has to do with having the age variable on the return, because you will have new entries and you will have exits, and you have to determine, is this a new filer in the state, how old is that person, is the exit due to the person dying or has the person just become a non-filer because they left the state or some other reason? It's a mechanical problem.

COMMISSIONER COGAN: But you're saying it has been done before or --

DR. SPILBERG: It has been -- there have been cross-year comparisons done using state data.

COMMISSIONER COGAN: If they're off the shelf, maybe you could provide them to us. If they're not off the shelf, forget it.

DR. SPILBERG: Yes, I'll try to see what's available that has been produced in the past. But there are also, like, transition matrices, things of that sort.

CHAIR PARSKY: Chris?

COMMISSIONER EDLEY: If I can go up to 40,000 or 50,000 feet for just a second. I think looking forward to that bright day in the future when we're done, though, I think we would do an enormous service to ourselves as well as the public if we actually had a coherent way of talking about the distributional issue that was as clear and intelligible as possible with, I’d suggest, no more than three different lenses. You know, hear three of the 46,000 different ways about thinking about distributional impact of the California tax system -- boom, boom, boom -- and here's how we would analyze our proposals relative to whatever. But something that -- so I guess what I'm just saying is, it's probably not too soon for us to be thinking about how we educate the public as we roll out our analysis and our explanation so that they'll be able to wrap their minds around all of this distributional stuff.

CHAIR PARSKY: Well, I do think that the same suggestion might apply to each of these issues that we're now talking about.

COMMISSIONER EDLEY: Good point, right.

CHAIR PARSKY: That's why we thought that it was important to revisit these, and then lead into just some preliminary discussions of alternatives, which are coming. But I think you make a very good point. Each of these three areas that we have been addressing, we want to try to put through that kind of lens. Namely, here's how you need to look at this, or here are alternative ways to look at this. And then see if we can get some common ground here.

Go ahead, Mark.

MR. IBELE: If there are no more questions or comments on the distributional side, we can go on to talking about some of the options and alternatives.

And, again, Phil is going to talk about the personal income tax, and then I'll cover the sales and use tax.

DR. SPILBERG: Okay, so in this part, we have tried to do some calculations where we would expand the tax base in those two tax sources. And I'm going to start off with the personal income tax.

And let me just start off by saying that I found this somewhat disappointing in what the calculations came out with, so I'm just going to lay down the expectations low to begin with.

CHAIR PARSKY: Since they were your calculations, you know, you had some control over them. Now, come on.

MR. IBELE: He left the country.

DR. SPILBERG: Well, let me start off with the good news. The good news is that it is possible to dramatically reduce the tax rate if one expands the tax base to eliminate all deductions and all credits. Then for 2006, the top rate will have dropped from 9.3 percent to 4.08 percent. However, there are many winners and losers when you do that. And, in fact, there are some extreme changes to the tax-burden distribution.

To achieve a similar level of progressivity, it required -- I had to put in basically four tax rates, and also put in a $200-per-return exemption.

Now, keep in mind, this is illustrative. This is not a proposal of any sort. This is just trying to just work through the numbers, and seeing how I could increase the tax base. And when I put in basically this tax structure and that exemption amount, the top rate only came down to 8.35 percent, from 9.3 percent and 8.35 percent. And that's where it was pretty disappointing to me.

CHAIR PARSKY: But, Phil, this operates under the assumption that you're only dealing with the personal income tax.

DR. SPILBERG: Yes, right.

CHAIR PARSKY: And I think that's important to bear in mind. This is if you only did changes there. Before we're finished, we're going to mix and match by June or July here. But that's -- go ahead.

DR. SPILBERG: Yes, the criteria that I laid for all of those simulations -- and there are just like three of them that I ran -- was for the personal income tax to be revenue-neutral.

CHAIR PARSKY: Over a trend line, is that what --

DR. SPILBERG: No, just for that one year, for 2006.

COMMISSIONER POMP: And is this adjusted gross income?

What are you using as your base?

DR. SPILBERG: Adjusted gross income.

COMMISSIONER POMP: Adjusted gross income.

COMMISSIONER BOSKIN: It's a flat rate on AGI, I think.

DR. SPILBERG: Yes.

COMMISSIONER BOSKIN: Let me just ask something that may help clarify this.

So since the sales tax collects just about half what the income tax collects, right --

DR. SPILBERG: About $30 billion versus $50 billion, yes.

COMMISSIONER BOSKIN: Yes, that basic -- in round numbers, we'd have to smooth this out in some detail. We could abolish both the existing income tax and the existing sales tax and substitute a flat rate 6 percent tax on AGI, given we'd have to adjust that a little bit?

DR. SPILBERG: Roughly, yes. It has to be a little bit lower than that.

COMMISSIONER BOSKIN: Okay, so that's one way to think about the magnitudes involved. The bigger the sales tax, the less the income tax. The broader the base of the sales tax, the less we have to rely on the income tax. The broader the base of the sales tax, the lower we could have the rate on the sales tax.

But we could get rid of the 8 percent, 8¼ percent marginal rate on the sales tax, and the income-tax structure with a broad-based 6 percent, roughly speaking, flat --

DR. SPILBERG: Not precisely. Because just keep in mind that the general fund only benefits from the first -- the 5 percent on the sales tax. So that is the only --

COMMISSIONER BOSKIN: Some of it goes to the counties?

DR. SPILBERG: Yes, so the rest of it really goes into other funds. So the $30 billion only covers --

COMMISSIONER BOSKIN: Okay, so it would have to be more like 7 percent?

DR. SPILBERG: Yes.

COMMISSIONER BOSKIN: Got it.

COMMISSIONER EDLEY: And the sales tax is more regressive? So the regressivity of a flat tax could be to some extent, moderated by limiting the sales tax.

COMMISSIONER BOSKIN: That's where I was kind of headed with that. So for those of you very worried about the bottom half of the income distribution disproportionately consuming the sales tax and the appearance or ethics -- or whatever you want to call it -- of lowering the marginal tax rates at the top, you could kind of mix and match.

Now, we're never going to be able to get the thing to line up every $5,000 of income to be identical, but that's kind of among the ways to think about the trade-off.

COMMISSIONER POMP: What zero bracket are you thinking of, Michael, in this simulation?

COMMISSIONER BOSKIN: Well, I was just taking these numbers. If you want to have --

COMMISSIONER POMP: Okay, but you weren't planning to tax at 6 percent the very first dollar earned, so you’re going to have some zero bracket?

COMMISSIONER BOSKIN: Well, if we got rid of the sales tax, I might think about something like that or have a modest one, because we're getting rid of all the sales tax that people pay.

COMMISSIONER HALVORSON: As long as we're looking at various innovative ways of doing --

COMMISSIONER BOSKIN: So I'm rather agnostic about that relative to what else goes on.

COMMISSIONER HALVORSON: As long as we're looking at various innovative ways of doing something. At the last meeting, we heard somebody say that of the top 30 economies of the world, 29 of them used the value-added tax, and we're the only one of the top 30 that don't.

And I'm a little confused exactly how a value-added tax works. But I'm curious, have we done any modeling at all on that? Is that coming up?

CHAIR PARSKY: We're going to come to a discussion about, can we get some analysis done of the value-added tax and the property tax. We're kind of taking it one step at a time here.

COMMISSIONER HALVORSON: Got it.

CHAIR PARSKY: Okay.

COMMISSIONER MORGAN: Could I ask you, Mr. Chairman, when you commented that Curt Pringle wanted to discuss the flat tax, is he talking about similar to what we're talking about here? Because people also use that term, “*flat tax*,” to say, "This is what I pay to the federal government,” and the flat tax is whatever percentage the state establishes of that.

So I think the term, by some people, gets used differently.

CHAIR PARSKY: We're going to have a discussion at the next meeting of various alternative ways. I think Michael has just kind of converted this into --

COMMISSIONER BOSKIN: I was just doing an arithmetic calculation. That’s all.

CHAIR PARSKY: He’s just doing an arithmetic calculation, which I think is important to bear in mind because I think it is possible to deal with both a change in the system, more predictability or less volatility and, at the same time, be comparably progressive, and you combine things.

COMMISSIONER MORGAN: Has the staff or Finance

Department done any calculations -- say, if we took the 2007 federal taxes paid by Californians and just taxed every taxpayer a percentage of that, what would the percentage be to equal the budget or the revenues of '07? Has that been calculated?

DR. SPILBERG: I don't know if those calculations were done for 2007. But calculations like that have been done. It's called "*piggybacking*." And there have been some simulations done for piggybacking proposals.

COMMISSIONER MORGAN: Can you give me an idea of what the range has been when you've calculated?

DR. SPILBERG: It's something that we could get back to you on.

COMMISSIONER MORGAN: Some states do do that. I'm just wondering if we have ever done that.

CHAIR PARSKY: Okay, keep going.

DR. SPILBERG: Okay, so my next slide asks the question, why was, on that four-tax-rate tax structure, the tax reduction so small. Keep in mind that we eliminated all deductions and all credits. And the reason is that the tax base for high-income taxpayers is already very broad. And the reason it is broad is because for high-income taxpayers, those that file a joint return -- for families, basically -- itemized deductions are phased out. They start phasing out at $310,837. This is for 2007. And eventually, they basically come out to be only 20 percent of their actual itemized deduction.

For exemption credits, those also are phased out, starting at $310,000 for families.

So it turns out, when you look at the tax base for high-income taxpayers, their taxable income is actually pretty close to their adjusted gross income, and they don't have any credits, tax credits.

And the next chart basically shows you the percentage of the deductions are of adjusted gross income along the income distribution.

And the next chart basically shows you credits as a proportion of tax before credits. And you can see that those decline with income.

So the first slide over here now shows you the simulation that we did for the flat-tax rate. And you can see, there is some very high increases in taxes for low-income taxpayers. For example, for taxpayers with $10,000 or less in adjusted gross income, the increase in tax is about 34-fold, though, the average tax increase is not large. It goes up from $7 per return, to $233.

And as we go -- but that's still very large tax increases, and there are large tax reductions towards the top end.

I did two more simulations. The second simulation basically just imposed a tax structure that, for tax rates at 2 percent tax rate, 4.18, and 8.3. And the way I picked those tax rates was to try to get as close to the current distribution of tax burden as I could. But that still resulted with some very large tax increases, especially at the lowest AGI groups or groupings. For example, for $10,000 to $20,000 over here, I had an increase of 919 percent. But it increased from $30 per return to about $277.

The final simulation that I just ran -- and, again, those are illustrative. They're only for the 2006 tax year, which is not necessarily going to be representative of the years that we're going to have in the future. But it showed -- this allowed me to get at least closer to the current burden distribution, though still there are some increases in tax at the lower tax levels, tax brackets -- income levels, and some reduction in tax at the upper income levels.

COMMISSIONER BOSKIN: All these are static estimates; right? They assume that there's no more economic activity, for example, from the lower rates?

DR. SPILBERG: Yes. Those are even beyond static. They're mechanical. I had done nothing but just run the numbers.

CHAIR PARSKY: Your conclusion about how you were disappointed in what changes you could make focused exclusively on the personal income tax; right?

DR. SPILBERG: Yes.

CHAIR PARSKY: So your conclusion is that in order to maintain neutrality/progressivity, there wasn't really much you could do all by itself on the personal income tax?

DR. SPILBERG: Right.

CHAIR PARSKY: John?

COMMISSIONER COGAN: Phil, were you able to do any simulations on the reduction in volatility associated with either of those options?

DR. SPILBERG: Well, we actually did. I didn't include this in this presentation, but it's something that we can present later on.

There was some reductions going to a flat tax, I believe, at a reduction in coefficient of variation of somewhere around 30 percent, is my recollection. But we can certainly share this information with you.

COMMISSIONER COGAN: Yes, that would be a good idea, actually.

If it's 30 percent and you sort of think about it, it could go all the way to a flat tax, and you're buying a 30 percent reduction in volatility, it’s not much of a purchase.

CHAIR PARSKY: I guess the question really is, if you had the budget reforms and the rainy-day fund and a 30 percent reduction of volatility, where would you stand?

MR. IBELE: I think one of the things that's going on with the volatility is, it's not -- it's the population that has capital gains, in addition to the rate that is imposed. So the population goes in and out of the taxability side. And the rate -- you know, this 1 percent reduction in the rate or the 2 percent doesn't have that much of an effect.

CHAIR PARSKY: Okay, go ahead.

MR. IBELE: We can turn to the sales-and-use-tax alternatives now. This is both a state tax and it's a local tax. And it's of importance, considerable importance to local governments.

There's the 5 percent general fund rate. There's a 1.25 percent state special funds, which is a realignment fund and a public-safety fund and the quarter cent that Mike indicated pays off the previous borrowing that we had. There's another 1 percent local rate. And then there's various special rates that different special jurisdictions have, mainly transit districts.

So that brings the rate, for example -- or it will bring the rate, for example, in San Francisco to

9.5 percent.

So when we talk about, in these next alternatives, we're going to talk about expanding the base, the revenue impacts or the potential rate reduction that you get from expanding the base. If we are consistent and I'll go out on a limb and say, I think we should have a consistent base with respect to the state portion of the base and the local portion of the tax, we're going to be expanding the base at the local level as well. And that's going to have a revenue impact. So that's something to sort of think about as we go through this.

So it's more of, I guess, an administrative issue, but it can get very complicated. Because depending upon whether or not the base is expanded to services, it would depend upon the industry complexion of a particular local jurisdiction, what their revenue impact might be.

What we tried to do in this --

CHAIR PARSKY: Just one question.

In the request that Michael made about if you eliminated the sales tax entirely and went to a flat tax, what could the rate be and the impact it would have, were you assuming only the state sales tax would be eliminated or all sales tax?

MR. IBELE: Well, in these simulations, we simply looked at the effect on the state general revenues. We didn't try to model what the impact might be at the local level. But, obviously, there would be. And it would vary, depending upon the jurisdiction.

What we tried to do is, we extended some of the simulations to different services, to an expanded array of services, and then looked at the business-tax side, which is about a third of all the payments, sales-and-use-tax payments, and had a simulation that involved an exemption for business intermediate purchases and also an exemption for business investment purposes to determine what the revenue impact would be there.

And one other thing before I show you these is, we have distributional charts of what the impact is on different quintiles. We avoided the doctrinal discussion about what happens to the business share of the sales and use tax. We didn't try to take into account the incidence of that and how much is passed on to consumers and how much is shifted back to labor, et cetera. This is -- the distributional charts are simply of the consumer side, what households pay what and what's their proportion.

So in the first simulation here, we extended the sales and use tax to all tangible personal property. And not surprisingly, the bulk of this is from about 90 percent. 60 percent is food and another 30 percent is prescription medicines.

Extending the base to these --

COMMISSIONER BOSKIN: The easy, popular stuff.

MR. IBELE: I'm sorry? I missed that.

COMMISSIONER BOSKIN: The easy, popular stuff.

MR. IBELE: Yes.

Oh, I should say these are descriptive, not normative, okay.

So this has generated additional revenues of about $5.2 billion, or a rate reduction on the state side of approaching 1 percent.

And in the next slide, the distributional impacts are not terribly surprising at the low end, at the lowest decile, given the consumption patterns of that population, the effective tax rate measured against annual income increases from a little over 3 percent, to about 5 percent. It's only slightly changed at the upper end.

The shares, which are shown by the blue and gold there, significantly less at the upper end and, you know, slight changes at the lower end.

And then the next slide on this -- and I won't spend any time on it -- just shows the actual tax change by decile, ranging from about a little over $100, $125, to just under $600 for the highest decile.

Alternative 2, we tried modeling extending the tax to selected personal services. And this is largely things like amusements, repair services, automobile repair. And we tried to focus on those services that are largely consumed by households, and tried to stay away from the services that are also consumed by businesses. But there is some -- we do pick up some business intermediate purchases in this. We pick up just under a billion dollars in additional taxes on businesses.

So the additional business services we pick up would be lodging, energy, telecommunications. But we tried to concentrate on the second bullet there, which is automobile and other repair, amusements, admissions, and so forth.

One thing to keep in mind about this particular simulation is that it does pick up these areas that are already being taxed at the local level. Many localities have taxes on lodging, transient occupancy taxes, energy -- we've talked about the taxes on that -- and telecommunications, which many observers think is already arguably overtaxed. So that's something to keep in mind.

This would result in revenues of about $6.2 billion, or fund a rate reduction of about 1 percent.

The next simulation which is No. 3 --

COMMISSIONER KEELEY: Mr. Chairman, if I could ask a quick question of Mr. Ibele.

MR. IBELE: Yes.

COMMISSIONER KEELEY: As I understand it, we had a presentation, I think, at our first or second meeting from the State Budget Officers Association. I think they listed some 160 services. And they have a code for each one of them. And some states who have sales taxes that extend them to services, like Hawaii, includes 158 of the 160, and then some have three or four or five, like we do, I think, services that are currently taxed under the sales tax that extend to services.

There was some discussion here, as I recall, maybe at our last meeting, that something that would be interesting for us to look at would be what if you extended the sales tax to those services which met two conditions:

Number 1, they were not business inputs; and

Number 2, they were not consumed primarily by middle-income, moderate-income, and lower-income individuals.

We had that conversation on a couple of occasions briefly, as I recall. And I wonder if that might be -- Mr. Chairman as well as Mr. Ibele -- if that might be worth looking at as well.

Many states, as I recall from previous charts on this and information we've received, try to find maybe two or three dozen services out of the 160 or so that are recognized by the State Budget Officers or another association, perhaps. That would be interesting because this is interesting and helpful, this select group of services. It may also be even more useful, or at least equally as useful, to look at that notion. And I'd be glad to submit to you some information in that regard.

Some folks have done some work on that. But I think that would be helpful because if our premise here -- I've heard it on a couple of our meetings -- that we don't want to extend sales tax on services to business inputs, and in order to -- the regressivity of extending sales tax to some services, you'd want to pick those services that weren't primarily consumed by low- and moderate-income individuals.

Now, admittedly, some of those services might not bring in a lot of revenue, either. And Gerry and I have had that conversation, or Mr. Chairman and I have had that conversation. But I think there may be something fruitful to look at in that regard.

Thank you, Mr. Chairman.

COMMISSIONER POMP: I have a question, Mr. Chairman.

Where is the list of services that you modeled here?

MR. IBELE: I'd be happy to provide it to you.

I can give you some examples or we can --

COMMISSIONER POMP: Okay, I'd like to actually see what you included.

COMMISSIONER COGAN: Maybe you could send that around?

MR. IBELE: Should we circulate that?

CHAIR PARSKY: Yes. Just circulate it around to everybody. You don't have to do it now, but make sure everyone gets it.

COMMISSIONER BARALES: I wonder, though, if he could mention if you have some on top of your head or some right in front of you, if you could just mention them.

MR. IBELE: I will tell you that religion was down, and we didn't include religion as a service to be taxed.

COMMISSIONER EDLEY: It's hard to put a boundary.

COMMISSIONER BOSKIN: That's one of those “pay me now or pay me later.”

MR. IBELE: Let's see, for the second simulation that we had done, hotels and motels, electricity, gas, water and sewer maintenance, refuse collection, cellular telephone, a bunch of telecommunications, moving and storage, electrical repair, rug and furniture cleaning, reupholstery, household-operation services, motor-vehicle repair, motor-vehicle rental.

COMMISSIONER COGAN: Enough, enough.

MR. IBELE: I've got it all here. Legitimate theaters and opera.

I will circulate it.

Alternative 3, we basically extended this. A much more extensive version of Alternative 2, which is basically including -- the big ones are legal and financial services, health care, also not a very popular one to extend services to. Education and some of these -- again, this is descriptive. Some of these may be outside what the Commission is interested, but it gives you a sense of what the magnitude would be, the magnitude from extending it to this -- this number, services would be about $21 billion in additional revenues or fund a rate reduction of about 2.3 percent.

Again, the distribution, quite a substantial increase in the effective tax rate for the lowest decile. And then sort of narrowing as we climb in the income strata.

COMMISSIONER MORGAN: Help me understand what you mean by "*taxing education*."

MR. IBELE: This would actually be extending the sales tax to the payment of tuition at schools, universities.

COMMISSIONER MORGAN: So it's a tax on a tax, so to speak.

CHAIR PARSKY: Mark is going to take that on if the recommendation comes through.

COMMISSIONER MORGAN: Yes, put him on the Board of Regents.

COMMISSIONER DE LA ROSA: Is that private high schools and things like that?

MR. IBELE: Yes, that's right.

COMMISSIONER DE LA ROSA: Elementary schools, private also?

MR. IBELE: That's right. It's sort of a global view of what happens other than things where there's a constitutional prohibition. Taxing everything, taxing all the services and what's the revenue impact of that.

This, we get into the -- and I mentioned this before -- this is exempting business intermediate purchases. Alternative 4, this would be exempting business intermediate purchases of things like lodging or car rentals or things of that nature.

Practically speaking, it does bring up the question of how you would administer something like this. Because having a business -- buying an intermediate good, it would be basically administratively very difficult to not impose, or have the seller not impose the tax at that point. There could be a mechanism whereby the business at the end of the tax year, the annual year, submitted a form and had a credit against the income tax or something of that nature. But it does raise some administrative issues.

This is essentially a revenue reduction, because everything is off the base here. And that's about a little under a billion dollars.

And since the distributional charts are just on the consumer portion, there's -- we didn't attempt to see what the distributional impacts of this would be.

Alternative 5, this is exempting business purchases. And this has come up a number of times. It came up, actually, just today with the representative from NUMMI, and it basically would allow an exemption for any depreciable or capital purchases.

A large portion of that -- I'll give you an idea of what that might be. A large portion is actually vehicles, automobiles and trucks. For example, the revenue impact of exempting automobiles and light trucks is about $1.5 billion. Heavy-duty trucks is about $200 million. But there are some other machinery components in here as well.

Computers, telecommunications. Communications is about $400 million. Computers, about $400 million. Software, about $400 million.

One of the options -- and this goes back to when the State had a manufacturers' investment credit which went away in -- 2003? 2004?

DR. SPILBERG: Yes, 2002.

MR. IBELE: 2002 or 2003 -- one alternative to reduce the cost of this, which is approaching $5 billion, would be to either have a partial exemption -- and many states have not a full exemption of investment equipment, but a partial exemption, or to have something like a manufacturers' investment credit. And that would reduce the cost of this.

But it does sort of go to what has been expressed by the Commission as getting away from taxing what are considered inputs or intermediate purchases by businesses.

COMMISSIONER HALVORSON: A quick comment on that.

The biggest single expense that many businesses have is their health-care expenses. And so taxing that would also be a business input.

MR. IBELE: Yes, that would -- I don't think we included that in -- this is just capital equipment. That would have been as part of the intermediate purchase.

COMMISSIONER POMP: Mr. Chair, just to clarify.

So by *"intermediate purchase,"* you mean something that enters into the good? In other words, I'm trying to understand the difference between 4 and 5.

MR. IBELE: Okay.

COMMISSIONER POMP: And maybe it will be obvious when you hand out what you covered. What was your definitional criteria?

MR. IBELE: Well, the criteria would be -- for intermediate goods, it would be purchased by the business, and then not as a -- they're typically services consumed directly by the business itself as opposed to having it be used up by the production of a good.

COMMISSIONER POMP: So a service presently taxable that now we're going to exempt?

MR. IBELE: Yes, that's right.

COMMISSIONER POMP: Well, this would be if you have your own tax revenue service.

MR. IBELE: Let me check my notes here.

Yes, that we're currently taxing and would now exempt from the tax. But not capital goods. Capital goods are just in Alternative 5.

COMMISSIONER MORGAN: But if Tesla in San José buys chips from Intel to put in their new car and you didn't tax the computer chips, which alternative does this fall under?

MR. IBELE: I'm sorry, can you say that one more time?

COMMISSIONER MORGAN: If the new car company, Tesla, in San José were to buy computer chips from Intel to put in their cars and you didn't tax those chips, which alternative would this fall under?

MR. IBELE: Well, those are not being taxed now under the way the current system is structured, because those would be considered a sale for a resale. And they're incorporated in a tangible product, which is then sold and is then taxed. So those are not taxed now and they wouldn't be taxed under any of these alternatives.

COMMISSIONER MORGAN: When people talked about inputs, and you say rentals and lodging, that defies logic to me.

How is renting a car then an input to the business? So that's what you consider a service that the business uses?

MR. IBELE: That is considered a service, yes.

COMMISSIONER MORGAN: So that's under 4?

MR. IBELE: Correct.

COMMISSIONER MORGAN: Strange input.

CHAIR PARSKY: To kind of bring this discussion around, part of the purpose behind this was to get all of the commissioners thinking about the difficulty of trying to be highly selective within the sales-and-use-tax categories. That doesn't mean that our recommendations can't ultimately try to make those choices. But I would just bear in mind, again, that we're trying to come up with something that we can really all advocate the Legislature adopt. And picking and choosing within this system will bring out any number of different pros and cons about each.

That doesn't mean that we shouldn't seek to make recommendations on reforming, revising the sales tax. We should think about that. I think we should be thinking about all elements of that, from eliminating it entirely, to making some other adjustments. But part of this exercise is to get everyone thinking about the difficulties of the selectivity within this.

COMMISSIONER MORGAN: And, Mr. Chairman, are you looking to this commission to select those items? Because another possibility is a recommendation to this commission, that sales-tax revenue be raised by a certain amount. Because if we recommend anything, it will be debated and changed in the Legislature.

CHAIR PARSKY: Well, the Legislature has a prerogative to do anything.

COMMISSIONER MORGAN: Right.

CHAIR PARSKY: I am just reminding everyone that they at least have given us an agreement that they will take the entire package of recommendations for an up-or-down vote.

So the simpler -- achieving our goals, but the simpler we can be, that still achieve the goals, and the harder it will be for special interests of one or the other to pick and choose, the better.

COMMISSIONER MORGAN: So if we pick and choose, it gives cover to the Legislature?

CHAIR PARSKY: No, I would say the opposite a little bit.

COMMISSIONER MORGAN: If they vote it up or down --

CHAIR PARSKY: I’m not sure our judgment would not be refuted by any number of different interests.

We certainly have the prerogative to pick and choose, without any question. I just want you to understand the difficulty of going through that exercise.

COMMISSIONER MORGAN: I agree, and that's why I'm suggesting that we might not be using our time wisely to do that.

CHAIR PARSKY: Well, then that's an interesting conclusion. And when we come back at our next session and have some broader options to look at, I think people will begin to see the difference.

Okay, well, any other comments that any commissioners might have?

(No response)

CHAIR PARSKY: What I'd like you all to think about -- you've, I think, unanimously agreed that we should seek an extension of the time period. Think a little bit, and please don't react now, but let me know.

It seems to me that there are kind of two alternatives I'd like you to think about in terms of extension. I heard kind of two approaches.

One would be to try to get our report in by the end of June, and the other would be to try to get our report in by the end of July.

I would really not like to extend it beyond, although I enjoy being with all of you. However, that might mean the following: Either way, my suggestion would be we think about a meeting -- we have our April meeting, that's at Davis. We think about a meeting the 4th or 5th of June, that would be after both the initiative is voted on and a, quote, "May revision."

Now, our Executive Director may come back and veto any of this because he's going to be overwhelmed with work. But just think about that. And then have another meeting around the 18th or 19th of June, and then try to do a report by the end of June. That's a little tight, but that's possible.

The other alternative would be to stick to the 4th or 5th of June as a meeting, but then wait until maybe the 15th or 16th of July, with some work being done in between, and report by the end of July. Those are kind of two alternatives.

Think about everyone's schedule. It's not locked in, but --

COMMISSIONER BOSKIN: So you want us to send you a note about our views on this?

CHAIR PARSKY: Yes, if you could, and I'll try to balance everyone and try to get unanimity. Unless someone would like to do it in August or September, I think that that kind of is what I heard.

Chris?

COMMISSIONER EDLEY: I would strongly prefer to defer to what you can work out with our betters, frankly.

CHAIR PARSKY: Okay.

COMMISSIONER EDLEY: Frankly, I think we can declare our druthers, but I think I really would prefer that you as chairman chat with the Speaker and the Governor and the President Pro Tem.

CHAIR PARSKY: I want to make sure that I haven't really eliminated anyone totally. So just let me know what your druthers would be. I think I can work out either of those dates in terms of a deadline, although I --

COMMISSIONER BOSKIN: The 4th or 5th of June is almost certainly impossible for me, because it's the last week of classes and I'm teaching every day.

CHAIR PARSKY: We'll adjust the June -- just come back and let me know what would be impossible.

COMMISSIONER EDLEY: But let me say for me, Gerry, for me, the most important thing is to maximize our contribution to the political process. And what that translates to in terms of timing is something that, frankly, I can't make a judgment upon. I think it depends on --

CHAIR PARSKY: Okay, let me do a little counseling and I'll come back to everyone.

Fred, do you have a comment?

COMMISSIONER KEELEY: Mr. Chairman, was it your desire to go on with some other items and then --

CHAIR PARSKY: No, no, this will conclude the presentation for today.

COMMISSIONER KEELEY: Okay. With that thought in mind, Mr. Chairman, first of all, thank you very much. I think that's a very thoughtful recommendation to hold a couple of more meetings. And thank you for doing that.

I would offer -- and John Laird is still here -- between the two of us, because he's an actual graduate of the University of California at Santa Cruz. But between the two of us, we could probably wrangle an invitation for the Commission to go to the People's Republic of Santa Cruz and have the meeting at the UC Santa Cruz campus, if that's of any interest to you.

If I might, Mr. Chairman, in keeping with meeting at the University of California campuses --

CHAIR PARSKY: Chris Edley has kind of given me some discretion. I think he'll give me discretion on the location as well. It’s okay.

COMMISSIONER KEELEY: Mr. Chairman, if I might go through a very quick list of items.

You had indicated earlier, when I was sort of expressing some displeasure that some folks had not gotten back to you with positive suggestions who had testified before us before, and you had admonished them to get something positive, not just what are you against, what are you for; and you did correct me that you had not only said that to one panel, there were actually two panels to whom you had said that.

So California Forward, a board which Mr. Hauck and I serve on, they have produced a specific response to you in that regard. And I'll just pass these around.

CHAIR PARSKY: Okay.

COMMISSIONER KEELEY: So you can have those.

I would also like to let you know that in that regard, you have partners -- we all have partners in this effort. And California Forward is a partner in trying to deal with tax reform as well as budget reform and other issues.

I want to just give you a sample of the kind of work that is being done. They are holding community dialogues about tax reform and tax policy all over the state of California. And this is an example. There's going to be a meeting in Santa Cruz next week on this topic. And this is typical of the kind of thing California Forward is doing throughout the state.

Mr. Chairman, I'd like to also enter into our deliberations for the next time we meet a couple of proposals for perhaps the staff to evaluate and for the Commission to consider.

One of our partners in all of this enterprise of state government is county governments. And county governments are, as you know, our delivery system, mostly for health and human services, but also for the work being done, somewhat in the criminal justice system, some pieces of it are owned more by the state than the locals anymore. But they are the delivery system for a lot of what the state wants to have done. They are a bit hamstrung by both their taxing authority, which sometimes is inconsistent with the taxing authority that cities have, and they also are hamstrung a bit by current definitions on full cost recovery in terms of their fee system.

And the reason I raise this is because if our partners at the county government level are creating essentially a drag on state resources, that creates less flexibility for the State in terms of what discretion it has to meet its obligation.

So if I might hand out a couple of proposals that I would appreciate if it got into the mix of our considerations for next time.

The first one is a sales-tax authority for counties in the incorporated area. I'll distribute that. And I know there's a sufficient copy for Mr. Ibele and for Mr. Genest as well.

And lastly, a proposal for full cost recovery for county fees.

The County of Yolo has done a particularly good job in documenting this particular piece, this particular problem for counties who, in fact, are our subdivisions in the delivery of services, if I might, Mr. Chairman.

Mr. Chairman, thank you for your kindness in allowing me to present these.

COMISSIONER HAUCK: Mr. Keeley, you're spreading your carbon footprint around.

CHAIR PARSKY: Thank you.

I think for purposes of -- we certainly will address each of these proposals.

I think it would also -- we will have a presentation about the flat tax and derivatives of the flat tax at our next session. And I think we should also at least have a recitation of the property tax and the impact on progressivity, regressivity of changes in the property tax. It's an issue that has come up.

I know there are a lot of issues that are volatile. I know that issue will be volatile. But we can't really do all of the work we're supposed to be doing without at least addressing it.

COMMISSIONER HALVORSON: Mr. Chair, I was going to -- if we had more time, and we don't, but are we going to speak again briefly to the concept that we had multiyear budgets and plans? And also I think if we, as a commission, come out recommending full transparency and take all of the issues that are in the spend rate of the state but are not visible and add those to the process, I think that would be a major step forward. And also speak in favor of looking seriously at a carbon tax, and for a number of reasons. I think it makes a lot of sense for us to take a leadership role in that. We heard excellent testimony on it earlier today. I think that we should revisit that as well.

CHAIR PARSKY: I haven't -- no, I think that it's a given that as we look at alternatives, we will consider that. Anything that has been previously discussed, we will. We hadn't had a discussion, really, of the other issues. And I thought we ought to have that, given the fact we have some extra time.

Chris?

COMMISSIONER EDLEY: Two quick things.

First, I think we neglected to say to the staff, "Wow." I mean, really, thank you. It's really just terrific work.

MR. IBELE: Was that a good thing or a bad thing?

COMMISSIONER EDLEY: It's a very good thing.

CHAIR PARSKY: Take it any way you like. Take everything you can at this point.

COMMISSIONER EDLEY: Thank you. I feel incredibly well-supported.

Secondly, just for the property-tax discussion, I had two particular ideas that I was hoping that staff would think about or fold into the mix. And one was the idea of going back to the concern that was raised earlier about corporately owned property in which there is a change in ownership but sort of percentages of ownership shift and so forth. And at what point, as ownership shifts over time, do you declare that there's actually been a transfer -- kind of, I guess, what we call a realization event in the income-tax arena? But sort of the idea of maybe saying if there's a 50 percent change in ownership, then that triggers a mark-to-market, something like that. So that's one piece.

A second option, it seems to me a little bit more radical.

CHAIR PARSKY: "*Mark to market*" is a term that is used in a different context.

COMMISSIONER EDLEY: Oops. Yes, sorry.

But the second would be the notion of eliminating Prop. 13 for all property except owner-occupied residences, primary residences, and multifamily dwellings that receive a federal or state subsidy.

CHAIR PARSKY: You're determined to create controversy as we leave this. All of your suggestions about what should be discussed around the head topic of property tax, please provide to the staff.

COMMISSIONER EDLEY: Great. Just be sure I get blamed -- or credited, as the case may be.

COMMISSIONER BARRALES: Folks are talking about what they'd like to hear about or talk about. I think it might be important in light of the presentations by some of the business groups last time, and I guess they were admonished and all that, and I wasn't as concerned about they came and had their job, they talked about what they –- you know, “It's a tough place to do business, and please don't make it tougher.”

I think it might be useful, because I know we've talked a couple of times about how important or how little of importance the tax structure is on location or relocation issues and decisions and other things along those lines.

I thought it might be helpful to invite some of the folks who were actually building the 21st century economy in California today. In other words, folks from biotech, high-tech, other industry executives who might be interested in talking about the decisions that they make, how they make them, and how the tax structure might affect them, to hear firsthand from folks who are making those decisions. So I would encourage us to look at a possibility for getting those folks involved.

CHAIR PARSKY: And, once again, Ruben, if you have some suggestions of people that would be particularly articulate, please provide them to the staff.

COMMISSIONER BARRALES: Right. Okay, we'll do that.

CHAIR PARSKY: Okay. Well, thank you all very much. We've run a little over in time. But I really appreciate it.

Thank you, Mark and Phil.

Thank you very much.

(The meeting concluded at 4:27 p.m.)

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REPORTER'S CERTIFICATE

I hereby certify:

That the foregoing proceedings were duly reported by me at the time and place herein specified; and

That the proceedings were reported by me, a duly certified shorthand reporter and a disinterested person, and was thereafter transcribed into typewriting; and

That the foregoing transcript is a record of the statements of all parties made at the time of the proceeding.

IN WITNESS WHEREOF, I have hereunto set my hand on the 14th day of March 2009.

DANIEL P. FELDHAUS
California CSR #6949
Registered Diplomate Reporter
Certified Realtime Reporter