STATE OF CALIFORNIA

COMMISSION ON THE 21st CENTURY ECONOMY

REVENUE AND TAXATION

STRUCTURAL ALTERNATIVES

PUBLIC MEETING

Thursday, February 12, 2009
9:06 a.m. – 5:03 p.m.

University of California, Los Angeles
De Neve Plaza, Plaza Room
De Neve Commons
351 Charles E. Young Drive, West
Los Angeles, California

Reported by: Daniel P. Feldhaus
Certified Shorthand Reporter #6949
Registered Diplomate Reporter, Certified Realtime Reporter

Daniel P. Feldhaus, C.S.R., Inc.
Certified Shorthand Reporters
8414 Yermo Way, Sacramento, California 95828
Telephone 916.682.9482 Fax 916.688.0723
FeldhausDepo@aol.com

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

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

MONICA LOZANO
Publisher/CEO
La Opinión

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

MARK IBELE
Board of Equalization
Commission Staff Director

ASHLEY SNEE GIOVANNETTONE

LORI HSU

ANTONIO LOCKETT

JESSICA MAR

MICHELLE QUINN
Staff Writer

MARGIE RAMIREZ WALKER

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A P P E A R A N C E S

Public Testimony

MICHAEL FEINSTEIN
former Mayor & City Council Member
City of Santa Monica

JOHN LAIRD
on behalf of Speaker of the Assembly, Karen Bass
District 47

Presentations

"Observation on Income, Sales and Consumption Taxes"

CHARLES E. McLURE, JR.
Senior Fellow
Hoover Institution
Stanford University

JAMES R. HINES, JR.
Professor
Department of Economics and School of Law
University of Michigan

"Broadening California's Tax Base I – Tax Expenditure Programs"

PAUL WARREN
Principal Policy Analyst
Economics, Revenue and Taxation
Legislative Analyst's Office
State of California

ALLEN PROHOFSKY
Manager
Tax Policy Research
Franchise Tax Board
State of California

ROBERT INGENITO
Chief, Research and Statistics
Board of Equalization
State of California

A P P E A R A N C E S

Presentations

"Broadening California's Tax Base II -
Sales Taxes on Services"

ANNETTE NELLEN
Professor
Department of Accounting and Finance
San José State University

ERIC I. MIETHKE
Partner
Nielsen Merksamer Parrinello Mueller & Naylor, LLP

ROBERT INGENITO
Chief, Research and Statistics
Board of Equalization
State of California

"California's 21st Century Economy"

JERRY NICKELSBURG
Senior Economist
Anderson School of Business
University of California, Los Angeles

Panel One – "Observations from Organizations"

DAVID WOLFE
Legislative Director
Howard Jarvis Taxpayers Association

LENNY GOLDBERG
California Tax Reform Association

Panel Two – "Observations from Organizations"

TERESA CASAZZA
President
California Taxpayers' Association

A P P E A R A N C E S

Presentations

Panel Two – "Observations from Organizations"
continued

JOSEPH R. CROSBY
COO & Senior Director
Council on State Taxation

KYLA CHRISTOFFERSEN
Policy Advocate, Legal & Taxation
California Chamber of Commerce

MICHAEL D. SHAW
Legislative Director
National Federation of Independent Business

Panel Three – "Observations from Organizations"

JEAN ROSS
Executive Director
California Budget Project
- and –
J. FRED SILVA
Senior Fiscal Advisor
California Forward

"Approaches to Broadening the State's Tax Base"

MARK IBELE
Commission on the 21st Century Economy
State of California

Also Present

ANNE MAITLAND
Tax Research Specialist
Franchise Tax Board

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BE IT REMEMBERED that on Thursday, February 12, 2009, commencing at the hour of 9:06 a.m., at the University of California, Los Angeles, De Neve Plaza, Plaza Room, De Neve Commons, 351 Charles E. Young Drive, West, Los Angeles, California, before me, DANIEL P. FELDHAUS, CSR 6949, RDR, CRR, in the state of California, the following proceedings were held:

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CHAIR PARSKY: Welcome, ladies and gentlemen. I know that there are a few commissioners that are not here yet, and I know will be here. But we'll try to run these commission meetings on time, and so we'll begin.

First of all, I want to thank our hosts at UCLA for making all these arrangements for us. We thank them very much. Our chancellor stopped by to say "hello." Our executive vice-chancellor came by, as well, last evening.

And on behalf of all of the commissioners, thank you, UCLA, very much.

This is our second public hearing of the Commission on the 21st Century Economy. And we have a very full agenda, as you can see from the screen, which we will try to get through as efficiently as possible.

We welcome public participation in these sessions. And so the first item for us is to hear from anyone in the public that would like to make comments, and then I'll ask the Commissioners to make some comments if they would like.

Two of our commissioners were not with us at the last meeting, and so I will certainly ask Becky and Bill to make comments, if they would like, and then anyone else. I'll try to give a few observations as we begin before our agenda.

With that, there is one member of the public, Michael Feinstein is here and he has some comments to make to this commission.

MR. FEINSTEIN: I had no idea I'd be the only one. Anyway, good morning. I'm a former mayor and city council member in Santa Monica. I served on SCAG's Regional Comprehensive Plan Task Force for several years, and I'm cofounder of the Green Party here in California.

A few comments on connecting land use, tax policy, and job creation.

I know some of you have talked a bit about carbon taxes in the past, and I just want to encourage you to continue on that path.

Carbon taxes, as a form of true-cost pricing, send the right signals in the economy for every economic act that we take. And especially in this state, knowing that we have to go green anyway, carbon taxes will reward the green economic activity, and people will profit by doing the right thing, which reduces the tax burden on the overall society by not externalizing costs. So it's really efficient.

The other thing I really want to focus on is the land value tax that Henry George recommended. We've got a state where, for most of the last few decades, we have been growing in population which increases the land value. But we socialize the costs in society, but we privatize the increased land value to the property owner. That doesn't do anything to create that extra value.

We had a speculative bubble just now in our society, in part because people believed they could make so much money on land. But the money they were making on land wasn't something that they were doing to deserve it. But it's because of population pressure, all the other nice things we do -- parks, freeways, rail systems to improve that value of land.

Pittsburgh has been the one city in our country that has looked at dividing the tax so that you increase the tax on land and you decrease it on buildings. That rewards the people who improve the land for what they did, which tends to be more of a center-right idea. But you're returning the socially created value to the society. That tends to not increase the price of land in the long run, which makes land more affordable, which makes affordable housing, more parks, open space more affordable as well; but in particular, the structural deficit that we have in the state and the fact that as we grow in more population, that the social cost of running the state are outstripping the income that we get. If your tax system internalizes the land value increase that we are naturally having, then you're finding a way to keep pace with the infrastructure costs that you have.

And now, in a time in our society where we have stripped back a lot of the land value, it would be a time I believe, for you to instruct your staff to look at how -- since we're really restarting from the bottom up again with where land values are -- how such a system could be transitioned in. Just like we know, if you put in a carbon tax, you have to figure in a transition strategy; you can’t just do it overnight or else you'd hurt business. It would be hard to do this, if you keep the kind of protections that people like Joel Fox want to keep people still in their homes but also make this work over time. And I would hope that you give your staff direction to do that.

Thanks for your time.

CHAIR PARSKY: Thank you very much.

If there are no other public comments?

COMMISSIONER POMP: Mr. Chair, could we just ask a question of the speaker?

CHAIR PARSKY: You may.

COMMISSIONER POMP: I assume you would be in favor of a split roll then?

MR. FEINSTEIN: As a starting point, yes, definitely.

COMMISSIONER KEELEY: Mr. Chairman?

CHAIR PARSKY: You have a question? Yes.

COMMISSIONER KEELEY: Thank you.

If I could ask one other question.

At a previous meeting of the Commission, there was some discussion on the Commission with regard to a carbon tax. And I suspect that today there will be more. And one of the issues or observations or criticisms that's raised about a carbon tax -- and I think there's solutions to this, but I think it's a legitimate criticism -- is the regressive nature of the carbon tax.

Let's say that you placed that at the refinery level on gasoline, diesel, and jet fuel. Downstream from that, obviously, the price of gasoline would go up X cents a gallon, depending upon what you valued carbon at. But assuming that it does have this downstream regressive implication, does that concern you? And if it does, have you given some thought to what might be done to deal with that regressive --

MR. FEINSTEIN: Yes, definitely. The approach to dealing with the regressive nature is to make it as an overall green tax shift, where you decrease taxes on labor while you increase them on environmental costs. So a combination of decreasing the income tax and decreasing the payroll tax for businesses, and you could do it in a revenue-neutral way with the same amount of money that you do increasing your carbon tax.

The Red-Green, Social Democratic Green Party Coalition Government in German did that for several years when we were in power there. There's a track record. They did it with their payroll tax -- their social security contribution. So you can easily handle the regressivity.

And again, that means if you want to make this cross-partisan and appeal to people across political lines, people in the center-right who feel like we shouldn't be taxing work because you're taking away rewarding ingenuity -- that's the word -- indeed, if you cut your income taxes, you are helping people, and cutting your payroll taxes, you are helping people work and keep what they're earning, but you're also doing it in an ecological context for the society and they can go hand in hand.

COMMISSIONER KEELEY: Thank you, sir.

Thank you, Mr. Chairman.

COMMISSIONER BOSKIN: We don't have much of a payroll tax in California. And I think that the federal government probably wouldn't much like us trying to usurp their revenues. So we're back to the income tax.

MR. FEINSTEIN: Yes.

COMMISSIONER BOSKIN: And a lot of that falls on labor, a lot of it falls on capital. And some on entrepreneurial effort, if you want to distinguish that between the two, among the factors.

So in a California context, what would you do? Just raise carbon taxes, collect the revenue, and have a proportionate cut of an income tax or something like that?

MR. FEINSTEIN: I would still try to find a way to reward small business. And being used to being in office, I would say, “Staff, please look into what are the small ways that could” –- I mean, I wouldn't want to just do it for the workers' side. I think it makes sense to do it a little bit in both. So I’d try to find out how you could reward small business as well as income tax.

COMMISSIONER BOSKIN: Is there a reason you distinguish among businesses by size? I mean, large businesses have lots of employees, too.

MR. FEINSTEIN: Yes, I guess what I'm saying -- I mean, I just think that the payroll tax -- that's a good point. I just think of the payroll tax as something that really helps –- that’s where my mind was -- it really helps small businesses. So that's where my mind was.

No, you're, right, it should be any size business, but payroll taxes were the easiest way to get the small businesses.

COMMISSIONER BOSKIN: Thank you.

MR. FEINSTEIN: Thank you.

CHAIR PARSKY: If there are no other questions, let me turn to some comments from the Commissioners.

Let me just start by reminding the public, and all of us, of the overall goals that have been set for this commission. I think there are -- first of all, as far as the Commission is concerned, nothing is restricted. Everything can be placed on the table for discussion. So there are no restrictions. But the overall goals as set out by the Governor and the legislative leaders, I would kind of group in six categories. And I hope we will all kind of bear this in mind as we're looking to try to come up with recommendations.

First, to establish a 21st century structure that fits with the state's 21st century economy.

Second, to make some recommendations that we believe will provide stability or will stabilize state revenues and reduce volatility.

Third, promote the long-term economic prosperity of the state and its citizens.

Fourth, improve California's ability to successfully compete with other states for jobs and investments.

Fifth, basically, reflect the principles of sound tax policy, including simplicity, competitiveness, predictability, stability, ease of compliance and administration. That may be the hardest challenge, given the subject that we're addressing. But at least it's a goal we should keep in mind, I think.

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

Now, if we keep in mind kind of those six general principles, I think it will help us. Now, we may not be able to achieve all of those with the recommendations; but I think all of the recommendations that we come up with, we ought to pass through that screen and see how we do in relationship to those goals.

As I said, in my mind, nothing is off the table. But the other thing I think we should keep in mind is that the focus is meant to be on the revenue side of the equation. Not exclusively, but to be focused there. And we should keep in mind, although our job is not to do the job of the current Legislature and Governor -- that is up to them. So we're here to look at the longer term, not the immediacy of the problems. But I do think we should bear in mind what our elected leaders are doing. So as they come up with recommendations for changes in the law -- recommendations that may address the expenditure side of the equation, recommendations that may deal with such things as a rainy-day fund and other things like that, we should take that into account in terms of how our recommendations will fit within that kind of structure.

So I think we'll try to keep that in mind as we go along. And as I say, I'll try to remind everyone of this prism we're trying to get through.

And the only final thing I will say is, I think everyone here has a lot of experience at dealing with one or more aspects of this subject. I think it will be meaningful if we can come together and provide a unanimous recommendation to our policymakers. So I, for one, really have that as an overall objective.

We are clearly temporary. There isn't anyone that is -- well, there may be one -- not running for office. However, our job is temporary. And so I think we have the ability to think away from the immediacy of elective office that perhaps some of our colleagues in Sacramento pay a lot closer attention to.

So with that introduction, I would really like to ask either Becky or Bill, neither of whom had an opportunity to be at the last session, to make any general comments they would like, and then, of course, any of the commissioners can make comments before we move to our agenda.

So we'll start with Becky.

COMMISSIONER MORGAN: Thank you, Mr. Chairman.

I will. And most of what I have to say is for reaction from other speakers and from commissioners. Having been part of the 1987 State Conformity Legislation, and knowing that during my days in the Senate, and knowing that there was also tax reform in 1993, I think we've discovered that it really hasn't saved the state, either of those. But hopefully, we'll come up with some suggestions that will get us there. And knowing that there are only six states in the country that aren't having a budget-gap problem, wouldn't it be great if California could lead the way in solving the gap problem, as we have led the way in so many other things?

For me, one of the real issues is volatility that we are experiencing. And as I've looked at the charts that have been in our notebooks, certainly the most volatile is capital gains. And I think that's one of the issues that this commission is going to need to address.

And certainly stability of revenue is also crucial. And stability comes from jobs and the taxes that employees pay.

The reports are out that California is the second toughest state in the country in which to do business. And the small-business people are suffering from not having tax credits on manufacturing, goods that they purchase to create jobs and to create new products for California to be competitive. We are losing 3,000 people a week in California because they are going to other states that are cheaper and are a better place in which to do business. And I think California needs to return to being business-friendly. And we're not supporting the entrepreneurs and emerging industries as we have sometimes in the past. And we have an opportunity to do that, because coming out of Silicon Valley, we have had the entrepreneurs that start new businesses. And they're ready to go with a lot of clean-energy businesses. But they're not excited about doing business in California because they have to pay a tax on everything, and they have to go through multiple regulations. The most regulated state in the union in some industries. And I think we, I think, need to look at that.

So we have volatility, stability, and to me fairness in taxation.

And I personally don't think it's fair to the retailers that they are taxed, and catalog sales and Internet sales are not taxed.

I just came down here from Truckee, California, and there were three businesses that are out of business in one block. That's how hard it is in our small communities.

I think it's also not fair that I and everybody on my street, but two are paying four times the taxes that the two people that were there pre-Prop. 13 are paying. That's not fair. And I think it needs to be addressed.

And I'm sure we'll hear from Mr. Fox about that.

One of the ways to get revenue is to reduce expenditures. And I know we're talking about the revenue side. But as I read in *The Wall Street Journal* this morning that the budget compromise that we hope has been worked out in Sacramento cuts $8.6 billion from education. I have talked to many, many people in education. And I, in the 21st century, see no reason for county offices of education. There is one in every state, even Los Angeles, which has thousands and thousands of people -- of students.

The latest figures I have is 2006-07. But in that year, the 58 county offices of education spent

$4.9 billion. If we could take that and put it into K-12, directly to the thousand school districts, we would not be cutting what we are from education, which is the thing that I care, frankly, the most about, and it's where I've spent most of my life.

So county offices of education have two constitutional roles: Special education and professional development. I believe, with the technology we have available today and the size of our school districts, that special education could be taken care of within the existing school districts. And as far as professional development, I know, through the work I do with our foundation, that there are many professional-development programs that are excellent and that can be used in the districts.

And I know, Mr. Chairman, you served on the Board of Regents. I wasn’t here last --

CHAIR PARSKY: In another life.

COMMISSIONER MORGAN: In another life?

I wasn't here last month, and I apologize for that, but I was back at Cornell University, where I serve on the board.

We are able to recruit at Cornell some excellent professors from Berkeley because we can pay more. And they're both Land Grant universities. The Land Grant universities, colleges within the University at Cornell are now charging tuition of $22,000 per New York resident and $37,000 per non-resident, whereas California is charging $8,000.

I suggest that we look at what's happening in some of the East Coast colleges and give the Regents and the Trustees a chance to raise the fees in exchange for setting up a very robust scholarship program.

And somehow, if we could get the Legislature not to penalize UC and the state colleges and the community colleges if they do raise the fees. But we, I think, have to look at who can pay and continue our hopefully need-blind admission to our colleges and universities, but look at what's possible to help the state budget.

CHAIR PARSKY: Thank you.

As I said, nothing is off the table. However, at the break, I'd ask you to talk a little bit to Monica Lozano about the topic of student fees. That's an interesting subject, and I think it certainly can be discussed. However, I think Monica and I would be happy to talk to you a little bit about the problems associated with the fee issue.

COMMISSIONER MORGAN: Yes, and I'm well aware of that. I fought that battle for nine years in the State

Senate. But I still think it should be considered.

CHAIR PARSKY: Thank you.

Bill, did you want to make some comments?

COMMISSIONER HAUCK: Thank you, Mr. Chairman. I'm happy to be here. I plan to do a lot of listening. This is a distinguished group of experts, and I'm sure I'm going to learn a lot.

So why don't we get on with it?

CHAIR PARSKY: Thank you very much.

Any other comments before we begin the morning agenda from any commissioners?

COMMISSIONER KEELEY: Mr. Chairman?

CHAIR PARSKY: Michael.

COMMISSIONER KEELEY: Please, Mr. Boskin first.

COMMISSIONER BOSKIN: Yes, I think it's just worth spending a moment reminding everybody -- I'm sure everybody paid a lot of attention to it, but it's been several weeks -- what we learned, for those of us that were able to be there and for those of us that were able to study the charts in San Diego. And there were a variety of things -- and there are many things that people have on their mind on the Commission. And I won't get into a discussion of the many ideas -- some I support, some I don't -- that were raised there. But just to go back over the --

CHAIR PARSKY: Move a little closer to the mike.

COMMISSIONER BOSKIN: -- just to go over some of the highlights of the information we got from the Legislative Analyst's Office, from the Department of Finance, from the data, from some of the public participants, and some of the other people that presented.

And there are four or five that are just facts that we have to deal with in the context of the six goals that we have had laid out.

First of all, is that California is a relatively high-tax state. We have among the highest income tax, personal income taxes, corporate income taxes, and the highest sales tax.

Our property tax ranks, what, thirty-something out of the 50. So we're relatively low. It raises a lot of issues.

But, anyway, point one, we're a high-tax state. And if we're going to worry about this competition, these people moving out of the state and the job losses, we're going to have to understand that high marginal tax rates may be affecting that, and that has to be one of many considerations we have to deal with.

The second is that the composition of our taxes has changed substantially over time for many reasons: Some policy, but mostly just changes in the economy.

Changes in who is earning what, when, where, and how. And we've been averaging -- we can get the exact numbers, which will be important to our deliberation -- something like 6 percent of personal income. And the composition of that -- I sent a chart around, I don't know if that was distributed -- which graphed it for each of the main taxes. And our income tax has risen immensely from the 1970s, from something like 1 percent of personal income, now it's 3 percent, round numbers. Our sales tax has declined for some of the reasons that were just mentioned, and many others.

So there are a whole bunch of issues and factual issues that we will have to deal with.

And the third and perhaps most important relative to one of our primary goals of trying to come up with a system that is less unstable, less volatile, that prevents this once- or twice-a-decade crisis where we have to radically cut this or radically raise taxes or both in the short-term to deal with a pressing problem, which winds up hurting lots of people and causing a lot of havoc; that if we could somehow have a revenue base that was less volatile and geared to sort of what we do -- that was about the same, on average, and we can leave it to other people to fight whether we have a bigger government or a smaller government, we would probably disagree on the panel on that, that that would be a good thing, *ceteris paribus*.

There are many reasons for that instability. But very clearly, two of the things that were pointed out last time as main contributors -- Becky mentioned one -- capital gains, which are taxed in full as nominal income in California are very volatile. And many other components of the income tax are particularly important in California, including things like stock options in Silicon Valley, et cetera, that wind up with our very progressive income tax. “Wind up” meaning that we're relying on a small fraction of people and their substantial variable pay to collect revenue. And then when that collapses, when bonuses aren't being paid, for example, and people aren't exercising stock options, as well as the capital gains.

So those are some issues that are just facts we have to deal with. They are unpleasant facts, but they're a part of the infrastructure we're going to have to confront as we design things and we deal with some of the other priorities each of us has and the Commission has.

Thank you.

CHAIR PARSKY: Just to pause on those comments about “relatively high-tax state,” “the composition of the tax having changed," "the revenue base being somewhat volatile." Does anyone have concerns -- those are general statements, but does anyone have concerns? That's not the only thing we should be concerned about, but just to get out on the table.

Is anyone concerned about the facts relating to those three statements?

Chris?

COMMISSIONER EDLEY: Well, two things. One is, Michael didn't mention, but I want to emphasize that -- unless I misunderstood when he says "high-tax state," he is really referring to marginal rates as opposed to the average tax burden. And this, of course, goes to -- and the marginal rates are, obviously, very important in terms of their incentive effect.

But second and relatedly, I just want us to keep in mind that changing the marginal rates at the top or changing the treatment of capital gains, and stock options, and so forth, in order to reduce volatility has distributional consequences for the tax burden.

COMMISSIONER BOSKIN: Of course.

COMMISSIONER EDLEY: And for my own part, I think it is very important not only that in our deliberations and our recommendations we be transparent about the distributional attributes of our options --

COMMISSIONER BOSKIN: I totally agree.

COMMISSIONER EDLEY: Right -- but secondly -- personally, my strong preference will be to look for a package which, in toto, certainly does not erode the distributional characteristics of the overall tax system.

So to the extent that we do something with capital gains or stock options, et cetera, I will be looking for something else in the mix that will even out in the aggregate the distributional consequences of the package as a whole, comparable to what we're looking for in terms of revenue neutrality.

CHAIR PARSKY: And the only comment there would be, to keep in mind that the distribution mix, based on the fact that the laws have remained in effect, and not changed much, have evolved over time, just the same way --

COMMISSIONER EDLEY: Right.

CHAIR PARSKY: -- a trend line has evolved.

COMMISSIONER EDLEY: Right.

CHAIR PARSKY: But in order to pass through the prism of fair and equitable, one of the goals, we have to definitely keep in mind those comments.

COMMISSIONER EDLEY: Thanks, Gerry.

COMMISSIONER KEELEY: Thank you, Mr. Chairman. A couple of things.

Welcome, Senator Morgan -- so glad that you're here -- and Bill Hauck, who has done so much for this state and continues to, especially in higher education.

When we were walking in the door, I know he sort of shudders to come to a University of California.

But maybe we'll hold one of these at a CSU, and you and I can feel much more comfortable, Bill, and it will all work out.

COMMISSIONER HAUCK: Right on, Fred.

COMMISSIONER BOSKIN: And don't forget California's many excellent private universities.

COMMISSIONER KEELEY: And California’s many excellent private universities, of course.

CHAIR PARSKY: We can ask Princeton if they want to hold it there.

COMMISSIONER KEELEY: Mr. Chairman, on your comments and the comments by Mr. Boskin, a couple of things come to mind. One is, I don't fundamentally disagree with the argument or the statements that Mr. Boskin made. I think reasonable people can disagree on how you read the chart in our packet for our previous meeting with regard to whether or not California is a high-tax state.

The LAO's chart on that ranges a high of total tax burden in Louisiana of 21 and a half percent, to a low in Maryland of 14 and a half. And we are 17.6. So without -- I don't want to get into a big debate about it. I do think reasonable people can disagree on whether we are a high-tax state.

I do think that it's very legitimate to raise the issue of modernizing our tax system to reflect the economy, and as the day moves on and as our meetings move on, I suspect members of the Commission -- and I know I will -– will be offering a number of recommendations.

In that regard, Mr. Chairman, I would like to do a little bit of administrative work with you in the Commission context here.

There was a letter prepared by the State Treasurer, Bill Lockyer, within the last day or so, and forwarded to you, which speaks to, among other things, his support for a carbon tax. And I have a copy of that. And I'm wondering if you have a copy of that, if you might be kind enough to distribute that at some point during our meeting today. If you could provide copies of that, or maybe Mr. Ibele has a comment on that.

CHAIR PARSKY: I did receive that letter, I think yesterday. And I asked the staff to distribute it to the Commission. I don't know if that was done yet.

MR. IBELE: Mr. Chairman, the letter from the Attorney General is in Exhibit 10. It's the first item there.

COMMISSIONER HALVORSON: The Treasurer.

CHAIR PARSKY: The Treasurer.

MR. IBELE: From the Treasurer, sorry.

COMMISSIONER KEELEY: Thank you very much.

MR. IBELE: And also actually, Commissioner Boskin, the information that you provided to us is also in Exhibit 10. And that's been distributed as well.

COMMISSIONER KEELEY: Thank you very much.

Mr. Chairman, on a couple of administrative matters or housekeeping matters, so this is our second of what I imagine will be four meetings.

CHAIR PARSKY: I think that's it.

COMMISSIONER KEELEY: Okay, fair to say? Okay, good.

I think we may want to have some discussion at some point today -- perhaps not now, perhaps at the end of our agenda, when we're doing some other kinds of work -- to have a discussion about how these agendas are built, when packets are made available to commissioners, how witnesses are selected, how panels are chosen, what emphasis is made.

I hasten, Mr. Chairman, to say that I think that last time and this time, the folks who appear in front of the Commission are outstanding individuals with a great amount to contribute to this.

Having said that -- and I don't mean this as a verbal eraser -- I think that there are many people who could also contribute to the work of the Commission. And I think especially in the area where we talked at some length, a number of Commissioners mentioned a carbon tax, and I felt that there were some -- I don't know that I would call it assurance, Mr. Chairman, but I would call it acknowledgment, that a number of commissioners had raised that issue and that we would have an opportunity at this meeting to receive input on that.

I was told by staff when I inquired, when I looked at the agenda and the panelists, that the way that I was to -- if I was still interested in that topic, how I was to address that was through questions of the panelists. Fair enough. I'll be glad to do that.

I do think in building the agenda for our next two meetings, I would suggest the following: That you do consult with us in open session, at the end of today's meeting, about what next meeting should look like. And perhaps we should reserve our final meeting as, in effect, an open public negotiating session among and between the commissioners, because I think that that will take some considerable amount of time.

Thank you, Mr. Chairman.

CHAIR PARSKY: Just one brief comment. My recollection is that we -- as I summarized what the Commissioners wanted to be discussed, the carbon tax was clearly mentioned. And we committed to have it on the agenda for discussion.

I think that there was some difficulty in identifying who would come forward and make the presentation on the carbon tax. And my understanding is that the staff has identified someone from Berkeley who will come on and will be specifically on the agenda at the next meeting. So I apologize if it wasn't able to be on the agenda for this meeting; but there is no question that it will be separately on the agenda as we had indicated.

COMMISSIONER KEELEY: Mr. Chairman, thank you. I had that discussion with Mr. Ibele, and I believe that it will be Professor Bornstein who will make that presentation. I have been in contact with him. He would love to do that. And thank you, Mr. Chairman. I appreciate it.

CHAIR PARSKY: Sure.

COMMISSIONER PRINGLE: Mr. Chairman?

CHAIR PARSKY: Sure.

Yes, Curt?

COMMISSIONER PRINGLE: Thank you very much, Mr. Chairman.

I actually am very happy with the way the agendas are drawn up because I see the road map, which is: Let’s at least get a basis of knowledge that we all have some foundation, and then we can share and bring up other concepts. And I certainly know Mr. Keeley brought up the concept of a carbon tax before.

I'd like to know, Mr. Chairman, where is the time in which we list those other tax reform concepts that we can equally debate and discuss?

If, in fact, you choose, Mr. Chairman, to have all of that done at our next meeting, then I think either at this meeting or after, we all submit to you some specific tax modification changes or new concepts that we would like to discuss in total at that time, so that after that March meeting, we will be prepared to at least contemplate as a commission all the various ideas.

I know that's the path by which you're working down because the last meeting, Understanding the State Tax Structure, this meeting getting into more detail in that, and also filling in the holes of the last meeting, that allows us all to be pretty much at the same spot, at least, in that discussion.

But I certainly appreciate Mr. Keeley's interest in one specific tax. I have a few more myself that I would like to talk about in terms of tax restructuring.

And I'll bet you every other single member of this commission does. That's kind of why we're here.

So if there is some public place by which we could provide that or if it's specifically working with you and the staff to ensure that all of those various ideas that every Commission member has, as to a tax restructuring concept that should be before the Commission, I think we should give them all equal time if they are of concern and priority to any member of the Commission.

Also, if I could, I want to make sure I'm not just technically limited, and I think I am just in terms of getting all -- I took my binder home and tore out all the good pages and was sharing --

CHAIR PARSKY: How many of those in number -- I've got to make sure I've got it.

COMMISSIONER PRINGLE: There were three. Three really cool charts that I thought were important.

And I know what suit one of them is still in. But I would like to have available online and make sure we can have easy reference to some of the PowerPoints and other things that were presented, so we can go back to them and have them in an accessible fashion.

If I'm missing it and they're somewhere out there, just tell me and maybe we can post it somehow.

But if I'm not missing that, if there's just some way that we can ensure that all of the presentations, as good as Mr. Keeley and I think they have been, if we could ensure that they're all available to follow back up on and to double-check some of those charts, that would be of great convenience.

Thank you.

MR. IBELE: You're missing it. They're somewhere out there. They're actually on the Web site. And if they're somewhat hidden, we sort of can clarify that; but all the presentations from last meeting are there.

COMMISSIONER PRINGLE: Great.

MR. IBELE: And I think the ones from this meeting have already been posted.

COMMISSIONER PRINGLE: Then that is awesome. Then you need to write, probably on a piece of paper, how I can get there.

MR. IBELE: Well, we have an excellent Web team, so that's why they’re up already. But I'd be happy to do that.

CHAIR PARSKY: The directions on how Curt gets there will be the fourth piece of paper that he keeps as well.

One quick comment I would make as far as agendas. We did save quite a bit of time at the end of this meeting for open discussion among the commissioners under the heading of "*Discussion of Alternatives*." And I would say -- and it's not just limited to the discussion here -- any Commissioner that has a specific item that he or she would like to have covered on the agenda of the next meeting, please identify it then, or identify it as soon after this session for staff and we will try to cover it.

In terms of alternative taxes -- and the carbon tax was raised by several -- I thought that it would be best covered under an agenda item that we might refer to as taxation of energy as a whole, and that would allow us to cover the carbon tax and other taxes that relate to energy. And so I think we'll try to make sure that's covered at our Berkeley session.

But any other areas -- there are some other areas of taxation that haven't been mentioned. But I'm sure that Curt or anyone else can raise them either at the end of the meeting or as soon thereafter as possible, so we can get them on the agenda.

Monica?

COMMISSIONER LOZANO: Yes, just in reviewing my notes as it relates to the agenda and in the context of your opening remarks about the goals of the Commission, I had written down that, in fact, we were going to look at rainy-day funds as a model for eliminating some of that volatility.

If you could just clarify what you meant, because I think I heard you say we were taking that off the table, and only --

CHAIR PARSKY: *(Shaking head.)*

COMMISSIONER LOZANO: Okay.

CHAIR PARSKY: No, what I meant to say is that that is a subject that everyone wanted to see in connection with our recommendations. But what I was urging is that if our elected leaders are moving to an agreement that would establish a rainy-day fund, we should look at that in context. Because if that satisfies us in terms of how that will be addressed, we can endorse it. If it doesn't satisfy us, we can make recommendations on how it should be altered in the context of dealing with our goals.

And I think at least what was out on the table -- it doesn't have to be the ultimate conclusion -- but what was at least out on the table -- and we may need to clarify that -- was that the use of a rainy-day fund, in and of itself, without other changes to the revenue side won't solve the volatility issue. But we need to clarify that to make sure everyone is in concurrence with that and why.

But my comments were only taken in the context is that my understanding is that we will be hearing about that subject relatively soon, as the legislative leaders and the Governor come up with their agreed proposal.

COMMISSIONER LOZANO: Thank you.

CHAIR PARSKY: Any other comments?

Yes, George?

COMMISSIONER HALVORSON: Yes, just a very brief comment. But it strikes me as we're going forward in trying to figure out what the sources of what the revenue should be, that we need a better process to figure out what the level of expense will be. And that part of the budgeting process ought to include multiyear budgets and projections in a very detailed way for all of the major expenditures. Prisons, for example, we should never be surprised by a prison expense. We know where the prisons are, we know what the occupancy is -- all of those issues. We know what the run rate is likely to be. And so what we need is not just a one-year budget for prisons; we need to know what do we need next year, next year, and the year after, and have that detailed.

The same thing is true for just about every other major expense. We're now building new roads. We know what the infrastructure costs are. And unless we have some sense of what the out-year spend needs are going to be, it's pretty hard to figure out what the revenue stream needs to be to deal with those.

So I think as part of our recommendation, we should be looking at both sides of that equation. We should be recommending more consistent, more objective, more data-driven, long-range expense projections; and then require the administration annually to report back against those projections. Not just make them as a throw-away at the end of a discussion, but basically have a plan for the prisons for the next five years. And then each year, as we look at the budget, figure out how the expenditures for this year are going to fit that plan.

So I think if you try to run a business -- I've been a CEO of something or another for decades -- and when you try to run a business, if you try to do everything on annual self-contained budgets and you don't look at capital plans and you don't look at long-range operational plans and you don’t look at strategic plans, you will screw up any organization that you're attempting to run, and you will not get the revenue stream right.

So I think to get the revenue stream right, we need to do a better, more sophisticated job of getting the expense stream right. And I don't think we need to have the, say, passing locked-in solid, multiyear budgets, but definitely a far more detailed, far more competent process in that area I think is called for.

COMMISSIONER HAUCK: Mr. Chair?

CHAIR PARSKY: Yes, Bill.

COMMISSIONER HAUCK: Just quickly on that point.

I agree with George on that point. And just to let you know, California Forward, which is an entity you may be familiar with, that was co-chaired by Tom McKernan and Leon Panetta, until recently, until the President took Leon away from us, we have been working on this specific subject, and actually have legislative counsel drafted both constitutional amendment and statutory language to entirely change the structure of the California state budget.

What George describes is absolutely true, running a hundred-billion-plus organization with the Legislature adopting a budget, you know, on a given day, recognizing that 30 seconds later, the budget is out of balance, and never looking at it again for 12 months is entirely unworkable -- and it’s both budget-wise and politically -- and we're seeing the result of that in Sacramento right now.

So we have done a lot of work on this subject and, as I said, have a structure drafted. We discussed the concept with the legislative leadership. Mr. Keeley has been intricately involved in this. And if you'd like at some point, we can share that with you.

CHAIR PARSKY: Well, we are going to hear, this afternoon, from California Forward on the budget project.

COMMISSIONER HAUCK: I am a member of that group. And just so that -- I'm sure they'll talk about that, but it is definitely --

COMMISSIONER BOSKIN: We won't ask you to recuse yourself from you questioning.

COMMISSIONER HAUCK: No, I won't.

CHAIR PARSKY: Jennifer?

COMMISSIONER ITO: Thank you. And I just want to thank the staff for getting these materials together, and just for the opportunity to be here at the table.

And I just wanted to recognize just the crisis that we're in right now, of incredible proportion and importance, and really take advantage of the opportunity that we have here to take this long-range view.

And I also agree that this is an opportunity for us to look at the current structure of our taxes. And I appreciate at the last meeting looking at where the opportunity -- where the current revenue streams are coming from. And I really want us to go deeper today and question some of the original intent behind some of the current structures to see if the original intent still stands valid; and for us to revisit some of those assumptions given our current economic and social trends and demographic trends, and that we really take this time to look at what this 21st century economy is here in California and what we would like it to be.

And I agree that we also need to look at this in terms of -- I think it was raised in the January meeting that volatility might not be such a bad thing. So I don't want us to send proposals through the prism of reducing volatility on the revenue side at the expense of the robustness of public resources. And that I, too, am concerned that it's more about reducing the volatility and expenditures, and it's more important to make sure that we do look at both sides of the equation and ensure that we have sufficient funds that are both stable and predictable for the long term so that we can make investments in the infrastructure –- in our deteriorating infrastructure, and also to make the upgrades that are going to be required based on technological advances, and to prepare ourselves for a new green economy, which has also been spoken a lot of here.

And the other prism that I would like -- that I'll be looking at, in any proposal, is also the distribution of the tax burden, as well, and looking at equity in those terms.

Thank you.

CHAIR PARSKY: Richard?

COMMISSIONER POMP: Thank you, Mr. Chairman.

Having participated firsthand in the breakdown of our air-transportation infrastructure, and having just arrived about 12 hours late, I was going to wait until the rest of me caught up with my body, but I've been sort of inspired by what's preceded.

There is a problem with this format of speakers. And it's sort of inherent in it, and that is, we have heard from awfully good people and very passionate people who feel deeply and earnestly and sincerely. But what is difficult, I think, for the Commission, unless they're so heavily imbued in the literature, you're never quite sure when you're hearing someone say "X" with great conviction, is that a consensus view of people in the field, or could we easily bring in ten other people to say "not X"? And it's just very important as we go forward that we give the appearance of balance. And I think the staff has labored very diligently to do this. But we have limited time, and I think the panels were an attempt this afternoon to sort of deal with this. But there is limited resources. And so we just really have to keep that in mind.

Secondly, there are things that I think are an obstacle to business, or at least they're always on their short list of their complaints about California that we could do something about.

The overregulation, I have no firsthand information whether it's true or not. But, you know, that's hard for us. The minute we shift our focus, we really are going to lose our ability to come up with a consensus report. And yet it's very hard to divorce taxes from spending. The simple question: Are taxes too high? Well, I can't answer that without looking at the goods and services that I am getting in return. It's like the private sector: Did I pay too much for this suit? Well, I can't answer that without looking at the quality of the suit.

And yet the minute we allow too much of our concerns to shift to spending, we really will be -- we will have lost our total focus. But businesses for an awful long time have been critical of the California tax-appeals process, with very good reason. And they have been asking for an independent tax court which, in the great scheme of things, is not a major cost, and would go a long way to at least assuring business that they do get a fair shake here in California. If you're going to have high taxes -- and I'll talk about that in a moment -- well, the social contract is, you have an unbiased, dispassionate forum in which to litigate those high taxes.

The second thing is -- and in this field, it's known as “pay to play.” Unfortunately, Illinois has given this a bad name. But "pay to play" has traditionally meant that you shouldn't have to pay an assessment before you have the right to challenge that assessment.

And that is not true in California. It is true in many, many states. It is true in the federal system. And this has been really a bone of contention for business for an awfully long time. And changing that wouldn't be a major cost, either.

And so there are these things which I think could help bring business on board, whatever it is we end up doing that I would like us to consider at some point.

Now, more to substance. You know, in the abstract, questions like, "Are taxes too high?," really provides very little useful information. Because what we're really concerned about, are taxes too high for a particular goal, economic development? Are they hurting us, in which case, we have to ask, are the taxes too high for our target group of people? Are they too high for entrepreneurs? Are they too high for people with capital gains and trusts and dividends? Are they too high for retired persons? Are we chasing them to Nevada? Are they too high on young professionals who we're trying to attract to the state?

And so in my mind, to begin to think about “too high,” you have to tell me why you're concerned; and, now, let's take a look at that target group and see what we can do about answering that question.

The same thing about corporations. Are taxes too high on corporations? Well, which corporations do you have in mind? Multistate, capital-intensive, labor-intensive, those that are part of the related family of corporations, those that sell primarily within the state, primarily outside the state?

So it's just very hard for me, anyway -- maybe not for others -- but for me to sort of get my hands around abstract questions like "too high."

I would agree, they're always too high. I'm not going to say no. Of course, taxes are too high. I mean, I pay more than the salary of the auditor who seems to find me every year. So, of course, I think they're too high. But it's not very useful for me to say that.

On the volatility issue, you know, I realize this is essentially a capital-gains issue and it's essentially the top 1 percent of the population here in California. If we were to exempt them, we would solve the volatility problem; but we'd, of course, confront the distributional problem that the dean spoke eloquently about and Jennifer spoke about.

I don't see volatility as the end. It's a means to an end, and that is really the spending based on unrealistic assumptions about the continuation of the robustness of your revenue system.

I mean, just to make it personal -- and sometimes there is a risk in extrapolating from your personal life. It doesn't always carry over. But in my simple-mindedness, I'm a state employee. My salary is fairly predictable, there is no great volatility there. But I also do some consulting work. There's good years; there's bad years.

Now, if I lock myself into a lifestyle based on a good year, I have a problem when I have a bad year. But the answer to that is not to consult. I would think just the opposite: Do more consulting, not less. And, yes, I could solve the volatility issue by not consulting, but I'm really quite baffled as to how that solves the problem. Going to give up money, that's the solution? No, the solution is to be more responsible about budgeting.

And so I guess I join previous speakers who have expressed probably even more eloquently this issue about, is volatility really the issue. And I think we also, as we go through our work, have to just be sensitive to self-serving anecdotes, and assuming that what seems to be true, is true.

And one of the lessons I drew from San Diego's meeting was just how little we actually do know about the relationship of a state tax system and economic development.

I don't know whether cutting the capital-gains rate on the wealthy will encourage them to invest more. Maybe it does. But the real question in my mind, will they invest more in California? I assume most of their capital gains really don't have much to do with California, except for the entrepreneurs who are selling businesses. And I don't know what percentage of the capital gains they represent.

I mean, we know the famous stories, like Mr. Hyatt who went off to Nevada before he had a capital gain. And you're always going to have that problem unless you exempt capital gains. Nevada is zero. So the difference between zero and six, zero and nine, it's always going to be enough to make me think about changing formally my life, getting a Nevada driver's license. I probably already have a ski place over in Lake Tahoe or somewhere, and now it's a question of counting the number of days I'm there and getting a Nevada driver's license and severing my connections here. I know that this is stuff tax lawyers make a living out of doing.

But you’re always going to have that problem. You're surrounded by tax shelters. There's not much you can do about that. You have your own little tax haven to deal with. And whether it's zero and six, zero and nine, it's going to be enough when you are talking a $20 million capital gain to think about at least formally leaving California and obtaining Nevada residency.

So I think we have to be very careful in making sure that we act based on rigorous empirical evidence rather than propositions that seem like they should be right, maybe are right at the federal level but not necessarily right at the state level, and certainly beware of self-serving anecdotes.

Thank you, Mr. Chair.

CHAIR PARSKY: Thank you.

The only comment I would make is that I really do think it's important not just to focus on one goal all by itself. The issue of reducing volatility is not the only goal that we need to be looking at. And I think each of us have to step back and say, how does it fit within the objective of reducing volatility and yet, at the same time, promoting economic activity that will increase jobs and competitiveness?

And finally, I think we need to step back and say, although the challenge is great and the time frame is short, we should ask ourselves, do we want to suggest nothing? Because that's an option. This august group could easily step back and say the problems are too great and we just don't have time to address them.

COMMISSIONER EDLEY: And we're moving to Nevada.

CHAIR PARSKY: In fact, the incentives created around Las Vegas right now are very high. So let's all keep that in mind as we work our way through these immense problems.

Okay, let's move on to our agenda for this morning. And, first, we have two speakers under the heading of "*Observations on Income, Sales, and Consumption Taxes*."

COMMISSIONER EDLEY: Gerry, I'm sorry to interrupt, but I just want to register an objection. I was very concerned to see that President Obama drafted Monica Lozano to be on the group advising him on how to save the global economy. I think it's going to distract her from her commitment to us. And I think it's worth us going on record to --

COMMISSIONER BARRALES: To protest?

COMMISSIONER EDLEY: -- with our objection to this.

CHAIR PARSKY: I think I would urge Monica to solve that problem first because it will make this a lot easier.

COMMISSIONER EDLEY: Okay.

COMMISSIONER MORGAN: That's right.

CHAIR PARSKY: He couldn't have picked a better person.

COMMISSIONER EDLEY: Exactly.

CHAIR PARSKY: Okay, two panelists, Charles McLure and James Hines will provide some insight.

And let's let both of them go through their presentations, and then we can ask either of them questions.

Charles, why don't you just introduce yourself and then proceed?

DR. McLURE: Okay, good morning, Mr. Chairman, Members of the Commission.

Having written at length on the nuttiness of state and local taxes, including California's, I welcome the opportunity to suggest, once again, how to reduce the nuttiness of our state's tax system. I will concentrate on how, in a revenue-neutral context, to make California's tax system more nearly neutral --

CHAIR PARSKY: Charles, could you move the mike a little closer so everybody can hear you?

DR. McLURE: Okay -- and more conducive to investment and competitiveness.

I will concentrate on the sales tax and the corporate income tax. I will try to tell you when I'm stating what I think is a consensus and when I'm not.

You may find it useful if I begin by highlighting one aspect of my professional experience. As Deputy Assistant Secretary of the U.S. Treasury from 1983 to 1985, I was responsible for developing the Treasury Department's proposals to President Ronald Reagan that became the basis of the Tax Reform Act of 1986, which is still the most comprehensive reform of the U.S. income tax since its introduction in 1913.

Much like this commission, we at Treasury were asked to develop a plan for tax reform for fairness, simplicity, and economic growth based on sound economic principles and, believe it or not, free from political interference. We focused on broadening the tax base and lowering tax rates within the context of revenue and distributional neutrality.

Although our proposals were initially labeled idealistic and politically naive and were watered down considerably, the 1986 Act was enacted with overwhelming majorities of both houses of Congress.

Even now, after two decades of erosion, the

1986 Act remains a high-water mark of post-war federal tax reform.

Finally, let me tell you that reform of the California tax system is not the primary focus of my research. Thus, there may be questions particularly of fact that I will not be able to answer. Your staff and the government officials can help provide information.

Let me begin by discussing the sales tax. And here, I think virtually all of what I have to say would be the consensus position of people in my profession.

If someone came before you today to suggest that California is to impose a tax on production that would distort production incentives, discourage investment, and reduce the competitive position of the state's producers in California markets and other domestic markets and in export markets, you would probably think they were crazy. Such a proposal violates common sense as well as accepted tax-policy norms. But that is exactly what the California sales tax does. In 2003, 45 percent of the state's tax collections came from business purchases, not sales to households.

In my view, the first order of business should be to eliminate sales tax on business purchases. That sentence is italicized. And I think there's no doubt that that would be consensus in the profession.

While it is perhaps most urgent to eliminate taxes on business investment and R & D spending, we should not stop there. We should eliminate tax on virtually all business purchases.

Some may argue that there is no need to take this action because California's taxation of business purchases is only slightly above the national average of 43 percent, or because much of the tax on business purchases is exported to purchasers in other states. These views reflect faulty thinking. I can use a simple analogy from sports to rebut the first contention.

Suppose that each team in a basketball league tied their players’ shoes together. A team could obviously improve its competitiveness by untying the players' shoes, whether or not the other teams decided to do so. Similarly, whether California can improve its competitive position by rationalizing its sales tax does not depend on whether other states have equally or more irrational sales taxes.

California sales tax on business purchases cannot be exported to out-of-state buyers unless the state dominates the relevant regional, national, or international market. California is large, but it is not that large. It dominates few markets. Rather than being exported, California's sales tax on business purchases is likely to reduce employment and incomes of its workers and landowners. Nor can California export its tax on business purchases because its reliance on this form of taxation is only slightly above the national average.

In appraising how California's taxes affect prices, employment, and incomes, and how it would affect those if it were rationalized, the taxes levied elsewhere are not relevant.

Reducing drastically the taxation of business purchases would reduce sales-tax revenues unless the tax base were expanded or rates were increased. Actually, both would be required. The sales-tax base should be expanded by including many intangible products and services provided to households that are now exempt. Of course, most business purchases of intangible products and services should not be taxed.

Taxing primary goods, besides requiring higher rights, distorts consumer choices and has undesirable distributional consequences. Taxing intangible products and services would not fully offset the reduction in the tax base occasioned by eliminating taxation of business purchases. A rate increase would be required to maintain revenue neutrality.

Increases in tax rates are ordinarily seen to be undesirable, but a rate increase required to rationalize a tax treatment of business purchases would not represent a tax increase. Obviously, not in a revenue-neutral context. Rather, it would bring a tax that is now concealed in the prices of products out in the open, making the cost of government more transparent.

I want to say two sentences about a tax you should not consider.

Ohio recently adopted a tax on gross receipts, including receipts from sales to businesses. The Ohio tax runs directly counter to what I have just said, and California should not consider such a backwards step. Again, I believe that is the consensus position.

I'm now going to talk about the corporate income tax. And what I'm going to say probably isn't the consensus, but it's what I think. It is hard to think of a good reason to tax corporate income, except to prevent individuals from avoiding individual income tax by incorporating. The case against state corporate income taxes is even stronger. Economists commonly observe that a jurisdiction that cannot affect the cost price of capital should not tax the return required to elicit investment within its boundaries. This presumption, by the way, does not hold for economic rents, which is the term economists use for returns that are above what's required to elicit investment.

The difficulty of actually taxing corporate income in the state where it originates is a further reason for not trying to tax it.

I'm going to skip an explanation of the difficulties and simply say that states have long used formulas to apportion the nationwide income of multistate corporations based on their fraction of the taxpayers' operations.

Until the mid-1970s, virtually all states used a formula that assigned equal weights to the state's percentage of nationwide payroll, property, and sales.

In 1978, the U.S. Supreme Court upheld the constitutionality of Iowa's use of only sales to apportion income, setting off a dramatic shift in assigning greater weight to sales and lower weights to payroll and property. Almost 80 percent of states that tax corporate income now assign at least half the weight to sales, and at least six now use only sales to apportion income.

California assigns half the weight to sales and the other half split evenly between payroll and property.

You may hear suggestions today that California should further increase the weight on sales, perhaps to 100 percent, to encourage economic development. In thinking about this development, it is useful to note that for a corporation with relatively little of its operations in California, an apportioned income tax is not really a tax on income earned in California. It is a set of taxes on the factors in the apportionment formula. Sales-only apportionment, therefore, produces a strange amalgam of taxes, ranging from a tax on corporate profits earned in the taxing state by firms operating only there, to this peculiar form of tax on sales in that state for firms operating primarily elsewhere. This is something I can explain further, if you need it.

So how should we think about the corporate income tax? On the one hand, it does not make much sense to tax corporate income except as a backstop to the individual tax. But if we're going to tax corporate income, we should do so in a way that makes sense. Unlike sales-only apportionment, which doesn't make sense, the present formula arguably reflects reasonably well where income originates. On the other hand, sales-only apportionment would probably be more conducive to economic development. But if that is the objective, it might make more sense and be more transparent -- and I think that's what I would suggest -- simply to reduce the corporate income tax and replace revenues with a higher sales-tax rate.

Is backstopping the only reason to retain the tax? Does the federal corporate income tax provide adequate backstopping? I think you can see why I said that is probably not the consensus.

I've been asked to say a little bit about the so-called flat tax. I won't say much. I will say more if you need me to.

The first thing about the flat tax is one of the primary attractions is elimination of all deductions in the individual income tax, thereby simplifying the federal income tax. But if California were to eliminate deductions and the federal government were not, the result would not be simplification for Californians; it would be greater complexity. In a world of TurboTax®, maybe that doesn't matter, but a lot of people don't use TurboTax®. I think California should not go it alone.

Turning to the business side of the flat tax, just note that the way the tax is structured, it would encourage investment because it would not tax the minimum return that is required to elicit investment. If, however, California attempted to impose such a tax, it would almost certainly need to utilize an apportionment formula as it does with corporate income tax to determine California's share of the taxpayers' nationwide tax base calculated under the flat-tax rules.

I believe this implies that the California flat tax would encourage investment made anywhere in the U.S., not just in California. But California would experience all the revenue loss or the need for a higher statutory rate.

I, thus, do not think it is worthwhile to substitute the flat tax for the income tax to achieve that result.

I can think of a few good ways to reduce revenue instability but would not endorse most of them.

We could eliminate -- I mean, the obvious thing is to have a head tax, tax everybody and that will be stable.

We could eliminate the taxation of capital gains and change the tax treatment of stock options. I think that this would be to allow a relatively small tail to wag a very large dog. The tax treatment of capital gains and stock options should be decided on principles such as equity, economic efficiency, effects on innovation and investment, and cost of compliance and administration.

On the other hand, it might be possible to specify that, unlike most revenues, that revenues from certain items, such as the taxation of capital gains and maybe even stock options, if you can separate out that income, could be directed specifically to a rainy-day fund rather than trying to use some other kind of budgetary rule.

Another potential change would be to rely less heavily on the income tax and more on the sales tax or on excises such as a tobacco tax, which are more stable. Again, I think the mix of income and sales taxes and the role of excises should be based on, first, principles, not effects of stability of revenues.

Eliminating the sales-tax exemption for food would also reduce revenue instability. It would allow lower statutory rates and it would reduce the distortion of consumption choices. On the other hand, it would, obviously, increase the tax burden on low-income families.

This latter, the burden on low-income families, might not be dispositive if there are other ways to address distributional concerns. One possibility would be to adopt something like an earned-income tax credit of the type at the federal level. I'm not an expert on that, but I'll provide some references to a couple of papers by people who are, one who happens to be sitting in the room today.

At bottom, the solution to the problem of revenue stability is not to be found in tax policy; it is to be found in budget policy. The solution is relatively straightforward in concept, if not politically. When revenues greatly exceed their trend-line growth rate, all the excess should not be spent. Rather, the bulk should be placed in a rainy-day fund to provide a cushion against declining revenues or used to retire debt.

I have a list of summary recommendations. My time has expired. I won't read it.

CHAIR PARSKY: Thank you very much.

Jim, why don't you go ahead, and then we'll come back around and have a few questions, because we're running a little bit beyond our time. But, please, you go ahead.

DR. HINES: Sure. Thank you, Mr. Chairman, Members of the Commission. I'm very excited to be here today.

I have a multimedia presentation which will be illegible to you because, for members of the Commission, it's available only on that little screen. But copies, I think, are in your binders.

COMMISSIONER BOSKIN: We have a big screen in front of us.

DR. HINES: Oh, there is? There's one there?

There's a hidden screen, everyone, up here in the front.

The other thing I want to say at the outset is that my remarks today, as my remarks on other days, represent the consensus opinion of people who really know what they're talking about.

CHAIR PARSKY: That covers everything you say, every day?

DR. HINES: Basically, yes.

COMMISSIONER MORGAN: These Midwesterners.

DR. HINES: I think the following goes without question: Efficient taxes are those that raise revenue effectively and with the least associated economic distortions. And when you think about the problem of state taxation, there's certain revenue sources that are available to states that are really efficient, in that sense, and they are paradigmatically, as one of the earlier speakers noted, taxes on land and real property; and, secondly, taxes on personal expenditures.

The reason that these tend to be the most efficient of the taxes is that those bases are the legal mobile in response to high tax rates.

Less efficient taxes include, in particular, those on business income, property, and activity, because business are notoriously mobile; and personal income, maybe not as much as business, but a close second, including capital income.

What has happened in response to this mobility, this mobility is a problem for every jurisdiction, not just states, but countries, too. And there are a lot of small countries that face exactly the same problems that, you know, California faces now.

Internationally, what has happened is that countries have evolved their tax systems in the last few decades. And the way that they've evolved is that smaller jurisdictions tend to get more of their revenue from expenditure-type taxes and less from business income taxes and personal income taxes.

If you look around the world, that is what has happened. And as time has gone by, even the medium- and larger-sized countries are moving in the direction of having more expenditure-type taxes and less in the way –- a lot less of their revenue coming from taxing business income. The reason, again, is just this problem of mobility. If you try to tax heavily a mobile base, you know, the activity flees and your bases erode and it's very inefficient, too.

So then how can California increase the efficiency of its tax system? Well, the most obvious answer -- and I say this as a resident of Michigan -- is to tax land and real property at higher rates. You've got all this land and real property. You're not taxing it very heavily. It's the most efficient source of revenue. It is a puzzle to the rest of the country why the rates are so low on this otherwise very effective and efficient source of revenue.

The next most obvious answer, if we're not willing to go with the most obvious, is to rely more heavily on expenditure taxation and less on business and personal income taxation. And for reasons I'll talk in a minute or so, the way to do that is to expand or increase your taxation of -- to use your sales-tax base, to increase the base of your sales tax and to increase the rates, if you want to go that way. Although I'm very sensitive to the comments of Dr. McLure, which is, of course, that presumes that you also want to make your sales tax an efficient tax, and taxing business purchases is not a way to have an efficient sales-tax base.

Now, what about the distributional consequences of heavier reliance on expenditure taxes? That's not a trivial issue. That said, there has been recent research in the last decade or so on what are the distributional consequences of taxing, say, gasoline purchases or general sales purchases? They're not as dire as they at first seemed. And the reason is, that we'd sometimes mistakenly tried to look at the distributional consequences of expenditure taxation relative to people's incomes. That's not the right way to think about that problem. The way to think about expenditure taxation is to say: What is the distribution of the tax burden on expenditures relative to people's expenditures?

It gets you a slightly different answer than the first one. To be sure, there are distributional concerns with movements towards greater reliance on expenditure taxes or excise taxes, but they're not as bad as they at first seem, because the right kind of denominator in that calculation is expenditure rather than income.

But having said that, they are definitely -- expenditure taxes are less progressive than the current progressive income tax.

But if you're in a state like California, which has access both to expenditure-type taxes, sales and excise taxes, and also has access to an income tax, you can do a lot to undo the distributional consequences of greater reliance on expenditure taxes by combining greater reliance on expenditure taxes with a progressive shift in the income tax. That is, if you change the income-tax structure to make it more progressive at the same time that you put more reliance for revenue on expenditure taxes, you can undo the distributional consequences and get the greater efficiency associated with expenditure taxes at the same time.

So how can states tax expenditures? Well, general sales taxes serve that function. Excise taxes do also. And the advantage of excise taxes -- these are specific taxes on things likes tobacco, gasoline, and alcohol -- also have the benefit that they can be used to discourage, you know, driving cars or smoking cigarettes, or whatever it is, in a way that can serve a lot of social functions. So they have a lot of desirable features, although, again, there are always issues about compliance, and there's quite a bit of evidence about that.

There is sometimes discussion of trying to have a value-added tax at the state level, to try to tax expenditures indirectly that way. Michigan tried this. The second half of the 20th century, this is what Michigan tried. And part of the reason I'm here today is to offer the Michigan example as a cautionary tale, too, because it did not turn out to be a happy experience in Michigan. And I want to talk to you about what happened in Michigan.

Turn the clock back to 1953, and that was when Michigan first started its attempt to have a value-added-type tax at the state level. It was something called the *"business activities tax"* in Michigan. And it had particular features that I won't go through.

It was abandoned in 1967. And the reason it was abandoned was that at the time, there was a movement among states to try to tax income. Many states didn't have income taxes until the 1960s, and they relied basically on sales taxes and property taxes for most of their revenues. Places got excited, including Michigan, about having an income tax. And so they scrapped this sort of business-type tax and replaced it with a corporate income tax and a personal income tax was adopted for the first time in 1968.

So starting in 1968, Michigan for the first time had a corporate income tax much like California's current corporate income tax, and also adopted a personal income tax.

Okay, the corporate income tax lasted from 1968 to 1975. And what happened during that period, that seven-year period, when we had a corporate income tax, was there were extremely volatile state revenues from the corporate tax.

Now, you know, Michigan is dominated there by the auto industry -- or was dominated by the auto industry and related industries. And so it's a particularly volatile sector. But still, the general problem -- you know, one of the problems of the corporate – or one of the features, anyway, of a corporate income tax is that it generates volatile revenues because corporate profits are highly procyclical. You know, they go up a lot when the economy is doing well; they go down very far when the economy is faring poorly.

And as you can see from the evidence there, every two years, the Michigan revenues were flying all over the place, from the corporate income tax. Especially if you look at them in constant dollars, which you have to because this is an era when there was a lot of inflation. You know, you started from more than $1 billion dollars in constant dollars and you went down to $650 million, and then up to $1.35 billion, and then down to $780 million. It's just, the state was getting sick of this volatility.

So in 1975 legislation was passed to replace the corporate income tax and six other business taxes, notably including a tax on inventory property, with what was called the "single business tax" in 1976. It was called the "single business tax" because it was a single tax to replace seven other taxes. It looked more like a value-added tax than its predecessor that had been adopted in 1953. Firms paid tax at a low rate, 2.35 percent of basically what we would call their value-added, which is their sales minus their purchases from other firms, but where you don't deduct things like labor expenses from the tax base. And that's how you can get a lot of revenue at a very low rate.

Expenses for structures -- you know, real property in Michigan were fully deductible. But for multistate firms -- which is all the big firms, of course -- they deducted only a portion of their total U.S. equipment expenditures based on a formula. And that's where the problems started with this thing. And Dr. McLure mentioned or alluded to this problem earlier. Because in states we tax multistate businesses not the way that we do international businesses, but using formulas to, you know, allocate their U.S. profits amongst jurisdictions, it creates a lot of problems for states trying to implement a value-added tax. And Michigan ran square into those problems.

There were a lot of constitutional challenges about Michigan's system that claimed that it violated the dormant commerce clause of the Constitution. These claims were fought in Michigan courts. And the state usually lost them but then won on appeal narrowly. And it became clear over time that there were serious questions about the constitutionality of Michigan's system of allocating investment expenses, basically because of this multistate business problem.

In 1999 there was a reform to the deduction for investment expenditures was replaced with investment tax credit at kind of a low rate. And then at the end of 2007, the tax was ultimately eliminated. Michigan now has a different system, with about a 5 percent tax on corporate income and a modified gross-receipts tax, which, thank heaven, doesn't look exactly like the Ohio tax that Dr. McLure correctly criticized, at a fairly low rate.

Okay, what happened? Why did Michigan adopt its value-added tax in 1975? There were several reasons.

The first was, the state had a budget shortfall. You could cook up a new system and address the current budget shortfall all at once by having a new system. And so that was one advantage of the tax.

A second was the belief that this system would create a more stable revenue source and that the state wouldn't have to endure all this fluctuation in revenue.

The third was that the tax permitted firms to deduct capital expenditures from the tax base and, therefore, did not discourage investment in the way that a corporate income tax does. And by not discouraging investment, of course, you promote economic development within the state.

And the fourth reason was that the single business tax wasn't like a corporate income tax, where only corporations have to pay it and unincorporated businesses, like LLCs and partnerships, don't have to pay it. Instead, all business entities had to pay it and so it was more efficient in that regard.

Okay, if those are the reasons why Michigan did it in 1975, why did they get rid of it 31 years later?

Here's why: The first is that firms have to pay this tax, even when they make losses. It's not an income tax. A value-added tax is a tax on value added. You can have losses and still have plenty of value added. And people don't like paying a lot of tax when they've got losses.

Second, the Legislature was unwilling to give generous treatment of investment expenditures to firms in cases where the expenditures were made in other states. Because of the nature of the formulary apportionment of multistate businesses, you were trapped in this situation where if a company had operations in Michigan and in Ohio, it invested in a bunch of equipment in Ohio, Michigan was required to give the same generous tax treatment of those investment expenditures as if the expenditure had been made in Michigan. Because what you have to do for formulary reasons is, you glom together all of the firms -- you know, countrywide expenditures and then allocate the deductions based on a formula. And so it disregards where the investment was made.

And the Legislature, it's like, why should we give up revenue to encourage economic development in Ohio? And so that was a big problem for the tax.

The third issue is that the single tax business burden was heavy. In order to replicate the revenues from the single business tax, you would have had to have had a very high rate of corporate income tax. And it partly reflects that it's easy to gin up a lot of revenue using a value-added tax, and the state did that.

The final thing was, of course, one other reason why the Legislature acted, was that there was a statewide referendum that was going to come out on the ballots later that year that would have called for repeal, and the tax was wildly unpopular among voters in the state. So they acted, you know, a couple of months in advance of the election.

Okay, what's the issue with value-added taxation in one state? The problem of treating multistate businesses is huge. And let's face it, every big business is a multistate business. So it is not to be sneezed at. And the second point is, tax burdens were high, as I mentioned. You would have had to have had a corporate tax rate of 14.3 percent to generate the same revenue that the single business tax was generating. That tells you, that's a high -- you know, heavy burden on state businesses.

The use of the value-added tax, it's done on an origin basis in the state context, meaning, it's a tax not that is destination-based, the way international value-added taxes are, but instead, based on the stuff that's produced in the state. And as a result, the burden doesn't wind up shifted onto consumers in the same way that a national value-added tax would, as Dr. McLure pointed out.

Finally, the flip side of creating stable tax revenues, which the Michigan value-added tax did, it did create more stable tax values. But the flip side is that the tax burdens on taxpayers were stable, too. And, therefore, it didn't decline when the taxpayers had a lot less income, and that was a huge problem for the taxpayers.

Okay, so what does the future look like? The world is moving strongly away, in the direction of expenditure taxation, and away from business and personal income taxation.

If you look just at the United States, you will miss that picture. The United States is an extreme outlier in the world right now. More than 134 countries have value-added taxes; the United States does not. Every rich country in the world has a value-added tax except the United States.

I realize we're not here today to fix American tax policy but, instead, just California. However, it's clear where the international trends are. And it's also clear why. Value-added taxes, expenditure-type taxes of that sort, place the tax burden on a much less mobile part of the tax base than income production is. As a result, you get a more efficient source of revenue and you get a lot less base erosion than you would otherwise.

My final point there is, I think we can see the future. And the future is that all jurisdictions are going to wind up with greater reliance on expenditure-type taxes. The question is when, not whether that's going to happen. We see it around the world.

And the thing I would urge you in California is, do not look at the rest of the United States. California is a huge player in the world. Look at the world because, you know, of course, there are all these trite observations about how big of an economy California has. You do have this huge economy. And look where the world is going. They're using expenditure taxes. I don't see really any argument not to move California more in that direction, too.

CHAIR PARSKY: Thank you very much. In order to catch up on our agenda, let me make a suggestion. And, obviously, any of the commissioners, please feel free to speak to any of the presenters. Why don't we try, as we get through the rest of the agenda, let's try one question of Charles and one question of James from a commissioner, and then we'll move on to the next items, and then we'll have other commissioners ask questions.

So, first, does any commissioner have a question of Charles?

Okay, Richard, you'll take the Charles question.

COMMISSIONER POMP: Charlie, first, I compliment you on separating out the consensus view, which I think you're quite right in describing that way from your own view.

If you were putting together a tax-expenditure budget for a sales tax, California sales tax, would you include in that any of the exemptions for business inputs?

DR. McLURE: No, of course, not. I mean, the taxes on business would be a negative tax expenditure, if there is such a thing.

COMMISSIONER POMP: Right.

DR. McLURE: Obviously, it depends on how you define your tax, your baseline. But I think the baseline shouldn't be one where you tax all business purchases because that's not a good tax.

COMMISSIONER POMP: Okay. And do I get a chance to ask Dr. Hines? Or did I shoot my --

CHAIR PARSKY: No, we'll get one more commissioner to ask Jim a question.

COMMISSIONER POMP: All right.

CHAIR PARSKY: You want to use up your question? Okay, Michael.

COMMISSIONER BOSKIN: I just want to establish something, so as you look at this, you think, as a general proposition, we ought to be moving more heavily to broaden our sales-tax base to reduce our reliance on income taxes, and within the sales tax, like Charlie, you think we ought to rely less on taxing business inputs. But I just want to ask one conceptual question, since it was raised earlier.

When you look at the mobility issue you described, would it be fair to say that it's the consensus of economists of all stripes that as tax differentials rise, that affects mobility more? So as, say, if California's rate was 10 percent above somebody else, there would be more reason for mobile factors to leave than if it was 3 percent above it?

DR. HINES: Yes -- well, I'm not sure I understand. If California already has a heavier tax and then it increases it by 1 percent, I don't know that there's a consensus that that increase would have a bigger effect than if California were even with others and increased it by 1 percent.

COMMISSIONER BOSKIN: No, no. I’m just talking about, the mobility is a function of the differential;

right?

DR. HINES: Right.

COMMISSIONER BOSKIN: The larger the differential, the more concerned you have to be about having jobs and capital and entrepreneurship leave the state; right?

DR. HINES: Yes.

COMMISSIONER BOSKIN: So while we might have specific cases where that wouldn't happen, there's widespread agreement that that is true among economists; correct?

DR. HINES: Absolutely.

COMMISSIONER BOSKIN: Thank you.

DR. McLURE: Mr. Chairman?

CHAIR PARSKY: Yes, Charles?

DR. McLURE: I wonder if I might be able to tell one little anecdote and a clarifying thing about the value-added tax that Jim discussed and I didn't't.

The anecdote, in 1975, I was on leave from Rice University, and someone from the governor of Michigan's office tracked me down and asked me what I thought about this new tax they were proposing. I felt that it was a bad idea. And he says, "Well, I guess we'll ask somebody else then." They clearly were shopping for endorsements. It was a bad idea then. They found out 30 years later it was a bad idea.

On the value-added tax, let me just point out that the kind of value-added tax that Michigan had, as Jim described, is virtually unique in the world. Nobody else does it that way. All those other 134 countries use what's called the "credit method," where you calculate tax on your sales and subtract from that the tax you pay on your purchases. Then that works. And it's always imposed on a destination basis, so that your exports aren't taxed and your imports are. And that obviously has a lot of advantages.

I have argued for years that a state VAT of that type was not possible. I now think it is -- in fact, we know it is because Quebec has one. But Quebec does so in the context of a federal VAT in Canada. In fact, Quebec actually administers the federal tax there because of the unique political and ethnic situation.

Next week, I'm co-organizing a conference in Washington which looked at questions of design and coordination with state taxes. If the federal government should ever decide to impose a credit method VAT and pay its bills, and I have concluded, first, that, based on the Quebec experience, it obviously is feasible to have a state VAT of that type, not the Michigan type. It's also feasible, and I think vastly better, to have it kind of piggyback on a federal VAT that creates a clean, neat retail sales tax, not the kind of goofball systems that all the states have.

CHAIR PARSKY: Thank you.

I just want to make one comment about Jim.

I understand, Jim, that you're visiting Boalt and Berkeley, and that you've turned down an offer at Harvard. But that there's some pressure or concern as to whether you would stay there.

With my retired Regent hat on, we hope that you'll stay at Boalt and Berkeley at the same time.

DR. HINES: Thank you. I think one of the Commissioners put you up to that. Thank you.

CHAIR PARSKY: Thank you both very much. We'll move on to our next panel. Thank you.

COMMISSIONER KEELEY: Mr. Chairman?

CHAIR PARSKY: Yes?

COMMISSIONER KEELEY: Thank you, Mr. Chairman. While we're changing panels, I wonder if we could discuss your desire, how to manage the meeting and to make sure -- I at least perhaps misunderstood it. So your desire is that with regard to these panels, one commissioner will be recognized to ask a single question to each panelist.

Is that your desire?

CHAIR PARSKY: It's not my desire. I'm trying to catch up on the agenda. If we catch up time-wise, I'm more than happy to keep it. But in order to get through the entire agenda, I wanted to try to streamline the questions asked of the people. So until we catch up, if a commissioner has asked a question of the previous panel, we'll leave it to other commissioners to raise a question with the next panel. It's the only way I can see that -- we could ask questions of the first panel for the entire day. So I wanted to just see if we could move along so we can get through the whole agenda.

COMMISSIONER BOSKIN: Mr. Chairman, can I make a friendly suggestion?

COMMISSIONER KEELEY: I think I might still have the floor here for a second. May I? Do I still have the floor?

CHAIR PARSKY: Yes.

COMMISSIONER KEELEY: Thank you, sir.

First of all, I think you do a very good job of running these meetings. I thought last time we got way off time at the beginning. You got us way back on time by the end of the day, and I thought that was good. And I appreciate the sentiment behind what you're suggesting here.

I'll just register as one commissioner a concern that time is our enemy in this entire enterprise. But I don't think that the Commission's work is going to benefit from strict adherence to a four o'clock recess time or adjournment when we've got the task we have in front of us, when we've brought the kind of folks who are in front of us, and the Commission is charged with the task that it is.

I think your motive and intent here is wonderful. I don't think we ought to slavishly adhere to a four o'clock deadline, and would rather that we have sufficient opportunity for the commissioners to ask the questions they think they need to get answered or clarified in order to then be able, in our next meeting and the meeting after that, to produce a good product.

But, Mr. Chairman, it is not a criticism of you and your intent. I don't think this is anywhere near the best way to proceed. But I've registered that. Thank you, sir.

COMMISSIONER BOSKIN: Mr. Chairman?

CHAIR PARSKY: Michael.

COMMISSIONER BOSKIN: A quick suggestion.

Many of the panelists now and for the rest of the day have provided very extensive PowerPoint presentations. Some of those are partially duplicative of things we had in San Diego. Many of them new stuff. But my experience is, there's a tendency to try to go through them point by point. And if we could ask the panelists to summarize their main points. We have the whole presentation in front of us. That might free up a little for questions, so you could be a little more generous on the questioning to accommodate. But I'll leave that to you. It’s just a suggestion.

CHAIR PARSKY: I think that's a also good suggestion. And I will do my best to expand the Q&A session as we move along.

Okay, next?

Paul, you'll begin?

MR. WARREN: Sure.

This may seem a little out of order, but since we have things cued up this way, we're just going to proceed.

I’m Paul Warren with the Legislative Analyst's Office. I'm going to talk to you a little bit about tax expenditures, evaluation issues, policy issues from the legislative standpoint that we think are important to talk about.

My first slide, there we go.

You treat tax expenditures pretty much like you treat any other kind of direct expenditure program when you're thinking about, is it a good use of state tax funds. What's the need for the program, what is the objective, how do you measure that, do you have data to actually measure it? And is the tax-expenditure approach really the best way for accomplishing that goal?

Tax expenditures do have advantages. They're easy to administer. And taxpayers do a lot of the work. Or even in some cases, taxpayers don't need to do anything to get advantage of the tax expenditure. It's like entitlements in that everybody can play; that is, everybody gets the benefits if they qualify and they're available across time. And tax expenditures can be targeted in ways that get to really the core of individuals or businesses or whoever the tax expenditure is targeted at in a very effective way.

The disadvantages are really the flip side in some respects of the advantages. Okay, there are process issues, issues of effectiveness, and issues of administration.

On the process issues, it's not subject to an annual review of the Legislature. And at the federal level, they have an annual review, or the president comes out with a list of all the tax expenditures. But I think in recent years, that process has fallen apart a little bit. And certainly at the state level, we don't have some kind of oversight of that process. Tax policies are often uncoordinated with the program side of the policies.

For instance, there are different committees that work on, say, social services, than work on tax policy, who might be interested in the earned income tax credit. And they have very different perspectives. What the folks who just went on would talk about as good tax policy might not be good social policy.

And in California, there is a burden for eliminating or modifying tax expenditures that is greater than the burden for creating it in the first place.

Just a quick example of the need for oversight. The automatic nature of tax expenditures means that expenditures of tax resources occurs automatically. And this is just a real crude example of what's happened with housing subsidies. It includes both the mortgage interest and property taxes in California. It has roughly doubled over the last ten years. Okay, and that has a tax consequence of something on the order of about $3 billion in 2006, as compared to a decade earlier, okay.

So that just kind of happened because of what was happening in the markets and people's reaction, desire for housing, and what is happening in the market.

Effectiveness issues. A lot of times -- this is true for expenditure programs, of course, too -- goals are not clear all the time, data are not available to really evaluate them well. Tax expenditures can have very high costs if they're not targeted well. Deductions are worth more to certain individuals than others. Sometimes you have to itemize to get the value of the tax expenditures. So that means people who don't itemize can't play. So there are various reasons why these tax expenditures may not be as effective as you hope.

Administrative issues. Tax expenditures can complicate the whole tax system. And the more targeted you make them, the more complicated they can get.

I know the first time that I had to try to do the federal capital gains changes back in -- I can't remember when it was, in the eighties or nineties -- that was when I went to TurboTax® because it just got too complicated for me. And I just do this kind of stuff for my livelihood, to a great extent. So I share in this concern quite a bit.

Also, administrative issues of -- you know, data on tax expenditures is not always available. You know, there are confidentiality issues that make it difficult for academics who do a lot of the evaluation work for us. They have a hard time sometimes getting this data.

Okay, so tax expenditures and evaluations. Big issues here. People make their livelihoods doing these kinds of studies. State and local taxes, for instance, is a good example of the difficulty of trying to evaluate some of these tax expenditures.

What is the rationale for the deduction of state and local taxes on our federal tax system? One rationale, which I think is a pretty useful way of thinking about it, is that there are spillover benefits to state and local taxing. For instance, education has spillover benefits because people are mobile and they may move to other states or other parts of -- even within states. And so subsidizing that, there is a reason to do that. But a lot of services are really directly consumed by individuals, too. So where is the balance between the tax expenditure as recognizing spillover or that it's really just a consumption of services?

So once you have that conceptual argument, then you say, "Well, how do you evaluate that? What kind of data do you have?" And it gets very complicated.

I'm just going to spend just a second here running through -- there's lots of work being done on these issues all the time.

In 2005, President Bush put together a panel that made a report about reforming the federal tax system. And I'll just give you a sample of a few of the recommendations that they made on the tax expenditures.

They would really change the mortgage-interest deduction into a credit, refundable credit, that would be 15 percent of mortgage interest payments with a cap.

The whole idea being is to target it better, to not make the mortgage-interest deduction so much a broad subsidy of housing costs, but to really try to make it more into what people need to actually buy a house and get into that market.

You can see here, they eliminated -- they propose to eliminate the exemption for state and local taxes. And they changed charitable giving so that you didn't have to itemize, and so it was open to everybody.

We had done a variety of reports over time. I list four of them here on tax expenditures at the state level. And in general, I think we conclude that state tax expenditures don't have as near the impact that federal tax expenditures have. Sometimes they may change location decisions within states. But that for the most part, we think that they're not well targeted and we spend a lot of money on them for uncertain impacts.

So to conclude, tax expenditures can be effective. But what we have right now, many times, they're poorly targeted and poorly designed. By eliminating or refining them, you can broaden the tax base and reduce distortions in decision-making. And we need a way to have some kind of routine process for monitoring them and making changes in them to make them as effective as possible.

And I thank you.

CHAIR PARSKY: Thanks. Allen, why don't you go ahead? And then we'll do all three, and then ask the questions.

DR. PROHOFSKY: Thank you, Mr. Chairman, Commissioners. I am Allen Prohofsky of the Franchise Tax Board. I have provided a written statement that is too long for the amount of time that I have here. Since Paul ably covered most of the general policy issues, I'm going to skip most of what I've written on that to get into talking about the numbers. What are the largest tax expenditures, income-tax expenditures we have in California.

Real briefly, though, I would just like to agree with Paul's point that I think tax expenditures should be treated like other expenditures. That it would be nice to have a system in which you look at each program individually, ask yourself, “Is this a good program?,” then ask yourself the question, “Is it more efficient to administer this program outside or inside the tax code?”

That having been said, let me talk for a little bit about what we see on the income-tax side.

We generally have three common types of

income-tax expenditures.

And actually, let me back up a step and let me just say, there are some issues in defining what to call a tax expenditure and what not to. I want to talk more conceptually and not get hung up on the labels. But most of the tax expenditures fit into one of three categories.

The easiest type for us to measure are the credits. Claiming credits is the last thing you do when you fill out your taxes. The cost is reported right there. And what you see when we put out our *Tax Expenditure Compendium*, the cost that we report for credits is simply the amount by which tax was reduced through the use of credits.

The second type of expenditure is the income-tax deduction. These are amounts that taxpayers are allowed to subtract from their income before they calculate the tax due on that income. Most of these are also easy to measure.

What we do is we maintain a sample, a giant tax calculator with hundreds of thousands of observations of actual tax-return data. We go in at the individual taxpayer level, add back the amount of their deduction to their income, recalculate their taxes, compare what they pay now to what they paid before. So most of those are easy to measure.

There are a few exceptions. The prime example of an exception is in the area of accelerated depreciation. It is not obvious when we look at a tax return and see an amount of depreciation, how much of that would have been allowed without the acceleration. And it's not obvious from looking at that tax return how the acceleration now affects the amount of depreciation that taxpayer will report in future years. So those are much more difficult. We normally have to turn to outside sources of information about the particular type of property that we're studying.

The third common type of expenditure is the exclusion. This is when a taxpayer receives something of value, say, an employer contribution to a pension plan, but they're not required to report that value as income. There are a few exclusions that we do have good tax-return information, such as when you back out for state purposes the exclusion for interest paid by federal debt obligations. Those, we treat like the deductions. We have that number there, we add it back into income and recalculate.

Other exclusions, if there's nothing reported on the tax return about how much the taxpayer isn't reporting to us because they're not required to, it's more difficult to measure. Some of the measurements are subject to a little bit more error. We often, in fact, end up turning to things like federal estimates, and then making adjustments for issues like California's share of the population, and differences between state and federal tax rates.

Having said something about what the numbers are, let me talk for a minute about what the numbers aren't. What we report for the size of the tax expenditure is not necessarily the same as the amount of money that you would get if you repealed the tax expenditure. And there are a number of reasons for this.

The first is simply, you may choose to phase in a policy. For example, if you eliminated or replaced the mortgage-interest deduction, you might say, "We're going to grandfather existing mortgages," in which case the full revenue effect wouldn't be felt until the existing mortgages got paid off.

The second reason the repeal estimates can be different is because sometimes when one expenditure goes away, another one can take its place. For example, suppose I'm a taxpayer and I'm using my enterprise-zone credits, and I've got some research and development credits, but I'm not using all the R & D credits because I've already zeroed out all my tax.

If we eliminated only the enterprise-zone program, I would use more of my R & D credits. So the amount by which my tax would increase would be much less than the amount of enterprise-zone credit that I stopped using.

A third source of difference between expenditure and repeal estimates is that there can be changes going on in the economy because of some interactions. For example, again, if we eliminated the mortgage deduction, that could result in a decrease in the price of housing, that could result in a drop in the size of the expenditure for property-tax deductions, even though we did nothing to change the law on property-tax deductions.

Similarly, you can have things where you have explicit changes in taxpayer behavior. Say, we got rid of the exclusion for Section 529 education plans. Well, if we did that, a lot of taxpayers might increase their funding for Coverdell education plans and their exclusions there. And so the repeal of the 529 plans would be the net of what you save in not excluding 529s, minus what you lose from increased funding in the Coverdells.

Okay, that having been said, now that we have a better idea of what things aren't, can we find the --

COMMISSIONER BOSKIN: The chart.

DR. PROHOFSKY: -- the chart somewhere out there.

But, anyway, I'll keep talking while we're doing that.

The chart is taken from our tax-expenditure report. Let me start by noting that the numbers that we put into this report are actually a few months old. There have been changes in the economy. Probably some of the numbers will change a little bit the next time we update the chart. But overall, for the latest update of our report, we listed 74 things that we chose to classify as tax expenditures. And the total estimate, if you add it all up, comes out to just a little bit less than $40 billion.

The chart that I have presented here shows the top 20 of those.

And I think there are a few things that I find interesting when I --

COMMISSIONER BOSKIN: In revenue collections, or what?

DR. PROHOFSKY: Revenues --

COMMISSIONER BOSKIN: $40 billion against a base of what?

DR. PROHOFSKY: A base of about $60 billion.

COMMISSIONER BOSKIN: So that's about two-thirds.

DR. PROHOFSKY: Yes, it could be, if you could lower rates by about 40 percent if you got rid of everything. Although you can look at this list, and you can see there are things there you might not want to get rid of. That's another issue.

This top 20 accounts for 90 percent of the total, and the top ten, about 75 percent.

One thing I find interesting, if you look at the list, is that there are no primarily corporate expenditures in the top ten. The highest on the corporate side is No. 11, the R & D credit. In part, that's because the corporate tax base is smaller. It's also, in part, reflective that we are less in conformity with federal on the corporate side. In particular, the single largest federal expenditure item on the corporate side has to do with accelerated depreciation provisions that we don't conform to.

Another thing that I find interesting, looking at this list, is that eight of the top ten, and 15 of the top 20 are items where we are in conformity with federal law. And that raises some issues that we can talk about, if you're interested, in when that does and doesn't cause problems.

Sometimes going out of conformity does create a big burden; sometimes it's much less of a burden.

Going back to the corporate, so in total, the corporate expenditures are about $3 billion out of the forty. So that's a little bit less.

And the final thing that I would note is that this, obviously, is a snapshot. These items can move around on the list. For example, when we looked in 2005, before the recent changes in the housing market -- what I'm showing here is 2008-09 estimates -- 2005, the exclusion of capital gains on principal residences was up over $6 billion before the housing market collapsed.

So, yes, these things can move around a little; but what you have here is the top 20 as we, a few months ago, estimated for fiscal 2008-09.

CHAIR PARSKY: Thank you.

Rob, why don't you go ahead, and then we'll come back around for questions?

MR. INGENITO: Thank you, Mr. Chair and Members. I'm Robert Ingenito with the California Board of Equalization. I'm going to basically complement Mr. Prohofsky's presentation with some sales-tax related expenditure information for you this morning.

And just to circle back to --

CHAIR PARSKY: “Complement,” that means add to it, right? Instead of “compliment” him; right?

MR. INGENITO: Supplement, either way.

Just to put things in perspective, the amount of tax expenditures in the sales and use-tax area is about $11 billion. Roughly, one-fourth of the amount that Mr. Prohofsky cited for personal income tax and corporate tax combined.

One thing I would point out in the sales and --

COMMISSIONER BOSKIN: Against the base of what?

MR. INGENITO: Let's see, local combined, about thirty-five, I think it is.

COMMISSIONER BOSKIN: That's about a third.

MR. INGENITO: That's correct.

One issue in the sales and use tax arena is that we actually cannot make good estimates on the amount of revenue loss associated with many of the tax expenditures. And as one example I'll provide, there is a tax expenditure with respect to purchases made with food stamps. Food stamps is generally to buy food, which, of course, is not subject to tax, but food stamps are also eligible to buy certain other items which are things like food coloring, ice, carbonated beverages. When someone using food stamps buys these products, they don’t pay sales tax on that, but there is no data on the split of food-stamp consumption by type so there is really no way to break out the amount of the revenue loss going towards this particular area.

So in my world, we can identify about

$11 billion worth of revenue from, roughly, three dozen tax expenditure programs and five of them account for 95 percent of the total.

And I can very quickly walk you through those five.

Okay, the first one that we're all familiar with is the consumption of food products. Food products consumed for use at home are generally not subject to the sales tax. However, the program doesn't extend to prepared foods, including take-out foods, restaurant items, these sorts of things.

This revenue loss is about $5 billion, almost half of the total. It's been on the books since 1933, I believe, when the sales tax was first instituted.

The rationale put forth is sort of an equity one. Food is a basic necessity of life and, therefore, its price shouldn't be increased by application of the sales tax. That's the argument that most folks offer.

As a quick digression, I would just point out everything I'm going to try to convey to you is consensus. I'm sort of just the facts kind of guy. My role with the Board is to provide objective, timely information so that the policy makers can make their decisions; and I believe my role for you is no different.

One comment that is often made with respect to this food-tax expenditure is that there's no sort of distinction to high-grade and expensive products. It can be argued by some that those do not constitute basic necessities. The way it works is, food is food. And as long as it meets the commonly understood definition and is not consumed off the home site, it's generally not subject to sales tax.

Okay, No. 2 is about half the size of the food-tax expenditure. It's the combination of gas, electricity, water, and steam. The sale or transfer of these things through generally accepted delivery means is exempt from sales tax. This one also dates back to 1933.

And the reason -- there's a little bit of history involved here. Companies providing these services at that time were subject to a gross-receipts tax that was levied in lieu of sales tax. And the State Constitution actually prohibited any other taxes levied on these service-delivery firms.

Those constitutional provisions were subsequently repealed but the tax expenditure remains in place today. The rationale again is a necessity-of-life one. But there's also a sort of double-taxation issue that gets raised from some proponents of this tax expenditure. The idea here is that gas and electric bills are subject to municipal utility user taxes, so that to impose a sales tax on top of that could be construed as double-taxation.

Prescription --

COMMISSIONER PRINGLE: Unlike gasoline, huh?

MR. INGENITO: So noted.

COMMISSIONER PRINGLE: Oh, I see.

MR. INGENITO: Number 3 on the list is prescription medicines. This revenue also amounts to almost $2 billion. It's exactly what you would come to understand, prescriptions prescribed by doctors and supplied by registered pharmacists are exempt from the tax.

Also exempt from the tax are certain medical devices -- actually, most medical devices, which could be, you know, everything on slide No. 6 I provide for you here. Also things such as wheelchairs, crutches, medical oxygen delivery devices -- anything that helps promote human health is exempt from the sales tax.

So from there, we go to revenue losses that are under a billion dollars, so they're becoming more minor. This one is a catch-all. It's animal life, feed, seeds, plant, fertilizers, et cetera, et cetera. I would urge you to omit the word "*water*" from the title. That's an omission on my part. I apologize for that.

This is just an extension of the food argument.

These are inputs which are generally used for the end result of animals and food products that are used for human consumption. So, again, the necessity-of-life argument is what is brought forth here.

The last one actually is the only example I'm aware of in the last two decades of an attempt to broaden the sales-tax base. This expenditure No. 5 is the so-called “snack tax” one. The exemption was repealed, actually, in 1981, when the Governor and Legislature at that time were dealing with a budget problem of similar proportion to the one that's being dealt with in Sacramento today. It's a $14 billion gap on a base of about $38 billion, $40 billion. So it's similar in proportion to what's being grappled with in Sacramento at this moment.

However, this tax expenditure was reinstated, in essence, by Proposition 163 about 15 months after it was imposed. The revenue loss is about $320 million. This one actually was the subject of some objection from both taxpayers and consumers. There was some confusion. One commonly thrown-out example was after this was implemented, the definition of a snack was a bit subjective.

If you purchased unpopped popcorn at a grocery store, that was not subject to tax. If you purchased a bag of popped popcorn, that was subject to tax. There were all sorts of inconsistencies and issues that sort of lead to the proposition being approved by voters in 1992.

And those being the big five, I'd be happy to answer any questions that you might have.

CHAIR PARSKY: Okay, we may have saved a little time.

So questions -- first, questions of Allen.

Becky?

COMMISSIONER MORGAN: Well, I'm not sure it goes to Allen or who, and it's really for my own edification.

In the late eighties, early nineties, there was a unitary tax put through. And could you just help me understand the status of that and what the impact was, pro or con? One of you.

This sort of refers to our previous two speakers as well as, you know, on corporate taxation.

You're too young to know.

DR. PROHOFSKY: And that actually goes back, there actually was one item somewhere on my list that's related. There are all sorts of questions -- this is the gray area in what you are defining as tax expenditures or not, is you have to start with this question of what are we defining as the corporate taxpayer. And there are different ways that different states do it.

COMMISSIONER MORGAN: No, I'm referring specifically to California, where it was a percentage, a formula that was worked out on sales, personnel, and something else -- there were three things. Wages, I think.

Remember that battle?

MS. MAITLAND: Anne Maitland, Franchise Tax Board, and I guess my role is historian. There are so many tax bills.

But I think, Senator Morgan, what you may be referring to -- are you referring to the allowance of water's-edge election as an alternative to the unitary method of apportioning?

COMMISSIONER MORGAN: Right, led by Senator Alquist.

MS. MAITLAND: That is a somewhat different issue than some of the other issues that we've been talking -- that have been raised today about how many apportionment factors you actually have. Rather, it was more a question of where do you look? Do you look solely within the water's edge of the United States operations or do you do that on a worldwide basis? That was after many years of debate and challenges in the Supreme Court, becoming, in effect, a national and international issue. California did move to a water's-edge election for taxpayers, that they needed to keep how they were going to decide to structure their businesses for tax purposes for a certain length of time.

And my memory on whether or not that's been considered a tax expenditure, is that we have --

DR. PROHOFSKY: Well, now, that's where I was headed a minute ago, it is No. 15 on the list. And my take on that is that the reason that we list it as a tax expenditure is because it's elective. You can debate what you want your tax base to be. If you say everybody should do formulary apportionment, that's fine. If you said everybody should file water's edge, that's fine. That's still an interesting policy discussion worth having. But to us, as far as the tax expenditure, what we're trying to measure here is the fact that it's elective, that taxpayers can choose whichever way off they're better so you don't get as much revenue as you would with either pure system.

COMMISSIONER MORGAN: And that's my concern. Is it fair and is it impacting the budget of California as a tax policy?

DR. PROHOFSKY: On this chart, we're showing about a $700 million impact at this point.

CHAIR PARSKY: Curt?

COMMISSIONER PRINGLE: Yes, I just have a brief question of Paul and Allen in the context of there was expression that, in fact -- I don't like the term at all “tax expenditures" -- from my perspective, these are places where taxes are not charged, so it's not a cost to the tax base, just like services are not charged and a variety of others; but I will put my point of view there, and it may not necessarily reflect in the language of the day. But, in fact, every one of these you articulated don't have an annual review process or annual follow-up or juxtaposed against annual expenditure outlays and the like.

Out of the major tax-expenditure areas, or areas where there are deductions or taxes not charged, how did they come into being?

The question is, weren't they all established by the Legislature? And show me the ones -- tell me the ones that weren't established by the Legislature.

MR. WARREN: Well, you know, we were actually talking about this issue the other day at work. And several of them kind of are accidents of history, in a way. For instance, when income taxes were first instituted, we taxed income. And then somebody said, "Well, wait a minute, what about benefits? That's really an extension of income." Well, we didn't tax benefits. So then when you start thinking about tax expenditures, then that becomes kind of like, it's income that's not taxed.

COMMISSIONER PRINGLE: It's kind of like rollover minutes? They didn't think about cell phones back there, either; but I'm sure if they did, they would have grabbed those rollover minutes that go from month to month.

MR. WARREN: I'm sure they would.

The mortgage-interest deduction is similar in history, in that it came -- back when personal income tax was put in place, people borrowing large sums of money to buy homes was not so prevalent. People saved up a lot more. But there was a deduction for business-related income expenses. And the mortgage-interest deduction is kind of an outgrowth of that. So some of them were kind of accidental.

Of course, you've worked in the Legislature, so you know that these things are, in some respects, part of the baseline for how people think about taxes; right?

COMMISSIONER PRINGLE: Sure.

MR. WARREN: And getting rid of them would be a significant challenge.

COMMISSIONER PRINGLE: That's right. But on Allen's top 20, which ones of those were not established by the Legislature, or legislative action?

MR. WARREN: Well, I think -- I mean, implicitly, they all had to be established.

COMMISSIONER PRINGLE: So out of those top 20, which ones were established with the legislative prerogative of a sunset clause or a termination time?

MR. WARREN: I know there have been bills in recent years that have had different kinds of sunset clauses in them, but it's the exception rather than the rule.

COMMISSIONER PRINGLE: Right, and why would a sunset in the Legislature's grand intelligence be added to any type of exemption or deduction?

MR. WARREN: Well, for the same reason why we might have a sunset on programs. You know, we used to have had a very extensive sunset process on the program side, say, in education. But it's a way to review how it's working.

You don't want every year to sit down and go, “Well, should we do mortgage-interest deduction again this year?” You want to --

COMMISSIONER PRINGLE: But I thought that's what I heard you say, that because they aren't annually reviewed, they continue to float or that somehow the Legislature didn’t think about their longevity in their creation. And certainly I served in the Legislature, when we debated the longevity of certain credits or deductions and how important it was, not for an annualized basis but for a continuing basis.

MR. WARREN: You know, I'm not sure that we have an official position on this. But my own kind of thinking off the cuff here is, you would want to have some periodic deep review of how are these tax expenditures working, and try to really have a process that collects information where you can -- the Legislature can learn deeply about what are the issues with these different programs or tax expenditures. On an annual basis --

COMMISSIONER PRINGLE: That actually answered that question, because I had heard in your testimony that you were contemplating on annual --

MR. WARREN: But you still want to review it on an annual basis. Like the information that I showed about tax expenditures, say, for the mortgage-interest deduction, it would be important for people to go, "Hey, this is going up fast. This is something to keep our eye on," okay, because it is affecting our collection of revenues, okay. And whether they take action on an annual basis I think is a different question.

COMMISSIONER PRINGLE: But just a question of the income tax in the state of California, have we not had a mortgage-interest deduction?

MR. WARREN: I'm sorry, I'm not sure I --

COMMISSIONER PRINGLE: Since we had a tax on income, has there ever been a time in which we didn't have mortgage-interest deduction

MR. WARREN: Not to my knowledge.

COMMISSIONER PRINGLE: Okay, so it's not one of those things that just popped up and that people aren't aware of its effect and impact?

MR. WARREN: But I don't know that people are aware of how it's changed over time. That's my point.

DR. PROHOFSKY: And if I may just add for completeness, not here at the top but further down the list, there are actually a handful of items that were imposed either by the federal government or by the voters rather than by the Legislature.

COMMISSIONER PRINGLE: And could you point those out? The one I saw was the inherited property tax.

DR. PROHOFSKY: That's one. The exclusion of lottery winnings is one. The interest earned on federal debt instruments, those are the ones that come to mind.

COMMISSIONER PRINGLE: Okay, thank you.

CHAIR PARSKY: Any other questions?

COMMISSIONER POMP: I have a question or a comment.

I mean, a tax-expenditure budget includes so much, including what you pick up from conforming to the federal definition of taxable income. But there is a useful subset. And there are always tax expenditures that are proposed on the grounds of stimulating economic development. And they usually come with a very high price tag. Every lobbyist knows if you get it adopted as a tax expenditure, you will avoid annual examination of it; which is why, when we lobby, we like to do things as tax expenditures. It's really inexcusable not to revisit those. They're big bucks. Generally, at least, if your experience is the same as in most other states, it benefits disproportionally a small number of corporations. The taxpayers have every right to know what are they getting in return for a couple hundred million dollars every year. And there are some states that have a mandate to review a subset of the tax-expenditure budget.

And I would think, Mr. Chair, that one of the useful roles we could play -- I mean, this is all part of getting spending under control -- is not to have hundreds of millions of dollars escape the kind of budgetary review that would have occurred if they were done as spending programs.

And for every tax expenditure, there is an equivalent spending program that could have been adopted. You give me a tax expenditure and I could convert it into a spending program.

And so these really -- there are gray areas, but you can't let the gray areas drag you down so that nothing useful comes out of the discussion. There's very useful discussion to be had around the more tax-incentive type of tax expenditures.

CHAIR PARSKY: Chris?

COMMISSIONER EDLEY: But it's also probably helpful to keep in mind the two-thirds requirement, right, so eliminating a tax expenditure, presumably, would require a two-thirds vote as opposed to the majority vote required to put one in place?

COMMISSIONER POMP: For new ones. But we have inherited a whole bunch of old ones that live with us every year.

COMMISSIONER EDLEY: And would require two-thirds vote to eliminate them; right? Which is not to say that other things we are going to propose wouldn't also require --

CHAIR PARSKY: Absolutely.

COMMISSIONER EDLEY: -- a UN Security Council resolution.

CHAIR PARSKY: In the future, maybe.

Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

To follow up on Mr. Pringle's comments, one of the ways to look at the budget each year is that the budget submitted by the Governor and ultimately disposed of at some point by the Legislature and then back to the Governor for his or her blue-pencil authority, one way to look at that is they have selectively gone through the code and looked at which programs they choose to fund and which programs they choose to fund at what level.

The mere fact that the Legislature and the Governor enact a statute which creates a program doesn't mean that it will ever be funded.

In the alternative, with regard to tax expenditures, tax expenditures are always funded in the budget. And so they really have a very, very privileged place that is very different than programs. For example, you could pass a bill creating a marine-life protection program with a Democratic Legislature, a Republican governor signing it, and that program may never be funded by the budget submitted by the Governor or enacted or adopted by the Legislature. In fact, the code is littered with hundreds of programs that have never received a penny's worth of funding.

Yet alternatively, the tax-expenditure program, which receives, in my view, virtually no review or oversight, is annually funded. Every one of those ideas continues to exist and is annually funded by omission. By the Legislature and the Governor not taking any action on them, then they are funded or authorized to continue to exist.

So I agree with Professor Pomp and the speaker, Pringle that -- and I'm not sure if Speaker Pringle thinks that maybe what I'm going to say is something that he agrees with, but from the sound of it, I think there's a lot to be said -- and Dean Edley as well -- there's a lot to be said for our commission making recommendations on the life cycle of tax expenditures.

It may be that there is no political stomach, or even good policy rationale for getting rid of mortgage-interest deductions or something of that nature. But there is certainly six or eight or ten on the list that are worthy of some serious review by the Legislature on an annual basis which may lead to policy debate and a different outcome with regard to whether those tax expenditures make good sense.

I do have a question of Mr. Warren about -- and maybe others who would want to weigh in on it -- do you believe that the tax expenditures uniformly have a policy basis and a metric for determining whether that policy basis or objective is being achieved?

MR. WARREN: We put out, roughly every decade, a summary of all tax expenditures. And I haven't been involved in writing one of those, but I've talked to the folks who have, and I know they struggle on occasion with trying to figure out what is the rationale for this particular tax expenditure? And certainly, you know, in terms of data on -- if you don't know what its objective is, then it's pretty tough to collect data to say whether it's working or not. So I think it is a problem in cases.

I also think, you know, there are problems, like what my colleague here talked about with, we don't even really know what the impact is, that is, in terms of on the State Treasury, of quite a number of the tax expenditures that we have. So the agencies do a good job of trying to estimate what they can, but they just can't get numbers on everything. So it's a particular concern to our office, I think to say, that the state is doing something and they don't really understand what the impact of it is.

COMMISSIONER KEELEY: Thank you very much.

Thank you, Mr. Chairman.

CHAIR PARSKY: Before we break, Curt, could you just -- did you agree with Fred or was that not accurate?

COMMISSIONER PRINGLE: Actually, I think I did agree with Fred, as long as it's on my terms, that it really isn't a proper use of the term that we reserve money in the state budget annually for a mortgage-interest deduction when, in fact, we have never had income tax paid on mortgage interest. That there's definition behind the types of deductions, exemptions, and credits that are provided that are created in the statute for specific purposes by legislative action. And I think there is a difference between elements such as exclusion of employer contributions to pension plans and other things like that. And I would argue, probably, that the top five or six on the list of the largest income-tax expenditures, as they're called here, aren't really the type that you put in that basket.

I would agree that there were many exemptions, credits provided and deductions to try to establish a certain outcome. And I think that is something that we all could reasonably establish as good fiscal practice, that we would encourage the Legislature, before they add any more of those, to state what any measurable goals may be, and, in fact, at a sunset date for future exemptions or deductions, say "Have we met those goals, and does the Legislature wish to continue those?" I think that is reasonable, and there have been many times that that has been discussed in different revenue and taxation committees of the Legislature.

So I think that's certainly something that I personally don't have a problem with. I just have a problem lumping in things that have never been collected and claim that they're somehow being funded because they've never been collected; and we should put those types of elements in the same context as certain types of credits or deductions that were established for specific purposes.

COMMISSIONER LOZANO: Mr. Chair?

I'm sorry, go ahead.

CHAIR PARSKY: I was going to say, we'll focus on what the two of you agree with for the moment and then we'll see how far we can take that.

COMMISSIONER LOZANO: Just one last comment because I agree with one of my other fellow commissioners, that what's caught my eye in all of this, in addition to what we've already talked about, is the focus on business tax credits and business incentives.

If the purpose is to stimulate the new economy of the 21st century, and what we're seeing in some of the presentations is that, in fact, it has not led to the types of investments and activity on the part of our business sector, I'd like to know that and why it's not moving us in the right direction if it hasn't been as effective; and if it is, in fact, at the federal level that we're going to get the most to gain.

So I'd really like a focus on, in fact, business incentives and the business tax credits as it relates to the sorts of investments and R & D, et cetera, that we're so interested in.

CHAIR PARSKY: One last one, Michael. Go ahead.

COMMISSIONER BOSKIN: One quick substantive question and then one point of personal privilege. It will take 20 seconds.

I think that if we look at these, as was laid out, there are pros and cons for each one of them; there's historical reason, as Curt and others have mentioned, for each of these things. And I think the question before the Commission isn't to sort of go and pick out No. 7 and No. 14 and make some trivial little change. The big question we have to think about is: Is it worth it, will we wind up with a better system, on all the dimensions we've been talking about, to get rid of the bulk of them and lower rates? It seems to me, that's kind of the big question we have to ask ourselves.

Now, everybody might disagree, they want to fight for one or two to stay in or something like that. But you can only get a broader base on lower rates by getting a lot of them. And so I think that's a big question.

On the point of personal privilege, I am in the unique position today, not because I asked the staff to arrange this, of having two former students addressing us.

So Allen was a teaching assistant for me in economics, introductory economics, more years ago than either of us care to remember. And Eric Miethke, who is going to be speaking to us later, was a student of mine as well.

And I'm sure I speak for all the professors at the UC system, the state college system, the State University system, CSU, the community-college system, and certainly the many fine private universities and colleges in the state, that even when we scratch our heads, wondering why they don't agree with us, it's a great joy –- a supreme joy of a teacher is to come back and have their former students teach them and their colleagues. So thank you.

CHAIR PARSKY: Why don't we take a ten-minute break and we'll come back and finish our next panel before lunch?

(Recess from 11:35 a.m. to 11:46 a.m.)

CHAIR PARSKY: We're ready to complete our morning program. But before I do that, we have a message from the Speaker that her representative here would like to give us.

John?

MR. LAIRD: Thank you, Gerry.

I'm John Laird. And I've been attending these just on behalf of the Speaker as sort of an informal liaison.

And you are in her district and she fully intended to be here today; but for those of you that have seen the front page this morning, you understand why she is not. And so I just was asked by her to extend her greetings and welcome to you, and to let you know she is intensely interested in this, she's following it closely, and she really intends to make good on her commitment to bring legislative action to what you propose. So I just wanted to make sure that that was on the record. And thank you for letting me do that.

CHAIR PARSKY: Thank you very much.

Okay, my suggestion is that we complete our discussion of the next panel. We were also going to have a discussion led by our staff on approaches to broadening this state's tax base. My suggestion is that we're going to move that to the end. We've saved some time for a discussion of alternatives among commissioners. And I think Mark can help us kind of steer that discussion and include at that time comments that he would make, summarizing the underlying concept of this morning's discussion, which is how the state's tax base could be broadened.

So with everyone's concurrence, I think that will allow us to complete our morning panels before lunch.

Eric, you're going to lead us off here?

Or Annette? Which order do you think would be easiest?

Annette, okay, why don't you proceed?

MS. NELLEN: Good morning. I will go quickly through these slides, since you do have these. I do want to focus on -- I guess I need the -- sorry.

I just want to comment on slide No. 3 regarding the tax base as it ties back to the last panel on the expenditures, where, statutorily, our sales tax applies to tangible personal property. If I go to measure expenditures, it would not pick up not taxing services and most intangibles. That actually is not in the expenditure list.

I can give you about ten reasons, at least, to broaden the sales tax, or think about broadening the sales tax. Let me just focus on a couple of these.

One, we do have a high rate here in California, and so broadening the base would allow for a lower rate that would be attractive to business, as well as perhaps addressing the regressivity of the tax.

Also a comment on No. 4 on addressing base erosion. Just as an example that consumption patterns today have changed from what they were, certainly back in the 1930s. You can look at iTunes now being the largest music retailer that's not subject to tax.

Also, there's some comparative analysis from the Bureau of Economic Analysis, comparing 1970 consumption to 2006. This is gross consumption. But total household expenditures on clothing increased from 1970 to 2006 by almost 400 percent, while expenditures on a category called "recreation and culture" increased 862 percent, again showing changes in our consumption patterns.

Also on No. 5, improving distribution of the tax burdens, some things to think about. The data shows that households with income over $75,000 are three times likelier to have access to broadband than households with income below $30,000. Which means they have access to digital downloads, which is not something that's subject to our sales tax, even though it might be the equivalent of a tangible personal property that would be.

Also, another thing to think about in the distribution of the tax burden with our exemptions is looking at 2006 consumer-expenditure data from the Bureau of Labor and Statistics, the average expenditure for entertainment, if income is under $70,000, is $1,500, compared to $7,600 if your income is over $150,000. So that's actually -- that kind of pattern, where it's far greater consumption on average for someone with higher income.

Just really illustrating, when we do have an exemption for any of those, it is certainly not a very-well targeted exemption because it's giving the benefit to even higher income who could pay the sales tax. And other remedies that you could use, like refundable income-tax credits to address the regressivity of broadening the base on some of these items.

Additional items on the -- just to move -- or maybe not. That's okay.

Going on to the next slide -- whether this will do or not, wherever this is pointed -- there we go. Number 8 doesn't get mentioned often, but local governments, they're always very eager to get the big-box retailers because it produces a lot of sales tax for them. Broadening the base at least would hopefully broaden who they're trying to attract to their jurisdictions.

On No. 9 here, I say, keep up with other states. That doesn't mean we should do identically what every other state does. But on the business perspective, states do compete with other states for getting business. And if there's some area where our tax system isn't being efficient, that might limit us in being able to be more attractive to businesses. So I think you do have to look at the whole package in comparing one state to the next.

Let me just go on to the next slide here.

So far as implementing any change to broaden the base, any change is difficult. And there are some items here that certainly are particularly challenging.

I do want to just emphasize that often, a reason that comes up why we can't do this is because it failed in Florida, Massachusetts, and Maryland; it failed recently in Michigan.

I would look at that very carefully. In Florida, Massachusetts, and Maryland, a lot of what they were expanding the base to was business inputs.

And I agree with Dr. McLure that I think it’s the consensus position that it's not an effective way to operate a sales tax, where you have pyramiding of it. So you really should try not to be taxing business on what they purchase. You should be trying to impose a tax on the final consumer. And in those states, a lot of what they were taxing was going to be taxing businesses.

Also, in Michigan, while they were broadening it to -- they proposed to broaden it to a lot of personal services, that legislation was passed October 2nd and became effective December 1st. Two months is not enough time for these businesses to start getting ready to do sales-tax collection. So that's just something to look at and why those were not successful efforts.

COMMISSIONER KEELEY: Mr. Chairman, can I ask a quick definitional question? Just very quickly.

At our last meeting, the phrase that was used is, "Don't tax business inputs."

Is that what you meant, what you were just describing?

MS. NELLEN: Yes, because when a business is paying tax on what they're paying, that represents their sales price, and then the consumers are paying a tax on a tax. That's pyramiding.

COMMISSIONER KEELEY: Okay, thank you.

MS. NELLEN: Also, so far as implementation considerations, it's going to be very tough for small businesses that becomes subject to it -- a hair salon that becomes subject to it. I would encourage you to look at ways that can be simplified. For example, small business theoretically should be able to actually collect and remit, report the sales tax on their income-tax form, as well as their estimated income-tax payments, the quarterly payments. There are ways that these could be done more simply.

And also something that doesn't get mentioned a fair amount up here is, I think some consideration of the businesses that would start becoming subject to collecting and remitting sales tax, to give them some compensation -- because there are some start-up costs of getting ready to do that. There's purchasing the software to do it. I think reflecting that there is a cost of doing that, if there's some kind of a refundable credit to help them on that.

And I'll end my marks there. Thank you.

MR. MIETHKE: Good morning, Chairman Parsky and Members of the Commission. My name is Eric Miethke. I am a partner in the law firm of Nielsen, Merksamer, Parrinello, Mueller & Naylor in Sacramento, California. I've also been in private practice. I've been a corporate tax counsel. I've been a counsel at the Board of Equalization, and I've worked for both houses of the Legislature. And in the spirit of full disclosure, I've also been the student of Professor Pomp, which he may disavow by the end of these comments.

We have submitted a detailed testimony for the record. I'll try to be brief, recognizing the tightness of the schedule.

I do want to restate the obvious, that the views in my written testimony today are mine, and those of my colleague, Greg Turner, and not those of our firm, our clients past or present, who also may disavow any knowledge of our undertaking as well by the end of this.

One point I think Professor Pomp made early on, is to try to make policy not by anecdote but by data. And in all honesty, that seems to be one of the criticisms that I have at this point, which is, that there is this mantra that there is a decline in the percentage of taxable sales as a percentage of total consumption. Then the next step is, this is because the sales tax was first imposed in the 1930s, when the majority of the economy was made up of the purchase of goods. Now, the 21st century economy is in transition away from goods and towards services. Therefore, the drop in consumption of taxable goods must be attributable to replacement of those goods with these services. So, therefore, we must expand the sales tax base to these 21st century services or face the inevitable erosion of the tax base.

If there's one thing I can leave you with today, it would be the notion that, in our view, that premise just hasn't been proven out by any of the California specific research data. And we really need -- I really recommend that the Commission try to tie that down.

What's the basis for that? Well, it's hard to get a clear picture, if there is erosion of the base, how serious it is. We did put a chart as an attachment to our testimony that showed taxable sales as a percentage of state GDP over the last 35 years. There has been some decline, but it's not a huge decline. And it certainly doesn't necessarily compel hasty action by the Legislature or the Commission to act.

But even let's assume that this erosion has taken place. We don't know whether, with any great certainty, whether the decrease in taxable sales has been at least partially caused by a proportionate increase in consumption of goods that are already exempt from tax. So as Mr. Ingenito's prior testimony indicated, 95 percent of the sales-tax exemptions fall into three categories: Food, prescription medicines, utilities.

But, really, those don't have much to do with the 21st century economy. Those have a lot to do with perhaps increases in the cost of those commodities relative to other things.

It could be also that the decline in taxable consumption could be explained by an increase in consumption of services that we're unlikely to tax in any event because, again, they're necessities or it would be extremely regressive to do so. These might include things such as housing, medical care, education, and possibly even public transportation.

So if, in fact, that decrease in taxable consumption has been going into these categories as well, it will be very, very difficult to enjoy the thing that there is consensus on, that a good tax should have a broad base and a lower rate if possible.

I'm just saying that if, in fact, consumption is going into those categories, it may be difficult to achieve that.

And as I alluded to just a second ago, I'm not completely convinced, at least, that you can't explain some of this migration out of taxable goods into something else. It may be just a difference in the relative inflation of price and not necessarily a change in consumption patterns. And I don't know how many of these studies that are often cited, control for that, but it's certainly something for the Commission to be aware of and for the staff to take a look at.

One thing that you don't hear a lot of that I do think is important as we talk about the sales tax, and we also have good data on, and that's something I call "rate erosion." And what do I mean by that?

Well, California has one of the highest sales tax rates in the nation. 20 percent of the state's sales tax, plus an additional portion of the sales tax on gasoline, it's diverted out of the general fund to other uses. And that includes local law enforcement, retirement of debt-reduction bonds, transportation programs, and realignment of services with local government.

Now, these all may be valid uses of the money. I'm not saying that they're not. And they also may be funded at the optimal level. But as the years pass, we really don't know whether that's true or not.

And one point that you might be interested in, the half-cent program for Prop. 172 for the local police and fire, is completely off-budget in the sense that it is not in Schedule 8 of the Governor's budget presentation, it doesn't show as sales-tax revenue that's raised, and it doesn't show as sales-tax revenue that's transferred, but it is revenue being generated by the sales tax. So even though the sales tax is often much maligned, it's actually doing quite a job of generating quite a bit of revenue; the problem is, it's getting diverted.

So you may want to revisit some of these earmarked programs and their connection to the sales tax. I’m not saying that the programs are bad, but really questioning should they have a dedicated portion of the sales tax fixed to them? Because it is quite a bit of revenue when you total all this up. I think my estimate -- maybe Bob, when he testifies, might be able to comment on it -- I think these total somewhere around $8 billion. That's a lot of money.

I want to touch briefly on the fact that we've talked about here's what California doesn't have within its base. But there are important things that California does have in its sales tax base that other states don't, one of which has been touched on many times. Manufacturing inputs, I'm not going to talk any more about that. It's been belabored. It is consensus. It shouldn't be there. It causes a problem.

The order of magnitude, I believe, is that 30 to 40 percent of all of the sales tax is paid by business, which is a big number. A very large number.

Second, California is one of the few states in the nation that places a sales tax on gasoline. And we are the only state in the nation that includes within that taxable measure, both the federal and the state excise tax. Talk about pyramiding.

In the recent run-up in gasoline prices -- and, again, I hate to keep putting more on Bob’s plate -- but the state got just a windfall of about an additional billion dollars in a two-quarter period on top of the many billions that they're already collecting on gasoline.

California taxes sales and purchases by state and local government. We tax sales and purchases by nonprofit organizations, such as churches, unlike a lot of other states. And we do tax some goods that are deemed necessities in other states that they are partially or wholly exempt in other states, such as clothing.

So when you're looking at this, the point of this is that, when you're looking at the California tax base and you want to compare it to other states, make sure it's a fair comparison, not only looking at what other states tax that we don't, but look at what we tax that other states don't. And look at the relative amounts of money involved. It's rather substantial.

I think there was a mention earlier about that the California sales tax is part of an integrated tax system between state and local government. One of the major exemptions in the sales tax is for utilities. But those utilities don't go untaxed. That tax base has been ceded to local government, which has a very high, in most places, utility user’s tax, a higher rate than the sales tax.

The same way with short-term housing, such as hotel rooms. Many states have a sales tax on the rental of hotel rooms. Well, in California, that's tax base that's been ceded to local government, and they apply the transient occupancy tax. So I think that's important to bear in mind.

So, too, when we're talking about comparing

California to other states, bear in mind, too, of the role the sales tax plays in relation to all the other taxes. Like, for instance, we talked a lot about Hawaii at the last meeting, that they tax 160 services. Well, their sales tax is a huge part of their revenue base. Only 30 percent of the tax base in Hawaii is the income tax; 46 percent of the tax base in California is the income tax.

If we were to have the same ratios as Hawaii and California, we'd have to transfer $14 billion of revenue from the income tax to the sales tax. That's a lot. And if you talk about the exemptions that I think we would concede would be in place in a broader sales-tax base, that might be difficult to achieve. And you're also moving from a highly progressive income tax, probably the most progressive income tax in the nation, to a tax in California that's neutral, at best, and, in the eyes of many, regressive.

There's a bunch of other issues that are covered in the paper. I won't go into any detail about them. I will just mention them, and you can ask questions, if you'd like.

We have something in California called Proposition 218 that may create issues for, again, this integrated state-local relationship. That's going to be some issues there in terms of how you integrate the state sales-tax base with a local sales-tax base if you go beyond tangible personal property.

I believe it was Professor Boskin that talked about the mobility of services and what effect would that have. If we taxed custom-computer programming in California, what effect will that have? I think it's a very good point.

There is a problem between -- a competitive problem. If you're a large business, you can staff up and you can internalize services. If you're a small business, you're buying them from third parties. Is that something we should be concerned about?

The question of volatility. Do we know for a fact that if we expand to services, are services any less volatile than goods? In other words, are we going to export the problems of the income tax to the sales tax if we attach the base to services that are jettisoned when the economy goes bad?

There's also state and federal constitutional limits on the imposition of sales tax, such as domestic and foreign air commerce, banks and insurance companies, et cetera.

And then finally, I guess the issue of public backlash against some of these things, like the snack tax, which I was around for, you may have to take that into account.

And I want to end with just one quick comment, and that is this discussion of the effect of the 21st century economy. Things have moved in and out of the sales-tax base throughout history. If you think about it, in the early days, in the 1930s when the sales tax was created, people went to the movies. We didn't tax that, but we taxed the concessions because it's purchase of food in a place where admission is charged.

Well, then came broadcast television. No tax on the service of watching TV. And you're going to the refrigerator to get the snack: No tax.

So then along comes the invention of the VCR. All of a sudden, you're renting video cassettes. Taxable. And the snacks, still not taxable.

Then the rise of cable television. Taxed service through the utility user's tax, in many places, and the snack tax kicks in for a couple of months.

And so, again, in and out.

So should we be concerned today, necessarily, if all of a sudden we're downloading music from iTunes? Possibly, but I don't think it's necessarily so. And we should just move very, very carefully and, as Dr. Pomp recommended, try to make policy with facts and data as opposed to anecdotes and fear.

So with that, I'll end and take questions.

CHAIR PARSKY: Bob?

MR. INGENITO: Thank you, Mr. Chair.

What I would like to do, actually, is two things: Number one, provide some additional perspective on this Federation of Tax Administrators survey that's been offered several times before you now, showing how California taxes service is relative to other states.

But before I do that, let me take on some of the issues that Mr. Miethke punted my way. I can provide some perspective for you on the history side of this. So my slides will be germane to some degree; to some degree, they won't.

Okay, when the sales tax was first imposed back in the 1930s, the base rate was 2.5 percent, all of which flowed to the state's general fund.

The rate has actually gone up and down over time. It hit about 4 percent in 1969.

One of the points that Mr. Miethke was making was in reference to what the insiders call "spillover." In 1972, the rate was dropped from 4 percent to 3.75 percent. But the base was expanded to include gasoline. Hence, Speaker Pringle's comment earlier this morning about double taxation on the excise tax and sales tax on gasoline there.

But there were formulas also adopted at that time which basically, when you boil it down, go like this: When taxable sales growth is weak and the price of gasoline is high, formulas kick in which divert taxable sales revenues -- sales and use tax revenues from the general fund towards transportation funds. And that's what the state experienced, among many things, back in 2006-07 and 2007-08.

The number was close to a billion dollars. That absent other legislative action, this money would not have been available for general fund purposes. It would have been sort of walled off for transportation purposes.

It's less of an issue now with the dramatic declines in gasoline that have occurred over the second half of 2008 that are holding thus far in 2009. But, again, should gasoline prices rise towards the end of this year, assuming the recession that we're experiencing doesn't end soon, you'll have another period of weak taxable sales growth and strong increases in gasoline prices.

The second point he made was in reference to the amounts of sales and use tax revenues that don't flow into the general fund but are collected by the state. And he is exactly right with respect to Proposition 172. I wasn't in Sacramento in the early nineties. I don't know the history, but what I do know is that the Governor's revenue schedules don't show it. It's inconsistent with the way these revenue schedules show revenues from Proposition 99, which was a 25-cent excise tax increase on cigarettes. The state collects that money, distributes it to localities. That money does show up in the Governor's revenue schedules. But Prop 172 local public safety funds do not.

So if you take the $3 billion or so, roughly, from that, you combine that to the additional $3 billion that the state collects and then does send down to the locals for certain health and social services programs -- that money is in the schedules, by the way -- that gets you to $6 billion.

Another billion and a half right now is being siphoned off and used to retire these so-called Economic Recovery Bonds that were issued by the state in 2005 and in 2008. That arrangement will turn off once these bonds are retired. Current administration projections are they'll be retired in 2015-16. So this arrangement has quite a few years to go, and if our taxable sales stay considerably weaker than the administration is estimating, that year could be pushed off even further than that.

But you add those three sources together, you get about seven and a half billion dollars of money which is not flowing into the state's general fund for allocation by the Governor and the Legislature.

COMMISSIONER MORGAN: Can you repeat that amount, please?

MR. INGENITO: Roughly seven and a half billion by my math. I don’t have the numbers exactly in front of me, but off the top of my head. And it rounds to eight, which is nice.

So having said that, what I'd like to do -- we've talked about how services have become, in larger proportion, the extent which is open to some debate. But the services that we're here to talk about -- what I'd like to do now is just show you some things that are additional inside the FTA survey, some of which you've been apprised of. Mr. Spilberg made these same points at the outset that I'm going to make, in his meeting with you in San Diego. We are a relatively low-tax state when it comes to the number of services that we tax.

The 2007 FTA survey says we've taxed 21 services out of the 168 that they keep track of.

One thing that wasn't mentioned by Mr. Spilberg, and I actually watched the testimony this morning just to make sure of that, is that the FTA survey has been conducted in 1990, 1992, 1996, 2004, and again in 2007.

So one thing I did was grab some historical data, just to see how California's proportion of service industries that are being taxed compared over time. And it's been pretty constant.

FTA is reporting a larger number of services now than they did back in the nineties. And California has actually increased by two the number of industries that are taxed in the service sector. So we're still roughly proportionate to what we were back in the nineties.

COMMISSIONER DE LA ROSA: Can I ask a clarifying question?

MR. INGENITO: Sure.

COMMISSIONER DE LA ROSA: 168 are categories that are taxed in other states?

MR. INGENITO: These are total categories that the FTA keeps track of. It's my understanding that no state taxes all 168. Several come close.

COMMISSIONER DE LA ROSA: But if you compile them nationwide, you'll come up with 168 services?

MR. INGENITO: Yes. Certain states don't have a sales and use tax whatsoever.

COMMISSIONER HALVORSON: Some state somewhere has taxed at least each of these items? Somewhere, somebody has taxed this?

MR. INGENITO: That's correct, yes. That's correct.

One thing that's never mentioned with this FTA data is that basically the Federation sends surveys out to tax administration officials in all 50 states. And in 2007, eight states failed to respond to the survey. So what they did was they plugged in the 2004 values for those states for the 2007 report. So it's not necessarily even true that the data for those eight states are consistent.

You would hope, I would suppose, that if you didn't respond to this, basically you did so because there were no changes. But I don't know that to be the case, and at least wanted to bring that to your attention, that not every state responded to the survey.

Going inside the actual numbers for California, this slide here actually shows, by category, the total number of services that FTA keeps track of and the number taxed in California.

And I'm not going to go through every single instance, but just some things to highlight for your consideration here is, if you go down about halfway down the slide, you'll see the "amusements and admissions" category. FTA tracks 15 different categories of service sectors; California taxes one. That would be video rentals. And I think this is mentioned by Ms. Nellen earlier on.

There are 14 others. Of all 14 of those, at least 20 states tax all of them, and that list consists of things that you might expect: Cable television, satellite television, bowling alleys, billiard parlors, even pinball machines -- they get their own category, which kind of surprised me when I looked at the numbers.

COMMISSIONER PRINGLE: Someplace we’re going to see 20 percent.

MR. INGENITO: Other points to keep in mind, other specific services that California taxes -- I'll just list a few here, and also give you some perspective on how many other states tax those same services.

Materials that go into repairs, we tax those. Forty-seven other states do as well.

Service contracts, we tax those. Thirty-two states do.

Gift-wrapping was mentioned. Twenty-one states tax those.

Tuxedo rentals is another one.

Other ones that significant numbers of states tax that we don't would include things such as telephone-answering services, commercial linen supply, shoe repair, so-called 900 telephone number services. So if you call a 900 number, that's not taxed currently.

It is taxed by 29 other states.

MR. MIETHKE: Is that entertainment?

MR. INGENITO: No comment.

Health clubs, tanning parlors, those sorts of things. So just to provide perspective as to what we're taxing and what we're not taxing.

I have this list. I can provide it to your staff director. If you'd like to see the whole list, I'd be happy to just submit it instead of run down the rest of the numbers.

One final conclusion I'd like to make is just a summary of what the Governor's 2009-10 budget proposal included with respect to services and what the impact would be if it's approved on my agency, the Board of Equalization. Mr. Spilberg has testified in front of committee, and I believe he mentioned this to you as well, that the list that the Governor proposed to tax in his initial 2009-10 budget that came out January 10th includes appliance and furniture repair, vehicle repair, vet services, sporting events, golf, and amusement parks.

There was no attempt, as far as I know, to do an analytical evaluation as to whether those services are more justified than others. It was just a strict attempt to get cash in the door. And those are the lowest-hanging fruit on the tree because the Board of Equalization already has relationships with those types of establishments.

So, for instance, vehicle repair generally isn't taxed right now but parts are, so the Board actually knows where car dealers and car repair places are. So it was an easier way to get cash in the door than having to do the alternative, which had be to go find all these firms, do the outreach, you know, ramp up the auditing and collections procedures, and all this sort of thing. So that's why the list that is in the Governor's budget is what it is.

Now, from the Board's perspective -- I'm going to the next slide -- audits and collections actually would be easier from our perspective if the tax on services was applied to these specific establishments, because it would actually ease the workload we have in trying to figure out from a given operation how much of their sales are taxable, how much are not taxable. So there actually is some efficiency opportunities from that perspective. It's only if you were to extend the sales tax to services more broadly that there would be an increase in the Board's administration costs.

Right now, about 800,000 firms are registered with the Board of Equalization, as far as permits go. If you were to include services to be taxed, all of them, our estimate is that an addition two million firms would need to be registered. So it is almost -- well, it's over three times the amount of outreach that would be needed to actually find these folks and get them into the remitting process.

With that, I'd be happy to answer any questions that you have.

CHAIR PARSKY: Charles, why don't you come up to the chair also? Because I cut off the questions of you, and will now -- if any commissioners have any questions of Charles, as well as anyone on this, we can deal with them before we have our lunch break.

So questions?

Curt?

COMMISSIONER PRINGLE: Quickly, Eric, I know in Annette’s presentation, one of the positives was broadening the sales-tax base could be a benefit to local governments. And on yours, you state the opposite.

MR. MIETHKE: Well, conceptually, if you broaden the tax base, since the tax base is integrated between the state and local, one of the requirements, of course, is that any local government that imposes a sales-tax ordinance has to conform to the state tax base. So then if the state extends its tax base, presumably the local government would have to conform.

So I think Professor Nellen's point, which is correct, is if that were to happen, local government would be a beneficiary of that.

The problem is, is that very point I made, which is that the local sales tax is not implemented by the state; it is implemented by a local tax ordinance in each jurisdiction. And each one of those tax ordinances say, "imposed on tangible personal property."

So to extend it to services, if you're going to pick up the local share, that's going to have to change.

Now, the problem with that is, of course, under Prop. 218, if you are going to change a tax ordinance and it has the collateral effect of raising revenue, then it opens up the possibility that that will have to go to an election of the people in each jurisdiction.

Now, I'm not saying --

COMMISSIONER PRINGLE: But, first off, let's say -- so you know that every local entity has tangible personal property as the base --

MR. MIETHKE: Every one that I've seen. Certainly Los Angeles does. Because I checked that, and it's in the paper.

COMMISSIONER PRINGLE: So if Los Angeles today changed that ordinance to say that their sales tax would apply to every entity that is presently charged sales tax under the state law --

MR. MIETHKE: In other words, just automatically conform to whatever it says off into the future.

COMMISSIONER PRINGLE: But if it were done today, does that constitute a Prop. 218 challenge, or issue?

MR. MIETHKE: It opens up an issue for several reasons. One, it would be a delegation of the local taxing authority, in some senses, directly to the state that automatically conformed them. I'm not saying that it's positive one way or the other.

COMMISSIONER PRINGLE: But it's not a violation of 218?

MR. MIETHKE: I'm not saying it is and I'm not saying it isn't. I'm saying it's an issue. It certainly is going to cause uncertainty, and someone is certainly going to litigate it.

COMMISSIONER BOSKIN: If it was designed to be revenue-neutral, you'd lower the rate as well as broaden the base. That would avoid that problem; right?

MR. MIETHKE: That might be an answer if, in fact, the rate reduction does occur. But then what that's going to say is that each jurisdiction is going to have to go through that. And there might be a possibility that that's not going to happen.

COMMISSIONER PRINGLE: And similarly --

MR. MIETHKE: And it sets up the possibility for dislocations.

COMMISSIONER PRINGLE: And the only other issue, you were talking about the, what, Prop. 172, half-cent sales tax for local and public safety purposes.

Is that the only sales tax that's established in the State's Constitution?

MR. MIETHKE: It is the only rate that's in the State Constitution.

COMMISSIONER PRINGLE: So that rate, that half cent, and the use and distribution of those dollars, is constitutionally established? So to modify that in any way --

MR. MIETHKE: It would take a constitutional exemption -- or a Constitutional change, that is correct.

CHAIR PARSKY: Richard?

COMMISSIONER POMP: Yes. I hesitate to say anything because a wise speaker knows, you never get in the way of the audience and lunch. But just a few very brief comments, and that is --

CHAIR PARSKY: But you are his professor, so it's all right.

COMMISSIONER POMP: Yes, but I haven't been their professor, so…

Every state taxes services because all tangible personal property incorporates services. It's just the degree to which it does.

There's some items by custom and tradition we call "tangible personal property" that are almost exclusively the value, it’s exclusively services. Think anything with intellectual property: Art, CDs, DVDs, software, canned software.

So we're not really talking about a new issue here; we're merely asking the question, should services be taxed when they exist in isolation from tangible personal property?

If I buy a boat, it's sales-taxable. If I buy a book on how to sail, it's sales-taxable. If I buy a video on how to sail, it's sales-taxable. If I hire Eric to teach me how to sail, it's not sales-taxable. It's not a very satisfying line. I picked that last example -- Eric and I are actually sailing buddies. And while we've done well, he, of course, assumes it's his prowess, and I probably should be taught by him how to sail.

But the point is, it's not a logical line. This is an historical line. It's The Depression. The action is intangible. It's not in services. We needed money, we need it quick and fast. So you're not going to fight the battle of how to tax services. No one cared that much in those days. And people kind of viewed it as a tax on labor, and that was bad in the midst of The Depression.

So we get into this regime where we're going to tax tangible but not services. And then as the clock goes forward, we act as if there is some logic to that, when there really isn't.

I'll save the rest of my points until the afternoon.

CHAIR PARSKY: Yes, George?

COMMISSIONER HALVORSON: Just a very quick point.

One of the reasons we're looking at taxing services is that the sales tax is being threatened a little bit by the Internet. And there's an increasing number of sales that are happening on the Internet that's likely to continue to increase.

Do you see any way that we can tax Internet sales effectively for California relative to sales tax in any way?

MS. NELLEN: Well, yes, a few things on that.

California has an issue with collecting use tax. You can talk to a lot of people. They don't know what it is. We've been kind of lax in really pushing it. It's showing up as a line on an income tax form.

And while there are some measures, like a lot of states have grouped together to streamline sales tax with the hopes that Congress will exercise their authority in the commerce clause to say that the states can make a remote vendor collect the sales tax from customers in that state. But looking at a global economy, that's not going to solve all the issues. You still have to, I think, educate taxpayers that there is a use tax and find ways to make it easier for them to do that.

Some states, you give them a table, saying if your income is within this range, use the table amount to show your use tax, or you can keep your accurate records of what it is. I think there was a proposal at the last Legislature to do that. But I think the reality is, we need to educate people about the use tax and their responsibility on that. It's gotten kind to of an odd state.

COMMISSIONER HALVORSON: That's pretty hard.

MS. NELLEN: Well, it's an odd tax. I've been doing presentations, it's not unusual, someone in the audience, sometimes even someone who might be an elected official, stands up and says, "I didn't pay my use tax." I can't imagine someone standing up and saying they didn't pay their income tax. But some educational effort is needed there because reality is, if you're going to keep a sales tax, the use tax is going to be an important component. And people purchasing not just from other states, but from other countries, the use tax is what's going to need to be used to collect that.

MR. MIETHKE: Let me just add one real quick thing on that. There's really two elements to this. But before we get to that, understand the magnitude of this. The most recent Board of Equalization estimate that I saw is a little over a billion dollars for uncollected use tax. About $700 million due to business-to-business sales, and the remainder is business-to-consumer sales.

You have this ironic situation that businesses that are registered with the Board of Equalization as retailers, all of that is being collected already because they're being audited by the Board. You have the other half of the business community, though, that isn't, not paying it.

I'm on record as telling the Legislature, I think that makes no sense. And rather than waiting for Congress to act, what would make sense to me is to require businesses -- all businesses to permitize, file a use tax return, and declare it.

We are tracking this for personal property-tax purposes, and it seems to be that it's an easy, already-imposed way to pick up $700 million.

There's a second problem, which is digitized goods. That's a much, much different problem than tangible goods that are passing from state to state, because digital goods can be transmitted all over the world fast. Many more difficult compliance problems.

We may not be able to reach it under the sales tax eventually.

COMMISSIONER HALVORSON: All right.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

Anyone who wishes to comment on it.

We discussed very, very briefly at our last meeting what had taken place in New York state with regard to Internet sales for businesses that have either a brick-and-mortar presence there or a sales arrangement with someone as an associate, or someone with a similar kind of arrangement.

Do you see -- and perhaps I should ask Mr. Ingenito about this -- from the Board of Equalization's perspective, do you see particular problems with that in terms of administration? It seems like the New York situation is now settled as a matter of law, anyway. And if California were to deal with that in a similar fashion, what administrative issues might arise for the state?

MR. INGENITO: I would need to get back to you, Mr. Keeley, on the administrative issues.

Representing the research side, we've done some investigation as to what the revenue impact might be from a similar proposal here.

COMMISSIONER KEELEY: And what does that tell you?

MR. INGENITO: In the neighborhood of a hundred million dollars is what we could hope to get.

COMMISSIONER KEELEY: Okay, thank you.

Professor?

MS. NELLEN: With New York, talking about having a rebuttable presumption that if you have associates in a state that are helping you get sales or are advertising for you, that you can rebut that, then you don't need to collect the sales tax.

COMMISSIONER KEELEY: Right.

MS. NELLEN: The decision that came out recently, just this last month in New York, I'm sure that will be appealed, but it's interesting; subsequent to that, California has already introduced identical language, as has Connecticut, as has Minnesota, and North Carolina, is studying it as well. So they're eager to get this revenue because when New York passed that law, Amazon started collecting sales tax. Overstock.com got rid of relationships with the people they had in New York.

I would hope it wouldn't come to that kind of position where we're changing the law, where we know it's going to be challenged and perhaps the legislation overturned. That's not really, I think, an effective way to move forward. I think maybe finding a way to -- how can we effectively collect this tax? But putting in a rebuttable presumption where it is almost impossible for the company to rebut it is kind of a desperate effort, a desperate approach, in my perspective.

MR. MIETHKE: And my only comment would be in the 1980s, the Board of Equalization in working with the Legislature actually expanded section 6203 to include one particular thing that was a nexus-creating activity, and that was getting revenue through a home-shopping show that was carried on a California cable network. So the idea was, that the cable network had a physical presence here. They took the case up where the cable company actually got a percentage of the sales in their viewing area as compensation.

Similar facts, in a way. It kind of feels the same. Held against the state.

So this is very early. I think all of us are still evaluating the decision to see what kind of implications it has.

Certainly, this will end up in the U.S. Supreme

Court, which you could interpret as saying they punted to Congress, let Congress handle it. There's lots and lots of issues. I think it's difficult to say where it's going to go.

COMMISSIONER KEELEY: One last question.

There's some conversation that's gone on here at the Commission, and then in discussions with other folks over the last couple months, about what kind of policy lenses we might want to look through in terms of considering an expansion of the sales tax to services.

Two that have been suggested in order to deal with the issue of regressivity would be, number one, that you would try to identify those services where there is some evidence that the consumption is by -- you could look at this positively or negatively -- either it is -- there's some evidence that those services are consumed mostly by upper-middle- and upper-income folks, or that it is not consumed by lower-middle-income and lower-income folks, whichever way you want to look at that. And the other one that seems to be around this table, some consensus -- I don't know that there is on the first one that I mentioned, but there does seem to be on the second one, which is not to tax business inputs -- but I'm interested in what guidance you might provide us, if any.

You provided us with a sampler of comparisons with other states about what kinds of services were taxed and not. But among some of the others that are not taxed in California, they're, I think, kind of interesting: Horse boarding and training, pet grooming, landscape services, income from interstate transportation of persons, fur storage -- kind of creepy, but whatever -- automotive storage, investment counseling, marine towing services, dating services. You know, they're all kinds of --

CHAIR PARSKY: Be careful. Be careful.

COMMISSIONER KEELEY: I know. I'm a single man. I understand the concept, but I pay my fair share.

So, anyway, there are all kinds of services. And, of course, I picked out the ones that help make my case. But I'm wondering what thoughts you might have on that, as lenses through which to consider an expansion.

CHAIR PARSKY: And maybe you want to conclude your comments by giving some advice to the Commission as to whether or not it would be productive to go down, item by item, in making an overall recommendation.

MS. NELLEN: Yes, that's a good and difficult question. Because as you start singling things out to be taxed, you can get into complicated situations where somebody provides a mixed service. How do you separate that out? Typically, a kind of all—or-nothing approach works best.

I'll give you an example, in my paper of, you know, people are concerned about, "Oh, we shouldn't tax veterinary services." And I could see how that might start and someone say, "Well, no, we should carve out the services for getting a rabies shot because that's so important for public purposes."

If that is the case, pull that out and address it in a different way by somehow writing some kind of a subsidy to get a rabies shot, but still tax all the veterinary services. Don't start carving out veterinary services because you're just going to make it far more complicated.

But I think you can find more some services that, as you're saying, maybe it's more prevalent purchases among higher-income individuals, and where you wouldn't see a likely overlap with other types of mixed service, like, maybe one item on it was a sporting event. You buy the ticket, tax is added on to the ticket. There's not anything hopefully more complicated on that, but really looking at the issue of complexity.

Also, I think looking at the income distribution where, for many of these services, they might be used by all income levels, but far higher average usage by higher income. So when you decide to exempt it, realize you're giving a large benefit to higher income.

If you want to provide relief and still tax that service, it can be done, for example, through refundable income-tax credit. But California could tie onto an earned income-tax credit that exists at the federal level.

CHAIR PARSKY: Okay, thank you all very much.

We'll take a 30-minute break.

Charles, did you want to say something?

DR. McLURE: Yes, I had just one comment.

I was really struck by this figure of 800,000 registered sales-tax collectors now, and if you want to include all the services, it would add two million. You don't want to do that, clearly. And I don't think the way to do it is -- you may want to eliminate some services for other reasons, but you don't want to do it just to reduce the number.

It seems to me that there must be some kind of threshold. Almost all value-added taxes have thresholds. I think most, if not all, of state sales taxes don't have thresholds. Maybe Annette knows. But clearly, there should be a threshold so that you don't have to comply with this tax if you don't have fairly large receipts. Now, obviously, there's a problem then of businesses splitting themselves to get both pieces under the threshold. So it's not so straightforward. But, clearly, you don't add two million more tax collectors.

CHAIR PARSKY: Okay, with that, we'll take about a 30-minute break for lunch and then continue afterwards.

Thank you.

(Lunch recess from 12:43 p.m. to 1:28 p.m.)

CHAIR PARSKY: Let's start our afternoon session.

Jerry, the subject of your presentation is *California's 21st Century Economy*.

Now, that is an interesting subject. And I hope that you're planning to spend about two days on this subject because I'm sure there will be a number of questions. But I'll turn it over to you. You try to take this august group through your thoughts on that subject.

DR. NICKELSBURG: Or talk very fast.

CHAIR PARSKY: Either way.

DR. NICKELSBURG: So the first thing is, if you look on the first slide, I actually wasn't ready on December 11th, 2008. That's one of the hazards of using templates. That was the date of the last release of the Anderson Forecast. So that will get changed in your materials.

Principally, what I want to talk about today is some research which relates to California's changing economy. And I want to do an historical analysis of

California's evolving economy and how it interacts with our tax system, and then a cross-sectional, or a comparative analysis of California with other states, to kind of get to the kernel of the problem that we're trying to deal with now; and then go through a simulation, which gives some idea of at least one kind of solution, or the kinds of solutions that we can look for to the kinds of recurrent budget crises we have today as we go forward.

And so what I want to do is kind of skip pretty rapidly here to this slide and talk about, initially, this research was motivated by a lot of discussion that California's budget crises were an outgrowth of Proposition 13. And so I began to look at kind of the whole spectrum of the tax system. And just to briefly summarize -- and this was looking at California compared to other states, all 50 states, for property taxes, California does tax property less or rely on property tax less than other states -- at least less than the average, but not much. But what was really significant in this was that a reliance on property tax or the lack thereof just doesn't seem to be correlated with fiscal stress. And one might think that that's really because the property tax is kind of a local tax; and it's the transfers that occur that push that onto the state. And that's what's happened in California. And we're going to see later kind of the impact of some of these transfers. And, actually, California local governments do rely on transfer payments to a much greater extent than most states.

But in the top ten, which is where California sits, California is the only one with -- top ten in terms of transfers to local governments -- California is the only one with these repeated fiscal crises. So it's not the transfers, per se.

We looked at sales and use taxes, and, of course, we have heard a lot about that and the variability and so on. But we don't rely that much on sales and use taxes. That's really not the source. All the action, as quite a number of people have testified to already, is in the income tax. California is No. 5 in reliance on income tax in terms of all 50 states.

And kind of interestingly, amongst the 50 states, California is the one with the most variable income. And they kind of divide up into two kinds of states: One is extractive-industry states: So, Louisiana, Texas, Oklahoma, Colorado. And the other are knowledge-based economies: California, New York, Connecticut, Massachusetts. And we'll talk some more about that.

So what I want to go through now is an historical analysis.

And, first, I want to tell you what you're looking at here. The blue line in here -- and this goes from 1948 through 2008 -- the blue line is the growth in personal income, the percentage change in personal income has been adjusted for inflation and put on a fiscal-year basis. And, of course, one of the things that you notice is that it rarely goes negative. Generally, on an annual basis, personal income adjusted for inflation grows. Sometimes it goes negative but not much, not many. On a quarterly basis, it does happen; but on an annual basis, generally not.

The red and black are the deficits and surpluses. That's also adjusted for inflation, and it is put on a per-capita basis, adjusted for the fact that California in 1948 was obviously a much smaller state than California in 2008. So we can put these into some sort of perspective.

And, now, if you look over on the left-hand side, one thing to notice is that the blue line, it kind of bounces around up and down, and you get changes in these growth rates. But if you compare that to the deficits and surplus, there's kind of no pattern, there's no correlation there. And that happens all the way up until 1967.

So what happened in 1967? Up until that time, you know -- from earlier than 1948, back in the 1930s, we've had a progressive income-tax system. But the highest rate was not very high, and there weren't many people in that bracket.

In 1967, the new governor, Reagan, replacing the outgoing Governor, Pat Brown, after three years of deficit and confronting another one, reluctantly signed a bill which increased the income-tax progressivity and pushed the top rate up to 10 percent.

And what is really striking here is if you go from 1967 to 2008, there are only four times -- and we're going to talk about those four times -- there are only four times in that span where a change in the percentage growth in real personal income doesn't correspond to either a deficit or a surplus. What I mean by that, is that a decline in the growth rate -- not a negative growth rate but a decline in the growth of real personal income corresponds to a deficit, and an increase in real personal income corresponds to a surplus.

Those four exceptions, out of these 42 observations, the first one corresponds to -- well, the blue blocks that you see there correspond to increases in the tax rate, marginal tax rate up to 11 percent. And so the first one that you want to look at is 1974. And that's right after an increase in the marginal tax rate from 10 percent to 11 percent.

So what happens is you get a downturn in the growth rate of real personal income and an increase in income-tax rates. And that, at least in part, offsets what might otherwise have been a deficit.

The second and third one are 1993 and 1994, exactly the same thing happens. We go from 9.3 percent to 11 percent, and you get some counterbalancing.

And then the fourth observation is 1999, real personal income was growing at over 6 percent. The growth rate slowed down slightly but still over 6 percent. But that one is really the one that breaks the pattern without kind of an obvious explanation.

And so it's striking, I mean, these kinds of correlations are rare in statistics. But this is a regular pattern that's been happening for 42 years.

And so there’s a couple of things that I want to point out about this. One is, 1978 Prop. 13 comes in. And the pattern prior to 1978, from 1967 to 1978, it's same as the pattern from 1978 to 2008. The only thing that you really see that is different is after Prop. 13 came in, the deficits, which would be predicted, anyway, become much more severe because the state began to transfer money to local governments, particularly school districts; and it took a while to kind of work that out. And that's why you see those red bars right after 1978. They become a little more negative.

Then the other thing that you notice is that kind of adjusting for that Prop. 13 transfer period. As you go kind of from left to right, these deficits become more and more acute.

And what is the explanation for that? The explanation is really that the California economy changed. In the seventies and eighties, we were much more dependent on manufacturing. And the kind of manufacturing that we did was a lot of final assembly, a lot of sort of more traditional manufacturing. And so when you had a recession, where you had large layoffs in manufacturing, these were middle-income factory workers. They weren't taxed very heavily, in the first place. And so you got some fluctuation. You got these deficits which the state had to deal with, but they weren't huge.

But then as we move into the nineties, the rate of change of manufacturing as an important part of California's economy accelerated -- that is, or became a larger negative -- we lost manufacturing jobs at a faster rate than in the U.S. as a whole. But also, more importantly, the kind of manufacturing changed. We went to being much more a knowledge-based, technology-based manufacturing state where pharmaceuticals, chemicals, electronics, instruments, high-tech manufacturing became much more the rule, and final assembly moved out of the state to other places.

Now, what that means, and how we can interpret that what's happening here for the California economy, is that you have, in manufacturing but also in the design and engineering and all those supportive functions that aren't counted as manufacturing in the NAICS code, but as professional business services, the workers are, on average, are more highly compensated. And that compensation is more closely tied to the performance of the company.

So when Lockheed experienced a downturn in sales in the seventies, the factory workers didn't have a downturn in their income. But when the high-tech companies of California of today experience a downturn, then stock options, bonuses, entrepreneurs' profits, they all turn down. And that's become such an increasingly important part of the way the California economy, as a knowledge-based economy, functions.

And that, really, is what explains why you get this amplification, why you get a much larger deficit in the current decade than previous. So now, what I'd like to do now is go on to the analysis that looks across all 50 states. And this is kind of a dense diagram, so I want to take you through it.

I looked at all 50 states. All I'm showing here are those states who have the most variable income -- and California is one of the top ten -- and have an income tax. And the size of the sphere, in all of these balls or spheres, the size of the sphere is the variability of the total tax, is the general fund variability, basically. And so it's not just income tax, but it's total tax receipts.

So the larger the sphere is, the more variable our total tax receipts.

And then if you look across, just looking from left to right, that's the reliance of the state on income tax. And when you look across there from left to right, there's a little bit of a pattern, but you don't see much of a pattern. So reliance on income tax, per se, doesn't jump out at you as being the source of variability or increasing variability in your total tax base even for states with highly variable incomes.

If you go from the bottom to the top -- that is, starting at the bottom -- as you're moving up, you're going to a more progressive tax system. And there, you begin to notice some regularity. The higher up you get, the larger these spheres are. The more progressive the tax system, the more variable the total tax base, not regardless of how much you rely on it, but it is much more important than how much you're relying on income tax.

And then third, the numbers that you see next to these spheres are the top marginal tax rate. And what you notice is that the spheres that are kind of close to each other, sort of a similar kind of progressivity, the higher the top rate, the more variable is the total tax base. And so what all of this leads to is that both more progressivity and a higher tax bracket gives you larger spheres, gives you a more variable revenue stream.

And so this and what we've looked at before in the historical analysis, you know, California has changed its income, particularly in the top tax bracket is highly variable. And with a high progressivity in our tax system and a high tax rate, it means that we will have, going forward in the 21st century, these recurrent crises again and again and again, without some fundamental change in the way in which we structure these taxes.

And so then I wanted to do a simulation. And so I come back to Proposition 13.

What you see in this graph here is the variability of property taxes going across all states. And what you notice is the red is California.

California's property tax is actually a very stable tax, and that really is due to Prop. 13. We have a cap on the increase in property taxes once your house has been assessed for the first time. It's a 2 percent per year cap.

And so you have municipalities in California today in a bad housing market, in a bad economy, who have an increase in property-tax revenues. And it is kind of important to note, that's our most stable tax, and may be one of the most stable taxes -- well, this diagram says that it's one of the most stable taxes in the country. So I want to leverage off that to see in a simulation what would happen.

And I'm not proposing this as the best way to go. I haven't done a comparative analysis. But just as this is one way to look at it, and so here is what I did in the simulation: Took the California income-tax structure and reduced it by 40 percent. So lowered the brackets by 40 percent. And in concert with that, raised the property tax by 70 mill. In other words, property tax went from 1 percent to 1.7 percent. But left in place, the 2 percent per year restrictions, all of the other restrictions of Prop. 13.

So that was a simulation exercise done over 1991 through 2006.

And what happens when you do that is that you get, over time, a revenue equivalent general fund in Sacramento. But some years you get a little more and some you get a little less. But over time, you get the same revenue. You have just spread that revenue in a more orderly way. And you go from California being the large sphere on the upper right-hand side, with the highest marginal tax rates -- highest high marginal tax rate and the most progressive income-tax system, to that small, striped sphere.

It looks, really, like the spheres from these other states that have no progressivity in their tax system, and yet there is still progressivity in California's tax system. In fact, it looks out of place in this diagram, not just because of the color, but the size of the sphere.

So this is kind of one way, if you take a tax which is highly stable and you leverage off of that, you can really smooth these fluctuations out, and if not eliminate -- you know, come close to it and have kind of regular fluctuations that are much more predictable than the ones we have today.

But, of course, you know, not to leave this as kind of a panacea, you know, there are issues of social justice and progressivity; and one would need to address those in doing this. Also, in making any big changes, one wants to be very careful about unintended consequences. Neither of those have I studied, so I want to make sure that those caveats are there.

COMMISSIONER EDLEY: I'm sorry, just a clarification.

DR. NICKELSBURG: Yes?

COMMISSIONER EDLEY: On this clarification chart, the Y-axis is still just representing the income tax; right? And you've not simulated the distributional impact of the 70 mill increase in property taxes; is that right?

DR. NICKELSBURG: Exactly.

COMMISSIONER EDLEY: Okay, thanks.

COMMISSIONER BOSKIN: And just to ask one other clarifying question.

DR. NICKELSBURG: Sure.

COMMISSIONER BOSKIN: None of the potential -- perhaps modest, given that federal taxes are higher than state taxes -- the improved incentives to locate in California and expand in California, work harder in California from lower margin tax rates, are not fed back in, in any systematic way, I take it?

DR. NICKELSBURG: That's right. There is no attempt to address the positive incentive effects of lowering the -- all throughout the tax system, of lowering the progressivity, as well as the highest rate. So this is as if the disincentive effects of a 9.3 percent, plus the 1 percent millionaire's tax are --

COMMISSIONER BOSKIN: Remains?

DR. NICKELSBURG: Yes -- are still in place, exactly.

And so just to conclude, a highly progressive income tax plus a highly variable income, now that you say it, it sort of seems obvious, you're going to get a recurrent budget crises, and they will happen again and again and again. I mean, that is certainly one thing that we can predict without a change. It's not going to matter if we have a Republican in the state house or a Democrat. These crises will reoccur.

And Prop. 13 actually has some hints to us as to what one can do to stabilize the tax base. And, you know, basically, what you don't want to have are these feast and famine; because when you get a feast, there's a lot of money sitting around, waiting to be spent. But then what do you do when you have a famine? You have a crisis as in today. And by smoothing out the tax revenues, you really begin to address that issue, where the amount that you have to spend today is much more related to the long term. It's kind of like long-term budgeting, except you're doing it by restricting the amount you get in good years and increasing the amount you get in bad years.

CHAIR PARSKY: We'll open it up for questions. I just want to make sure that I understand one basic point that you've made.

Are you saying that the personal income tax on its own is not as variable, if you will, or a contributing factor? It's the way in which it has been applied, increasingly narrowing the base, or making it extensively more progressive that has created the variability. Is that a point you're making?

DR. NICKELSBURG: Yes. I mean, it has exacerbated the variability. So if we go back to this, if you look along the bottom line where you have basically little or no progressivity and look over on the right-hand side, those spheres -- so that's the variability of the general fund -- you know, those are states -- Colorado, Massachusetts, New York -- which have a highly variable income base. And their income-tax rates are not particularly low, but they have much less variability in their general fund, even though they rely heavily on income tax than California.

CHAIR PARSKY: That's what I sense.

Now, not to say that everyone doesn't have to focus heavily on any reduction in progressivity for other reasons, but I just want to make sure at least your point was clear.

Okay, questions?

Yes, Chris.

COMMISSIONER EDLEY: Thank you.

So do you have the wherewithal to simulate the distributional impact of a property tax that changes?

DR. NICKELSBURG: The answer is no. But if I were to do that, the kind of experimental design that I would want to do, is to be able to put in certain exemptions. So if you're going to increase the property tax, you might want to have increased exemptions for seniors, for example.

COMMISSIONER EDLEY: Right, or have some zero bracket or something, correct.

DR. NICKELSBURG: Right. So you'd want to put those in.

The other thing you'd want to put, going back to Professor Boskin's question is, is the incentive effects of lowering the income tax rates. And so, you know, you would kind of want to fold all of those in.

But one thing, you know, that is characteristic about California today, is that -- I guess it's been characteristic about California forever. But today, we see a lot of people who have not earned their income in the state. They have earned it in Omaha or Chicago or Hong Kong, purchasing houses in Newport Beach and Atherton and Malibu. And they certainly have an ability to pay, you know, if we are thinking about distributional effects. So putting more of the tax on one form of wealth, which is property -- you know, so it works both ways.

In terms of experimental design, you'd want to try and incorporate all of that. And so having said that it's that complicated, I don't have the wherewithal to do that simulation.

CHAIR PARSKY: Richard?

COMMISSIONER POMP: And what year is that for?

DR. NICKELSBURG: The variability runs from 1991 through 2006. So it's one observation on the variability over that span of time.

COMMISSIONER POMP: I see. So this ignores the recent stock-market downturn?

DR. NICKELSBURG: This does not include 2007 or 2008 data.

COMMISSIONER POMP: Right.

DR. NICKELSBURG: Principally, because we don't have it for --

COMMISSIONER POMP: Right. No, I understand, always the constraints.

Connecticut would look very, very different because we are so tied to Wall Street that we get about two-thirds of our income tax from a couple of towns in the southern part of the state where there's hedge-fund operations. So, you know, I understand constraints, but to bring it forward might make a very different picture.

DR. NICKELSBURG: But the failure of long-term capital is included in this.

COMMISSIONER POMP: Yes.

The second question -- I'm just trying to get my hands around it -- the wealthy people who have the predominant unearned income, including the capital gains, they hit that top bracket fairly low in California. I mean, you are in that top bracket.

Is it $94,000? Someone will have to correct me, but -- what’s that?

COMMISSIONER BOSKIN: Below $100,000.

COMMISSIONER POMP: Below $100,000.

So I wonder, I'm trying to get my hands around the progressivity of the income tax which, for the wealthy, is not very progressive because they're in that top bracket and the variability. So maybe you could just help me think my way through that.

DR. NICKELSBURG: The answer is that you hit that top bracket pretty quickly. But what we have in

California is a large number of people in kind of the new economy and the knowledge economy who have now hit that. And their income is tied to the performance of their companies. And so basically, they're being pushed into this bracket with more variable income.

And so I guess the sense of your question is, if you just raised the threshold level, would you lower the variability? And the answer would be yes.

COMMISSIONER POMP: Well, I guess I was asking -- or at least I was thinking, they are already in that bracket with base compensation. And now, the variability is still taking place at the same marginal tax rate.

DR. NICKELSBURG: That's correct.

COMMISSIONER POMP: In which case then I guess I'm confused about how we blame it on the progressivity or the correlation with the progressivity.

DR. NICKELSBURG: Well, I think it is a combination of the progressivity and the highest high marginal tax rate. So it really is both.

But if you go down on this, just looking at California, looking at one observation, you can't really draw an inference from one observation. And so to the extent that what you're saying is, well, in California, it may be more due to the high highest tax bracket than to the progressivity, that's probably a fair point. But when you kind of go down this list or go down through the states, certainly the progressivity is a factor in the amount of variability in the total general-fund revenues.

CHAIR PARSKY: Okay, Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

If I could ask you a couple questions.

One is, you've proposed a way to deal with what we've been calling "volatility."

DR. NICKELSBURG: Yes.

COMMISSIONER KEELEY: And it has two pieces to it. I think it's very, very interesting what you have proposed.

I'm wondering if you have any thoughts on a couple of other notions that have been advanced here at the Commission by other witnesses on previous occasions.

One is that you could have this so-called lockbox, that if the general-fund revenues exceeded, let's say, Department of Finance projections by a certain percentage, everything above that percentage would be required to be set aside, not available for the Legislature or the Governor under any circumstances other than when you're on the downside of the business cycle and general-fund revenues are underperforming against Department of Finance forecasts, then you could open it up to be able to cushion that downside. So that's one that has been suggested, which doesn’t involve changing tax rates or progressivity or anything else.

The other component part of that, that's been discussed -- and we'll get into this, I'm sure, with Joel later -- is the issue of a split roll of some kind relative to the property tax.

Your model envisions a possible way to increase by a certain number of mills. Another way to do that would be, for example, to redefine what constitutes a sale of non-residential property, so that you would more frequently, mark-to-market, non-business property, keep the rate the same so that everyone enjoys the same 1 percent rate, unless the voters approve it.

I'm wondering if you have thoughts on that combination? Because you have suggested a brand-new one -- at least to me it's a brand-new one, and it's quite interesting.

Do you have thoughts on the other one?

DR. NICKELSBURG: On the first alternative that you proposed, the lockbox, I think the real issue with respect to that is being able to forecast what kind of deficit is going to happen next and for how long. Because what you want to do -- and the concept is, you have enough reserve in there so that when you hit a drought, you can draw on that reserve, and you can smooth out expenditures in that way.

COMMISSIONER KEELEY: Or at least partially? At least cushion, if not prevent? Cushion, anyway?

DR. NICKELSBURG: Yes. And to be sure, it would cushion. But kind of the issue is that forecast. And so I think that's the thing to grapple with.

I don't have too much in the way of thoughts about splitting the property tax between residential and non-residential. It's not something that I really have looked at.

COMMISSIONER KEELEY: If I could ask you one other question then.

Your testimony is on the subject of what the 21st century economy might look like, and you made some comments about what it has looked like, how it made changes in the seventies and eighties, and then in the nineties some profound changes.

Some folks believe -- and I'll raise my hand as one of those that believes this -- that the economy, the composition of the state's economy is likely to change rather significantly over the next couple of decades as California, by virtue of not only the adoption of Assembly Bill 32, the Global Climate Change initiative, but also the sort of triangulation going on in the Obama

Administration about how they view national security, energy independence, and building a healthy economy going forward, how those are tied together.

What all that means, at least as far as I'm concerned, is that California, which is a trendsetter on global climate-change issues and is also a prime locus in the world for venture capital and innovation, that California could very likely be one of the major centers in the world for global climate-change solutions, both in the adaptation or adoption of those on a mass basis, whether it's change in fuel type for transportation or change in fuel type for how we generate electricity, and/or the place that venture capital has attracted because of intellectual capital being available, to then produce those solutions that will help the world deal with this issue.

Now, I know that's a long presentation, but it goes to the issue of what kind of California we will be in the future.

And I'm wondering if you have any thoughts -- I know this is sort of asking you to be more of a futurist here more than perhaps you would want to be, but I'm wondering if you foresee significant changes in the composition of the economy?

DR. NICKELSBURG: I agree with your commentary.

I think that that's exactly what is happening, you know, for two principal reasons.

One is that the California lifestyle is something that is attractive and that people are willing to pay for. And California, in the seventies and eighties, was not filled up along the coast the way it is today. And as a consequence, the premium that is paid to live in those parts of California has increased relative to other parts of the U.S. That means that it's affordable by more highly compensated individuals. That's one.

The second is that California has a huge set of knowledge communities. And that is why over half -- or approximately half of all venture capital investments occur in California. And California's innovation in alternative energy, in alternative propulsion systems, in the new green economy is already evident. And I think that will just accelerate as California's population increases, as kind of the pressures on land prices. So I think those trends are definitely in place.

Now, what that means for income is that what we've been talking about in the change of California from the seventies and eighties and even nineties to this decade, that continues, that means the variability of income or the tying of income of highly compensated individuals, of which we'll have a greater percentage of in our workforce, to the performance of their companies will continue.

COMMISSIONER KEELEY: Mr. Chairman, one question.

CHAIR PARSKY: Sure.

COMMISSIONER KEELEY: One final question on this, and that's a demographic question. California is a -- in our last census, there is no majority population by ethnicity. And when we take the census in 2010, I think most people are assuming there will be a majority either Latino population or certainly a majority non-white population.

There are issues associated with that that have to do with education, income, and so on. And that hasn't been discussed much at all at the Commission. And I'm wondering if you have thoughts about how California's tax structure might be affected by the changes in demographics, access to education, higher education, trained workforce in this new green economy? I'm wondering if you’ve thought at all about the demographic changes and how we might want to think about those in the context of tax policy?

DR. NICKELSBURG: Well, I have thought about those in the context of education, not tax policy. But

California is an immigrant state. And I think one of the real challenges for California is to make sure that our next generation is ready for the kinds of jobs that are here, or we're going to find that we're both an immigrant and an emigrant state. And we'll have those turnovers in population. So I think that's kind of the sorts of decisions that we need to make when it comes to education. But I think that education of the next generation of Californians, not just to operate in a particular high-tech sector, but because our economy changes so fast, to be flexible to retrain and redefine themselves as they go through their careers is sort of the key issue of public policy in California.

COMMISSIONER KEELEY: Thank you, Mr. Chair.

CHAIR PARSKY: One final comment and then we'll move on, that Fred made that I think is worth making sure we follow up on, and that has to do with this lockbox rainy-day concept.

And I think we have heard, and I think it's reflected in your comments, that it's an important tool in the budgetary process and in dealing with fluctuations in revenues, but that it has its limitations in terms of really dealing with the volatility that exists in the current system.

And I think it would be useful for the

Commission to understand and question that, so that it's not looked at -- that it may be looked at as an important policy tool that should be endorsed by this commission; but if we feel we're on solid ground that it's not enough to deal with the kind of volatility, we ought to reflect that. But I think we need to have that discussed.

COMMISSIONER EDLEY: Gerry, can I?

Yes, but…

I'd like a chance to talk at some point, and even better, if I could talk with the benefit of insights from our staff about rainy-day borrowing as opposed to saving for a rainy day. Because if we're thinking about the volatility issue, then when the rainy day is upon us, a notion such as borrowing and amortizing the debt over five, six years, so that you've recovered before the next downturn, I mean, at that point you know exactly how much you need in order to close a gap, and so you know how much you have to borrow. So analytically –- and if you're going to amortize, then which you're basically doing is saying, "We will have some revenue source or expenditure reductions that will be used to amortize the borrowing over a relatively short period of time."

So I just think some discussion about the pros and cons of saving for a rainy day versus retiring your rainy-day debt during the recovery, comparing those two policy tools would be helpful.

CHAIR PARSKY: I should have added to that, that I would put all of that, really, under the concept of --

COMMISSIONER EDLEY: Exactly.

CHAIR PARSKY: -- financing your rainy-day fund or lockbox.

COMMISSIONER EDLEY: Good.

CHAIR PARSKY: And I think those alternatives should be part of the discussion, too.

Thank you very much. We really appreciate your presentations. It was very interesting.

COMMISSIONER EDLEY: And fabulous charts. Fabulous charts. Best in show.

COMMISSIONER KEELEY: I must say now I'm clear about why you have to subscribe to the Anderson Forecast instead of simply being able to get it online.

CHAIR PARSKY: I can tell that the Commissioners like the specificity of alternative proposals. That's getting the attention of the people here. So we're trying to come out from under the clouds and down to earth a little.

Okay, next panel. We have three.

We have the Howard Jarvis Taxpayers Association first, with California Taxpayers Association -- California

Tax Reform Association.

Let's not get too excited.

This is under the overall heading of *Observations from Organizations*. And so it's meant to provide breadth to the Commission deliberations from several organizations.

So why don't you start?

MR. WOLFE: Thank you, Mr. Chairman, Members of the Commission. I will do my part to get you back on your time frame here. I actually will cover what I need to cover in less than five minutes.

I think no discussion of revenue volatility in the state of California can be complete without at least a passing nod to Prop. 13. And I'm glad the previous speaker addressed it in part.

We understand that the focus of this commission has been predominantly on the income tax and the sales taxes, because those are the two revenue streams that, indeed, have been the most volatile, going up and down with the economic cycles. But it is important to talk about the property taxes because of the integrated tax structure we have in the state of California. Although people normally think that the property tax as a local tax, clearly it has an impact on the state as it relates to school funding, in large part, because of the state obligation due to *Serrano* and other factors.

I just -- and the LAO, which has produced some great data on this -- we've handed out just this chart -- this is from LAO's report from last week, showing the revenue volatility of the PIT, the local property tax, the sales tax, and the corporation tax. And it is quite stunning, actually, to see that green line, the local property tax being extraordinarily smooth, in an upward direction. And really, as reflected on this graph, no downward trends at all, although that may change ever so slightly this year.

You see in the year 2000 to 2001 and where we are currently, significant decreases in other revenues. But this really confirms what we've been saying for a long time, and that is Prop. 13 provides a stable and ever-increasing source of government revenue.

Prop. 13 is blamed for a lot of things. I mean, we have a top-ten things of Prop. 13 -- Prop. 13 is blamed for the murder of Polly Klaas, the Northridge Earthquake, and all kinds of other things. But I think notwithstanding the fact that Prop. 13 lowered the property tax rate from 2.6 -- average 2.6 percent, down to 1 percent, it is important to note that per-capita property-tax collections adjusted for inflation are now higher today than they were just prior to Proposition 13's passage. And that's notwithstanding a more than halving of the rate. That's obviously due to new construction and change of ownership. But I think that is a telling fact in terms of not only the stabilization effect, but the amount of revenue it produces.

And, in fact, we would suggest that Prop. 13, and the way it's worked in California, is a ringing endorsement for an acquisition value-based system and far superior to current-market-value systems. And that is why we continue to get calls from across the nation, you know, how do we get Prop. 13 in our state. We've talked to Rick Perry in Texas, and we get calls from Florida. And in many of these jurisdictions, they have some of the same problems.

Utah, for example, has the problem with some of their properties in the resort areas having rapidly increasing values, and essentially crowding out the long-term owners who are not nearly as rich as the people moving into the resort area. So you have these kind of anomalies. And there is this effort to see how do you control increases in taxable value.

And, of course, we know how Proposition 13 does that. It does assign your taxable value to the acquisition value with a 2 percent inflation factor. And what this has resulted in is, quite frankly, in the aggregate, a lot of untaxed equity out there. And that untaxed equity, which Lenny probably doesn't like, but all that untaxed equity is actually the cushion that California local governments have when we have these decreases, these recessionary times.

And it has worked -- and if you talk to any county assessor in the state of California -- and most of them are very clear on this -- that Proposition 13 has really saved local government.

Imagine, if you will, what the state of California's financial situation would be right now if we had a current-value system, with the drop in the real estate market. You would see drop-offs in property-tax revenues as steep as you see in the personal income tax in the year 2000. But instead, you see these ever-increasing values.

And my final point on this is, I know we're talking about tweaking the system. We happen to like Prop. 13 the way it is. But any adjustment to Prop. 13 which moves towards an acquisition value-based system, including splitting the roll for commercial property, will have an impact on the preeminent issue that you're addressing here today, which is volatility. So that is why, although our organization does not represent business properties, we're mostly homeowners, we see the stabilization effect of maintaining Prop. 13 the way it is.

Thank you.

CHAIR PARSKY: Thank you.

The California Tax Reform Association.

MR. GOLDBERG: Lenny Goldberg.

I really appreciate the opportunity to be here. I know a number of you from being an old hand in Sacramento. I don't know if that's a good or bad thing.

I would say that the single-most irrational part of the tax system, from virtually every test, is the way we assess commercial property. Not the 1 percent rate. We're not talking about houses here, but the assessment on commercial property. And I'm going to just run through it really quickly. Whoops, I just turned that off.

Did I push the wrong button here? Oh, there we go.

We have a policy failure at every level, and it turns good economics on its head. It's a legal morass. This is just with regard to commercial, not housing.

We have fiscal policy failure, and it is bad land-use policy.

And I'll do this really quickly because I know you don't necessarily want to go through all these. But there are -- I tried to shut them down, close them down a bit.

And this is from an investment perspective.

New investment: Full market value of the land, fees, exactions, mitigations and easements, sales and property tax on new equipment -- every year we pay personal property tax on new equipment placed in service. On inflated land values, and that's when you start to look at the effect on the land market.

That investment creates growth, progress, other land values held by other landowners. New investment in infrastructure creates those land values. Those land rents are untaxed. The benefits -- in any reasonable economist analysis -- and correct me if I'm wrong, but I haven't heard it yet -- and Steve Sheffrin takes the same position -- not taxing windfall land rents, economic rents that are created by the value of others and taxing new investment instead turns good economics on its head. And we're seeing competitors tax the huge differentials.

Many, many charts. This is just one.

Bank of America was bought out, so there was a change of ownership by NationsBank in 2004. It's paying, on this chart, about five times the land rents that Chevron is paying for an identical building down the street.

We looked at a number of competitors in Silicon

Valley. IBM is paying four-tenths of a cent per square foot on its land, while others are paying dollars per square foot, others with which they compete.

Legally, we have a system that doesn't work at all. The ownership of commercial property is many -- are many, many complicated ways: Publicly traded corporations, real estate investment trusts, et cetera.

We see many indications -– many places where -- and this is from the Napa County Assessor, Martini sold its entire winery -- lock, stock, and barrel -- to Gallo, a 100 percent change of ownership, no reassessment recorded because ten partners sold -- or a number of partners sold to a number of other partners.

Conversely, when we had see-through office buildings in Los Angeles in the early 1990s, when they were empty, empty office buildings, it was easy to effectuate a transfer of ownership so that you could get locked in at the low Prop. 13 rate.

It’s one thing to say, come down when there’s bad times; go up when there's good times. Effectuate -- you manipulate the system to your benefit.

It can be reformed statutorily, but that's still messy. You have a lemon, you make lemonade.

Judge Quentin Kopp did it, worked on this in the 1990s, we worked together closely.

Fiscally –- and this has to do with investments in California. A virtuous cycle of infrastructure. You invest in the land, you generate land values, you get money back, you reinvest in the land. Thoroughly short-circuited by the fact that land values -- commercial land values are locked in. And it was pointed out to me that in the late 1980s, when California started to recognize its significant infrastructure deficit, that the Bay Area Council business leaders said, "You know, we should really be looking at capturing these land rents for reinvestment and infrastructure.”

You do get a burden shift to residential housing. And that's mostly because commercial property, and not because of the change-of-ownership issues -- mostly because commercial property doesn't have speculative values.

This is from Larry Stone, Assessor in Santa Clara County. This is since 1978. World-class explosion of Silicon Valley, shift from commercial property to residential property, including apartments. Fairly consistent and steady.

I'll skip this, except that the system promotes speculation and sprawling, you can hold land off the market forever. Downtown Los Angeles at very low value. Parking lots -- in East Oakland, there's junkyards that

Vietnamese businesses want to buy, and to buy in, they have to pay exorbitant amounts for the land because families have owned them since the 1950s.

Infill development is hurt. For the localities, big-box retailing is probably your worst land use, the big warehouse in a huge parking lot. But it becomes the best for the localities because they get a lot of money.

We've all heard that as a fiscalization of land use. But instead, you have higher land values than you might because you don't have a land market that functions to highest and best use.

It's simple policy solution. There's a complicated policy solution which is statutory change to redefine "change of ownership." Non-residential property periodically assessed at market value. That now, unlike housing, where as the examples, people -- rich people are moving in the neighborhood and you get taxed out of your home, the land value -- the commercial property reflects the value of the stream of future earnings available from that land.

There is no notion of being taxed out of it.

And, in fact, in terms of the volatility issue, which Steve Sheffrin speaks to, you're not going to get that much speculative value in there because you have to be able to make money. And as a result, when the economy goes down and the values go down, you're not wiping out a whole lot of speculative value. The volatility is still much broader than it is for income tax and the other things you've looked at. There are a number of issues that need to be addressed.

But let me go to the economic impacts. And this is why we avert our eyes from what really is an essential part of our tax system.

As Sheffrin says, “close to the economists' ideal of a non-distorting tax.” That would be in terms of reassessment, you would lower land costs by having a better working land market.

You would lower development costs given the fees, exactions, and mitigations that are imposed, and people would want to see actual positive commercial development, which right now does not pay for itself.

Infrastructure finance improved.

Competitors taxed equivalently.

And in terms of mobile manufacturing in the state, the costs would be borne by retail, hotels, offices.

We looked at the Hotel del Coronado sitting down on the beach in San Diego, not reassessed for many, many years.

There are potential trade-offs here. You're putting potentially $6 billion on the table. Although the numbers are very poor at this point, there's a lot -- you know, Sheffrin says $9 billion, others have -- Bill Hamm has said $8 billion. There were numbers that were much lower than that. But personal-property tax relief is something the assessor spent a lot of time on. If you were to exempt the first million dollars in personal property, you'd take a million and a half businesses off the personal property tax rolls.

So this is one that has been pretty unanimous, I would say, in terms of those who have looked at it seriously. This is *The San Diego Union Tribune*, in terms of -- you know, amenable to this reassessment. Polling has been generally favorable. Although, you know, when you get down to actual campaign and brass tacks, it's another story.

But I do think, my main point here is to say, this is something that is really an irrational hole. I've spoken before many business groups and in many places. People say, "Well, we don't like these taxes." Well, you can trade off the taxes. But the fact is, I’ve never really heard a good defense of this current system in which investment property is left to either avoid reassessment in various legal ways, or left to sit on the market at very low values, when those values are being created by someone else's investment, whether it's the public or private sector.

So hopefully that was short enough.

CHAIR PARSKY: Thank you.

Questions?

Becky?

COMMISSIONER MORGAN: A couple questions.

I'm wondering on this chart, we go only to an estimate of 2008-09 that we received. With the downturn in the real estate market, has anybody projected what we could anticipate in 2009-10?

MR. WOLFE: We haven't seen the actual numbers. I participated in the annual assessors conference about a month ago, and I was asking them that very question. I think out of the 58 counties, you will see a few of the counties actually have a drop-off in revenue, but you will still have counties in this real-estate market continue to generate more in property-tax revenues.

Again, if there is a -- there is going to be a flattening, but it does not appear at this time that there will be drop-offs in the aggregate across California. If it is, it will be very slight.

COMMISSIONER MORGAN: I ask because I believe that in Santa Clara County, which Lenny mentioned, half of the real estate owners are in to have their assessment reevaluated.

MR. WOLFE: Right. A lot of them are Prop. 8 reductions. A lot of homeowners going through Prop. 8 reductions. A lot of those homes, in one of the charts that he had, showing the disparity between commercial and residential, a lot of billionaires have built homes in Santa Clara County in the last 15, 20 years, probably driving a lot of that disparity. And those are the homes that, right now, are being -- they're no longer worth $14 million, they're only worth $7 million.

COMMISSIONER MORGAN: And the last question. On the split roll, a former director of finance had said to me that that was one of the few arguments that could be used in California to keep businesses in California, those that had been here for some time.

I'm not saying I agree or disagree, I'm just looking for a response.

Is that the fact that you've got those that are still pre-Prop. 13, is that keeping them here or do we have any evidence that it doesn’t makes any difference?

MR. GOLDBERG: Well, you know, really the disparities in all the data we've looked at come in land values alone. That if you have a hotel in California, and even in the case where I mentioned that IBM is paying four-tenths of a cent per square foot on its land while others are paying dollars, the buildings themselves, according -- and I don't know, the assessor's data, they do it a lot, it is not the best -- but the buildings themselves are often very similar. Because when you’ve reinvested, you're not going to be using a 1975 building in a high-tech 2008 year.

So, really, most of the disparities and the differences are simply in land values, which if those land values were assessed, the new investment then has a better working land market, which probably does not have the inflated values in it. But you do find a number of businesses are at full market value.

The reason I did that slide on Bank of America is when they were bought out at market, they were bought out by NationsBank, every part of -- every facility of Bank of America, every bank, every office building was reassessed at market value.

You do have a lot of properties that are currently at market value. It does not seem to have an effect. And most of that is land value and not building value in terms of differentials. And that's where most of your investment is, is in the buildings, not the land.

MR. WOLFE: I would like to follow up on that. I think that's a good point: Does Prop. 13 help to keep businesses here? And one of the biggest selling points, of course, to Prop. 13 is the predictability it provides to homeowners. But that predictability is just as important to businesses as well. It's the one aspect of their overall tax liability that they can calculate in their future balance sheets with absolute predictability.

CHAIR PARSKY: Edward?

COMMISSIONER DE LA ROSA: Yes, thank you very much. That was very informative.

I have a question, and I'm not trying to be confrontational. I'm just genuinely interested in this issue.

CHAIR PARSKY: Turn on the mike.

COMMISSIONER DE LA ROSA: I'm sorry.

I've got a question here, and I'm genuinely interested in this issue when you said that Prop. 13's been blamed for a lot of things and you've thought a lot about these questions that have been raised.

The question I have has to do with the whole notion of how members of a community feel about their investment in the government and the services that they get in return for their tax dollars. So school districts, it is really sort of a question that's been nagging at me, when I think about Prop. 13.

Prior to Prop. 13, my understanding is that school districts were funded by property taxes that were collected at the local level. And so the citizens and the families in that school district could see where they knew where their property tax dollars went, and then they could measure the return on those tax dollars by the quality of the education that the children and their communities were receiving.

After Prop. 13, what happened, I think -- and I could be wrong, so please correct me if I am wrong -- that had school districts –- the citizens were, in a sense, disenfranchised. Because instead of those tax dollars being applied locally to run the schools -- predominantly to run the schools, that the school districts became, in a sense, organizations that requested or needed funding from the state. So for the average California taxpayer, they pay their taxes, the money goes to the state, they have their own opinions about the integrity of the Legislature and the legislative decision-making, and then the monies come back to their school district.

And so the question is, have people raised questions about the way that people in local communities feel about their school districts and the link to property taxes that they pay after Prop. 13, and was it different than before Prop. 13?

And I know it's different than school-bond elections, because those have been passing a lot. But that's only for infrastructure, not for operations, as I understand. So that would be a different question and not applicable to my question.

MR. WOLFE: Well, the question comes up all the time. And, in fact, again, it's something that we've always characterized as an urban myth, is that Prop. 13 eviscerated education in the state of California.

Right now, our per-pupil inflation-adjusted expenditures are higher now than they were just prior to Proposition 13. Again, the glory days of California education where we were told we had P.E. classes and everything else, we look at the raw numbers, and we see more dollars being spent on an inflation-adjusted basis than in what was then being characterized as the glory days of education.

So in terms of dollars going into the system -- and I understand that the demographics are a lot different now, and there are a lot of explanations. But from our perspective, it hasn't been lack of financial resources. The local control issue, I think, is pertinent and relevant.

And I think an argument, that perhaps cities and counties might be able to blame Prop. 13 more than school districts because school districts, about the same time as

Prop. 13 was enacted, we had the series of decisions under the *Serrano* decision, which essentially took away the local control. And a lot of people who are blaming Prop. 13 need to shift some of that blame, if not the lion's share, to the *Serrano* decision, which was an equal-protection challenge under the California Constitution that basically said you had to equalize spending. And the only way you can equalize spending is at the state level.

And I would further add, this issue that you've just raised, that's being talked about right now in Sacramento in terms of the current budget fight, one of the sacred categorical 8 programs is class-size reductions. And there is this interesting debate about whether or not local school districts should have the flexibility to continue its class-size reduction or use that money for something else. It's a legitimate discussion.

MR. GOLDBERG: I'll only speak to one piece of your question, which is, I think it's undeniable –- now, some of that may have been because of *Serrano* -- but it is undeniable that we've had a huge centralization of finance in the State Capitol. And the notions and questions of local control have been -- pretty much have been eviscerated. You cannot set a tax rate, you cannot raise the tax without voters that local elected officials used to actually be responsible for the taxes that they enacted and the results of their activities in their schools or cities and counties, that's pretty much long gone in terms of local control.

And I remember -- some of you may remember Marian Bergeson, who was chair of the Local Government Committee, and she said Prop. 13 enacted a revolution in California by taking away the powers at the local level and bringing them to the state.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

A couple of things. I am going to make a couple of comments about the funding-equalization issue.

Equalizing funding, in and of itself, is not a virtuous act. What the result of the equalized funding is, in my opinion, is that we have agreed to equally underfund every child's education in California. That's an opinion.

I think that the evidence for that is that we are 44th in the nation in per-pupil spending. And I think it would be very hard to argue that California has sufficient per-pupil resources available. That's an opinion.

Let me ask you a couple of questions, though, about your issues with regard to sale.

It was my recollection in 1978, when Proposition 13 was passed, that there was not a distinction drawn by the advocates of Proposition 13, nor has there been a distinction drawn since then, that there are two classes of property taxpayers: Residential property taxpayers, and everybody else who is a property taxpayer. That from the perspective of the Howard Jarvis Taxpayers Association, there is one class of property taxpayers.

Would you agree or disagree with that?

MR. WOLFE: I would agree. I would say that California has had a uniform roll since the mid-1800s.

COMMISSIONER KEELEY: Okay, so when it is discovered that folks who maybe buy one or two or three homes in their life, and that's where they live, and they engage in those transactions in a highly uniform way, which almost always, with the exemptions provided for in Prop. 13, but with those exceptions -- the highly uniform way that those transactions take place which, with the exemptions set aside, always result then in a reassessment by the assessor.

Would you agree with that?

MR. WOLFE: Does a sale result in reassessment?

COMMISSIONER KEELEY: If there is a sale, that the sale results in a reassessment.

MR. WOLFE: Absolutely.

COMMISSIONER KEELEY: Okay, so we've done that.

Now, what's happened though, since Prop. 13, relative to business properties -- or let's say non-residential properties -- is that there are a wide variety of ways for what most people would consider a commonsense definition of a sale. X Bank buys Y Bank, and you know that it's been sold because you go by and there's a new bank name on the building. And they buy the property and they buy the building and they buy everything that goes with it. Tandem Computers is purchased by Compaq computers. There's example after example.

But because of the nature of the business purchase and the land purchase, because of the nature of the way some non-residential sales take place, it doesn't meet the definition of a sale under Proposition 13. And we know that that's the case.

What objection would you have then if there is one, and one only, class of property taxpayers? People who own property, pay taxes, and when they sell their property, they enjoy the fiction created under the law that their property is worth less than it actually is, for purposes of property taxation, that is a tremendous benefit under Proposition 13. What objection would you have to making sure that that uniformly applies to all property owners?

MR. WOLFE: We would have no objection when there's been a true change of ownership, that that be a reassessment of that.

COMMISSIONER KEELEY: Would you agree that -- let's stipulate that the facts that Mr. Goldberg presented with regard to Martini purchasing Gallo properties -- let's just stipulate that those facts are true.

Would you consider -- would you think that, in fairness, in this uniform view, that there is only one class of property taxpayers, that there should be a reassessment in that instance?

MR. WOLFE: Let me just say that what Prop. 13 says is “change of ownership” and does not define it. So it is up to the Legislature to define what is "change of ownership."

Now, we are actually trying to track down the true facts as to what happened with Gallo and Martini.

If the facts are as bad as alleged, our organization would not have a problem with treating that as a reassessable event. And, in fact, we've reached out to the county assessors to say, "Bring us your most egregious examples where there is true manipulation of the system, and we'll take a look at it."

But by the same token, let's not say: Well, if 50 percent of the stock changes hands in a multinational corporation, we don't see the justification for piercing the corporate veil in circumstances that would be out of the norm. In other words, corporate entities are corporate entities.

So are there examples between those two? Perhaps.

MR. GOLDBERG: Let me give you one that seems to be not at the attention of the assessor, but from talking to people in the commercial real estate business. It happens all the time.

That is to say, you have a shopping center. Sun Valley Shopping Center, managing general partner to the Sun Valley Shopping Center, Inc. Ten limited partners sell to ten other limited partners. They may even sell over time. You know, not in any one transaction, but in year one and then in year five you have a shopping center that is owned entirely, or 80 percent by different investors. And I would stipulate that real-estate investment trusts, you may own one-third of a property here and two-thirds of a property there; that actually property ownership in the commercial world, having nothing to do with the property tax circumstances, is very complex. It has to do with the liquidity that is in the system.

Can you get liquidity in and out of a property without having to sell the entire property? And that's the basis of commercial property ownership. That you could change -- you can change the law, and we've tried to do that. And we can make it better. And I look forward to working with the Jarvis Association on that. But it is -- you've got a lemon and you make lemonade, because change of ownership is a very squishy issue when you're really talking about moving liquidity and shares in and out of property ownership. It does not compute.

Selling a house computes. And the reason for being locked -- and I've had many debates with the Jarvis folks -- the reason for being locked in –- and if Prop. 13 didn't exist, we would have had to find a reason, another means of protecting people from explosive increases in their property values that had very little to do with their income.

The fundamental difference for commercial property is that the value of the property is based on the income earned from it. You do not hold it to live in it, live in your house and that the value -- the increasing values that come for that property as a result of the progress of society are all of -- they're only if they can be capitalized into income.

And so -- which is never the case with it -- which is not the case at all with the homeowner, until you sell the home.

COMMISSIONER KEELEY: I'll close with this, Mr. Chairman. In my day job, I'm the elected county treasurer, and I almost never say -- and John Laird's really going to watch to see if I say this -- “Treasurer/tax collector of the County of Santa Cruz.” My business cards only say "treasurer" because I'm so proud of the tax-collector part. But that's my day job. And in that day job, as you might imagine, I work pretty closely with the county assessor. And at least from my point of view, there is an essential fairness issue here.

Prop. 13 did not, in my judgment, differentiate between land uses, types of property, types of ownership, with very, very limited exceptions having to do with direct family relationships and that kind of thing. But I think it's fair to say that it was indifferent to the issue of the land use, the underlying land use.

Prop. 13 was neither marketed nor bought -- marketed by it's advocates nor bought by the voters based on some theory that this was going to be a pretty good thing for residential landowners and a terrific thing for businesses because of the way sales took place or what was defined as a sale.

So I appreciate your openness to the idea that there could be a way to look at certain transactions which currently don't meet the test of a sale under Prop. 13 for non-residential property. That could perhaps become eligible for reassessment, mark-to-market, because they are, in fact, a sale.

The fact that that's not available or rarely used by residential property owners should also be an indifferent issue.

MR. WOLFE: I would point out that in the ballot arguments, the opponents of Prop. 13 pointed out repeatedly that all the benefits, the lion's share of the benefits would unearth the business community. That turned out not to be the case as the relative percentages have remained equal over the years with --

COMMISSIONER KEELEY: That was not your argument. Your argument was a different argument. Not what your opponent's argument was; your argument was a different argument.

MR. WOLFE: But when you said the voters weren't presented with this issue --

COMMISSIONER KEELEY: By the advocates. Excuse me, thank you for the clarification. I appreciate it.

Thank you, Mr. Chairman.

CHAIR PARSKY: Okay, thank you, all. Thank you very much.

COMMISSIONER PRINGLE: Mr. Chairman, if I could, just very briefly, though. I did want to state that, you know, I don't accept the misrepresentation that local property tax doesn't benefit schools. As a matter of fact, in my county, over 60 percent of the local property tax collected stays in the county for local schools. So even though they don't vote on that on an annualized basis as to set the rate, the majority of property tax collected in my county goes to the schools within my county. Other higher property-tax communities, like LA County, they make a smaller contribution to schools as a percentage of the whole. But in our county, that is where the lion's share of school funding comes from for every single school district in Orange County.

And, secondly, Mr. Goldberg, isn't it true that, in fact, even though the voters may have restricted the opportunity for local property taxes to be raised, there are other taxes or benefits to local schools that local communities still have as they seek a parcel tax or, for that matter, even, as you suggested, bonding authority to create capital improvements within their --

MR. GOLDBERG: Right. I only spoke to local elected officials who used to actually be able to raise taxes and bear the heat or not, or lower taxes.

COMMISSIONER PRINGLE: But the local voters still have that opportunity.

MR. GOLDBERG: Yes, on the ballot, that's correct.

With regard to the -- I recollect that Orange County has complained mightily, in fact, because they get less money from the state by virtue of their local property tax going so heavily to schools. So it's not a zero-sum game, and I hesitate to get into school finance here –- but it's not a zero-sum game, but there is a significant backing out of your local contribution that relieves the state of its obligation.

COMMISSIONER PRINGLE: Sure. And, in fact, that wasn't a factor of Prop. 13. It was a subsequent piece of legislation that suggested how much money would remain for local schools versus local government operations. So that was not necessarily a factor of Prop. 13. But the Legislature decided what they would distribute within every county.

CHAIR PARSKY: Okay, the next panel, please?

California Taxpayers Association, Council on State Taxation, California Chamber of Commerce, National Federation of Independent Business.

We'll try to do all of the presentations first and then come back and ask some questions.

Okay, why don't we start with the California Taxpayers Association.

MS. CASAZZA: Thank you.

Thank you, Mr. Chairman, Commissioners. My name is Teresa Casazza. I'm the president of the California Taxpayers Association. Thank you for the opportunity to come and speak to you this afternoon.

Given the fact that I have about five minutes, what I'd like to do is just go over a few points in my prepared remarks, if I can. And then what I'd like to do, if I can, is comment on some of the presentations from this morning which might be helpful, and then let the other panelists talk and then answer questions, if I may.

We talked a lot about the economy. I think just I'd like to say that the best revenue source we have is a robust California economy. And I think we need to talk about how we talk about economic growth and investment. Not the stimulus word, necessarily, but really nurturing. I mean, we really need to preserve what we have in California. And I think that's something that we really haven't talked about much today, but it's something we've got to keep in mind because the tax revenue is really what's driving this economy and what’s driving what we need for services.

There was little talk about simplification, but it is a mission of the tax commission. And one of the things Cal-Tax believes strongly in and has been fighting for, along with the Franchise Tax Board, is simplification on federal income-tax conformity measures.

The Internal Revenue Code is where the California Tax Code starts. So we start with the Internal Revenue Code right now, as of January 1, 2005. And then we make all the exceptions and come up with our California tax income.

There should be an annual realignment of our income-tax code to conform with federal. This used to be done pretty regularly, and it is not done any longer. And it creates administrative nightmares. It creates inconsistencies. It creates, I would think, a significant part of the tax gap. It seems small but it's really not. It's a big part. I think if we're talking about what we want to do to improve our tax policies, federal conformity should be clearly one of the areas that we look at from a simplification and administration standpoint.

We talked a little bit about sales-tax nexus today. And I think the only comment I'd like to make is, I would caution us to take a very aggressive position to not take a very aggressive position regarding sales-tax nexus. It runs counter to federal law. There's a lot of things still pending, either in the courts or at the federal level.

Until sales-tax nexus is resolved, either by the Congress or by the U.S. Supreme Court, the state should not take an aggressive approach similar to New York's.

The recent New York case was at the lower court level. They did win in New York at their first lower-court level. And that is the first level. They still have a long way to go.

But without a federal solution, this is a very risky approach, and we believe it could drive high-tech jobs out of the state, and it's very questionable and very risky. So for California to move down this road without either federal changes or resolvement in the U.S. Supreme Court, we believe that's a very risky approach.

Sales tax on services. Boy, that scares me. It can relate in an incredible amount of inequities. I think Michael is going to talk about that later, about its terrible effect on small businesses.

We have to really be careful about the administrative difficulties of trying to create a sales tax, a broadened sales tax base on services. I think it will slow our economic recovery.

And talk about volatility. I do believe that a sales-tax base on services will increase our volatility.

It's a slippery slope. And, you know, definitional changes and definitional requirements are going to be difficult. I mean, just take a look at, like, the definition of "auto repair," if we put a sales tax on auto repair. So you go and take your car in, and you get a car wash, which I get when I take my car in, is that auto repair? And then you get a tune-up. Well, is that auto repair? If they put a GPS system in your car, well, is that auto repair?

I mean, you're getting into an area where definitional changes are going to really create an administrative nightmare for both the Board of Equalization and for taxpayers to comply with.

We had a pretty good discussion of Prop. 13 just a few minutes ago. And I just wanted to say a couple things as well. You know, Prop. 13 has been a stable revenue source on average. It's about 8 percent from year to year. Once Prop. 13 was passed, there was a task force that was put together to go over the definitional requirements and the implementation of Prop. 13, where the change-of-ownership language was created and where we took a look at how to address residential and non-residential property.

On the anniversary of Prop. 13, the 30th anniversary of Prop. 13 June last year, we did a study which I'll provide to the Commission and we can put it up on the Web site, which took a look at the effect of Prop. 13 on residential homeowner and non-homeowner property. And we hear that businesses are not paying their fair share under Prop. 13, but our analysis shows that that's not the case. And, in fact, commercial property, non-homeowner property is closer to market value than homeowner property is. And it is a stable revenue source on both sides.

To go back to kind of a subjective approach on a commercial-value property would not be good economic policy and a good thing for the business community.

I guess the only thing -- there is a lot of talk about volatility and, you know, the personal income tax. For a tax structure to be strong, I would think that you would want your taxes to be in line with how revenue does come in. So as we create more revenue in California, our taxes reflect that. The volatility comes into play more so when we're talking about how to budget for that. And, you know, we've talked a little bit about the concern about how we prevent one-time surges in revenue to be used for ongoing spending. And that's where we talk about how a lockbox or a rainy-day fund can be very important.

But I believe that that is the volatility that we're trying to address, not necessarily the fact that personal income is a volatile -- it's a fact, the economy is a volatile -- the business climate is volatile. To artificially say that we want to get a flatter system and not take into account what the economy is doing I don't think is necessarily the most successful tax-policy structure.

I just wanted to say a couple of things as well from some comments this morning. I think there's a little bit, maybe, of a misconception that some may have about how sales-tax revenue is faring, because a lot of the statistics we see is sales-tax revenue as a percentage of –- as a percentage of personal income tax, as a percentage of others. But when you just take a look at the numbers themselves and the amount of state tax -- state sales-tax collection, it's increasing pretty well.

In 2000, the year 2000, we had state sales-tax collection of $23 billion. In 2007, it was $32 billion. And in 2010, we're projecting $38 billion.

So in almost a ten-year window, we've got almost a doubling of the state sales-tax revenue.

In this day and age, that's a pretty good investment. I think we need to recognize that that has been a good source of revenue, and continues to be an ongoing increasing source of revenue for the state. It's just not growing as fast as the personal income is.

I think it would be important for me to just make a comment on the carbon tax since it was raised earlier today. And I think that that tax policy should be viewed in a broader context as we talk about the state's entire regulatory and fee program. The California Air Resources Board is in the process of approving a strategic plan on how to reduce greenhouse gas emissions under AB 32, and talking about implementing regulations which would have a significant amount of direct administrative fees, higher costs for electricity, natural gas, transportation fuels. They are considering a cap-and-trade system. They're considering a carbon tax.

Adding a carbon tax on top of an already costly regulatory system would prove to be a very crushing burden on California. So as we move forward with discussions about a carbon tax, similar to the comments made about the rainy-day fund that the Legislature is moving forward in that regard, so, too, is CARB moving forward in this regard. And it would make sense that we don't at all try to duplicate or overlap what is moving forward in the process already.

So, let's see, is there anything else I wanted to mention?

Internet sales. I just have to say something about Internet sales. And that is that, you know, Internet sales are taxed. The goods that you buy over the Internet are subject to tax and are taxable. The majority of Internet sales tax -- I think it's about 50-50 -- are from business. Business does pay the sales tax on Internet sales.

What happens is, we have a tax gap because the use tax sometimes is not collected on interstate sales. But there is sales tax that is a liability or a use tax if the company that's selling it doesn't have nexus. So the Internet sales itself are taxable.

We do receive tax from mail-order catalogs. We receive as much as we can legally currently be able to collect.

I just wanted to make that point because sometimes I think we forget that currently those are taxable. We do have a collection problem with the use tax in some circumstances.

Mr. Chair, I think I’ll stop at that.

CHAIR PARSKY: Thank you. I think we'll move on. Thank you.

Council on State Taxation is next.

MR. CROSBY: Thank you very much. My name is Joe Crosby. I'm with the Council on State Taxation, more commonly known as COST. COST is a trade association based in Washington, D.C., and we represent more than 600 of the nation's largest businesses.

There's a lot of material from our organization in your packet. I'm just going to briefly mention three issues.

First, some data that we have that we actually just released today on the state and local business tax burden in each state in the country.

Second, I'm going to touch on sales tax on business inputs, which has obviously been a key issue for today's hearing.

And then finally, I'm going to go back to something that Professor Pomp said at the very beginning of the day dealing with administrative reforms and potential for that in California.

First, with regard to the business tax burden. Ernst & Young, in conjunction with COST, for seven years now has annually estimated the state and local tax burden imposed on business on each of the 50 states. And as I indicated, the seventh version just came out today.

In this edition, we've also estimated the value of state and local benefits provided to business by government, so the benefits received by businesses from the government.

The reason we looked at this is when you look at rationales, which was something that came up earlier --

why do we tax certain types of entities, why do we do certain things -- from an economic perspective, the only rationale to tax business is to compensate the government for the benefits that government provides to business.

Two key learnings. First, businesses pay every tax in every state, essentially. We tend to think sometimes, well, this is a business tax and this is an individual tax or a homeowner tax or a residential tax, or whatever you want to think about it. Almost every tax imposed in every state is paid by business: The property tax, sales tax, personal income tax on business income, corporate income, various excise taxes, so on and so forth. In California, in fact, the single largest is the sales tax.

And the second learning from the study is that in every state -- and California is no exception here -- the burden of business taxes exceeds the benefits provided by state and local governments. In California, business taxes are about two-thirds higher than the estimate of benefits provided by state and local government to business.

As Dr. McLure said earlier, the fact that every state is in this boat shouldn't make the Commission happy. You should look at ways to make California different and better and more attractive to investment.

There's obviously some pretty significant political reasons why it would be the case in every state, because, as Dr. McLure also said, by pushing taxes to the business community, you decrease the perceived cost of government. Because those taxes then don't come through transparently to the consumer or the employee or the owner. They are buried in the cost of goods, in reduced wages and lower employment and reduced return on investment and so on and so forth.

That study is not in your materials because it just came out today. It is on our Web site. And I can get you copies of that.

Second, sales taxes on business inputs. Professor Pomp made an astute observation that we're not really talking about taxing services; we're really talking about taxing business inputs when we're talking about expanding the tax base. And I say that because the very first things -- and this is -- every commission to look at taxes, in every state, that has ever been created, starts with a predisposition that we ought to expand the sales-tax base; and almost none of them ever end with the recommendation that they do so. And it's because you quickly run into very real political problems and very real distribution problems that were raised earlier today.

California already exempts one of the largest items of consumer purchases: Food. It was mentioned by one of the panelists earlier. When you look at things that are considered services, I have never seen a proposal that would suggest that health care, education, or housing be taxed under the sales tax.

You've just taken off the table almost all of the categories of services that are consumed primarily by individuals. And what you are left with, if you hope to generate significant revenue, are services that are purchased principally by business. And so what you're really talking about, when you're talking about expanding the tax base, in any meaningful way, is a new tax on business inputs.

What you heard from the economists earlier today, indicating that that they reflect a consensus -- and, in fact, I think it's almost unanimity within the economic community -- that business inputs ought not to be subject to sales tax. And so you run into this conundrum. And the way most commissions deal with it is by moving away from that as a recommendation, playing around the margins, with extending the sales tax perhaps to some consumer services that aren't taxed now, one of the things that came up later -- I’m not making a recommendation, just an observation of other states -- is they look at things like amusements. So that's my second observation.

And I actually was just in Professor Pomp's home state of Connecticut on Wednesday, in Hartford, testifying before a joint revenue committee that's talking about this exact, same issue. And I predict, with I think a fairly high degree of certainty, they will not, in the end, tax all business services.

And then finally, with regard to administrative reform. Whatever this commission determines with regard to tax structure, I think it's important to keep in mind that the way that the national business community views California is not limited to the taxes you impose on them, it extends to the way those taxes are extracted. And I think that the easiest way to think about it is whatever you're going to make someone pay, make sure that it's not any more difficult to pay than necessary. Make sure that it's fair, make sure that it's efficient, and make sure that it is customer-focused. And there are certainly some reforms in there, in the materials as well, that California should consider.

I'll emphasize what Professor Pomp said, I think the most important thing that this commission could recommend to promote a fairness -- a perception of fairness, I should say -- not to cast aspersions on the way the process actually works here, is to provide for an independent tribunal to try tax cases with trained jurists -- it doesn't have to be a court, it could be an administrative tribunal -- that is available to taxpayers on a prepayment basis. In other words, they would go to this independent body and have their disputes heard before they have to pay the disputed tax. And they do it before people who are trained and expert in the tax law.

Thank you very much. And I'd be happy to take any questions.

CHAIR PARSKY: Okay, California Chamber of Commerce?

MS. CHRISTOFFERSEN: Good afternoon, Chairman Parsky and Members of the Commission. My name is Kyla Christoffersen. I'm here on behalf of the California Chamber of Commerce. And I'm keeping my comments brief. We will be submitting a more detailed, written discussion of our observations.

For purposes of today, I'd like to highlight just a couple of points.

My first point is that among the five principles that this commission has been based around and the recommendations are supposed to be guided by, we do believe that the economy, the importance of having a strong economy and encouraging long-term prosperity in the economy as set forth in the principles, as well as encouraging and improving California's competitiveness are extremely important. And we would urge the Commission to make that a priority in determining its ultimate recommendations.

A couple of other principles for the Commission that keep getting attention are, one, volatility, which has gotten a lot of discussion today. And the other is, whether our tax system is appropriately reflecting the economy. And on those two particular principles, this is our two cents.

On the volatility issue, we think that it's important to take care to ensure that this is a problem that really does need prioritization. Of particular importance, there is a pending proposal that the Governor and the Legislature have approved and is going to be on the ballot, which is the rainy-day fund, and we think that that is a proposal that does address volatility and should be given a chance to work before more radical solutions are sought.

On the issue of whether our economy is adequately reflecting the 21st century, our response to that is that the data shows that our tax surveys have generally followed our economy, the ups and downs of the economy. Over the past 30 years, the amount of revenues raised by the general fund through taxes has generally ranged between 6 or 7 percent of personal income. So we think that shows that, generally speaking, our tax revenues do come from a balanced mix of sources, and that that need not be necessarily a priority for this commission to look at.

But turning to the issue of the economy which we think is the most important, I think it's important to get the business perspective on what the tax climate is and what the economic climate appears to be to businesses who, we submit, are the state's job creators. And so their perspective is quite important.

Unfortunately, the perspective of the business community, in terms of the tax climate and the current tax structure, is that it is one of the most burdensome in the nation. And here's some reasons why.

The non-partisan Tax Foundation's 2009 national study confirms that California has the sixth-highest state and local tax burden. We have the highest personal income tax rate. The tenth-highest corporate tax rate. Our sales tax rate is above the national median. And only the property tax is considered to be slightly below the national average.

Additionally, California's high income tax, let me note, has a particularly hard impact on small businesses because many of them are organized as sole proprietorships and pay the individual income-tax rate.

On the issue of sales tax, on the issue of competitiveness, we are virtually the only state in the nation that taxes both inputs -- for example, manufacturing equipment -- and outputs, which would be the product that the manufacturing equipment is producing. That's a serious competitiveness issue with California, and we would urge that that be examined.

Moreover, in a cross-section of national tax climate rankings, California consistently ranks near the bottom. In the Tax Foundation's 2009 study, we're 48th out of 50; in the Small Business Survival Index, we are 48th out of 51. CFO Magazine, we are ranked the very worst.

So the fact that California has this dismal tax climate and the perspective of business means to us that there is definitely room for improvement in the area of making our tax structure more attractive for job-creation investments.

But what we would emphasize to this commission, we would urge above all that the tax system that emerges for the 21st century economy above all not do any more harm to the tax climate and California's competitiveness. And so that's something we would really emphasize.

Turning to my other point that I really want to make today is that there are a number of tax proposals that have been spoken of today and in the last hearing, and also just in the context of the many discussions going on because of the fiscal crisis that California is currently experiencing; and we just want to address quickly a couple of those proposals and why we think those would be especially detrimental to the economy and our competitiveness.

One of which is the services tax. We think that the services tax would drastically and severely impede our economic standing. It would severely impact a business's ability to recover in this economy. And one of the things that we would know is that a tax on services, in our view, is a tax essentially on labor. Because when small businesses have costs that immediately would increase 10 percent or whatever the services tax would be, there would be this immediate increase in cost of 10 percent for businesses. And for small businesses in particular, this is going to mean that they are not going to be able to provide as many jobs. And so we think that a services tax is essentially a tax on jobs.

And the other thing to note is that if you go the route of a targeted services tax that's discriminatory, it's going to harm certain sectors over others, and that's bad policy. If you go the route of a broad-based services tax, that's going to result in behavioral changes that may not result in as much revenue as hoped. For example, businesses can look to other states to hire a professional, such as accountants and lawyers. Therefore, California loses any tax income from that, or potentially does.

Additionally, more businesses may be inclined to move those types of activities in-house. So instead of contracting out to a business outside of your business, you would try to have your in-house lawyer or accountant do the work. And so, obviously, that's going to have a detrimental impact on the economy as well.

And so the other -- I'll just note briefly, the other tax that gets proposed a lot are targeted taxes, targeted towards certain industries. We also think that those are unfair, discriminatory, and bad policy. And we would recommend against those.

And on the issue of taxation of e-commerce, changing of the nexus standard, such as New York has done, on the issue of taxing digital downloads, we would caution -- we would add to Cal-Tax's caution in doing anything in the area with respect to, again, affecting California's competitiveness. The reason being is that when you're talking about the e-commerce marketplace, you're talking about companies who have an extremely high – more-than-average degree of mobility. It's very easy to move servers across state lines. And California consumers can be reached just as easily outside of California as within our borders.

And there are always going to be states, I can almost guarantee you, who are not going to tax digital downloads and who are not going to have vague and uncertain nexus standards. And so if California chooses to go that route, then we are basically competing with those other states that are going to set themselves up to be tax havens in the area. And I think that would be a real shame, since California is known for being a leader in the digital e-commerce marketplace.

And so those conclude my comments for today. Thank you.

CHAIR PARSKY: Thank you very much.

Last will be the National Federation of Independent Business.

MR. SHAW: Yes. Good afternoon, Chairman Parsky and Commission Members. It's a pleasure to be here to speak on behalf of many California small businesses.

NFIB is a national association, as the name would suggest, and we have about 23,000 members here in California, about 350,000 nationwide. So we do have a good bit of experience in this area.

And our members have a great number of opinions about California, not all positive, though the many that do choose to operate here like it for various reasons.

I wanted to talk really briefly. Much of what I would like to relate has already been said, so I'll curtail those comments as much as is possible. But I want to talk about two basic areas. One is improvements to the current tax system that we think would be beneficial to small businesses. And secondly, comment on some of the proposals that have been discussed today and in other settings primarily and through the Legislature.

But the first is the taxation of business inputs. It's been talked about I think quite a bit today, so I'll not say much other than to say it doesn't make sense to us in any way. The taxation, the value is being received on the other end. And so we think that taxing the business inputs discourages investments. That means that there's less employment opportunities, less tax revenue for the state, and so on and so forth. And so we think that that would be one area that should effectively be eliminated. And how that plays in with other elements of the sales tax, you know, we'll leave that to you to make the recommendations.

Secondly --

COMMISSIONER KEELEY: That's good.

MR. SHAW: Well, that's what you're getting paid the big bucks for; right?

Secondly, the minimum franchise tax. This is another tax that we don't think makes any sense. $800 just for the privilege to operate in the state of California. Well, this doesn't sound like a great deal of money. For small businesses, this could have a larger impact; and so we think that on the face of it, this is one that should be considered, again, for elimination. Of course, a lot of what I'm saying are tax cuts, so take that with a grain of salt. But in this particular area, we think that this is another tax that doesn't really make sense.

The value that that business brings to California's economy through employment opportunities, through a variety of other benefits in the economy, we think that more than make up for their privilege to operate in this state.

If a full elimination of that tax was not something that the Commission was willing to recommend, there has been legislation in the past several years that has looked at providing some type of an exemption for three to five years for new corporations.

Now, obviously, I think, for FTB this could create some compliance issues. And those would be some things that would have to be dealt with. But if you're not going to recommend a full elimination, at least looking at a partial exemption for businesses starting up because, again, this is a tax that's paid regardless of whether or not you're profitable.

Health care is another area. This kind of breaches into a whole 'nother policy arena. So I will be brief here. But I think that equal treatment of health-care expenses, particularly premiums, is something that we should consider as well because individuals are not treated the same as employers. That creates a discriminatory situation in health care, which has the effect of keeping people in their jobs just because they have health care in some cases. Whereas -- and I apologize for not having the exact citation for this. I recently saw a survey that indicated that 72 percent of full-time employees would like to be their own boss. Now, that may be more a function of their bosses and less a function of their entrepreneurial spirit, although we like to believe the latter.

But we think the equal treatment of health-care premiums would certainly be beneficial to the economy as a whole, and just basically bringing fairness to the tax system.

The last, I think, improvement -- and this is, again, another issue that's been talked about a great deal already -- is federal conformity. As much as is possible, this just makes it much more simpler for businesses, particularly small businesses, to file their taxes. And that saves them time.

And one of the things that I think is most lost in the discussion of businesses and conformity is the fact that small business owners spend enormous amounts of time outside of the regular business hours doing paperwork. That's not productive. That's not providing any benefit to the economy, that's not doing anything that's really generating that value that we like to see come out of the business operating in the state. So we would like to see conformity brought in as much as possible.

One key area for our members is health savings accounts. Obviously, again we're getting into health care a little bit. But it's not taxed on the federal level. We do tax contributions at the state level. Again, we don't think that that makes sense.

Also, expensing provisions for purchases of business equipment. Obviously, we're talking about this as maybe an either/or with the business input, the taxation of business inputs. But in the federal level, with the stimulus package, that those levels are being increased and extended. We think California, again, should follow suit.

And as was recommended earlier, if you're doing an annual realignment to the IRS code, that may be an opportunity there to address those issues.

In terms of proposals that are out there circulating right now, sales tax on services, as Ms. Christoffersen from the Chamber related, has impacts to small businesses. We think it's discriminatory in ways because small businesses would be going outside, more than likely, to get those services, effectively being subjected to a cost increase, whereas larger corporations could internalize all those costs.

One issue that's been raised in terms of the use-tax compliance problem that we're dealing with, if you add to that -- if you're adding to the sales and use tax services, it's going to make that problem even bigger, of that out-of-state compliance on the use tax, because if businesses that are going out of state to get those services, they're going out of state to get those goods in some cases and not paying the use tax, and now they're going out of state to get those services and not paying the use tax. Well, that's creating a greater compliance problem and may not be beneficial to the state in the long run.

And on the last issue, split-roll property taxes. These are taxes, obviously, that affect property owners. And a large number of property owners own businesses, and small businesses are typically -- there's a mix of owners and those leasing properties, they're going to be hit with the full brunt of that tax increase. Particularly in this economic setting, we think that splitting that out does not make any sense for businesses and could create further economic problems.

And so I would like to leave with one comment. Competitiveness is one of the principles of the Commission. California is certainly not competitive from the business community's perspective. And as these decisions, these recommendations are being considered and put forward, eventually, we think that that is one element that needs to be heavily weighted. Of course, we all say each one needs to be heavily weighted. But that is one that will have great effects long term on California's economy, not simply from the revenue budget side of the equations, but long term, in terms of job creation, job opportunities.

And small businesses being the job creators in California, three-quarters of all new jobs come from small businesses. We think that those businesses need that due consideration when it comes to competitiveness.

Thank you.

CHAIR PARSKY: Thank you.

Before turning it over -- I appreciate all the comments. Except for the last comments and the reference to some tax court or tax-appeal process, I think the four of you ought to think about what kind of recommendations you would make to this group to do something, as opposed to not do much, if anything. I think it would be helpful in the context. I know the organizations that you represent, and I certainly appreciate your concern for doing things that are going to impact all business. But I think the thrust of the appointment of this commission is that the current system of taxation has gone awry, isn't up to the 21st century California economy. And so not necessarily today, but I think it would be very helpful if each of your organizations would come forward with some strong recommendations -- and not just isolate one piece of the taxation system and say, "This wouldn't be good to do this. This would impact this," but take a look at a more comprehensive approach that wouldn't discourage business, but would deal with some of the issues that the Commission has to deal with.

COMMISSIONER EDLEY: Gravity-neutral.

CHAIR PARSKY: You see, Boalt Law School catches on relatively quickly.

COMMISSIONER KEELEY: Some others don't.

CHAIR PARSKY: Okay, with that, I'll turn it over to questions.

Yes, I'm sorry, you want to make a comment?

MR. CROSBY: Yes, Mr. Chairman, we've had some significant time limitations. But certainly, I would associate myself with some of the comments you heard from panelists the first thing this morning. Dr. McLure, I think, made an excellent suggestion. It’s something that no state has done but what every economist recommends: You ought to tax all goods and services sold in the state and exempt all business inputs from sales tax. It's pure economic orthodoxy. It would create a significant advantage for California businesses because it would stop penalizing them for investing in the state on the purchase of their capital equipment, as well as their operational inputs.

There are two problems with it. The first is political and the second is political.

And I would urge this commission to ignore those things. But, I mean, the data that we release today demonstrates that businesses are overtaxed here and overtaxed everywhere.

There are several things that I'd be happy to recommend.

CHAIR PARSKY: Well, I think --
MR. CROSBY: Make sure it’s as shown. It's highly unlikely to be adopted.
CHAIR PARSKY: Okay, I think you should operate under the assumption that this panel is not political.
MR. CROSBY: That is wonderful.
CHAIR PARSKY: And so we have carte blanche to recommend things that may never get done, but at least give us the opportunity to put forward something we can pressure the policymakers to do.
MR. CROSBY: I'd be pleased to do so.
CHAIR PARSKY: Okay, any questions?
Yes, Richard?
COMMISSIONER POMP: I tell you, in a state like this, Mr. Chairman, I wouldn't even know how to become political, it's so Byzantine. I don't know why we shouldn't take an aggressive approach regarding nexus.
Quill, which is the Supreme Court case that really imposed this constraint on states. 1992, the Court invites Congress to do something. It's now -- '92, what is that -- 17 years ago. Congress has no interest in doing anything. The politics are terrible for Congress to do something. Why should they change the law, take all the flak, and not keep the revenue?
So I think we have to do something. I think

New York has done all of us a service.

And keep in mind, Amazon started collecting in New York. And even if Amazon were to lose the case ten years down the road, there would be no refunds because that tax is owed by the consumer. So it's not even going to cost the state money, should Amazon lose the case.

I really don't understand. It seems to me, especially as a representative of a small business, you would want to be on the bandwagon to protect your Main Street retailers that are in competition with out-of-state companies and dot-coms. So that, I'm just not -- I don't understand that. I don't understand why California collects on catalog sales, you said, but not Internet. I mean, this all depends on whether or not there's nexus or not. It doesn't matter on whether you're doing a catalog or Internet. So it all goes back to nexus.

You know, I share the same concerns about taxing business inputs. And I would think your members, as small business representatives, you have that problem right now with tangible personal property. It's not a new problem with services. Your members buy in the marketplace what their big competitors produce in-house. So you have this problem right now, and it's a big one right now. So this is nothing new.

Let's see, what else?

I thought your opening remarks were quite appropriate, Mr. Chairman.

Joe Crosby has never been so nice to me before. I appreciate that. I think he's right, though, that a tax court -- and there's a lot you can do that will improve business climate. And a "business climate" can mean anything you want.

You know who the top four states are in business climate? Wyoming, South Dakota, Alaska, and Nevada.

COMMISSIONER EDLEY: That's why there's so many businesses there.

COMMISSIONER POMP: Yes, the dean has it. I mean, that's why the businesses are flocking, right, to Wyoming and South Dakota.

That's why your students are flocking to jobs there; right?

COMMISSIONER EDLEY: They can't wait to get away from the Bay Area.

COMMISSIONER POMP: And my students would love nothing more than to get a job here in California. And when I tell them it's a bad tax choice, who cares? This is a sort of fallacy, this whole thing.

CHAIR PARSKY: Humor is at the heart of this Commission effort. Keep going. It's perfectly okay.

COMMISSIONER POMP: Let me just see. I have just a whole bunch of thoughts. I'll try to be short.

The minimum franchise tax, that's paid only if you're operating in corporate form, though; right? Well, it's always my understanding, small business today is forming LLCs, LLPs, and really not operating as C corps anymore.

You like conformity, but I'll bet you don't want to give up credits; do you? Yes, you like conformity, but you don't want to give up any special credits for business. So nothing wrong with that, it's just beware of what you ask for.

Anyway, I'll concede my time.

CHAIR PARSKY: If there are no other questions, then we'll break –

COMMISSIONER KEELEY: Can I ask a question?

CHAIR PARSKY: Do you want to ask questions?

COMMISSIONER KEELEY: Of course, I do.

Thank you, Mr. Chairman.

If I might ask, and start with the California Taxpayers Association, a couple of issues I want to get clear.

You make a statement here, in your written material, you said on page 7 of your written testimony, or the document you submitted, "A split-roll property tax comes in two versions. One attempts to reassess non-homeowner property that reflect fair-market value when no change in ownership has occurred; the other seeks to apply a higher tax rate to the current acquisition value of non-owner-occupied property."

I would tell you that I know there is at least a third because those two are not, at least what I've been talking about, in a split roll. It doesn't have anything to do with that. It's just completely -- so I hope that in the communication back and forth, that you realize that there's at least a third version of a split roll. And that would be that there could be a redefining of what constitutes a sale. And that isn't anticipated in either one of your scenarios. So by way of communication, that that is clear.

There is also, in your discussion on page 3, with regard to sales tax on services and base expansion, correct me if I'm wrong, I thought what you said was that -- and it's reflected in here -- there is, I think, a suggestion, both by your testimony and by this document, that any expansion of sales tax to services, per se, is not a good idea for business and is not good tax policy.

Is that your position?

MS. CASAZZA: Not necessarily for business. But what I'm saying is, it's very difficult to go down that road as far as sales tax on services.

COMMISSIONER KEELEY: Why?

MS. CASAZZA: Because there's a lot of inequities that come out of it. The impact on small business, the volatility of it. If we're talking about volatility in an economic downturn, services are the first that go down and --

COMMISSIONER KEELEY: Let me ask you this question then: If, what we did -- because at least I've said this, and I've heard others talk about it, both in and outside the meeting -- that one way to look at how you would test whether or not you would expand sales tax to services, is that you would look at each service and try to discern –- and maybe this is very difficult, but at least in terms of lenses, that you would look first, is it a business input? If it is, don't tax it. Okay, that's one way to do it.

The second lens: Is it consumed largely by upper-middle-income and upper-income individuals and taxpayers as opposed to lower-middle-income and lower-income taxpayers to try to deal with, per se, the issue of regressive taxation?

MS. CASAZZA: By picking the service itself or by splitting the service based on some other criteria?

COMMISSIONER KEELEY: No, no, the service itself.

I'm going to use an extreme example here. One service code that is recognized by the National Association of State Budget Officers is "storage of fur." Okay, so let's assume for sake of discussion that's neither a business input nor is it consumed by low -- moderately low- and low-income individuals.

COMMISSIONER PRINGLE: Well, what are you using the fur for?

COMMISSIONER KEELEY: See, I knew this one would not be a good example. I don't know why I let myself do this.

COMMISSIONER LOZANO: You walked right into that.

COMMISSIONER KEELEY: Just straight into it.

Okay, in any event --

CHAIR PARSKY: Let’s start again.

COMMISSIONER KEELEY: Reset button.

There are many services listed by the National Association of State Budget Officers which I think reasonable people could look at it and say, you know, whether it is horse grooming or whether it is fur storage or it is whatever. You go down a list and you say, "Okay, those are recognized in a three-digit code as services.”

Whether we want to tax those or whether they would generate very much money or whatever, it doesn't strike me, per se, that if you filtered out business inputs and you filtered out those that were not consumed by low and moderate-income individuals, that there would be, per se, a negative impact on the business climate in California and, as we look at the changing economy -- and I understood what the professor said earlier, that's not a good way to look at our economy, is which parts are service and which parts are manufacturing, but that's an opinion. And I guess we can respectfully disagree whether that's the right way to look at it or not. But I'm wondering if, with those caveats, you still believe that -- and I'm interested in each from your opinions -- whether you believe that there is no architecture under which expanding any sales tax -- expanding sales tax to any service makes sense? That you could live with that idea? Because that's what I've heard you each say, is essentially you don't think so, that there's no service currently recognized in the United States by the National Association of State Budget Officers, there's no service that you think would be appropriately or benignly included for purposes of sales taxation.

MS. CASAZZA: Just a couple comments and then I'll open it up to others as well.

If you're talking about very selected, high-end services, you're not talking about a whole lot of money coming into the state.

COMMISSIONER KEELEY: That's a different issue.

MS. CASAZZA: Okay, but it is an issue.

The other issue is, you also have what's called a tax gap issue. So you have folks that do the horse -- what was it, the horse --

COMMISSIONER KEELEY: Grooming.

MS. CASAZZA: -- grooming. It's hard to catch those guys. It's hard to get them --

CHAIR PARSKY: I have one at home.

MS. CASAZZA: No, I'm just saying that --

COMMISSIONER KEELEY: Okay, now, you're as silly as I was.

MS. CASAZZA: No, no.

CHAIR PARSKY: He wants a "yes" or "no."

MS. CASAZZA: It's a hard answer, "yes" or "no." It's a real hard -- it's a difficult road to go down.

COMMISSIONER KEELEY: I think it is, too. But most tax issues, most taxation is difficult. That's why we wrestle with it so much. So I think there may be issues of administration --

MS. CASAZZA: Yes, big issues of administration.

COMMISSIONER KEELEY: -- and fairness and equity, and is everybody caught in the net that's supposed to be and so on.

MS. CASAZZA: Yes.

COMMISSIONER KEELEY: But as a matter of tax principle, what I heard all of you say at the outset was don't tax services. And then you each mentioned as business inputs. So fair enough. Let's say we took business inputs out and we took out those that affected mostly low- and low-moderate-income individuals because of the regressivity issue.

What do you care then at that point? From your organization's perspective, if we can generate a little more dough in California here, there, and someplace else, how does that hurt something that you care about in your association?

MS. CASAZZA: Yes, it's a valid question. I can say that I think the expectations of the revenue that would be coming in may be higher than what would be coming in. And so the budget would be based on revenue that will not be coming in, and then you'll have a higher gap to fill.

COMMISSIONER KEELEY: I don't mean to be argumentative.

MS. CASAZZA: No, no.

COMMISSIONER KEELEY: But that's sort of –- you know, if you have cake, you can have cake and ice-cream, assuming you had some ice-cream.

I understand what you just said. But I guess I could counter it by saying, well, if the Board of Equalization and the Franchise Tax Board got together and that was the law, and they had an administrative structure for doing that, and the Department of Finance and other revenue projectors who are actually pretty good at projecting revenue, projected revenue and, over time, you are going to get better and better at that, then that issue disappears as a problem.

MS. CASAZZA: No, I don't believe so. I have to disagree with you.

COMMISSIONER KEELEY: Okay.

MS. CASAZZA: Because a lot of the services can move. You can go to Nevada to get your horse grooming. You can, you know, get accountants and attorneys somewhere else. You can -- you know, there's --

COMMISSIONER KEELEY: Okay, all right, all right, fair enough. I mean, I don't think somebody in Santa Cruz is going to go get their horse groomed in –- because they -- anyway.

COMMISSIONER PRINGLE: Mr. Keeley, Mr. Chairman, could I, though, follow up on what your question is? And maybe these people have a hard time being able to give an answer, and I would respect that.

But, Mr. Keeley, specifically what you're saying, though, is would there be contemplation within the business community of extending or expanding sales tax into services?

CHAIR PARSKY: As a matter of tax policy.

COMMISSIONER PRINGLE: But what you suggested, though, is what would it matter if more money comes into the state. And I think that is part of the catch here.

So I'd like to ask the question just a little different.

If, for example, there were an elimination of business purchases or services being taxed under a sales tax, therefore a reduction in the burden on business from that component, and there very well may be a reduction of the sales tax rate, if it were then expanded to services as well -- in other words, if it's totally revenue-neutral, if somehow the wand is waved and the expansion into services and the reduction in business inputs being taxed is totally revenue-neutral, is there a fundamental business opposition to expanding into services?

MS. CHRISTOFFERSEN: I guess I can address that because that's one of those fun hypotheticals that are impossible to respond to. But I think that our general feeling is that, you know, the question is, should we assume that a services tax, an expansion, is going to put us in a better position than we are today. And we think that it's important not to assume that.

And emphasizing Teresa's point, in terms of, are we really going to get all the additional revenues that we think we're going to get, or are there going to be behavioral changes that occur such that we don't end up with additional revenues, possibly we end up with less? The services tax -- you know, we're perplexed by the fact that that's being proposed as something that may be less volatile because, you know, any revenue source is going to rise and fall with the economy. There is no such thing as a counter-cyclical revenue source. So even under a services-tax structure, I think that when the economy falls, you're going to have fewer revenues that come from the services tax.

So is it going to really improve our volatility in terms of whether our revenues reflect our economy? Like I said, there are figures that show that our revenues have steadily been reflective of our economy.

So from the Cal Chamber's perspective, we think it's important not to assume that the services tax is going to be the remedy and the answer to the things that are perplexing the Commission today.

COMMISSIONER PRINGLE: See, Mr. Chairman, I think I might, though, just ask -- I will withdraw the question so no one else has to publicly state where they're at; but I would really like to have you maybe contemplate that. Because, really, what I was suggesting is reducing the cost of business's taxing obligation and extending the tax broader to services. I actually have a hard time hearing business say that's not a good idea.

So, you know, we can all be trepidatious about the fact that government may not be honest and may end up coming back and charging you later, but that's not the question. The question would be if you reduce this, or take away that obligation to pay sales and use tax on inputs, and the trade-off would be to extend the sales tax to outputs including services, and possibly even at a lower rate, is that fundamentally something that's worthy of a discussion within your business organizations.

And maybe, Mr. Chairman, I could just ask them to share a comment back in a couple weeks.

CHAIR PARSKY: Well, I think that was at the heart of my first comment to them, was to think about things that you could come forward with, that you would recommend we do, recognizing that you shouldn't isolate just one form of tax. But we're charged with coming up with a comprehensive approach.

And so while I recognize that you are speaking on behalf of very important constituents, but just step back for a moment on the assumption that the recommendations as a whole will not be harmful to business.

Fred?

COMMISSIONER KEELEY: Thank you.

And let me associate myself with Speaker Pringle's comments. In our previous meeting, when this subject came up, I had said, and others have said that we did think that if there was going to be a contemplation of expansion to services of some kind -- maybe not the 168 that are recognized, but if you got that down to 20, 30, 40, that met a couple of tests that weren't business inputs and so on, that there would be a corresponding reduction in all sales tax across the board, so that we're clear on what at least is the state of the conversation going around here.

Let me ask, if I could just ask you one other question.

When you provide us with the report that came out today, that you folks had, in which -- these are my words, not your words -- I thought the import of what you said was that California receives more taxes from businesses than it returns by way of services to business.

MR. CROSBY: That's a fair characterization.

COMMISSIONER KEELEY: Could you -- because I won't be able to sleep tonight if I don't hear at least part of the answer from you --

CHAIR PARSKY: Please help him.

COMMISSIONER KEELEY: Please, because I don’t want to call Gerry in the middle of the night, asking these questions.

But my question is this: What would go into such an algorithm or such a formula for you to make that kind of determination?

I'm interested, for example, in whether or not you look at our public school system and our higher-education system and the transportation system.

What are the things that go into that for you?

MR. CROSBY: Fortunately, I am not an economist. The study is done by Ernst & Young. But I can give you an idea. I mean, it's all of the various services provided by state and local government. And there's an allocation done as to the portion of those services that are provided to business versus provided to residential homeowners.

The biggest assumption in any of that is the benefit of K through 12 education. There's been some work done by the Chicago Fed, by two economists, Oakland and Testa, on this very issue. And so the study relies on their research. They provide a range of the estimate of K through 12 education that can be assigned, and to directly benefit business. And so we picked the midpoint of that range.

And so certainly -- the report -- the purpose of it is to begin a discussion that actually came up earlier today, much like we're just talking about taxing business inputs, that many of these taxes exist not because they're economically sound, but because they're politically expedient. And I think that's the import of the report, is it highlights some of those things and provides basic data that allows further analysis of that; so that when these discussions take place, they take place with that information.

In many states, where we participated in commissions like this, there are discussions about whether business is paying their fair share without any foundation of what business is actually paying and what services they are being provided.

So, you know, it's our interpretation of our estimates of both of those. And we're unaware of any other estimates by any other organization of state and local business taxes paid. As far as I know, we're the only organization that provides that, and the first to match it with benefits received by the business community.

COMMISSIONER KEELEY: Thank you for that.

When we --

MR. CROSBY: Can you sleep?

COMMISSIONER KEELEY: Sure.

When we do look at that Ernst & Young report, some place it explains the methodology in there?

MR. CROSBY: Correct, correct.

COMMISSIONER KEELEY: Okay, we were cautioned or admonished by one of your fellow panelists earlier not to do things that are subjective relative to the tax system. So I'm wondering, if you've looked at that Ernst & Young report, the degree to which California’s, in my judgment, absolutely outstanding public higher-education system has been a backbone of economic growth in California, the degree to which that is evaluated on some metric that is objective?

MR. CROSBY: In creating this study initially, we recognized that we cannot answer all questions. We tried to answer a question that was being asked and for which there was no answer, which is, what is the burden of state and local business taxes. And so we've provided that.

We are simply a tax organization. We do not look at other sorts of economic activities. For example, the question that you asked is: What is the value to the California economy of the higher education system here? I don't know.

COMMISSIONER KEELEY: I'm asking a different question. What is the value to business of California's higher-education system? Because that is certainly something that business -- some of the taxes that business pays goes to fund that portion of higher ed. that is funded by the state, which is a declining portion, admittedly.

MR. CROSBY: Sure.

COMMISSIONER KEELEY: But nonetheless, the University of California and the California State University system and the 107 community colleges are considered, at least arguably, the finest in the nation, if not rivaled by maybe the University of Michigan once in a while, when people sort of aren't paying close attention.

MR. CROSBY: Right. All of the services that state and local governments provide, are evaluated and allocated either to individuals or to business.

COMMISSIONER KEELEY: Great.

MR. CROSBY: So every expenditure, excluding federal expenditures, because we'd have to look at -- which are, you know, 30 percent or so of the budget --

federal transfer payments that we'd have to allocate the portion of business taxes that are paid to the federal government, that then flow through to the state government.

So we exclude services provided as a result of federal transfer payments ––

COMMISSIONER KEELEY: Fair enough.

MR. CROSBY: -- and look at state and local expenditures from all source revenues and allocate those between businesses and individuals; so that all of it, including higher education, is involved.

COMMISSIONER KEELEY: Okay, thank you, sir.

Thank you, Mr. Chairman.

CHAIR PARSKY: Okay, thank you very much for this panel.

COMMISSIONER EDLEY: Gerry, let me just say, for the record -- I don't know if there are any journalists still here and awake, but I just want to go on record --

CHAIR PARSKY: Okay, that may be a contradiction in terms, but we're not going to get into that.

COMMISSIONER EDLEY: I just want to go on record. You folks -- if the business community wants to help lead on this issue, you've got to be more helpful than you were today. What Gerry said was not edgy enough.

I think that -- because we are going to make recommendations. And we would love to have some helpful input from you about how the business community thinks we can best go about trying to solve the problem that we've got. We didn't hear that from you today. We would like to hear it from you.

And again, just for the record, my name is Michael Boskin.

CHAIR PARSKY: As this commission continues to deliberate, I'll try to get a lot more edgy. It’s okay.

So thank you very much.

Next –- and I’m sorry, we didn’t take a break but I would like to get through this next panel.

The last panel discussion is the California Forward. So please come forward.

Yes, please.

MS. ROSS: Thank you, Mr. Chair and Members of the Commission.

I'm Jean Ross. I'm the executive director of the California Budget Project. And I'm learning to use the technology here. And I'm mindful that I am all, or with Fred, that stands between you and the end of a very long day. So I'll try to be fairly brief.

And I'd like to speak quickly to two points and very quickly to a third.

The first is the issue of volatility or growth in our tax system, and where do we get it, where do we not get it, and how does that either match or not match the 21st century economy.

The second issue is equity and what do we know, what can we glean from the best modeling that's been done in terms of equity of California's tax system.

And the very brief third point would be on our ability or lack thereof to effectively evaluate and then sunset, if need be, tax expenditure programs.

My first and I think my primary argument -- and, in fact, this is my mantra for this budget year -- is that the personal income tax is our friend. It is not the enemy. It is absolutely the best thing that we have going for us in California right now in a very bleak budget context.

And to do anything really to diminish that would both take our tax system out of alignment with where the economy is going, but also lead to even more dire budget consequences going forward.

And I think a lot of what the debate around the whole issue of volatility is, is a response to the last war. And by "the last war," I mean the dot-com boom leading to the dot-com collapse at the beginning of this decade rather than what we're seeing right now in terms of our revenue base. And certainly everything is in the tanks right now.

I was, thanks to the wonders of modern technology, pulling up the Controller's latest cash report, going through January a few moments ago. And it is an ugly, ugly picture. And I think we all understand that. But the one revenue source that's running above forecast is the personal income tax. The one that is -- and that's against, again, a fairly bleak forecast, but the one that is actually doing better is the personal income tax.

The one that is doing the worst is the sales tax. And, again, I think we all know that we are in the midst of a consumption-led economic downturn, and that's a lot of the problems that we see in the economy at large.

And I don't think the job of this commission is to respond to this war. Certainly, your scope is longer-term in nature.

So why do I say that our personal income tax actually is the best thing we have going as Californians in terms of mirroring the 21st century economy?

If you look over time, there are two related trends that are going on in the real economy. As a board member of mine always reminds me, the real economy drives our budget. And the real economy in California and the nation is, first, one of widening income inequality.

And if you look just at the tax data -- and I have a slide in your packet on page 14 which looks from 1995 to 2006 -- and this is adjusted gross income, so it's the income reported for personal income-tax purposes, we've seen the income of the top 1 percent -- and this is in inflation-adjusted terms -- more than double, while the middle income taxpayers, the middle fifth of those filing personal income-tax returns in California has gone up by less than 10 percent.

So, yes, we have seen a dramatic shift towards the high end in terms of where the income and wealth is in our society.

And sort of along with that, we have also seen a trend for the entire economy, particularly at the top end, towards more and more of that income coming from investments and specifically capital gains. And so both the fact that I think we always point to as being the problem in terms of volatility, and I'd say periodic swings in our tax revenue, really reflects a trend in compensation patterns that are part of the 21st century economy. And that is a shift from wage and salary income, to a greater share of the total compensation package coming from capital gains. And that's certainly related to more and more of people's pay packages, coming through stock options, more coming through stock grants and the like.

So what makes our tax system grow and fluctuate also leads us to have on occasion what I call, "Mr. Toad's Wild Ride" on occasion. But I think that that wild ride, where we go up and down, is also, if you look at the data trends over time, which gives us the greatest growth. And I think, again, to mirror or to tie our tax system to the underlying economy, you don't want to give up the growing part, you don't want to diminish the taxes where the growth is, and that's the high end in our economy, but, rather, to mirror that -- or, rather, to manage that on the spending side of the budget.

And we had Proposition 58 passed in 2004 which set up a pathway to a stronger budget reserve.

I would argue, we have never had good economic times to test whether or not that would work. We have been in a period of budget deficits ever since the voters approved that measure.

And since it didn't work -- in large part, because we haven't had a good year since it was enacted -- another measure was put on the ballot in September.

I think there are tools in place that can -- if we allow them the time to work, that could potentially help address that problem.

Second -- and it's also related because everything in taxation and economics is related at some point -- is the issue of who pays taxes and how do you effectively measure the incidence or the tax burden both as a whole and for specific taxes in our economy.

And we certainly hear all of the time, or a lot of the time in the circles that I travel -- and which are admittedly odd circles -- that the wealthy in California pay the largest share of taxes.

That, in absolute dollar terms, is certainly true. But if you look in traditional economic terms of how you measure tax incidence -- taxes as a share of personal income or household income, it's essentially the lowest-income Californians who pay the largest share of their income in taxes.

And I have that broken out by different taxes in a slide that's on page 17 in your handout.

And I would say that this is modeling that is done by the Washington, D.C.-based Institute on Taxation and Economic Policy, an organization, out of full disclosure, that I serve on the board of and that Professor Pomp serves on the board of. It is the only model in the country that looks comprehensively at the incidence of state and local taxes as a share of income. And I'd be happy to talk a little bit about that as well.

Finally, on the issue of services and what might that do for your tax system. I am mindful of the Chair's very good comments to the last panel to offer constructive recommendations.

I personally think there are a lot of good reasons to extend our sales tax to services, mainly, in terms of treating transactions with similar economic goals comparably throughout our tax system.

I don't think -- and I think there is oftentimes sort of a wish that by extending the sales tax to services, we can somehow address the regressivity of the sales tax. And there is not a lot of research. I wish there were better research on this topic.

I do not think that extending the sales tax to services either broadly or really in a targeted way will do anything measurably to change the incidence of the sales tax. And we can make light of imposing the sales tax on fur storage.

The first thing that came to mind is, well, that's going to bring in tens of thousands of dollars to help close the state budget problem, and that leaves only $40 billion left to go.

And I also think some of the comments made earlier today about pyramiding and some of the problems that I think people who are tax wonks agree that you can get into with the sales tax and some of taxing intermediate inputs do come if you begin to tax things like accounting and legal services and the like. So I think we just need to look at what you can expect and can't reasonably expect from extending the sales tax to services.

That said, I think there are a lot of good economic reasons to do it.

My very last comment, and I think hopefully you will take this, and I'd be glad to provide some very specific recommendations in this area, is that California lacks the data that we need to effectively evaluate tax expenditure programs. A total lack of data that ties how individual tax-expenditure programs work to the beneficiary of that tax-expenditure program.

Let me use, for example, the now sunsetted manufacturer's investment credit that California had for many years, which was tied to overall job growth in manufacturing in the economy, which was a gross measure. That credit failed the test that had been built into it, and as a result, did sunset in law.

But there was no way of knowing whether those businesses that claim the credit did better or worse than the manufacturing sector as a whole, because we do not require businesses to report employment on their tax forms in California. So you couldn't do any kind of a meaningful evaluation.

So I think if we want to move down that road, we need much better tools in terms of data-gathering. And we also need an ability, once the program is shown to be ineffective, to do something about it.

And I would argue that under the two-thirds vote that California has now, it is difficult, if not impossible, to eliminate an ineffective tax provision.

Thank you.

CHAIR PARSKY: Yes, sir?

MR. SILVA: I think she had a question.

CHAIR PARSKY: No, we'll let you go first.

MS. SILVA: Thank you.

Mr. Chairman and Members, thank you very much. My name is Fred Silva. I'm a senior policy advisor to California Forward, which is a nonprofit organization, a non-partisan organization that was conceived to bring governance and fiscal reforms forward to Californians. It's been in business for a couple of years now. And --

COMMISSIONER EDLEY: How's that going?

MR. SILVA: I want to indicate that you all are blessed with a couple members of this commission that happen to be on the leadership council of California Forward, Fred Keeley and Bill Hauck. Both of them have made lifelong commitments to deliberative bodies. So they'll be here with you -- and others, I suspect -- to go through these things.

But what I want to do is basically two things: One of them, is tell you a little bit about what California Forward's view is on a number of issues that you're talking about, and to provide a couple of to-do-something things, all right.

The first is that we asked the Center for the Continuing Study of the California Economy to give us an analysis of the backdrop of the 21st century economy, partly because of the leadership council's work and our general work on the future of state and local finance. We thought, what's the economy going to look like?

So we asked Steve Levy at the Center to produce a paper that might describe the 21st century economy. We thought that would be useful for you since, as the Commission on the 21st Century Economy, you might want to have some understanding of an analysis of what that economy might look like.

You have a copy of it before you. I apologize for not getting it into your packets earlier. It will be on our Web site on Monday, and the Center's Web site on Monday, as well as the Commission's Web site.

So it's for your review. I won't go over it now. You might want to chat with Mr. Levy about it.

But we think it would be useful for you to take a look at the components of the 21st century economy as you think about the tax structure.

Let me focus first on California Forward's ideas about fiscal reform, and they're relevant to one of the issues, major issues that you've been facing. We've suggested several things. One of them is that the state budget-making process, some now 50 years old, is an annual event that's based on the notion that you get what you got in the prior year plus growth.

We're suggesting that you basically end that process and, rather, go to a multiyear budgeting system with a multiyear forecast. That you have a five-year forecast, the first two of which -- that is what we refer to as the budget year, but the succeeding year as well -- have forecasts for specific expenditures and revenue estimates. And then the following three years, obviously, are longer-term estimates. You certainly wouldn't want to appropriate money for a third or fourth year out.

So we're suggesting that the state go to a multiyear budgeting system, that it be embedded in the Governor's development of the budget with performance metrics, so that the Legislature, as an institution, obligated to appropriate money for state spending, that it actually have a metric that they could use to measure the outcome of the Governor's proposals. And that, as the next piece, that the Legislature itself change the way it operates as an institution with respect to public budgeting.

The details of which are listed in the handout, and I won't go into at the moment. But we're suggesting that the --

COMMISSIONER HAUCK: I talked a little bit about this earlier.

MR. SILVA: Pardon me?

COMMISSIONER HAUCK: I talked a little bit about this earlier.

MR. SILVA: Great. Thank you.

So the next two pieces, one of them regarding the fact that California has this continuing habit of developing new programs without the financing. And we're suggesting that some form of a pay-go model, if you will, be instituted for proposals made by governors, proposals made by Legislatures, and the initiative process. So that when the initiative process brings forth a proposal to voters, to say, "Here's a new program; and, by the way, it's free, it doesn't cost you anything," we're suggesting it actually ought to internally contain a method for financing the activity, whether it's a tax reduction, and how that would be financed, or a new program.

The model for this, by the way, goes back to the Reagan Administration -- Governor Reagan Administration. When they wanted to do property-tax relief, they raised the tax to finance it. So their income-tax increase they did in their first term, or first couple of years in, most of that money was spent on property-tax relief. They didn't simply say, "Let's have property tax relief," and have the general fund finance it, but, rather, they had a means for financing.

The final point regarding the to-do-something list. We've suggested that the volatility problem connected with our revenue system is a function of the volatility and dynamics of the California economy; and that the best way to solve that as a finance issue, is to solve that in the budget process. Don't try to solve that in the tax structure.

And you've heard a great deal of testimony, perhaps the most compelling from Phil Spilberg, which was, you have a trade-off here between progressivity on the one hand and sort of this straight-line reduction in volatility on the other.

We're suggesting that through the budget process, that there be a way to define what we call non-recurring revenue; that is to say, a spike in the revenue system. And we'll use capital gains as an example. That both -- and that a transparent system be established so that an amount could be determined. And once that amount is determined, the Controller on a ministerial basis simply transfers the money into the reserve, have a lockbox in a reserve that has narrow abilities to transfer the money back out. And there is a standard for what you would do with that.

What's important here is that that process be transparent. So we've suggested that the joint legislative budget committee be given new responsibilities, and that that committee of the Legislature, along with the Department of Finance, certify an amount annually or updated as needed; and that they, in an open forum, determine that amount, and then that amount, of course, then is transferred by the Controller.

So that's a thing to do, number one.

Thing-to-do number two is, an issue that's been kind of as a sidebar for all of you, and that's the local tax system. It's tough because as you've heard from Phil Spilberg and others, you look at the income tax up on the wall there and you look at the sales tax, Eric Miethke offered you a softball today about the dilemmas that are faced with transaction taxes. And it isn't just the sales tax, it's the utility user tax, it's the transient occupancy tax.

And when we think about the state tax structure, you can easily stack a new tax on top of a locally levied one. This does not apply to the income tax or the bank and corporation tax, but it applies to transaction taxes.

So be careful when you're operating in this realm of trying to revise the transaction taxes, that you have these locally levied taxes as well.

That produces two issues. One of them is: Gee, is uniformity important? Do you want to simply take those over and take utility taxes and absorb them and then preempt the ability of local governments to levy them? That's an issue you need to talk about because uniformity would suggest, gee, there ought to be a statewide tax base for this. You'll have 485 cities at your houses. So that's an issue to talk about.

If in your short period of time you're unable to do that, then, Mr. Chairman and Members, I'd recommend that you figure out how to pass the ball on.

Other commissions in the last ten or 15 years have come to the conclusion that, "Gee, it ought to be fixed," and then they're silent or they have a proposal and then they're silent.

Your silence wouldn't be effective here. What I'm urging you to do is the No. 2 thing to do, is to say to either the Joint Legislative Budget Committee, the Department of Finance, “Take this issue on and work on it.” And then others can say, "Hey, JLBC, Finance, you haven't done anything here." So handing it off, if you're not going to face it, is an important element.

Finally, one of the pieces of paper I handed out is a piece on -- a dialogue that we're undertaking with the citizens of this state to talk about the revenue issue of California. This is an idea we had some time ago as part of our general outreach to the citizenry. We would like to increase the civic literacy regarding the tax system, which we thought would be a useful thing to do, to develop some common understanding about who levies taxes.

There is a list of events, regional meetings that we're having. We just had one in Fresno. We're hoping that at any one of those, any of you where it's a hometown meeting, that you'd all attend.

We found it's very useful to get business people, people who are just interested in the ways of the world, in to talk about the revenue system and how it works.

So that's it from California Forward.

I would be glad to answer your questions, as I know Jean would. And our two leadership council members, I'm sure, would enjoy that, too.

CHAIR PARSKY: Thank you.

A couple of things that each of you said that I would certainly recommend the Commission hear more on, because I do think that there is -- there's some divergence of opinion, if I understood what you were saying.

You are hailing the personal income tax –- or, in your words, calling it a "friend." And your analysis suggesting that we haven't seen enough with respect to a reserve, a rainy-day fund, how that might impact things, suggests to me that the issue of volatility, in your mind, might be addressed by not doing anything.

MS. ROSS: *(Nodding head.)*

CHAIR PARSKY: I think there's a difference of opinion over that subject. And I think that at the next meeting, we need to explore that a little more. Because I do think that there are very strong opinions that would suggest that that is not the case. And I'm not voicing an opinion there, but I think it's important that we get that out on the table and see if we can't explore it a little further.

The other thing that I was curious about, and I wasn't quite sure of the thrust of your comment, and that had to do with your comments about the disparity in income, per-capita income, which has widened; and that we shouldn't be looking at the personal income tax as being disproportionately imposed on a small number of wealthy individuals.

And my real question –- and, again, there are differences of opinion on that subject as well. But I guess the real question is, do you think that the nature of the 21st century California economy would suggest that we should continue -- and the changes in that economy -- we should continue to rely so heavily on the capital-gains tax, when it clearly has demonstrated its fluctuations?

MS. ROSS: And I would say, we tax capital gains as income. We do not have a --

CHAIR PARSKY: I'm sorry, I should have said as part of our taxation of personal income.

MS. ROSS: And I think I can answer that question on a number of levels. And I'll go back on volatility. And there is a page in the handout that I provided that looks over the long-term growth in our various revenue sources. And that's what I mean, in terms of a multi-decade trajectory, personal income tax is where the growth is in terms of our tax system.

In terms of how we tax higher-income individuals in California, I think you can have multiple goals, you've heard about a lot of them in this hearing and your last hearing, about do you use taxation to redistribute income to provide incentives and the like. And certainly, I wish I could say that I saw indications that the trend of increasing inequality in this state was beginning to come to an end. Every piece of data that we see suggests that the income gap not only between the top and the bottom, but particularly in this state as compared to other states in the country, the gap between the top and the middle is increasing.

And so I certainly think there is a role for taxation, if not exacerbating -- you can debate whether or not you want to use taxation to mitigate that inequality. I would hope that there would be broad agreement that you don't want to exacerbate that inequality, which is certainly what we have seen at the federal level over this decade, is that the gap in after-tax incomes is wider than the gap in pretax income. And that has to do with the top-loading of some of the federal income-tax reductions that have been done this decade.

In terms of how do you treat capital gains, first -- and, again, I think this is debatable -- I would argue that you do not want to send as a signal that work ought to be taxed more heavily than investment income.

I think as a society, we value work, we value hard work. I think it sends absolutely the wrong message to people who are out there earning incomes, if you tax income from work at a higher rate than you tax income from investment. And, again, I think that certainly is a point that can be debated. But I would hold as one of my core values that you don't want to tax work at a higher marginal rate.

In terms of how we rely on taxing capital gains, we have a trend in this economy -- and I think there's certainly -- and I think we're now revisiting how compensation packages have been structured because of what's going on in the private economy, a lot of what's happened in Wall Street right now. But there has been a shift where even, you know, down into the upper middle end of the wage-earner spectrum, where people get a larger share of their compensation from stock investments, stock options, capital gains, than they did -- and, again, there is a slide here based on Franchise Tax Board data in my handout.

And I think if you move away from the taxing capital gains, in essence, you're reversing, and you're becoming disconnected from compensation patterns of the 21st century economy. And I think, again, if I understand the mission of this commission, it's to look at how the state's tax system can be put more in sync with or can sort of build off of the trends towards the new economy.

So I certainly think if you step away from that, again, and emphasize taxes on work rather than investments, you're moving back into a past century in terms of California's tax system.

CHAIR PARSKY: Just to follow that, though, that wouldn't result in reducing all of the personal income tax on work and capital gains?

MS. ROSS: I'm saying that what you decide to do, I would certainly argue that you ought to tax income as income, regardless of where it comes from and at a similar rate.

CHAIR PARSKY: But it doesn't necessarily drive you to the conclusion that the current rate of taxation on personal income is appropriate?

MS. ROSS: No. I'm leaving that open. I think we certainly have an adequacy of revenue problem in this state right now. And so you could look at that. I would argue, and I think there's some economic reasons, at least in the short term, why you want to look more towards taxing income rather than consumption. And I think, unfortunately, it appears that we may be moving in the opposite direction. But that's a short-term issue.

CHAIR PARSKY: Right. And we're here for the long term.

MS. ROSS: You're here for the long term.

CHAIR PARSKY: One final question and then I'll turn it over, and that has to do with your comment about -- I want to make sure I understand -- that the volatility problem, in your mind, can be totally solved through the budget problem, through the budget process?

MR. SILVA: Yes.

CHAIR PARSKY: So, therefore, from your standpoint -- and, again, this is something we need to get out on the table because there are very different views on this subject -- you actually believe that there is no need to change the current system of taxation to deal with volatility?

MR. SILVA: Yes, that's true.

CHAIR PARSKY: Do you think that the current system of taxation ought to be changed at all?

MR. SILVA: Well, I would suggest that, as I mentioned earlier, this question of how we tax consumption and these transaction taxes, I think there's a lot of work that needs to be done in that area. Less so with the income tax. Less so with the bank and corporations tax.

You've heard lots of testimony about how these tax preferences ought to be reviewed. And I don't think California Forward has a particular -- hasn't provided an analysis of that.

Our only point is that to handle the revenue produced by a dynamic economy is that that revenue ought to be part of the allocation of resources through the budgetary process. And to the extent that there is revenue that occurs due to the volatility of the economy at a particular point in time, that that money should be pulled off and put in the reserve. And then what will happen is that the revenue that supplies services will then, in effect, level off, if you will. Because the appropriation base will be more level and will have less swings in it rather than these peeks and valleys. Because a piece of the peak is taken off, put in a reserve so that it can fund the valley.

CHAIR PARSKY: I understand that. But I think there will be differences of opinion on whether or not you can reserve enough to cover the valleys. But we will get into that.

I think it would be helpful for California Forward to think a little bit harder on the subject of whether the current system of taxation, the burden absorbed by the personal income tax, the business tax, the sales tax, and other taxes, is an appropriate allocation in the current system.

And it would be helpful to have some views from you on that subject.

COMMISSIONER LOZANO: Can I add something very specific?

CHAIR PARSKY: Monica?

COMMISSIONER LOZANO: Because we had a presentation from the Anderson School, and I'm not sure if you were here at that point in time.

MR. SILVA: Yes.

COMMISSIONER LOZANO: But they argued a reduction at the top of the marginal tax rate to reduce some of the vulnerability -- volatility. I call it vulnerability, but the volatility -- and a slight increase in the property tax. The two kind of go hand in hand.

And if you could -- perhaps not today -- but I would like to hear your reaction to that proposal.

MR. SILVA: Sure.

CHAIR PARSKY: That's a good suggestion.

MR. SILVA: Sure. Thanks.

CHAIR PARSKY: Other questions?

George?

COMMISSIONER HALVORSON: A couple of quick comments.

One of them is, I really like your emphasis on the multiyear budgets, multiyear planning. Basically, building a business model for the state, and then figuring out from that business model what are we going to spend year to year, what are we going to spend in various lines of activity, having that be, as I understand it, clearly delineated and having a sense then -- an accountability on the part of the Governor or the Administration to be very clear about that, and on the part of the Legislature, to be very clear about the funding you've been making decisions on that line. I think it makes a huge amount of sense.

And I think also if you get that, if you nailed that, businesses often run into situations where you need short-term debt as well as generate surpluses. And if you really do have a tightly managed system and you really do know exactly what the prison costs are going to be this year, and if you pay it back immediately -- I mean, taking short-term operating expenses and turning it into long-term debt is stupid. That just mortgages the state until it gets paid off.

But a short-term --

COMMISSIONER EDLEY: Only Washington can do that.

COMMISSIONER HALVORSON: -- can manage one of the cycles.

Yes, by the trillions, actually.

CHAIR PARSKY: If you've got to do it, you might as well do it big.

COMMISSIONER HALVORSON: Unless we're going to do it by $900 million or something, then it's a good plan.

No, but the point I was going to make is, if we really nail that and get the business model right and get the funding right, and then we go back and look and identify what are the more stable sources of revenue that we can have, that we can depend on going forward, I think that would be -- if we could go back and recommend that to the Legislature, that could be a very good thing.

I really love your chart on page 17. That's a great chart.

MS. ROSS: Thank you.

COMMISSIONER HALVORSON: And it's actually one of the first times I've ever -- I've never been a flat-tax kind of person. But actually looking at that bottom line, you can get a little sense of if those pieces all come together in the right way, there might be some kind of a simpler sort of system. It actually does point in that direction a little bit.

One question I had, though. When you talk about the disproportionality getting greater, have you done a study to figure out whether or not that's the same small number of people making a lot more money, or is that new people making money coming into the state? In which case, if they're paying a nine to one tax rate, new rich people coming in is actually good for California. But if it's just the current people making more money, then it's a whole different set of issues.

And if it is, in fact, new people coming in to pay more taxes, you may not want to discourage that.

MS. ROSS: I can speak briefly to that. And there actually isn't data available that allows you to do -- the Franchise Tax Board could do it, but they'd have to do it in-house for confidentiality reasons.

There isn't publicly available data that lets you get at longitudinally what's happening at the state level. There's been some research done, I think primarily out of the Brookings Institution over time. And certainly there is movement between quintiles or between components of the income distribution. But overwhelmingly, it is an issue of, if you're in the bottom, you stay in the bottom. If you're in the middle, you stay roughly in the middle. And if you're at the top -- and I think you're roughly – roughly, 90 percent or so of it is the rich getting richer and the poor and the middle staying pretty much where they are.

COMMISSIONER HALVORSON: It’s just that people do get locked into -- poor people without education, poor health, stay basically in the same, basic economic status for a lifetime?

MS. ROSS: Yes.

COMMISSIONER HALVORSON: And with multigenerational issues. And so you have got all kinds of problems on that end.

But the question I just wonder about, from just kind of an intellectual perspective is, on the top end, if that is, in fact, more people -- California is a great place to live. And if people with money are coming here and are willing to pay taxes, we may not entirely want to discourage that.

MS. ROSS: I'd actually say -- and I think we also in here do -- California's high rates on high-income payers, driving people away, and I don’t –- and I guess I didn't include it in this particular packet. We do have an equally beautiful slide on the number of millionaire taxpayers in California increasing at a rate that is about, if memory serves me correct, about six times the rate of the increase in income taxpayers as a whole since the imposition of the millionaire tax since 2004.

And we did this similarly -– you can crunch similar numbers -- and I wouldn't say they're moving here to pay higher taxes. I'd love to be able to say that, but I would say it certainly disproves that people are leaving to avoid paying the higher taxes.

COMMISSIONER HALVORSON: That's kind of my point, not that they're moving here to pay higher taxes;

but if people are, in fact, moving here, and once they get here pay higher taxes, I mean, this chart basically says that's good for us.

MS. ROSS: Yes.

CHAIR PARSKY: I do think the data is mixed, people coming in or leaving. I think there is a --

MS. ROSS: No, we've actually analyzed the IRS data, which does allow you to look at migration data as well. And, actually, the average income of people moving to California is substantially higher than the median income of those that are leaving California.

In fact, the average -- the median income of people moving to California is higher than those who sort of -- people like me, who essentially stayed here our whole lives.

CHAIR PARSKY: No, no, I'm talking more about the numbers. I'd be interested in knowing the number of people leaving in comparison to the number --

MS. ROSS: We can get you that data.

CHAIR PARSKY: That is what I'd like to see.

COMMISSIONER MORGAN: That is what I raised this morning.

CHAIR PARSKY: Right.

COMMISSIONER MORGAN: Because the newspapers and some state people said 3,000 a week. Well, where did that figure -- I don't know where that figure, 3,000 a week, was what was in the newspaper.

COMMISSIONER HALVORSON: 3,000 what a week?

COMMISSIONER MORGAN: People leaving California. And I'd like to know where that came from, and how it compares --

CHAIR PARSKY: We ought to be able to get some data on that.

COMMISSIONER MORGAN: -- to those coming in.

CHAIR PARSKY: Chris?

COMMISSIONER EDLEY: They're going to get those jobs in North Dakota.

MS. ROSS: Because the weather is great there.

COMMISSIONER EDLEY: So you California types like to talk about the seventh biggest economy in the world -- sixth, eighth, whatever, economy in the world.

CHAIR PARSKY: Who are you addressing as "you"? Who is "you"? Do you mean, California Budget and California Forward, that kind of thing?

COMMISSIONER EDLEY: So my impression is that virtually every other developed country -- if California is No. 7, if you take the top 30 developed countries in the world, that they all basically believe in the Keynesian idea that over the course of the business cycle you don't want to cut spending when you're in a recession and you don't want to raise taxes when you're in a recession. So just intuitively, since it is not the 18th or even 19th century and this economy is so big, it doesn't strike me as strange to think about macroeconomic effects when we're thinking about the optimal design of our revenue and expenditure strategy, our fiscal policy for the state -- period, paragraph.

The structure of –- and the structure of state expenditures, because we are so nationlike -- has, to some extent, the same kind of automatic stabilizer properties as the federal budget; right? We've got the entitlement programs and health and welfare, unemployment and so forth, that expenditures are going to be driven up. We're at the bottom of the business cycle.

So my problem is that, if all of these forces are basically going to inevitably -- strike that.

So isn't it true that any kind of revenue system that we would view as, indeed, appropriate from a policy standpoint, is going to have cyclical swings, as will our expenditures, because we like to have a certain amount of social welfare expenditures -- safety-net expenditures -- so there will be volatility. It's inevitable.

And so I guess I'm really coming around to the view that we weren't asked the right question.

We were asked -- it was sort of framed, or it's certainly framed in popular understanding, as you're reasonably smart people, or at least you're the smartest people we could trick into taking on this assignment; reduce the volatility by focusing on fixing the tax system. So the right questions would really be to think about -- viewing the tax system and the expenditure system, and I would say the financing system all as a piece -- how much of the volatility problem –- or how much of a disconnect between revenues and expenditures can we fix by fiddling with the revenue side? And then what might be some strategies for dealing with the package as a whole?

I guess what I'm suggesting -- and this is -- maybe I've shifted in the discussion part -- I guess what I've suggested is that we really do owe it to those who charged us to focus, I think, on the revenue issues as best we can and get as much help as we can in solving the problem from the revenue side, but not to the point where we actually end up with a revenue system that in other important respects is lousy -- is lousy, especially keeping in mind the fact that we've got this huge economy where we're not immune to macroeconomic forces in either our desires on the expenditure side or resources on the revenue side.

CHAIR PARSKY: I think that you've articulated it properly.

One kind of adjunct comment, we weren't charged with eliminating volatility. We were charged with taking a look at how you could reduce volatility.

It may be a nice theoretical exercise, but I don't think -- there would be a cost that I think this Commission wouldn't want to impose on eliminating it entirely, and you might not ever get there.

COMMISSIONER HALVORSON: Respond to and mitigate.

CHAIR PARSKY: Yes. And so I think we should bear that in mind.

The reason, though, I asked the question of the California Forward group, is that I do think -- and I think Monica's question or comment was right, just the same way we asked of the business representatives, I think it is important that you all come back or provide to us, in some form or another, a commentary on what was suggested by the Anderson School representative, which was an alternative, and to address, is there nothing you would do -- forget about the volatility as the be-all and end-all. Is there nothing you would do in reforming what is a system of taxation that hasn't really been reformed for a number of years in light of the current economy?

And you don't have to answer that question now.

Please, don't. But I would welcome input, and I think the Commission would, on both of those.

MS. ROSS: And I should say, my group is California Budget. We are separate --

CHAIR PARSKY: Right, but both of you.

MS. ROSS: Right, and I'm happy to do that.

I think that back to the volatility issue, and there's a trade-off between volatility and growth.

CHAIR PARSKY: Of course.

MS. ROSS: And I'm always mindful of the comment: Do you kill the goose that laid the golden egg because it lays golden eggs four years out of five?

And I think that is just something to keep in mind, because the growth in our tax system is in the personal income tax.

I think in this sort of lapse -- and I know your charge is on the revenue side of the budget. We do have to go back to Keynesian economics, a cyclical budget crisis and a structural budget crisis. The cyclical part is the downturn in the economy. The structural part is the even in good times, our tax system doesn't bring in enough to pay for the current level of public services.

And I think it's interesting, a lot of us who have tried to sort of noodle around with the numbers and it's kind of fuzzy to do, I think our structural problem is about $10 billion. And I think the problem with the Anderson School proposal this morning is, it doesn't get you to that structural issue, which I think is what motivated this Commission.

COMMISSIONER HALVORSON: Could you noodle the numbers a little bit and get there?

MS. ROSS: You certainly could. And I would argue on sales tax and services, that what you want to do is extend the sales tax and services, but use some of that to buy out a reduction in rates. Because I do think -- and I don't think that changes the distribution of the sales tax by income level. I think it gives you a better -- from an economic standpoint, a more efficient sales tax. But I would use some of it to buy down the rates because I do think we have a high sales-tax rate in California. I would do that.

I don't think I would do much to change the personal income tax itself.

CHAIR PARSKY: Your views on the personal income tax are clear, there's no question. They are not the only views in the house, I can assure you of that.

MS. ROSS: I understand that.

CHAIR PARSKY: Okay, Fred, did you have something?

COMMISSIONER KEELEY: Yes, very quickly.

On the issue, I think that Chris has got it right in a lot of ways.

I do want to say on this volatility issue, briefly, that volatility viewed as a problem somehow doesn't just fall from the heavens. It's really a matter of a lack of will on the part of the executive and the legislative to recognize that volatility and do something about it when you're on the upside of the business cycle or the downside of the business cycle.

But because of the inability of the executive, whoever it happens to be -- or the Legislature, whoever they happen to be -- the inability to deal with that for reasons that I certainly recognize having served in the Legislature for six years under both Republican and Democratic governors -- there are enormous political pressures to do the wrong things for the right reasons that then aggravate this issue. And then they dump it into the laps of the Commission and say, "Oh, my goodness, this must be some force of nature somehow."

It isn't a force of nature. It's a lack of discipline, and it's a lack of political leadership willing to deal with it. Fine, we will deal with it then on this commission. That's also okay.

But it isn't, per se, either a good thing or a bad thing. And it is a very solvable problem, but it's not solvable by political action with folks currently sitting there. And this is not about this Governor or this Legislature. This has been a problem for a number of years.

And so what we always do in these cases, I think, in California, is we then take essentially power away from those who have the power obligation to solve the problem. We take it out of their hands, put a fix in place to solve it instead of the political leadership taking care of it.

And so we will do that. I suspect we will recommend something close to the Ashburn Amendment to shave the peaks, to provide for the valleys. And we'll argue about what metric is reasonable to use and all of that. But we will end up with some form of a lockbox recommendation.

But I just want to be clear that this is very different than the business cycle or other things that are totally out of control that the Legislature and the Governor react to. This is a problem of not having the political will, given all other forces and all other pressures, to solve the problem on a year-to-year basis, having the discipline to do that. And that's fine. And we'll take that task on.

Thank you.

COMMISSIONER HALVORSON: Can I make one last comment?

CHAIR PARSKY: Okay.

COMMISSIONER HALVORSON: Cycles happen, and cycles are going to happen. It's just a fact of life. And the cycles don't happen on the expense side because we have to take care of kids and we have to feed prisoners and all of that. They happen on the revenue side. And so we have to have a strategy that mitigates the cycles from the revenue side without destroying operations. Because if we manage everything in a crisis mode on the expense side, every time a cycle happens, we're going to be dysfunctional and basically do a bad job of the state running things.

And I was just thinking, in health care, one of the things that happens is, we get a flu cycle every year. And for us to be surprised every December would be really silly.

CHAIR PARSKY: Okay, thank you, all.

Thank you very much.

Okay, I wanted to prove to my friend, Fred Keeley, that we weren't going to be limited just by four o'clock. So I hope I've established that today.

Mark, let's take 15 minutes here to kind of organize a little bit of discussion.

You had some comments you were going to make, and then let's organize some discussion just around what we want to have oriented for our next meeting. But make a few comments. And I apologize, we'll be finished by five o'clock for sure.

MR. IBELE: Okay, I was going to go ahead and give a -- I feel like I'm a little bit like the fellow who is supposed to clean up after a marathon. We'll see if I can clean up. And I think some of the things that came out, let me just mention to Commissioner Pomp that we did attempt to be balanced in the panel. Not "fair and balanced," I won't use that phrase. We can't use that anymore.

CHAIR PARSKY: The last panel established that without any question. Don't worry about it.

MR. IBELE: But looking forward to the next meeting, staff has tried to put together areas where there's consensus and interest among commissioners. And some of the things that have fallen out of that is despite the issues both on the distributional side and the administrative side, there is clearly additional interest in sales and use-tax base broadening, both on the services side and taxing those tangible personal products that we don’t now tax.

We are in the process of working with a

consulting firm that can help hone in on what are the revenue impacts of different tangible personal property end services, what are the distributional impacts for households. It's going to be more difficult on the business side because, as economists will tell you, taxes shift around and businesses can -- businesses don't pay taxes, so they would shift it to the extent that they can to capital to owners; to wages, labor; and pass on some of it to consumers. So it's a more difficult thing to do.

But we can use existing literature and existing reports -- for example, the Minnesota Incidence Studies, which has sort of standard assumptions about how the shifting occurs. The other thing that we're going to be doing with that is looking at -- as Dr. McLure indicated and Mr. Ingenito indicated, the business purchases are a sizable portion of the sales and use tax in California. But we are looking, investigating whether or not -- how expensive would it be to have a partial exemption for business inputs.

There is obviously a problem with people incorporating and calling a business input or calling a personal purchase a business input. But we could look at something, and will look at something like just exempting depreciable property, for example, which would -- I think one of the criticisms or one of the observations by businesses is we're taxing capital investment. So that seems to be an area where there is -- I hope I'm not saying too much -- but a fair amount of consensus and interest in the Commission about wanting to know what --

CHAIR PARSKY: Stay with the word "interest." It's better than "consensus."

MR. IBELE: Okay, good. Their interest has been piqued by this, okay. But also concerned about the distributional aspects of that.

The other thing that came out of this, and I think it ties together sort of the volatility issue, the rainy-day fund issue, and the flatter personal income tax possibility.

And that is, we're going to be looking at -- to the extent that we address, either through a different tax scheme for capital gains or a lowering of rates in the personal income tax, what do we buy in terms of volatility? Do we buy a lot? If we lower the personal income-tax rates by 50 basis points, what do we get in terms of a decline in the volatility? And based on that decline in the volatility, what would be a reasonable rainy-day fund to maintain?

I think just going back to Phil Spilberg's presentation in our first meeting -- Phil is, unfortunately, in Katmandu at this point, and that's not a figure of speech, he's literally in Katmandu, so he can't be here. But one of his points was that based on the state's current volatility, with the system that we have, we'd need, for a two-year protection, I guess his figures were on the order of close to $30 billion, as I recall. That's not necessarily bad, but it does raise this issue of what economists call opportunity costs. You have $30 billion sitting there. And presumably, one of the principal reasons for raising, for taxing, for a good part of government activities is you want to be providing public services, which we value presumably more than maintaining this rainy-day fund.

So there is -- it's not a -- assuming you have the political discipline, it can be done, but it can be expensive. And there's sort of, I think, a choice that commissioners have to make, is where is that trade-off.

Much like the trade-off that Commissioners themselves have to make about what is the right level of progressivity? How much does each taxpayer pay? Economics has very little, if anything, to say on that. And it's no more important than anybody else's point of view. Economics can suggest what the effect of a high marginal rate is or what a particular program does, but it can’t say, "That’s something we should do, that's how much that person should pay." There's no particular expertise in that. So that's the sort of personal income-tax side, structural changes. The progressivity, which is clearly an underlying concern.

I guess the remaining major point of interest, if we're talking about the state's major taxes, is this idea of the property tax. And I would like to hear -- I guess I would like to hear -- there's a couple of different directions to go on that. The incidence, the tax incidence, who actually bears the burden of the property taxes, one of those doctrinal debates in economics that has no clear answer, much like the corporation taxes. It sort of depends upon the market. But that's certainly, if not looking at the tax -- we could look at the tax burden possibly on the residential side. If it's looking at the split roll or something on the commercial side, I'd have to sort of recoup and think about how we might approach that, particularly -- not in terms of the revenue estimates themselves; in terms of the distributional impact.

CHAIR PARSKY: I think we also want to add -- make sure -- there's clearly continuing interest, and we've committed to have a presentation on the carbon tax.

MR. IBELE: Yes.

CHAIR PARSKY: Energy taxes or the taxation of energy probably ought to be incorporated into that discussion because that clearly is of interest. And we have a professor at Berkeley that is going to be available to talk to us about that.

MR. IBELE: Yes.

CHAIR PARSKY: I also think that the Anderson School presentation kind of triggered something, and that is maybe it would help the Commissioners if we put some clear alternatives on the table just to see what impact, covering these areas. That's one. There could be another. And I think we can come up with several alternatives, and have done some work on them to address the impact it would have, both on volatility and progressivity. I think it would be helpful.

MR. IBELE: I think we have the basics for that. And we've looked quite a bit at sort of what impact lowering the rates has, eliminating a lot of the tax expenditures. We've looked -- the data is less good on the sales and tax use side, but we're going to rectify that with the consulting firm that we've hired. So I think we can do that.

CHAIR PARSKY: If we could get all of that on the table, if you will, for the March meeting -- I think all of you should put in ink, not in pencil, the

April meeting, because I'm certain we're going to need it. But it would give this staff and some outside consultants a chance to do some rigorous work once we see the interest that the Commission may have in several of those alternatives.

COMMISSIONER LOZANO: I think all of that's great. And I think we're at the point we're seeing some modeling and some alternative scenarios, because we've generally covered the main areas of discussion. So I think we're there.

I just have a question about -- triggered, actually, by a couple of the presentations, including the one on commercial property and market-value assessments, et cetera. I'm wondering if there's not a way that we can also bring to the table some recommendations that would mitigate impacts on small business, et cetera. So it doesn't mean that because it has different proportional affects, that we should not do anything.

If, in fact, we're concerned about the impacts on certain segments of the population or certain segments of the business community, i.e., small business, I'm thinking that we've already heard a couple of alternatives. And maybe you can add that in to your scenario so that we might be able to say, "Let's do this, but try to offset some of the concerns by doing Y."

CHAIR PARSKY: I think that's a very good comment. And it builds off of, I think, what we were saying before, that changes in one form of tax shouldn't be seen in isolation, because we might be able to address volatility/progressivity in the context of making a myriad of changes. You might decide you want to do something with the property tax, but you will offset it with doing something else.

And so rather than continue to focus just on one form of taxation, maybe we ought to see if we can't come together with some combined approaches that keep in mind this desire to address volatility, but bear in mind the impact on progressivity that the package would have.

So I think Monica's idea is sound.

Richard?

COMMISSIONER POMP: I had asked Fred whether this was feasible, and that is to model the income tax using adjusted gross income rather than taxable income. And what that would mean in terms of it would be a dramatic rate reduction, but maintaining the same distribution to the extent possible.

And I don't know if that's going to be feasible or not. If I'm the only one interested in it, then it's not worth spending the effort.

MR. IBELE: We can do that. What is a little more difficult to do is -- I mean, it basically means we're removing all the below-the-line deductions.

What we can't at least right now do is get the above-the-line deductions, like health insurance and employer-paid retirement and so forth.

COMMISSIONER POMP: Right.

CHAIR PARSKY: Below-the-line deductions he can do.

COMMISSIONER POMP: Yes, and that's fine.

CHAIR PARSKY: And I think that might be useful.

COMMISSIONER POMP: I think that's a big improvement right there.

CHAIR PARSKY: That would be great.

Okay, any other comments before we -- we have two minutes.

COMMISSIONER EDLEY: Yes, I just wanted to -- there are a couple of things in which I'm deeply confused about the law, but --

CHAIR PARSKY: As the dean of the law school, if you are confused --

COMMISSIONER EDLEY: Right.

MR. IBELE: A tendency to overanalyze.

COMMISSIONER EDLEY: For example, I don't know what the state's constitutional provisions are with respect to borrowing authority and also some of the stuff about what requires -- making use of the ballot propositions for statutory versus constitutional change and stuff like that. But if I have questions, I can just shoot them to you and you'll find somebody who can make up an answer; right?

MR. IBELE: Or I could make it up. That would be a lot quicker.

COMMISSIONER EDLEY: Okay, fine.

CHAIR PARSKY: We'll find a lawyer that will give him an answer.

MR. IBELE: Yes, we would either ask staff at the Department of Finance or often Leg. Counsel would opine on that.

CHAIR PARSKY: Absolutely.

MR. IBELE: And this is who we referred the question about the two-thirds vote that came up last time. And we should be getting that opinion soon.

MS. MAR: It just needs the final approval.

MR. IBELE: And that will be on the Web site. So if there's something that comes up, just let me know.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

Mr. Chairman, so we are going to have more in front of us at our March meeting on the carbon tax --

CHAIR PARSKY: Yes.

COMMISSIONER KEELEY: -- on the split roll --

CHAIR PARSKY: Yes.

COMMISSIONER KEELEY: -- limited expansion of sales tax services, something on the lockbox issue, or some other mechanism that might be available for use.

We had also discussed at our previous meeting -- oh, also the notion of having some kind of accountability on tax expenditures. So I don't know that we need that next time. But it sounded to me like there was some general consensus here or general sense that a higher standard of measuring the effectiveness of tax expenditures and whether or not they ought to be continued, that that was something the Commission wanted to get its arms around a bit.

There was, at our first meeting, a brief discussion -- and I don't know, Mr. Chairman, if you or the members want to discuss this at any greater length -- and that was whether some revisiting of the vehicle license fee, if not to reinstate it, then to at least look at it again was discussed at our first meeting. We haven't discussed it today because we have panels on other subjects. I'm wondering what your desire is on that. We don't need to revisit everything every time. But I want to put sort of a placeholder.

CHAIR PARSKY: Okay.

COMMISSIONER KEELEY: And I have a suggestion on how maybe we can deal with some of these.

At the end of our last meeting, I also mentioned the notion of a permanent dedicated funding source for the resources agency.

Mr. Chairman, would this be helpful? I think we'll have a full plate next meeting with what has been agreed to already. Would it be appropriate for Commissioners to start coalescing their own thinking, and give that coalesced thinking to the staff, admitting that it isn't entirely hardened-up concrete, and that as members are starting to come together in their own minds about what might look right, would that be helpful to you if we did that in writing to you on some topics? Or, Mr. Chairman, do you think that would be helpful at this stage?

CHAIR PARSKY: I think it would be quite helpful in helping to structure the presentation for the next meeting. So any input that any Commissioner would like to give to the staff in terms of where their thinking is going, based on what they've heard so we will be able to, I think, and it would help us a lot in structuring the presentation for the next meeting.

COMMISSIONER KEELEY: And my last comment, Mr. Chairman, is that I'm imagining that what we're doing now is, starting at our next meeting, we'll be in the contracting-universe phase. We've got a few things in our sights here --

CHAIR PARSKY: Right.

COMMISSIONER KEELEY: -- for the next meeting, but those are for purposes of ending up at that April meeting, really concentrating on, I would imagine, a fairly free-flowing debate going through issue and issue with each other to determine what our recommendations are ultimately going to be.

Is that how you envision it?

CHAIR PARSKY: That's how I envision it, yes.

COMMISSIONER KEELEY: And I will get in trouble if I don't say this with the camera rolling, and that is, I want to thank the students at Pacific Collegiate School for their assistance to me in getting ready for today's meeting. If I didn't say that, they wouldn't let me come back to class.

CHAIR PARSKY: Jennifer, did you have something?

COMMISSIONER ITO: Yes, I also just wanted to request that we add some time at some point, either at the following meeting or at the April meeting now to talk about these budget process issues, these ideas of the multiyear budgeting. That we reserve some time to come to some agreement or consensus, or some kind of recommendations around that as well.

CHAIR PARSKY: I think there are a number of issues on the budgeting side, on the expenditure side, that we may want to make comment about and, therefore, I think it is useful. And I'm more than happy to have any of the commissioners outline for the staff how they would see the recommendations section working.

But I would just separate out issues like the budgeting process expenditure, except for -- including the rainy-day issue. We want to make sure we understand it. But I would focus our attention, really, on the revenue side, because that's the side that we will get the most attention on, that's the side we've asked about. And if we want to suggest to the policymakers anything along the lines of the budgeting, how they do it, all of that, that's perfectly appropriate. But I really think we should stay focused on the side that I know that we have the greatest opportunity to make a difference in.

COMMISSIONER POMP: Mr. Chair, could I request a ten-minute presentation by a member of the bar on an independent tax court?

CHAIR PARSKY: Which member of the bar?

COMMISSIONER POMP: Any member. There are lots of San Francisco lawyers that hold this issue very dear to their hearts. So we'll have no trouble finding someone.

CHAIR PARSKY: We'll try to carve out some time for that.

COMMISSIONER POMP: Okay, ten minutes.

COMMISSIONER MORGAN: Mr. Chairman, just a procedural question.

Are we violating the Brown Act in this Commission if we send e-mails to the entire Commission?

CHAIR PARSKY: Yes.

COMMISSIONER MORGAN: Okay. It should only go to you and staff?

CHAIR PARSKY: We are complying with the Brown Act. And, therefore, any discussion among the Commissioners in writing, other communications, needs to be made available to the public.

However, you are permitted, certainly, to give to the staff your thoughts about what ought to be discussed at the next meeting.

Thank you all very much.

(The meeting concluded at 5:03 p.m.)

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I hereby certify:

That the foregoing proceedings were duly reported by me at the time and place herein specified; and

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