STATE OF CALIFORNIA

COMMISSION ON THE 21st CENTURY ECONOMY

STATE OF CALIFORNIA

REVENUE & TAXATION

FUNDAMENTAL TAX ALTERNATIVES
Part Two

PUBLIC MEETING

Tuesday, June 16, 2009
9:05 a.m. – 4:20 p.m.

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

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A P P E A R A N C E S

COMMISSION ON THE 21ST CENTURY ECONOMY

Commissioners Present

GERRY PARSKY
Commission Chair
Aurora Capital Group

RUBEN BARRALES
President/CEO
San Diego Regional Chamber of Commerce

MICHAEL BOSKIN
Professor
Stanford University

JOHN COGAN
Professor
Stanford University

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

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

GEORGE HALVORSON
Chairman/CEO
Kaiser Foundation

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

JENNIFER ITO
Research, Training, Policy Director
SCOPE

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

A P P E A R A N C E S

COMMISSION ON THE 21ST CENTURY ECONOMY

Commissioners Present
continued

REBECCA MORGAN
President
Morgan Family Foundation

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

CURT PRINGLE
Mayor
City of Anaheim

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COTCE Staff Present

MICHAEL C. GENEST
Commission Executive Director
Director of Finance

MARK IBELE
Commission Staff Director
Board of Equalization

ASHLEY SNEE GIOVANNETTONE

LORI HSU

ANTONIO LOCKETT

JESSICA MAR

MICHELLE QUINN
Staff Writer

PHIL SPILBERG
Chief, Financial Research
Department of Finance

MARGIE RAMIREZ WALKER

A P P E A R A N C E S

COTCE Staff Present
continued

Public Testimony

WILLIAM SPILLANE
California State Director
FairTax.org

JOHN VALENCIA
Life Technologies

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

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Presenter

ROBERT CLINE
National Director
State and Local Tax Policy Economics
Ernst & Young
(Re: Business Net-receipts Tax)

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Table of Contents

Item	Page
Welcome and Introductions	
Chair Parsky	7
Public Comments	
William Spillane California State Director FairTax.org	9
John Valencia Life Technologies	11
Michael Feinstein former Mayor & City Council Member City of Santa Monica	15
Commissioner Comments	18
Presentation on a Business Net-Receipts Tax	
Robert Cline State and Local Tax Policy Economics Quantitative Economics and Statistics Ernst & Young LLP	36
Staff Presentation on Tax Alternatives	
Introduction re Tax Alternative Packages..........	149
Package 1	
Uniform Personal Income Tax Eliminate Corporation Tax Eliminate State Sales Tax Business Net-receipts tax	178

Table of Contents

Item	Page
Staff Presentation on Tax Alternatives *continued*	
Package 2	
Simplified Personal Income Tax Investment Tax Credit Reduce Corporation Tax Rate to 7% Reduce Sales and Use Tax by 1% Business Net-receipts tax	200
Package 3	
Simplified Personal Income Tax Three brackets Eliminate State Sales Tax on business Investment purchases Reduce Corporation Tax Rate to 7% Reduce Sales and Use Tax by 1% Business Net-receipts tax	206
Options	
Option A	
Carbon Tax on Gas, Diesel, and Jet Fuel at 18¢/gallon	215
Option B Capital-Gains Rate Reductions of 1%, 2%, 3%, 4%, and 5%	217
Commission Discussion of Options and Next Steps .	221
Adjournment	280
Reporter’s Certificate	281

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BE IT REMEMBERED that on Tuesday, June 16, 2009, commencing at the hour of 9:05 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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(The following proceedings commenced with Commissioners Morgan, Cogan, and De La Rosa absent from the meeting room.)

CHAIR PARSKY: we're going to try to begin our public hearing. We have a few commissioners that aren't here and will be coming in. But I think if we get started, we will attempt to a move through our agenda as efficiently as possible.

Let me just say, on behalf of the Commission, I want to thank UCLA for hosting us.

We have two public hearings that will remain, this being one and then we have a public hearing in San Francisco in July, as we move towards attempting to come up with some recommendations.

I'll have a few comments to make after our public-comment period. But I want to say that the subjects that we're going to be discussing today are very important. I think we are moving towards asking the commissioners to consider recommendations. There are a number of issues that will come out of this.

We welcome commentary from the public in particular. We'll be discussing a new form of tax that doesn't exist in California, and that's a tax that we will want to make sure we solicit and obtain as much commentary as we can about.

As I said, I'll make a few more comments before we get into our discussion.

The agenda for today will be, after the public-comment period, we'll have a presentation by Bob Cline about this new form of tax, referred to as a *"business receipts tax."* We will then move to a discussion of some options in terms of reform, packages -- we refer to them as packages of various forms of a tax. Some taxes obviously exist in California.

The staff will make a complete presentation about each of the packages, and Commissioners will engage in a dialogue. And we have some alternatives that could apply to any form of change that we'll discuss.

We'll try to come together this afternoon and see if we can't give some clear direction to the staff in terms of refinement and see if we can't move toward a concrete set of recommendations by the end of July.

As I said, I'll come back and make a few more comments before the presentation.

So with that, I want to thank all the commissioners for their hard work. And we'll turn to our public-comment period.

We have three gentlemen that have asked to speak: William Spillane, John Valencia, and Michael Feinstein.

And in that order, if you'd come forward. And if you could -- we'll take all of your comments in writing, of course; but if you could limit your oral presentation to about two minutes, that would be very helpful to us.

The first one, William Spillane.

MR. SPILLANE: Thank you.

I'm William Spillane, the volunteer California State Director of FairTax.org. Most of you have probably heard of it. It's actually an attempt at the federal level to eliminate the income tax and the payroll tax completely, as well as other taxes, and replace it with a national sales tax, inclusive sales tax, calculated the same way an income tax is, on an inclusive basis.

Let me remind you of the famous words of Dr. Milton Friedman: *"Only people pay taxes."*

Well, what does that mean? It means businesses don't pay taxes. So while you rearrange the deck chairs, push the deck chairs off the boat that talk about taxing businesses because those taxes are passed on. They have to be passed on to somebody.

Alan Greenspan, before Congress, said, *"Capital doesn't pay taxes. It's passed on to somebody else."* Of course, nobody asked him a question, they didn't know what he was talking about.

So it's either the customer or the employee or the owner. Those are the only three people as groups it can be passed to. And usually it's the customer, if there's any pricing power. So whatever you come up with, don't tax businesses. Businesses are fleeing California. Let's get them back.

Look at Ireland. They dropped their income tax to 12 percent. And after a millennia of poverty, they suddenly got rich. Investment flowed in. Investment is a source of jobs.

Now, the Fair Tax is structured as a federal program, so it eliminates the payroll tax, as well as the income tax, tax on dividends, capital gains, the alternative minimum tax, and the death tax. So that's a problem with the states.

But the Missouri House of Representatives just passed it. It got tied up in the Senate. In a committee, somebody got rid of it. There are lots of oxen being gored, no doubt about it, by the Fair Tax. But it’s the best thing possible. $22 million in research on this project. It’s not a back-of-the-envelope thing. Please look into it. I’ll leave some material.

But the Fair Tax can be used in California. It will take some adjustments, and it should be used at the national level and ultimately at the state level.

We’re not popular very much in California. That’s my fault. But in other states, our people are standing shoulder-to-shoulder. We have 52 co-sponsors in Congress for the Fair Tax. Only one Democrat, because one of the parties is hostile to it for no good reason, because it supports all levels of income. All levels. It’s good for all of us. It’s good for America.

Thanks very much.

CHAIR PARSKY: Thank you very much.

John Valencia.

MR. VALENCIA: Good morning, Mr. Chairman, Members. John Valencia here representing Life Technologies Corporation, headquartered in Carlsbad, California, and its chairman and CEO, Greg Lucier.

Mr. Keeley, Mr. Pringle, Mr. Houck, good morning.

COMMISSIONER HAUCK: Good morning.

MR. VALENCIA: Very briefly, Mr. Lucier regrets he couldn't be here in person but felt that the Commission's work was significant enough. You have his comments in full, in writing.

Founded in '87, Life Technologies began as Invitrogen Corporation. It is a biotechnology research tools company. Its products are in every nonprofit, every academic lab, such as UCLA, and every commercial biopharmaceutical lab. It helps -- its products promote research. It keeps bench sciences moving forward rather than having to replicate their experiments from ground zero each and every time.

With the acquisition of Applied Bio Systems in Foster City in Northern California, it also has applied technology, such as DNA sequencers that are found, for example, in forensic labs that help determine cold cases through DNA sequencing.

Let me just quote the most significant point that Mr. Lucier wanted me to make this morning. He believes that the number-one priority for the Commission is to address the goals established for you by the Governor in the context of retaining and creating private-sector jobs in the state of California. Few, if any, of the state's common goals for government can be met if the state's not generating new jobs, new economic activity, and the tax revenue they create. And we believe all proposals provided to the Commission should be judged against that priority.

They must also be judged relative to the tax structure and the benefits available to companies in other states and in other countries.

Life Technologies, for example, has fully a third of its employee population here in California, well in excess of 3,000 employees, out of a global employee population of closing in on 10,000.

It's present in seven other states with facilities and it's got a sales presence in at least a hundred countries around the globe, and is under constant petition and solicitation to either expand second-generation into those states or locations or simply relocate and abandon California.

And as Mr. Lucier works to integrate the consolidation of two companies, you can imagine that boards of directors and shareholders ask that same question routinely.

His defense, first and foremost, though not a tax policy, per se, is the incredible, enduring strength of the UC system. So a wonderful coincidence that we are here at UCLA.

But for that system -- and, again, while not a tax issue, per se -- without its advancement and without the synergy that it provides, particularly in life sciences and biotechnology, there would be little distinction between California and many other states, particularly as relates to the incentives and to the policies.

His positive proposals are detailed in the letter. I won't repeat them.

I will conclude with his recommendations, several of which you've discussed over your several hearings to date, on two that the company finds particularly objectionable. Particularly, given where it is physically located in California, Carlsbad in North San Diego County, Foster City on the South San Francisco peninsula, arguably two of the most expensive real property locations anywhere on the global.

He -- Mr. Lucier -- encourages you, in the strongest terms possible, to reject any recommendation for a split roll for property tax. This will create a disincentive for investors to build their own developments in California, forcing investment dollars and jobs to go to more favorable jurisdictions.

And finally, he encourages, based on the service sector that is particularly critical to life sciences, he discourages actively the Commission from recommending an increase in the sales-tax base, expanding to personal services.

With that, Mr. Chairman, Members, thank you very much.

CHAIR PARSKY: Thank you very much.

Michael Feinstein.

MR. FEINSTEIN: Good morning. And I've come back a second time to speak to you again in support of the carbon tax. And I also want to say, you've inspired me for reform. I've joined the California Constitutional Convention Movement, hearing how you were trying to make change. So it's going to keep happening in the state.

In terms of the carbon tax, I just want to add to what I said before, that I think you shouldn't think of it as a tax. I think you should just be thinking of it as a cost of business, just like land and labor. Because, in essence, a carbon tax is simply being conscious of the commons.

And right now, we externalize cost onto the commons. But there's no reason it shouldn't just be seen as a regular part of doing business. So I wouldn't want to put it off as something external that we're imposing upon the system.

Number two, obviously, it's cheap to pollute and expensive to work. And the incentives, for that reason, I would argue are in the wrong place in our system.

But an analogy -- and I would take a different perspective than our previous speaker, who spoke against the split roll -- when Prop. 13 came in, I don't think any of us said, "Okay, going forward in the future, we want to see a disproportionate amount of the burden on homeowners versus business." But it's played out that way because commercial properties don't reassess.

Well, in essence, we have the same problem, by lack of having a carbon tax, we are adding more of a burden in the system by taxing work than we should on economic activity, compared to taxing pollution. And I think there's a parallel there. And the corrective action of putting in a carbon tax would realign that in a healthy way for our economy.

Third, the $20 that you heard in your March presentation is very modest. It is a good starting point, but it is not a great burden on the state. And what I would add is that when you heard your presentation in March, at that point the Obama Administration -- there was no indication that it was not going to go down the same path that the President, when he was a candidate, said he was going to put all the permits out for auction. But right now, as we've seen, they're talking about making 85 percent allocated to business and only 15 percent for auction. That's the mistake the Europeans made. That's why it hasn't worked in Europe. And, therefore, we can't count on the federal government to start us down the right path in terms of showing leadership and helping the environment through a carbon tax, because they're taking the wrong approach in their cap-and-trade approach.

I would also add in terms of leadership, I was in Bali in December of 2007 at the UN Climate Change Conference there. And it's not just a question of us trying to spur leadership inside the United States and having California standards adopted nationally, like we did with the catalytic converter. But the folks from the G-77 countries who were saying, "We're not going to go ahead and make the kind of commitments on climate change because the western and northern countries who have created the bulk of the problem on the planet not only aren't reducing their percentage by themselves but, in effect, a lot of the other countries felt that not only do we have to reduce our own emissions by X-percent, but because we're responsible for so much that happened before, we need to go beyond that because already the global carbon sink has been filled by our emissions."

So when we get to the climate-change negotiations in Copenhagen in December of this year, we really have to show that this country is taking very affirmative steps.

And a carbon tax, in starting in California, I think wouldn't help just spur innovation in the United States and change in the long run, but it would be a global signal that would give a lot more confidence to other economies that need to embrace more internalization of costs to actually do so.

Thank you.

CHAIR PARSKY: Thank you very much.

(Commissioner De La Rosa entered the meeting room.)

CHAIR PARSKY: That concludes the members of the public that have asked to speak at this hearing.

At our next hearing, we'll also welcome commentary from the public as well.

Before we turn to the presentation of the business-receipts tax, I just want to make a couple of comments, and then certainly any commissioner can make comments that he or she wishes.

(Commissioners Cogan and Morgan entered the meeting room.)

CHAIR PARSKY: I think there have been a number of discussions in the public of the need for reform. Reform is a concept that I think a lot of people are talking about now with respect to California and the structure of California, how we go about governing; in some people's minds, lack of governing.

This Commission -- are you waving?

THE VIDEOGRAPHER: I lost audio.

CHAIR PARSKY: Well, that's okay. Some people do not mind.

COMMISSIONER COGAN: Now, you can say what you really think.

CHAIR PARSKY: In any event, I think it's important to have the public and the commissioners stay focused on what the Commission was asked to do. There are other organizations, one of which -- California Forward -- I've had a chance to meet with several leaders in, and we have two representatives on the Commission that are also members of California Forward. They have very important work underway in the areas of reform, under the heading of reform, that I know that they will come forward with.

Our commission was asked to focus on the tax system of California. But we certainly have the opportunity, in connection with our report, to make reference to other important reform efforts that are underway. And I think we all should consider that as we are finalizing our report.

If you focus on our task, one of the gentlemen mentioned the goals. And I have commented on those goals at each of our hearings. I want to comment on them again. And then as we go into a discussion today of specific reform efforts with respect to the tax system, I think we'll ask the staff and we'll ask Bob to see each of the proposals for reform through the prism of these goals, to see how we are addressing the goals.

One of the goals was to help reform the tax structure to reflect the state's 21st century economy. And the economy in the state of California has changed rather dramatically over the course of the last few years, and I think we need to take that into account as we development reform proposals.

Second, was to help reduce the volatility that is created under the existing tax structure, and particularly its dependence on the personal income tax, and an element of the personal income tax, namely, the capital-gains tax.

When we paused and asked that our report not be due in April but rather be due at the end of July, in part, that was due to the ballot initiatives that were for the voters to act on, that voters clearly did act in a very strong way, rejecting each of those initiatives. But it was clear from the initiatives that were put forward, that had they been enacted, they would have, in some way, addressed the issue of volatility.

We, I think, had a discussion about how much of an impact it would have. And I think there were a number of points of view that would have said the expenditure side and a rainy-day fund would not necessarily have solved all of the volatility questions, leaving still the need for this commission, as we look at our reform proposals, to see volatility as one of the our goals to try to address.

Without the ballot initiatives, it becomes even more important because we don’t have those reforms before us. And it was important for this to see whether those initiatives could have passed.

Third, the tax reform proposal should be aimed at long-term economic prosperity for the state. So economic prosperity, economic growth, job creation are clear objectives that we should test against any of the proposals that we consider.

Fourth, we should see, to the extent we can, how changes would improve the ability of California to compete with other states for jobs -- job creation or jobs and investments.

Next, whatever the reform proposals are should reflect principles of sound tax policy, including elements of simplicity, efficiency, predictability, ease of compliance and administration. We should test them, how would they impact any of those tax policies.

And finally, we should ensure that the tax structure is fair and is equitable. And we need to have an open discussion about changes that we're suggesting in the context of distributing the tax burden among our citizens, how it impacts issues of progressivity, regressivity. And all of these proposals that you will hear today will be tested, if you will, against that.

I would only urge that the commissioners, as you look at changes, I think -- I think, unless we decide that our report should reflect the fact that the Commission didn't need to be established -- and some may think that -- but the existing system doesn't address all of those goals adequately. So whatever we do, it will involve a change in the existing system. And that change, on each of those goals, may result in moving some things around with respect to those goals. And I think it's important that we bear that in mind.

I mean, any member of the Commission can certainly raise their hand and say, "We don't like any of these reform proposals. We should just leave the system alone." I haven't heard that, but that's certainly an option. But my point is that we can measure each of those goals against the existing system, and we should; but we have to recognize that there will be changes when you come forward with reform.

So with that in mind, as I said, we're going to try to divide our presentation and discussion today into two parts.

The first part will be a discussion of a new form of tax that was raised by a number of people presenting and a number of the commissioners. And we've engaged Ernst & Young, and Bob Cline in particular, to develop an analysis of a new form of tax for California.

And then after that, we will go through some proposals, packages that are options, that we tried to pull together based on input that we got from the commissioners in terms of how they would like to look at reform. And we'll try to see how we can get through.

With that, do any commissioners wish to make any other comments before we start?

COMMISSIONER BOSKIN: Richard's light is on.

CHAIR PARSKY: Richard?

COMMISSIONER POMP: Well, as long as the light's on.

CHAIR PARSKY: Richard, the light can be on or off. It doesn't matter.

COMMISSIONER POMP: I must say, apropos of your losing audio, I was giving a talk and my mike went off, and someone in the back stood up and said, "We can't hear you.” And someone in the front said, “Well, we can; and you’re not missing anything.” So…

CHAIR PARSKY: Is that a commentary?

COMMISSIONER POMP: Not on our speaker in this case.

Gerry, I just want to make sure, in terms of bookkeeping, when do you plan to circulate a draft? You have a number of wordsmiths on this commission. And I suspect there’s going to be a rather elaborate vetting process. And I just want to make sure that there is time for that. And if there are more, let’s say, noncontroversial elements of the report -- background, information, whatnot -- maybe we could get that circulated sooner rather than later. And, God forbid, the possibility of a dissenting report, so…

CHAIR PARSKY: We don’t talk about that.

We will start that circulation shortly.

What I hope everyone will focus on today, is to see whether or not we can come away from this meeting with some direction to the staff on a specific proposal or proposals that people want more work done on between now and our last meeting.

The analysis that you will hear, you may not find adequate. You may want to have more work done. And we’ll try to see how we should staff that incremental work.

With respect to other elements of the report, we will start circulating around that very shortly.

Michael?

COMMISSIONER BOSKIN: I think your points and Richard's points are very well taken, and if I could maybe elect to try to assist right now in fleshing out kind of the process and the structure.

CHAIR PARSKY: Okay.

COMMISSIONER BOSKIN: Obviously, we're going to see if we can come up with a reform package that may leave some elements of the current system in place. It may change others, it may junk the whole thing for something, whatever it is -- and hopefully we can, but in any event.

Then, there have been a whole bunch of more specific proposals which might be superseded if we came up with a package or not.

Then there are a whole bunch of, as you put it, ideas that are related to the tax system, but may be more on the budgeting side and on other aspects of our fiscal and the large system, including regulation and spending and intertemporal movements of funds, et cetera.

And it seems to me that it would be a good idea to leave here with a process for not just vetting those, but for structuring those. So if someone could envision, for example, either -- since it's not in our direct purview, it would be somewhat presumptuous of us as a commission, I think, to say, "Do this on the spending side." But we could say, in addition to these things, we recognize the close interaction of taxes and spending for many reasons. The reason we have taxes is so we can have revenue to spend on various government functions, and we need to have an effective government.

The reason -- so they're closely related; but we should either have -- there may be a few that everybody on the Commission would agree to, and we could maybe separate it into things where there was unanimity or overwhelming consensus, and those where at least a few commissioners thought that ought to be looked into. And that would give an opportunity for some ideas which we haven't had time to flesh out, but that several members thought without all the others feeling since they hadn't thought about it or don't agree with it, that they have to keep it out of the report. So we could have two separate categories of that sort, it seems to me.

The one area that falls between, which I think ought to be included within the body of the report and our main recommendation, are the administrative and regulatory things with respect to the tax system. We heard some very compelling evidence, and I'm sure virtually everyone in this room has had some experience just by the mathematical laws of probability, of having some screwy thing go on with the administration of the state tax system. And we had all this compelling discussion.

And maybe I'll defer to Richard and Chris and the lawyers, et cetera -- but that we have an adjudication mechanism where one of the two sides is the judge. And that just seems that's kind of prima facie outrageous in a democracy. And I think there was kind of strong consensus that setting up an independent adjudication mechanism of some sort -- and if we could get a small list of those things, we could include those. But they're really specific to the tax system as opposed to the larger fiscal system, and spending and deficits and borrowing and lending and so on.

CHAIR PARSKY: Any other comments?

I would just say that -- I'm sorry, go ahead, Chris.

COMMISSIONER EDLEY: Thank you, both -- all three of you for those comments.

The only thing I want to add is that I don't feel as though we've directly engaged the 21st-century dimension of our charge as yet. And that gives me a little bit of concern. And I hope we'll have an opportunity to discuss what that might entail. Because apart from the carbon-tax ideas, while I recognize that there's nothing new under the sun, I think we ought to give it a little bit more cogitation.

CHAIR PARSKY: Michael?

COMMISSIONER BOSKIN: As perhaps the person here with the most cognizance of long-running economic history, I think that's a good point, but we're nine years into the century. If we went back a century, we would have an economy with the same standard of living as Argentina, life expectancy of 43. If we went back 20 years, probably a quarter of the products we use in our daily life didn't exist.

So my interpretation –- everybody is free to do this the way they want -- maybe we should have a more thorough discussion of it -- is that at least now, and in the next few years, we know some things have changed relative to when the tax system was set up. Services have grown relative to goods, for example. But trying to exactly get the idea of what the economy will look like, we wouldn't even get agreement around the table, I'm sure what we'd like it to look like 50 years from now.

So I think, at a minimum, we can take account of things that have changed up to now, relative to some decades ago, when many features of the tax system were put in. That's how I've interpreted the spirit of the

21st century, rather than trying to guess or have us engineer -- try to engineer what the economy will look like. I think that's very problematic, in my opinion. I think that none of us would be prescient enough to tell us what the economy will look like in 20 or 30 years, let alone in 90 years from now.

CHAIR PARSKY: I do think your point is well taken in terms of -- I think we can and should be in a position to summarize where the economy has come as opposed to predicting where it will go in terms of shifts. And that, it seems to me, we ought to be in a position to be able to recite, in some form, in the report.

Now, we may not have had an adequate enough discussion of that, and we should make sure we do. But I didn't interpret, Chris, what you were saying as trying to predict where the economy will go.

COMMISSIONER EDLEY: Well, I'm not sure what I meant.

But Michael's -- look, I agree, obviously, that thinking about what the economy might look like in the future is, if not a fool's errand, let's just say that there's increasing amounts of uncertainty to it as one looks out.

On the other hand, I would think that there are some important trends about which we could be reasonably confident, or at least confident enough for those to be the predicate for policy judgments.

For example, what's happening with sales, with services, the service sector. Are there trends that we should expect with respect to the share of household income derived from salaries and wages versus other sources of income.

Are there competitive strategies being adopted by other jurisdictions increasingly, which we ought to try to anticipate and counter?

So I'd just like us to keep it in mind because, frankly, looking at the -- if one looks at the set of prescriptions that emerge from this commission, and there is nothing that's forward-looking, then I think reasonable observers might conclude that we really weren't trying to prepare the state for the generation ahead and we're being purely reactive.

CHAIR PARSKY: Becky?

COMMISSIONER MORGAN: I think that I would agree with Chris that we have not had much discussion on what today and 20 years from now is likely to look like.

I do have a report from the Bureau of Economic Analysis that shows California in the second lowest quartile of growth. And of 21 factors that are growing, only four of them are two-digit growth, i.e., 20 percent or 40 percent. And if we're looking at taxing what's growing -- not taxing towards growing so it will keep growing, those kinds of statistics that are put out by the Bureau of Economic Analysis might be worth looking at. But I certainly would like California, as I look at this map of the states all around us that are in the highest quartile of growth -- economic growth -- I'd like to get there for California. And our current policies don't get us there. So that's what I'm looking at: Can we develop policies that will bring us higher in the country, in our economic standing.

CHAIR PARSKY: George?

COMMISSIONER HALVORSON: My sense, from observing what's been happening lately and a little bit of what we've learned in this commission, is that the state goes from budget crisis to budget crisis. We're constantly dealing with crisis decision-making. We're making short-term decisions all the time in the context of a long-term world. And as a result of that, we've got setbacks in multiple areas relative to our schools or infrastructure, basically, the overall operations of California. And we really need -- and this was kind of 21st century -- we really need a vision for where we're going. We need to have a sense of where are we going with the state, what are the revenue needs going to be in the future, what are the expense needs, what are we going to do with the school system, what are we going to do with our colleges, what we going to do with our streets and roads, what’s that going to cost us? And then we need to work backward, I think, from that vision, and think of it as a multiyear vision, and create a revenue flow that supports and sustains that. And that needs to be a combination, I think, of some kinds of reserving for the good times to get us through the bad times; but also some flexibility relative to revenue, so that when we get to a crisis point, we don’t go back in and impair the infrastructure or impair the vision, but we can actually get through the time period. Some combination of borrowing, some combination of tax increases -- there has to be some revenue flexibility. Because if we don’t create a smoothing, then we are going to perpetually be damaging our ability to achieve the vision.

And if we start with a vision and have a really clear sense of what we want California to be, and then work backward from that to figure out the plan, and then work backward from the plan to figure out the funding, I think we’ll be doing the state a major service.

When we get into our funding decisions, if we make them in that context, I think we’ll be better served.

CHAIR PARSKY: That’s certainly an appropriate comment.

I just would urge the Commissioners to keep in mind that our task is not to determine the size of government and the magnitude of services that the government of California should provide. That's really up to the elected officials. And when we get into a discussion of revenue-neutrality, I think this will come out more clearly.

That, ultimately, whatever we recommend, I do think that the Legislature is committed to act on. But the amount of revenues to be created and the amount of expenditures to be made is a decision for them to make.

We can certainly make reference to the need for reforms and how the process goes; but the Commission was certainly not created in order to do the job of the elected officials.

COMMISSIONER HALVORSON: We don't need to pick the amount of money that's spent, but we should have a vision for California and know what that vision is going to cost us. And that ought to be the Legislature, and then we as a Commission can help figure out how to have a revenue source that gets there.

So I don't think we should set the -- I'm not suggesting that we set the revenue level, but I'm saying that this crisis-to-crisis mode doesn't make any sense, and we need a smoothing process that will be far superior.

CHAIR PARSKY: I think you'll see in some of the analysis that's done, that any one of the packages would address that issue in a much better way than the existing system, which is part of the measure.

COMMISSIONER POMP: Three points. Three good points.

First, I'd like to just reinforce the good doctor's observations on improving the administration, the tax system. We had very thoughtful inputs from the American Bar Association. We had a presentation orally that was very insightful. This helps enhance the business climate in some intangible way.

Second, no matter what the level of government is, we have all the great questions that you started today's meeting with. So these are really independent of whatever level the Legislature ultimately chooses.

The third point, I'll tell you what's a little missing, and it picks up on the dean's point, and there's still time, it would be useful to hear from the SBE and the FTB on what changes in the economy, of a technological nature, have meant for the challenges of applying the existing statute. You know, concept of delivery, a very critical concept. It is a completely new challenge to determine what "delivery" means in an era where I can send you an e-mail attachment, and you could download it on a plane. I no longer know where it is being delivered.

You know, it sounds like such a pedestrian example, but it's a very important example, and it's sort of emblematic of the changes in the economy and the challenges they pose for traditional statutes.

And it might be useful to get something in writing from both sales tax and corporate income tax, probably less so personal income tax, but I don't know -- just seeing what the Internet and the whole technological revolution has meant in terms of the existing statutes. And it may bolster some of the proposals and move to a different method of taxation.

CHAIR PARSKY: I think those are good suggestions.

Okay, let's now move to the next item on our agenda, which is a presentation, and then a discussion of a business receipts tax.

Let me just say that our commission engaged Bob Cline and Ernst & Young to help us with an analysis of this new form of tax.

And I'll let Bob introduce his long title that is on that card. But I've had an opportunity to spend some time with Bob, along with our staff. And I think he comes with a very strong reputation in this area.

I would just urge the commissioners to let him go through his analysis, then we'll come back and engage fully in a discussion, question-and-answer session.

Bob, if you'll introduce your long title, that would be helpful.

MR. CLINE: All right. Mr. Chairman, Members of the Commission, thank you for giving me an opportunity to talk with you today about some of the preliminary results of analysis we've done, looking at the concept called a "*net-receipts tax*."

I am in the national tax practice at Ernst & Young. I'm National Director of State and Local Tax Policy Economics. And what I am is an economist. That's how I view the world and the type of words that I use. I'm not an accountant, and I'm not a tax lawyer. So I'm probably --

CHAIR PARSKY: To some, that's welcome relief. To others…

MR. CLINE: No comment. Yes. Not being judgmental, but I am an economist that has spent most of my professional career on state and local tax policy issues. And I've testified in a number of different states, to tax commissions, to legislative committee meetings. And whenever the topic comes around to tax reform, I'm often asked in my presentation, the first question often is, “Tell us what the lighthouse state is. Tell us which state has the right system. Tell us where we ought to look for the state of the art.” And, of course, I have to start out with saying, there is no such thing. Every state is absolutely unique in terms of its economy, its traditions, its current tax system, and its future direction.

You can learn from the experience of others, but it is a California discussion. And, unfortunately, there isn’t that best practice that you can pick up on.

So let me talk a little bit –- and, Mr. Chairman, with your direction, I’ll try to keep my remarks focused and talk about what you think is important. And I know you won’t let me ramble on in different directions. So I’d like to focus on what is of interest to you folks.

Just very quickly, in terms of what I’d like to do, although you can’t adopt another state’s tax system, there are lessons to be learned, especially over the last three or four years. California is not alone at creating tax-study commissions and looking at alternative ways of taxing households, as well as business. So maybe there are some insights, some lessons to be learned.

I want to talk just briefly about what are some of these new taxes bases that other states are considering and of which several states have actually adopted.

I'll talk about my interpretation of the concept of a net-receipts tax. In working with the staff and the chairman, we've talked about the concept of a net-receipts tax. But I want to make sure you understand what we're estimating as we look at our analysis. And then talk about the preliminary estimates of the dollar amounts that might be raised from the tax base, as well as just initial discussion of who may bear the burden of the tax when the dust finally settles and if a new tax is implemented.

So that's the agenda.

This isn't really a disclaimer, but just to reiterate what the chairman said, is that we were asked to look at -- to analyze the revenue impact of the incidence, the economic incidence of a new concept, the net-receipts tax for California. And I just want to reiterate that Ernst & Young and I will have no positions, no recommendations on the policy side. We will try to provide you with the insights and information that may help you make some decisions about the direction you want to move in.

Let me very quickly tell you what I have heard in other states about the objectives that states are pursuing -- legislators, commissions, governors, and others.

What are they trying to accomplish with their business tax reform? And I think, Mr. Chairman, it's going to reiterate some of those objectives that you've already outlined.

I put at the top, "States are trying to improve their business tax competitiveness." And they're talking about the system of business taxation, everything from the property tax, to sales tax on business inputs, to the corporate income tax, and beyond. They're talking about a system of taxation; and states are concerned about how competitive their current systems are compared to other states. So that's a key issue.

They're making changes that reduce the taxes on mobile capital. And other than buildings set in concrete that might last for decades and decades, most of the capital that business invests today is mobile. It may take four or five years to move from one location to another if the economic conditions change or public-policy conditions change, but most capital invested by business today is mobile.

So states are looking at how to reduce taxes on mobile capital, including property-tax reductions. And I'll talk a little bit about Ohio, Texas, and Michigan. And all three of those reform efforts had a substantial property-tax component.

And I know that that may not be the California situation, but I just wanted to point out that that is part of what states are up to.

They're looking for ways to shift the tax burden out of state. That's always -- it's a time-honored approach to state business taxation, in particular. They're looking for ways in order to extend the tax reach beyond the borders of the state. That would include, for example, trying to figure out a way to impose a tax that doesn't come under the restrictions of Public Law 86-272, which restricts the application of a net income tax on business.

They're also trying to figure out how to collect the sales tax from out-of-state sellers that sell into the state. And that's the question of the *Quill* case, in protecting out-of-state sellers from being a taxpayer in a state. These issues are important. They're cross-border issues of how to expand the scope or the extent of taxation.

Point Number 2, though -- clearly, Mr. Chairman, you emphasized this one earlier -- they're looking for a more stable source of revenue. Just a reminder of where we've been. The corporate income tax fell 24 percent in the last recession, 2001 -- 2000, 2001 -- it fell 24 percent. In the last five years, state corporate income taxes have gone up -- have more than doubled. They've increased 115 percent. And so far, this recession, they're down 20 percent, just a reminder of how volatile the corporate income-tax base is.

States are trying to find a way to tax all forms of doing business, not just C-corporations. S-corporations, pass-through entities -- all forms of doing business.

The argument is broader base, lower rates, less economic distortions. And those are usually considered to be pluses for a state and local tax system.

They are, as I mentioned, trying to find effective ways to tax those cross-border sales under the sales tax or consumption taxes in the light of the *Quill* restrictions on states' abilities to tax out-of-state sellers.

And finally, states are changing their perspective on how to think about business taxation. I think -- I would say the tradition has been more in the line of, thinking about businesses in terms of profitability and, therefore, having an ability to pay taxes out of their current flow of income.

The subtle shift, or not-so-subtle shift, is a perspective that says that more weight is being given to the benefits perspective. Whether a business is profitable or not, it's using state and local government services, and should pay a fair contribution to cover the cost of those services.

And so to understand that distinction, property tax, more of a benefits tax, doesn't depend upon your level of profitability directly. Corporate income tax certainly, definitely linked to your ability to pay or your net income.

All right, now, here's a table I have been using in my presentations that is more information than we want to talk about right now. But I've put this together in trying to describe what states are up to and what are these different business taxes floating around out there. So this is my taxonomy of new state business taxes. And they're ranked from the top to the bottom in terms of the total size of the tax base, roughly.

So at the top, you have general gross-receipts taxes, like the new Ohio commercial activities tax, called the *"CAT."*

The traditional, the old guard, Washington state business and occupation tax, the B & O tax. The base is basically gross receipts of a business, whether those receipts come from selling to final consumers, to households, to other businesses in terms of selling them inputs, gross-receipts taxes. You have a sale, it's in the base and subject to taxation. Very broad base.

Texas, under their new margin tax, has one option you could choose, which says that your base is 70 percent of gross receipts. So it's floating around in the new system in Texas.

There's a modified gross-receipts tax. That's a tax base that's now has appeared in Michigan. Michigan replaced its old single-business tax with a new Michigan business tax. Two components: One is a gross-receipts tax with modifications, and the other is a business-income tax.

Their modified gross-receipts tax is gross receipts minus your purchases of tangible personal properties from other companies, to try to get rid of the pyramiding and the multiple taxation that occurs if you tax all those transactions under a gross-receipts tax. So they've subtracted out purchases of tangible personal property. The base gets more narrow as they make the subtractions.

Value-added tax comes next. Now, the value-added tax, which really has been around for quite a while -- when I was kind of reviewing my notes, it turns out that Michigan actually had something what they called the *"business-activity tax"* they adopted in 1953, which was a modified value-added tax. It happened one year prior to France adopting the credit invoice value-added tax. Michigan actually had a value-added tax before Europe did, by one year as it turns out.

Their single business tax was the latest version of that that was adopted in 1975, and died a not-too-quiet death in -- where are we -- 2007.

But for about 50 years, Michigan experimented with different versions of a value-added tax.

New Hampshire does have a value-added tax. It's called the *"business-enterprise tax,"* which works in combination with their corporate tax, or their business income tax.

What's the base here? Gross receipts minus the purchase of tangible personal property from other companies, minus services purchased from other companies.

So once you move to the value-added tax, you're subtracting all purchases from other companies. And that is sort of truly getting at eliminating this pyramiding that occurs under a gross-receipts tax, or the old European turnover tax. The same type of problem.

And so you kind of see, as you make these subtractions, you're moving down the list. Then you have a gross-margin tax, another version of Texas. Gross receipts minus cost of goods sold, which includes purchases of tangible personal property, but it includes a lot of other things. But that's one version of three bases in Texas.

Texas also has the third version, which is the labor-adjusted tax base, gross receipts minus labor costs.

Now, you choose one of these three bases. You don't get multiples in Texas, but you choose the one that gives you the lowest liability.

And then as we get to the bottom of the table, you've got the business income tax, the income tax applied to all forms of doing business, basically. And finally, you've got the corporate income tax, net income tax only applied to the corporate sector.

And the world consists of this combination, this bundle. The U.S. states are using some -- this combination of different ways to think about a business-entity tax designed to raise substantial amounts of revenue. There are other smaller taxes, net-worth taxes and others, but these are the major business taxes.

Now, I think in terms of thinking ahead and the experience from other states, I think the real issue is what's going to happen to these gross-receipts taxes in Ohio, Texas' version, Michigan's version. What's going to happen over time? I think the business community will press for more and more subtractions from the base. And if they do, these taxes that are gross-receipts taxes today might look more like a modified value-added tax in the not-too-distant future. But that's a little bit of speculation on my part.

The size, these taxes matter. They differ in size, they differ potentially in economic impact, competitiveness, stability, what have you.

Just some back-of-the-envelope numbers for you, really. We said, what if you wanted to raise $50 billion nationwide from one of these alternative bases? What kind of rate would you need? So it's not a California example, it's no specific state example.

Corporate income tax, about 5.8 percent, averaged over all the activity in the U.S.

A business income tax including not only C-corps but all other forms of business, 3.3 percent is the rate that would raise $50 billion.

The value-added tax, pretty close to 1 percent.

And a gross-receipts tax, .3 percent. And that just shows you why the gross-receipts tax is a very, very powerful base. It includes all those final sales, but also all those intermediate sales of one business to another. And that's why you can use a .3 percent rate to collect $50 billion nationwide.

So it gives you some idea of the size of these bases.

So they're different taxes, they clearly have different sizes, and raise different amounts of revenue.

Now, Mr. Chairman, if you would kind of give me guidance here. I'll just mention a few things about the recent experience. And we may come back to these in questions and answers. But Ohio, really back in 2005, Ohio was still reeling from the 2000, 2001 recession. They had lost 200,000 jobs in the state of Ohio. And they wanted to change. They felt that whatever they did, whether on the spending side, the revenue side -- they needed to do something to strengthen their economy and to grow the jobs. So they threw out the corporate income tax, the property tax on tangible personal property, got rid of the net-worth tax, and made a number of other substantial changes.

It resulted in the adoption of a new tax -- this was the gross-receipts tax. The rate was .26 percent -- it still is. Up to $1 million of your gross receipts, you pay $150. Beyond a million dollars, you pay 2.26 percent times the excess revenue. And so, in effect, you don't file a return unless you have $150,000 of receipts and you don't start paying at this .26 percent rate until you have a million dollars of receipts.

Just an example we'll come back to, is that it's important to figure out what size of kind of minimum filing threshold or exemption these new systems should have, because there's an awful lot of small businesses out there that you probably don't want to be in a new tax system. So the minimum threshold kind of takes those businesses out.

Ohio applies to all forms of doing business and most industries. There are a few exceptions. But it's a very broad tax in terms of the types of businesses and industries.

They adopted economic nexus. This was important to them. They said that if you're selling into the state, even if you don't have payroll and property or a physical presence in the state, you're going to be a taxpayer. It's the economic-nexus provision. Now, that was important because they thought that they had to protect the in-state companies from competition that wouldn't have to pay the CAT tax.

As I mentioned, they eliminated a number of taxes. And they actually cut overall businesses taxes by about $1.4 billion as part of their reform package. The jury is out as to whether or not those cuts will stick in this fiscal environment. But so far, the package has been unchanged.

The state and the Legislature maintains that Public Law 86-272 doesn't apply to this new tax. It's not an income tax. And, therefore, you're not protected in any way in terms of selling into the state of Ohio.

They phased in over five years -- which I think is a point worth noting -- new systems, replacing old traditional systems, there are risks, there are risks in understanding if you got it right the first time, risks in revenue forecasting. Ohio decided to phase the old one out and the new one in over a five-year period.

The revenue, in the first few years, have actually come in stronger than predicted or forecasted at the time the tax was adopted.

Very briefly on Texas. I've already set Texas up, and they threw out the old income/net-worth tax on business, adopted the margin tax. Three different bases. You choose the one that gives you the minimum liability. It certainly adds complexity to the new system. But what they were trying to do is to keep the distribution of tax liabilities across industries and across tax size, taxpayer size categories to a minimum. So they put in a lot of bells and whistles to make the new system match up closer to the old system in terms of liabilities. And that's not easy when it's a different base from the old system. So you end up with this kind of new package.

Unlike Ohio, they increased taxes on business substantially in their package, and they redistributed a lot of taxes from one industry to another and from one type of business to another.

They used the destination sales apportionment formula. 100 percent sales coming in to the state determines the amount of your margin U.S.-wide that goes into Texas. They said Public Law 86-272 is not applicable, and they require mandatory combined reporting, something California has had for years, so that's not anything new for you.

They didn't phase in the new tax. It came in full-blown. Unfortunately, the first year, revenue came in 20 percent below the forecast.

I know you've asked some questions about how reliable our initial estimates are of some of these new bases. Texas -- I think Ohio got it right, Texas did not. They're down about $2 billion in expected tax collections.

And already -- I mentioned earlier that you have to pay attention to these minimum fees -- or the minimum threshold, not fees -- but minimum threshold before a taxpayer files a return. Texas started out with a $300,000 minimum threshold. This year, the Legislature just passed a bill that will increase it permanently to $600,000, and temporarily to $1 million. And the argument is, they don't want those low-profit, small businesses in this recession being hit with substantial new taxes under the margin tax. So they're already changing that minimum, thinking that they didn't get it right the first time, the minimum threshold.

Michigan. As I mentioned, Michigan's been experimenting for 50 or 60 years, trying to figure out how they should tax business. In 1953, they actually had a business-activities tax, which is a subtraction method that you take gross receipts minus purchases from other companies with limitations, and that's the tax base.

They abandoned it in 1967. And just as kind of a footnote to history, the governor who pushed for eliminating the business-activities tax was George Romney. And George Romney, as you may remember, was president of American Motors. And American Motors back in those days lost money year after year after year. And George Romney argued strongly that the business-activities tax, based upon modified value-added, was taxing his company when it wasn't making any money. And he was a strong proponent of making the change.

And then in 1975, the business community and the Legislature brought back the value-added tax after a run of two recessions and sharp fiscal problems that brought back the value-added tax as a single business tax; and it lasted until, as I said, 2007, when it was replaced with this new business income tax plus a modified gross-receipts tax.

Unfortunately, they've already hit business with a 22 percent temporary tax increase on top of these original rates that were in effect for one year because of the fiscal crisis in Michigan. Again, nothing to be learned there perhaps because of the uniqueness of Michigan. But they're changing; they continually tinker with their system of business taxations.

The gross-receipts tax in Michigan raises about two-thirds of the total revenue, the modified gross-receipts tax. It applies to most businesses. Destination tax, economic nexus, kind of 100 percent sales factor apportionment coming in to the state.

They did allow a subtraction for the purchase of tangible personal property to sort of get at that pyramiding, to reduce pyramiding, business-to-business sales being taxed. But they weren't willing to go back to a pure version of value-added taxation by also allowing a subtraction for services purchased from other companies. So they're in the twilight zone again, between one system and another.

A lot of targeting credits were still in the new system. Significant property tax reductions. And what was clear from the figures is that the new system in Michigan, as has been the case in Texas and Ohio, the new systems will shift the tax liability from businesses in the manufacturing capital-intensive sector to businesses that are more labor intensive and more likely to be in the service sector. There are reasons for that shift, some intended and some unintended. But that's a general conclusion from the other state experiences.

COMMISSIONER BARRALES: Services –- are we holding up questions?

CHAIR PARSKY: Hold on.

Bob, go ahead.

MR. CLINE: I'll make a note on services.

CHAIR PARSKY: There will be several.

MR. CLINE: Okay. New Hampshire, briefly since New Hampshire is the state that continues to have a modified -- a value-added tax, just briefly, they kept it in parallel with their current corporate business income tax. It actually applies to more forms of doing business than just C-corporations. It includes pass-through entities, although their tax liabilities are very small in New Hampshire.

You pay the business-enterprise tax at .75 percent of this modified value-added, and you pay a corporate income tax, a business income tax of 8.5 percent; but you get to take the business-enterprise tax, the modified value-added tax, as a credit against the business-profits tax. And so the way I think about it is that you calculate your tax under the two different approaches and pay the larger of the two.

So you have a lot of firms that will probably always be in the business-enterprise tax based upon value-added. Other firms may always stay in the business-income tax camp. But they are interacting, the two systems.

They adopted it because they wanted stability, neutral taxation that doesn't tax capital more heavily than labor. They wanted a more neutral economic impact. They wanted to broaden the base, to make sure they got more revenue from all forms of doing business and all industries. And they were also intentionally going for increasing the number of taxpayers that were taxable in the state. For example, those that used to be protected by Public Law 86-272.

All right, so there is experience out there with taxes --

COMMISSIONER BOSKIN: Could you just briefly summarize that public law?

MR. CLINE: As an economist, I will try.

Public Law 86-272 was passed -- and Mr. Pomp can help me out here -- was passed because states were attempting to tax businesses that had only peripheral, only minor contacts with the state, perhaps just sending in salespeople to take orders and then ship the orders out of state to be filled and to have products shipped into the state.

And because the states were being fairly aggressive, the business community and others went to Congress and said, “That’s overreaching by the states, they’re taxing interstate commerce that is beyond their reach,” and Congress passed Public Law 86-272. As I understand it, it was a temporary law change that said that the state cannot impose the corporate income tax on a business whose only presence in the state is this sort of solicitation of sales to be serviced outside the state and for goods to be shipped into the state by common carrier.

So it really did prevent a number of businesses from being taxpayers under the corporate income tax.

It’s still there, but --

COMMISSIONER POMP: It’s a throwback.

MR. CLINE: That would -- yes.

A number of other issues dealing with these interstate issues. The cross-border issues, we’ll come back to in just a few minutes.

What is the net-receipts tax? Again, as I understand it, after talking to the staff and the chairman, this is how I would describe the tax that we're looking at. The tax base can be thought of two ways:

Number 1, and I think the simplest way to describe it, the tax base is total revenues of a company minus all of its purchases from other companies, whether it's tangible personal products -- tangible products, services -- all your purchases would be subtracted from your gross receipts to get the tax base. Of course, that is, as I've already mentioned, a value-added tax. That's, I think, the right way to think of it from an economic perspective.

But there's a different way to look at it. You should get exactly the same base, in theory, if not in reality in practice, you should get exactly the same base if you say, "Where did the difference between total revenue and total purchases go?" Well, that's cash the business had. What did they do with the cash? They paid it in wages and salaries and compensation, including fringe benefits. They paid it in interest to bondholders or for loans. They paid it in terms of distributed earnings to investors, capital investors, and they kept some of it as retained earnings.

And so the value-added tax could also be thought of as the sum of all the payments that a company makes for the factors that it uses, capital plus labor.

Sometimes it helps to think of it as total revenue minus purchases from other firms. Other cases, it helps to think of it as the sum of all the payments to the factors that a company uses in manufacturing or producing goods and services.

And I'll probably bounce back and forth in answering some of your questions, because they really should be equivalent if you structure them correctly.

But a key feature of what we think the net-receipts tax is that the Commission asked us to look at, the net-receipts tax would allow immediate expensing of capital equipment. So when I mentioned that the base could be total revenue minus total purchases from other companies, that includes buying a building or buying a new machine or constructing a building. The purchase of capital equipment is also immediately deductible against your gross receipts.

Now, for those in the know, that's immediate expensing of capital spending. It can't get much more generous than that in terms of reducing the taxes on the flow of income from capital.

COMMISSIONER BOSKIN: Well, we have had investment tax credits, for example.

MR. CLINE: That is correct. And you could always drive the taxes to negative taxes, so that you actually subsidize the purchase of capital. But one of the real arguments in favor of --

COMMISSIONER BOSKIN: Which we did in 1981.

MR. CLINE: That’s correct.

One of the real arguments in favor of this kind of tax on value-added is that if you allow the full expensing of equipment, it’s called a consumption value-added tax. And it probably does -- it has a strong incentive to increase capital investment relative to the corporate income tax, which falls primarily on the return to capital. And so it will change the relative attractiveness of people versus machines, machinery and equipment; and it will, in a sense, have a neutral treatment of those two big buckets of inputs.

You’ll pay the same additional tax whether you hire another person, pay them $100,000, or buy a machine that costs $100,000.

What happens in the future, you’ve got to deduct the cost of the machine when you bought it. In the future, there’s no additional depreciation. There’s no subtraction in the future for depreciation. So in a sense, some people would also argue, it gets rid of depreciation tracking over time. But in reality, a state tax like this will be operated in tandem with the corporate income tax, at the federal level will draw on it, and so you'll still see these concepts floating around out there.

As I say, it's a consumption-style VAT. It doesn't really tax the normal return on capital investment. And I think it can be thought of as a consumption tax. So it looks more like a sales tax than it does a corporate income tax. But it would be administered as an entity-level business tax, not as a transaction tax. So you have to -- you're kind of forced to change the way you use your words and your perspective. And when you think about this kind of tax, think more about an entity-level tax, maybe the sum of these payments to factors, or total revenue minus purchases from other companies if that helps you understand what the tax is.

All right, then very quickly, let's get down to what we did in preparation for this meeting.

We tried, our first charge was to coming up with a preliminary estimate of our understanding of what this proposal is. And I've tried to kind of outline what that is. We assumed it's going to apply to all forms of doing business, corporations as well as pass-through business entities. It applies to almost all firms in all industries, with some exceptions. We did not put into the base the value-added of federal, state, and local governments; nonprofits, including education and health services. We did not put in the value-added for religious and charitable institutions; and we left out financial services and insurance from the base.

COMMISSIONER EDLEY: We should have taxed the private universities.

MR. CLINE: I believe we did.

CHAIR PARSKY: We're going to let you get Boalt up to the level on your own.

MR. CLINE: All right, well, moving on to the details, so these are standard exemptions that were done in Michigan and New Hampshire and Europe. They tend to be what countries and states have decided should not be included in the base.

Financial services and insurance, the concept is, they would continue to be taxed under their current tax structures, not moved into -- as we estimated the impact, not moved into the net-receipts tax.

Generally, you'll see statements -- anyone who has studied value-added taxation -- strong statements that says no country has yet figured out how to effectively tax insurance and financial services under a value-added tax. It's difficult. It is difficult to define what value-added is, and it's difficult to find out whether interest paid is a purchase from other firms or it's part of the value-added of a bank. So there are real challenges. And for our initial estimates, we left those two industries out.

We put in a small-business exemption, $500,000. It sounds like a big number; but from my earlier discussion of the other states, it's not out of line with what we're seeing in some of these other non-income tax based systems.

We apportion the base to California using a single sales factor apportionment formula. It's the new formula that is an option now in California under the corporate income tax. And we assume that it would apply to all of the taxpayers under the net-receipts tax.

What it means is that exports are subtracted from your -- if you think of it as total receipts minus purchases, your total receipts from your exports, in a sense, are not taxable because it's a destination-sales concept. If you ship out of California, you don't pay tax on the value-added of that taxpayer at that point. But if someone ships into California, that shipper, that seller into California would pay the value-added tax on the sale that came into California. So you do tax the imports, you don't tax the exports.

That's not quite like the credit-invoice system in Europe, which fully removes exports and imports from the tax system. There's still some embedded taxes floating around in the background here on exports. So it's not like the credit-invoice system, but it is a destination-sales apportionment system.

Here's some preliminary numbers. Now, here's what we did, and let me just quickly step through the columns.

By major industry groups, these are our estimates of the initial tax base from this net-receipts tax given what I described as assumptions about how it might work. And I can guarantee you that, regardless of where this commission goes, if it does include this type of new tax, it's not going to look exactly like this. So this is not a specific legislative proposal; this is our initial estimate of what a tax with these characteristics might look like.

The first column is "Apportioned Gross Value-Added." The word *"gross"* because I haven't dealt with capital yet. Gross value-added from 100 percent California companies that operate and sell in California only, plus all of the multistate firms selling into California. It's the value-added that goes with all of those sales. So I call it the apportioned value-added into California. 1.3 -- and I have to be careful to get the units of measurement right -- that's $1.3 trillion. The base is $1.3 trillion, starting point. And you see the distribution by industries.

Now, let's go to the second column. "Capital Expenditures." This kind of consumption value-added tax lets you subtract all of your capital purchases, say, real and tangible personal property gets subtracted from value-added to get a net-receipts tax base. So we estimate, in this initial version, that $232 billion of capital expenditures in one year would be subtracted, giving you a net-receipts tax base of a little over $1 trillion.

"Small-Business Exemption" will exempt a lot of companies but not necessarily a lot of dollars of value-added. We estimate that the small-business exemption at $500,000 would reduce the base by about $105 billion. That's about a 10 percent reduction in the base.

So if you kind of back up, the capital expenditures reduce the gross base by about 18 to 20 percent. The small-business exemption reduced the net base by about 10 percent, to give you a rough idea of magnitudes.

Subtract the small-business exemption, and you have $942 billion in the tax base. And the table shows you how that's distributed.

Now, we did not at this point, because we don't know what the package of changes might look like that the Commission is considering or may actually recommend, we did not try to put this tax into a system of changes or a package of changes. So right now, we're just looking at it as a stand-alone piece, an additional piece to the system.

CHAIR PARSKY: And we will see this in the context of other changes. This is at the 2007 level. But we'll need to see this in the context of a complete business cycle. We'll get into all of that. But this just will give you an idea of the way in which the tax base gets calculated.

MR. CLINE: And, Mr. Chairman, I think we're almost there, if I could have just a --

CHAIR PARSKY: Yes. You're doing just fine.

MR. CLINE: -- a couple of minutes.

CHAIR PARSKY: Keep going.

MR. CLINE: The next page, just to help those who don't want to make the divisions or the multiplications by themselves, this is simple proportional amounts that will be raised from a 1 percent tax rate, or different tax rates. A 1 percent tax rate would raise $9.4 billion with this, as we have described and based upon our initial estimates of this tax, 1 percent rate, raising less than $10 billion, but $9.4 billion in revenue.

Now, what we didn't do, when we changed the rate here in our simple table, is we did not do dynamic feedback analysis, where we would try to estimate what would happen to the private sector as you increased the rates more and more and more. It would have a negative effect on the base, and it would reduce the additional revenues from increasing the rate. We'd have to build that dynamic impact in to really get a much more complete picture of what would happen at different rates of taxation.

But, now, what I do want to share with you in closing is our initial look at where we think this tax burden in the long run will fall after its put into place, and consumers and businesses have had time to adjust their behavior. We have a tax-incidence calculator, a model that we use to do these kind of analyses. And basically, what that model was saying is that the ultimate burden of the tax is going to be determined by the market conditions in which businesses operate. For example, if you have businesses in California selling only in California and selling to local markets, we would assume that a tax increase like this, or a new tax, this net-receipts tax, would very likely be passed along in higher prices to the consumers within California that are buying in these local markets.

The process gets a little bit more complicated for imports from other states.

The import coming in, as I mentioned, would be subject to value-added taxation or the net-receipts tax for the portion of the value-added from that company selling into the state, but it might come in with less of a tax burden embedded in it would, than a company that operated in California paid the embedded tax -- was subject to value-added taxation throughout the different steps.

It’s not pyramiding, but somebody’s paying this tax on the value-added at each step. So you might have in-state companies having a higher embedded value-added tax than some of these out-of-state companies selling into California. That will hold down the ability of some of the California companies to pass along their full taxes and higher prices within California. In that case, we think the burden is going to be passed back not to capital, but to labor and land and other more fixed capital in California.

To the extent the California companies can’t pass all of their embedded tax and the final value-added tax forward to in-state consumers in higher prices, a significant portion -- most of it will be passed backwards to lower wages for people working in California, lower payments to the owners of land, and some other reductions in the payments -- to capital, but it's a modest amount.

The reason why California wouldn't be able to shift a lot of this back to capital owners is because if California increases a tax like this in isolation of everyone else, others aren't going to raise their tax, the multistate companies outside of California; and, therefore, you don't have the ability to pass it along to U.S. or California consumers. So most of it is passed back to labor as a factor of production.

So that's kind of our initial thinking about this tax, of where it's going and what happens. And what I'm about to show you is a chart that shows how we think this tax would be distributed by adjusted gross-income levels of residents of California. But the exercise at this point is not to put this new tax in a package of tax changes, but to look at this net-receipts tax distribution by AGI levels in isolation.

So the exercise we did was to have the existing tax structure, put the net-receipts tax on top of it, and see how that changes the distribution of business taxes in California.

We'll be ready to do that type of analysis if the Commission recommends some packages of changes that might include the net-receipts tax.

CHAIR PARSKY: And just to pause so the commissioners understand the process, I talked rather extensively to Bob. And although we need to look at this in package format, I thought the commissioners would want to see, in just looking at this form of tax in isolation, what the impact would be. It will be obviously important for commissioners to see, well, if we move in this direction, what other changes would we want to make in order to adjust the distribution impact of this tax.

MR. CLINE: So just to mention that mechanically the way we do this, is we make the tax change and we look at effective tax rates industry by industry in California, and we determine, based upon those effective tax rates, how much of the tax might be shifted through in higher prices, depending upon market conditions; how much might be shifted out of state, be exported. So we go through this calculation industry by industry.

And what happens is sort of an intermediate step in this process. Just to give you an example, we took a $10-billion net-receipts tax, ran it through our calculator, determined that about 71 percent of the $10 billion would go to higher prices for California consumers, 19 percent lower income to labor in California, and about a 9 percent reduction in capital income in

California. Land would be the clearest example of immobile capital that would bear the burden. And a very small portion exported.

Now, it's highly concentrated on consumption because we put this on top of all other business taxes in California. And California can't shift that increment outside of the state to any significant extent. So it's this marginal impact, looking at what would happen with a $10 billion net-receipts tax put on top of other state and local business taxes in California. I think that percentage on consumption will come down as we fine-tune these estimates and we think about some of the subtleties in the shifting process. So I think it may be an upper bound. But it is what we are showing in our initial run.

COMMISSIONER BOSKIN: So --

CHAIR PARSKY: Wait. Complete your discussion before we move on.

MR. CLINE: I'm one slide away.

CHAIR PARSKY: I know. One slide.

MR. CLINE: So we took those buckets, we put the $10 billion into those buckets, and then we needed to distribute the buckets by AGI categories. And we used various proxies. For example, for capital income, we used interest and dividends received from information the FTB provided us from individual tax returns. We have consumption distributions by AGI from consumer expenditure surveys. We have wages and salaries distributed by AGI brackets from the FTB income-tax data. So we used those distributions to distribute these buckets by AGI brackets.

So then the graph on the next page shows you what we found with this initial look at the way we have described the concept of a net-receipts tax. Notice that it would be characterized as regressive. The percentage of AGI paid at each decile of income, we've arranged -- and this is probably the last time you'll see a graph with deciles of income on it because the Commission staff is putting together distributional analysis in a different way, and we will be integrating what we do into that format. But for purposes of this graph, we just ranked all the families from lowest to highest incomes, and divided them into 10 percent slices, the deciles.

Now, we've left out the first decile, not because we're trying to make a policy statement about low-income people, but just because from the data we use, the variation and the noise in that first decile is very, very large. Not too many people that do the incidence analysis feel comfortable that they are actually picking up the distribution of taxes in that first decile of low-income people because the data we use, like expenditure data, tends to overstate expenditures and understate income. And it sort of blows up the impacts. But the picture is the same. The first decile would be higher, but the decrease continually over the income range would be the same. It's about 1.2 percent for this $10-billion net-receipts tax. For the second decile, that begins at about $30,000 of income, and goes down to .6 percent of the tenth decile income level.

So it is, according to our initial calculations of the proposal that we're looking at, as we interpreted it, it is a regressive tax in terms of just looking at this marginal incidence.

Mr. Chairman, I do have kind of a concluding slide on lessons learned or we could go to specifics.

CHAIR PARSKY: Oh, no, go ahead.

MR. CLINE: Okay.

CHAIR PARSKY: Finish the slide.

MR. CLINE: There are -- kind of ending this discussion that maybe has gone on a little bit too long, some lessons learned, I think, from other states. Business tax reform packages have been multiple tax changes. When you're talking about reform, you're not talking about increasing the rate of a single tax; you're talking about changes in multiple taxes in the system of state and local taxes.

The jury is out as to whether or not the changes should be considered revenue-neutral. I think this commission is probably tackling that issue. It's been tackled in every one of these other states. Should it be revenue-neutral in terms of business taxes, should it be revenue-neutral in terms of the sum of business and household taxes, what do you mean, how to think about revenue-neutrality.

The states that have allowed -- have sort of relaxed the revenue-neutrality constraint for business taxes have had more flexibility to deal with the significant redistribution of tax liabilities from one industry to another and from one type of taxpayer to another.

What every state's experience has shown is that you may get relatively small changes in overall taxes and have almost as many winners as you have losers if you're just counting firms whose liability goes up or down, you may have almost as many winners as losers, although the dollar changes are concentrated in a small number of companies. But you just have to understand that you're going to get significant redistributions of liabilities.

I think it's prudent to understand what they are so there are no surprises; that you do understand what kind of alternative you're looking at.

Identify those winners and losers, and

document -- try to identify them, try to capture that in terms of your estimates.

I think it’s important to involve the business community in any discussion of a change in fundamental form of taxing business entities. These are really complex issues, complex taxes, every business is different. And you really do need business’s feedback to understand winners and losers, as well as the unintended consequences of major changes.

Pay attention to the transition issues. You’ve got to get from your old system to the new system, if you go in that direction. You have to phase it in. I think you have to consider seriously phasing in.

You have to look at the balance-sheet impacts. Business will be very upset if they lose the deferred-tax assets, like net operating losses that they’ve been carrying forward to future years. If those disappear because the corporate income tax is eliminated, how will those asset values be protected for the firms on their balance sheets? States are giving serious attention to those kind of transition issues.

And then finally, focus on the long-run economic benefits of a more competitive state and local tax system. It is jobs, it is the growth of the economy that’s the objective. And you should consider the competitiveness aspects of the changes, consider the positive benefits on the private sector of a more competitive system, and try to build the case for change in terms of jobs and income and growth in the state economy.

So kind of a conclusion of my remarks, kind of looking at the work we did for the net-receipts tax, as well as experience in other states.

CHAIR PARSKY: Thank you very much. I think that was quite thorough.

This is a complicated subject. I think the Commission was asked to look at whether or not major reform should be recommended, putting forward a new form of tax. It certainly would fit that category.

But please bear in mind that, at least for our discussion today, two stages: One stage was to try to understand the mechanics of this form of tax, maybe some want to see it in the context of, as described, a form or it looks like the sales tax. And there are some people that have said, well, the state sales tax ought to be applied -- it's not fair to have the state sales tax not apply to services. Clearly, this form of tax would extend to services.

Others may see this as a way of dealing purely as a business tax, and may say, "Well, this is a better approach to take than the existing state corporate income tax." So there are a lot of different ways to look at it.

At first, I will tell you that I was a little bit petrified at the notion of putting forward a new tax for us to consider. But I think we're in a situation where we should consider real reform. We may decide to reject it. So part of the method here is to get this form of tax out there, let the public see it, let us see it, talk to people about it.

Obviously, Bob has done a tremendous amount of work in this area. And then potentially see it in the context of a package of changes that would address, I'm sure, some of the concerns that some of you may have on the regressivity issue that was presented; but it should be seen in the context of the package.

Okay, with that, let's see if we can't go down the line -- and focus a little bit on trying to get Bob to dialogue on the nature of the tax, how it would work, and so forth. But everything's open.

Yes, Edward?

COMMISSIONER DE LA ROSA: Thank you very much for a great presentation.

I just was wondering if you had any idea of the top two or three ways by which taxpayers might try to game the system to reduce the burden on them at the expense of others?

MR. CLINE: As I mentioned, as an economist, not being a tax lawyer or an accountant, I don’t have the familiarity with the details of individual taxpayers’ situations. But let me comment a little bit about some of the challenges, some of the real problems that I think the net-receipts tax would encounter.

One thing that happened in Michigan -- maybe the most challenging aspect of the system, the new system, with a single business tax in Michigan and the business-activities tax before, was to try to figure out what to do about capital investments made in other states. For example -- and they’ve tried four or five different versions of how to deal with that issue. Initially, they said, under the single business tax, is that you only got the subtraction for capital expenditures if you invested in buildings in Michigan; or if it was tangible personal property, you only got to subtract the apportioned amount that was apportioned using payroll and property located in Michigan.

So they tried to tie this expenditure deduction for capital equipment to Michigan. It had to occur in Michigan.

Well, it got challenged in the legal courts as discriminating against interstate commerce; and they backed off of that and went to some alternative ways of trying to determine where the capital expenditures occurred and what would be subtracted.

When the SBT finally went out of business, it had reached its sunset, they had migrated to an investment tax credit for investment in Michigan, which seemed to, they thought, finally resolve the issue. But it creates complexities and it raises issues. I wouldn’t say tax planning or gaming issues, but it does fundamentally ask -- it asked in Michigan, does Michigan want to give a subtraction for a capital investments in another state or should they try to limit those benefits only to Michigan capital investments?

And so there’s real complexity, and it’s an issue that has to be really thought through and dealt with carefully.

But it’s big. I mean, you saw the size of the base. There was, like, an 18 to 20 percent subtraction from the gross net-receipts tax base for capital-expenditure deductions.

And so I would say that just given the magnitude of that number, it deserves real careful attention and discussion, whether -- I wouldn’t call it gaming, I just call it a fundamental issue in the structure of the tax.

CHAIR PARSKY: Ruben?

COMMISSIONER BARRALES: So for the net-receipts tax, obviously, the burden, if you will, is –– the burden is not to get feedback -- the burden is on consumers. And then the second tier would be on labor income.

If one of our primary goals is to create more jobs, retain more jobs, isn't there -- it seems as though there would be pressure -- which is not a bad thing -- for more productivity, but to reduce labor costs. So some could argue that this actually wouldn't help create jobs, it would actually do the opposite.

MR. CLINE: Excellent question and observation. An important one also.

In Michigan, the SBT was this additive approach. Not total revenue minus purchases, but summing up the payments to factors.

Although it treated capital and labor uniformly, imposing the tax on the contribution of both, when you looked at the return data, it showed that about 70, 75 percent of the base was labor compensation in a heavily unionized state. It caused trouble continuously over the life of the SBT because there were arguments that you're taxing labor too heavily.

What happened is that they switched the -- they rebalanced, with more of the tax coming from labor's value-added than capital's value-added, which was the corporate income tax, rebalanced, was treating them both in a neutral way; but there still were people who said, "It looks like a tax on labor to me. It's too high. Let's exempt unemployment comp. Let's exempt workers' comp."

And continuously, kind of looking at that as an additive approach, they kept focusing on the wage component, arguing that it was not providing the incentives necessary to expand the employment as opposed to capital investment.

I think economists, in general, take a longer view and say, without capital equipment, without the increased productivity, the wages and salaries won't grow as rapidly. Capital is just as important in the future income stream of creating an income stream for labor, that you don't just jettison that balanced approach to taxing the two categories of inputs; you kind of try to hold the line and say, "No, it's a reasonable way to create the base." But, yes, you still see these efforts to try to reduce the perceived portion of the tax paid by labor's contribution.

COMMISSIONER BARRALES: Right.

CHAIR PARSKY: Curt?

COMMISSIONER PRINGLE: Yes, thanks.

I kind of want to just understand a little bit more about this exercise that we're engaged in.

What you really are looking at is a replacement of the bank and corp. tax, primarily; right? I mean, that's what -- all of the presentation doesn't address other areas where there's business taxes; is that right?

MR. CLINE: That is correct. This is only looking at the net-receipts tax in isolation, with the important assumption that financial institutions and insurance would be kept under the current system.

COMMISSIONER PRINGLE: So bank and corp. tax minus banks?

MR. CLINE: Right.

COMMISSIONER PRINGLE: So we're really in a juxtaposition of where this tax would fit in a context, it is more -- I mean, I understand this application of the sales-tax realm, and I guess that's where I kind of want to just ask a couple questions.

What do you do under this? I mean, I'm just looking at your basic premise as to what that net is. And you basically state it's total receipts minus all purchases from other firms.

And so is that all purchases of goods and services?

MR. CLINE: Yes, it is. All purchases of goods and services.

COMMISSIONER PRINGLE: Is it all purchases with an existing sales tax?

MR. CLINE: If you could explain it a little bit more for me.

Is it in the gross receipts or --

COMMISSIONER PRINGLE: No. Is there a payment of -- I mean, are you contemplating that there would be or would not be a sales tax on those purchases of goods? That would also be deducted as a part of that deduction from the total receipts?

MR. CLINE: Thank you for the clarification.

I believe the -- this is only looking at the net-receipts tax in isolation. And a question -- and so whatever other taxes are in place, would continue to be imposed when we did the net-receipts tax calculations here.

CHAIR PARSKY: I think, Bob, what Curt may be asking, though, is in doing the calculation for what the base would be on which a rate would be applied, what impact, or not, would existing sales tax or other taxes have on it?

COMMISSIONER PRINGLE: Well, but more specifically --

COMMISSIONER BOSKIN: If you subtract the gross price for the net of tax price?

MR. CLINE: Yes, we don't have an explicit subtraction for that in our calculations. The question is, whether or not the GDP accounts, how they handle it -- I know it’s an indirect tax on the GDP accounts. What I don’t know --

COMMISSIONER BOSKIN: You say cost of purchases from other firms?

MR. CLINE: The question is whether -- and I guess I can’t say to the extent to which if the sales tax were passed along in higher prices -- the real question is not what was listed as the sales tax -- 6 percent or 7 percent -- on the invoice --

COMMISSIONER PRINGLE: Or 8 percent or 9.

MR. CLINE: Right.

No, the real issue is, from our perspective of trying to understand what it is -- from an incidence perspective, it’s trying to trace through the ultimate change in prices when given that combination. But we did not make an explicit adjustment to remove the sales tax from gross receipts.

COMMISSIONER PRINGLE: Okay, that’s all I wanted to find out.

MR. CLINE: Yes, we did not.

COMMISSIONER PRINGLE: So you -- so under the next column, “Firm’s payments for labor and capital,” you would -- therefore, you created two definitions of what’s been measured.

MR. CLINE: Right.

COMMISSIONER PRINGLE: In this case, the firm's payments for labor and capital. But, therefore, all other taxes that are paid would also be taxed; is that right?

MR. CLINE: The way to think about it is --

COMMISSIONER PRINGLE: I mean, they would not be deducted is what I'm asking?

MR. CLINE: That's a detail that would have to be worked out in the proposal. I believe that the SBT in Michigan began without any subtractions for sales taxes from the gross sales amount. But over time, those systems have changed. And I think, in fact, in the CAT tax maybe in Ohio now, they've allowed some subtractions for excise taxes and sales taxes.

COMMISSIONER PRINGLE: No, thank you. I just wanted to get, Mr. Chairman, to the point of talking about removal of these business inputs. I mean, what we are deducting, a percentage increase in the sales tax on top of that is what the business is paying for that good. So they're paying the price for buying that new delivery truck, plus the sales tax on that. And I guess in my head, I'm trying to see what we are replacing, or at least what we're discussing.

MR. CLINE: Right.

COMMISSIONER PRINGLE: And if we're replacing just the corporate tax rate businesses pay, that's one thing. If we're replacing the corporate tax rate, plus the sales tax on goods that businesses pay, that's another thing. And that's all I'm trying to get at.

CHAIR PARSKY: And when --

MR. CLINE: We haven't dealt with that.

CHAIR PARSKY: They haven't done that, but when you look at the packages in preliminary form, you will see one package would eliminate the corporate tax and the sales tax, state sales tax.

COMMISSIONER PRINGLE: On the business consumption? Or are you making it a collective on everything?

CHAIR PARSKY: Wait until you see how the packages will work, of course.

COMMISSIONER PRINGLE: Okay. Very good, Mr. Chairman. And I'll wait and see that. And, in fact, I just want to look in terms of what that charge through business is.

CHAIR PARSKY: Right.

COMMISSIONER PRINGLE: So, say, if it's a deduction here, then it's a deduction just of their corporate income tax charge as opposed to a deduction --

CHAIR PARSKY: Sales tax.

COMMISSIONER PRINGLE: So what is the equivalency to compare.

And there's always going to be winners, losers, applications that apply. But does this, just because this premise that you had suggested earlier, that purchase of property, land, buildings, the purchase of those would be one of those reductions off of the receipts; correct?

MR. CLINE: Correct.

COMMISSIONER PRINGLE: So what have you seen in terms of the bias towards purchase versus renting of, you know, space?

MR. CLINE: Right. That's also an excellent question.

The Michigan experience was that, in theory, if you think of the value-added tax as payments to those factors of production, the base should be compensation, interest paid, rent paid, royalties paid -- what am I missing? -- profits.

What Michigan said is that they were concerned about the question you just raised, about biasing renting versus building on your own. So they reversed the treatment of rental payments. And so what happens is that rent paid under the old SBT -- rent paid was subtracted from the base, and rent received was added to the base. And they argued that that created the level playing field between renting and buying the assets. So they compromised the theory at that point and said, "We're going to reverse the treatment of rent." And it was basically because of the question that you raised.

COMMISSIONER PRINGLE: But what was your rationale, to include rent or not to allow the deduction of rent?

MR. CLINE: Well, it isn't our rationale because it's not our proposal.

COMMISSIONER PRINGLE: Okay.

MR. CLINE: We just tried to take the broadest definition of value-added --

COMMISSIONER PRINGLE: I see.

MR. CLINE: -- because we don't have a specific proposal in front of us to work with. So we didn't make judgment calls about sales tax or rental payment. We just took the broadest measure of value-added.

COMMISSIONER PRINGLE: Okay. So my question then doesn't need to be answered because it was somewhat answered before. The property tax, therefore, that's paid, even if the receipt -- or the purchase of land or building is deducted off of receipts, that property tax would still be not a deduction off of that, is what you would assume then?

MR. CLINE: No, I'm not going to assume anything about that level of detail.

COMMISSIONER PRINGLE: No, no, no, but your revenue estimates.

CHAIR PARSKY: In your estimates.

MR. CLINE: In the revenue estimates, we subtracted capital spending from the gross-receipts number.

COMMISSIONER PRINGLE: Does that mean property tax --

COMMISSIONER POMP: Not property taxes, I would assume.

MR. CLINE: At the level at which we estimated this, we did not go through that level of detail. We're using aggregate measures of economic activity in California. And what that does -- and we're focusing on compensation, wages and salaries, interest paid, dividends paid, rent paid. Those concepts, of and by themselves, don't include taxes. You know, they're concepts of the payments to the private-sector factors of production.

Now, whether or not you'd want to --

COMMISSIONER PRINGLE: That's good. But I believe when you buy a piece of equipment, the cost of that equipment isn't just the purchase price, it's the sales price.

And I was just similarly looking at if you purchase a piece of land, does that tax still apply from a business perspective?

And you are suggesting, none of those taxes are reduced -- are eliminated through the proposal. I see --

MR. CLINE: No, our proposal doesn't deal with those taxes. Our proposal looked at these aggregate payments to the factors of production.

In theory, you could say government gets paid a portion of value-added. I believe the way that we actually estimated it, we did not include that government portion of value-added in the base.

COMMISSIONER PRINGLE: Okay.

MR. CLINE: So it may be we took all of those taxes out. But we didn't do it explicitly based upon --

COMMISSIONER PRINGLE: I only have two other questions before the chairman turns off my mike.

I wanted to -- I understand that now, where you're coming from.

When you talk about extending to out-of-state companies or others that are doing business here, how have other states addressed that ability to capture that activity? And how deep are they capturing that activity beyond, you know, methods that are being done in California? Have they addressed things through capturing Internet activity or other things like that?

MR. CLINE: Well, I would be glad to talk about the perspective we had on the apportionment issue from the analysis that we did of the net-receipts tax. We didn’t look at Internet sales -- you know, all those other issues you raised were not part of what we were asked to look at.

What is true is that the 100 percent sales factor apportionment formula that we assumed for California for the net-receipts tax base estimate, is consistent with the new option in California. And it is consistent with where I think the trend among the states is going. We probably have -- we certainly have more states now that have 100 percent sales factor apportionment that have equally weighted -- the UDITPA equally weighted formula.

So I think in terms of the movement of where states are going, you’re seeing much more heavily weighted sales factors; and, in fact, I think the states are still moving to 100 percent sales factor apportionment.

So what that means is that we took a net-receipts tax base -- let’s say the U.S.-wide net-receipts taxes for multistate companies. We apportioned it to California based upon the percentage of sales of those companies going into California.

So what you have is a value-added tax base which, fundamentally, is where your property and payroll is located. That's what creates value. And you're using a destination-sales apportionment formula to determine what state it's taxable in. That's a reality you kind of accept. And so this proposal has that combination of destination-sales perspective, which is market-based, versus a tax base based upon value-added, which is origin-based; and you're getting a mixture of the two in the way we analyze all this.

COMMISSIONER PRINGLE: And I would just, maybe in a rhetorical sense, ask the question, how close are we today in California in collecting all of that potential tax that you have estimated on a national basis that's apportioned to California, how successful have we been at capturing that, therefore, comparing our present system to what --

MR. CLINE: I can't answer that because I haven't looked.

COMMISSIONER PRINGLE: -- theoretically –– that's why I was trying to make it a rhetorical question.

MR. CLINE: No, I haven't looked at California's current system, so…

COMMISSIONER PRINGLE: And a final thought, though, I think one of the things that jumps out here is really the distribution of what this tax burden would be, and particularly one that is suggested that it would be disproportionate to the consumers.

And, in fact, I think that is a relatively easy thing to consider. Because if a sales tax, for example, were to be extended to services, at least the 71 percent in higher consumer prices would be reflected; right? At least to the purchase of those services?

MR. CLINE: If I could answer it this way --

COMMISSIONER PRINGLE: Sure.

MR. CLINE: -- what you proposed as expanding the sales tax to inputs, it's been our experience in other state studies that we've done -- we've done a study for the Council on State Taxation, for example, where we looked at the base-broadening proposals that states have been making to expand to services under the retail sales tax. And our general conclusions is that that's really a discussion of taxing business inputs, not taxing households.

We think 70, 75 percent of that new revenue comes from business input purchases -- legal services, accounting services, and other professional services. And so it's a question -- it's a debate about business input taxation.

What would happen under the net-receipts tax, is that you would get subtractions for those purchases of services from other companies, from your tax base, in determining your net tax base. So you won't get that pyramiding, or that taxation that you get under the sales tax at very high rates, like 6 or 7 percent on sales of services from one company to another.

And so some people would argue that something like this net-receipts tax would be an indirect way to tax more of the service sector without trying to extend a very high rate retail sales tax to services that are primarily consumed by business.

But -- so you need to play the two -- you need to recognize the interaction of the two.

COMMISSIONER PRINGLE: Sure. All right, thank you.

And, Mr. Chairman, actually, I know it's somewhat scary to look at that distribution of the tax burden and to see exactly where it applies and how it applies; but I actually think that theory isn't bad to extend to all of the different proposals that may be out there, to really see how that interrelates. Because we oftentimes talk about different other taxes without really seeing where that tax burden gets distributed. And I'm not afraid of having that discussion, and I look forward to it.

CHAIR PARSKY: We will have that discussion as we move to these packages, clearly.

But one more time, I just want to emphasize, I thought that for all of us and for the public, it was important -- this would be a new form of tax. As I said, some commissioners may view this as a mechanism, among other things, to extend to services. Others may look at it differently. But it needs to be seen in the context of other changes that would be made.

Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

Thank you for your excellent testimony and your excellent presentation.

MR. CLINE: Thank you.

COMMISSIONER KEELEY: It was very clear, very concise, and very helpful.

I have a few questions.

The Chairman, in opening this morning, I think directed or suggested that we look at proposals in the context of the task that's been given to us by the Governor in establishing the Commission. So I'm going to try to focus in on that with my questions.

First of all, is it your view that the states that have worked to implement a net-receipts tax, that they've done so with some thought in mind about what they want their state to look like? The economic composition of their state, or what they imagine it might look like?

Do you have any thoughts on that, when you've spoken with these states?

MR. CLINE: Well, let me just begin with a clarification that New Hampshire adopted their modified value-added tax back in 1993, so it's been around for some time in New Hampshire. As I mentioned, Michigan has kind of experimented with it over a 50-year period.

The new states -- Michigan, Ohio, and Texas -- would not say they have a net-receipts tax or a value-added tax. They would describe it more accurately -- and accurately, I think -- as gross-receipts taxes.

CHAIR PARSKY: Just stay then with New Hampshire for a moment because it may help in responding.

MR. CLINE: All right. Now, New Hampshire has argued that the value -- they have the two, they have the corporate income tax running parallel with the value-added tax -- and they have argued that there are benefits to the value-added tax in terms of its broad base, relatively low rate. They do not include retained earnings of corporations in the tax base, and there's what -- I think they also exclude rent paid from their tax base. I mentioned that Michigan may have adopted that aspect of it.

They would argue that it has reduced the level of taxation on corporate -- on capital investments because, as part of the package, they brought down the rate on the business income tax when they adopted the broader base value-added tax component.

So I think they would argue that, overall, they were paying attention to the impact of their system of business taxes on mobile capital and investments in the state.

Ohio, certainly --

CHAIR PARSKY: One more time with New Hampshire --

MR. CLINE: Okay.

CHAIR PARSKY: -- because it's potentially the closest analogy to what you have been discussing.

How would you say that form of taxation addresses the issue of promoting economic activity and growth in this state? How would they say it --

MR. CLINE: Well, I hope I remember this number right.

About the time that they adopted -- that New Hampshire adopted this business-enterprise tax, they call it, the "BET" -- they estimated that one-half of 1 percent of their business taxpayers paid seventy- -- I think it was 70 percent -- maybe closer to 60 percent of their taxes. One-half of 1 percent.

So they argued that there were very high rates on capital investments for a handful of company -- a relatively small number of taxpayers that tended to be larger capital-intensive taxpayers. And so they know that in the change, by bringing down the corporate income tax rate and replacing it with a broader base tax, all forms of doing business, low-rate services, manufacturing, everyone included, that they were bringing down the effective tax rates own new capital investment in the state. And that was, I think, done intentionally.

COMMISSIONER KEELEY: Okay. And when they did that, did that then have the desired effect of growing a bigger pie for them? Did they attract businesses? Did they have businesses -- did the businesses think, who were there, said, “This is a good thing. We’ll now expand because they’ve done this?” Have other businesses said, “Gee, this is great. We’re going to migrate to that state because of this change?”

MR. CLINE: I’m not familiar with any research that may have been done in New Hampshire.

COMMISSIONER KEELEY: Okay.

MR. CLINE: But in Ohio, they’ve issued two annual reports. The Ohio Business Roundtable has issued two annual reports, talking in a sense, testimonials from business, talking about the new CAT system, and the substitution of the CAT for the corporate income tax, the net-worth tax, and tangible property taxes. So that they -- I mean, and it's anecdotal evidence.

COMMISSIONER KEELEY: Our State Treasurer, who used to be the Attorney General, who used to be the President Pro Tem of the Senate, who used to be an assembly member.

COMMISSIONER POMP: School board member.

COMMISSIONER KEELEY: And used to be a school board member in San Leandro.

CHAIR PARSKY: A young boy.

COMMISSIONER KEELEY: Yes, when he was nine, apparently, he was a school teacher.

He has a great phrase. He says, *"The plural of anecdote is not evidence."* But if you're saying they put an anecdotal report together then…

Let me ask a couple other questions.

COMMISSIONER MORGAN: What is the answer to those anecdotes?

COMMISSIONER KEELEY: It's whatever story you want to tell presumably is the answer to the anecdotal report.

In putting this particular tax or something like this tax in place, those states that have done that, experimented with it and so on, were they clear at the outset, in essence, what they were managing towards?

MR. CLINE: I think they were.

COMMISSIONER KEELEY: Okay, what were they managing towards?

MR. CLINE: And I think I mentioned it in some of my -- whether it was summary or the overview points -- they were concerned about the competitiveness of their state and local tax systems.

COMMISSIONER KEELEY: Okay, so let's stay with that one.

So with the competitiveness of their state and local tax systems, they made a change. And what happened?

MR. CLINE: At the time, for example, that Ohio adopted the CAT tax, we, in terms of working with the private sector, actually did modeling of what the expected dynamic impact on the state economy would be from the change.

COMMISSIONER KEELEY: Okay.

MR. CLINE: Then the State Department of Economic Development did their own analysis of the benefits, potential benefits of adopting a different system of business taxation. And both of our analyses concluded that there were substantial increases -- would be substantial increases in employment and investment compared to the replaced system of business taxes.

So it's always one package relative to the other package.

COMMISSIONER KEELEY: Understood. Understood.

And with regard to the issues around jobs and income, did any of the work that you did or the department in that state did take a look at the, essentially, distribution of those either new jobs or increased income available for wages and benefits? Did anybody look at that question?

For example, you might get more jobs, but where are those jobs? You know, what kinds of jobs are they? Are these good-paying jobs? Are these low-income jobs? Did you have any -- did you look at that?

MR. CLINE: In Ohio in particular and also in Michigan, the analysis of the new system -- replacement system in Michigan, analysis was done of the distribution by occupation, for example, of the potential change in employment. So those questions were asked and addressed in various ways to different extents across the states. So there was certainly recognition that one of the driving forces behind reform was economic competitiveness. So people ought to talk about whether or not they think an alternative system is better for economic development than the current system. So there were attempts to answer those questions.

COMMISSIONER KEELEY: Well, the answer to the questions depend upon what values you treat. For example, this Commission received a report some time ago about -- that was flogging the idea that Texas was a much better place to do business than California. It was done by, among other people, Art Laffer and some other folks. And two of the things they pointed out were just major benefits of doing business in Texas rather than California.

Number one, that Texas had a lower minimum wage, which I think some people may want to stand up and do back flips and think that's an extraordinarily wonderful thing; and other people may say, "I wouldn't consider that," and I would count myself among them, I don't think that's something that you would want to say, "Gee, isn't that wonderful?" But those are value-system differences.

They also said that a major benefit of doing business in Texas rather than California is that it's a right-to-work state. That's a value-system decision about whether you think that is something you ought to put on the plus list or the minus list.

So I go back to the question, when you said that they looked at these issues, so what kinds of jobs, economic growth and development, what took place?

MR. CLINE: I can't answer that question.

COMMISSIONER KEELEY: Okay.

MR. CLINE: Our responsibility was to look at the expected impact in terms of revenue of a net-receipts tax in California. We were not asked to do a comprehensive analysis of the experience in other states.

COMMISSIONER KEELEY: No, no. Fair enough. Fair enough.

MR. CLINE: I just can't answer that question.

COMMISSIONER KEELEY: No, that's fair enough.

I think it does raise the question, though, of making changes in taxation, changes in taxation makes changes in job-creation opportunities and so on, per se, that isn't necessarily a good thing. It could be, but it isn't necessarily a good thing.

If, for example, you lose 100 jobs and you create 150 jobs, and you lose 100 jobs in the high-tech, high-paying industry and you create 150 jobs in the low-paying service industry, what have you done? Is this a good thing or not a good thing? Those are value decisions you should make based on where you're trying to manage your economy at some level or what you think tax policy does to simulate growth and development and which parts of the economy. So maybe we'll get to that later on as a way to look at it.

Let me ask a couple other questions.

Do you think that the net-receipts tax is fair and equitable? And if so, fair to whom and equitable to whom?

MR. CLINE: As I said in that introductory slide, I and E & Y have to be very careful that we're not recommending any policy changes for California. As you mentioned, it's a value judgment as to whether you think it's more fair or less fair. It has tremendous dimensions across industries, across types of taxpayers, across household AGI levels. And I just can't comment on that. I can't help you there, other than to acknowledge that it's a key issue.

COMMISSIONER KEELEY: So then let me ask you on page 18, on the incidence of distribution by income deciles and the effective tax rates.

So you acknowledge there that what happens is that in the second decile you're at 1.2 percent, and at the tenth decile, you are at something just below .6 percent; is that right? Did I get that right?

MR. CLINE: That's correct.

COMMISSIONER KEELEY: So that looks pretty regressive as -- just on the face, with this one tax, one way, one way to model it, one tax, not looking at the entire package, and so on.

But that would have a regressive effect; is that correct?

MR. CLINE: Economists would describe that pattern as a regressive distribution of taxes. It takes a higher percentage of the income of lower-income people than higher-income.

COMMISSIONER KEELEY: And what effect do you have -- let me try to tie it back. Instead of asking you for a value judgment, let me try to go back into what may be the area you're more comfortable with.

So if that were the case, if that's the preliminary incidence results, if that became the incidence results, that has, from a business perspective, people making business decisions, what kind of -- whether they want to locate in California or retain their business in California, expand their business in California -- this says what to them? How does this help make them -- how does this help them make a business judgment if they knew this?

MR. CLINE: My objective, our objective in working with the Commission was much more modest. It was to try to give the Commission insight into what had actually -- what we think it would look like, if adopted. I can't help you in trying to interpret how that issue of equity interacts with the real economy. I just can't help you there.

COMMISSIONER KEELEY: Okay. Let me try one last question, and I'm not trying to be difficult, I'm truly trying to understand this.

Let me ask on this point that the Governor gave us as one of our charges in his Executive Order. We are supposed to improve California's ability to successfully compete with other states and nations for jobs and investments.

Do you have any view, without getting into value judgments, do you have any view about whether or not a net-receipts tax, as outlined here, what effect, if any, that might have on California's competitiveness with other states and nations for jobs and investments?

MR. CLINE: I don't --

CHAIR PARSKY: Maybe take a different approach.

When other states moved in this direction, did they do an analysis of that question?

MR. CLINE: They did.

CHAIR PARSKY: And when they did, what did they conclude? Not you, but they.

MR. CLINE: I mentioned that what I did see in both Michigan and Ohio, was analyses of the impact of the proposed changes on the private-sector economy; documenting what they thought the change in total number of jobs would be, the percentage growth in real incomes to the residents of the state. And the studies that I saw and participated in showed positive economic impacts of substituting a tax system which had less of a burden on what I describe as mobile capital, and perhaps a greater weight on the consumption-tax aspects of the system. That was only looking at the economics, not at the equity issue about changes in the distribution by income level of the taxes.

CHAIR PARSKY: No, that's probably a given. But at the same time, if you then built into this, well, how would you compare -- for instance, how would you compare, with all that taking into account, this form of tax, with taking -- not proceeding with this tax, but taking an existing sales tax and applying it to services to broaden the base, what then might you see with respect to regressivity and all of those? And I just want to emphasize that it's important both because this would be potentially a new form of tax -- and I'm not an advocate of it -- but I think since other states have considered it, it's really worth thinking about, and it needs to be looked at on its own, but then it needs to be looked at in comparison to others.

And, as I said, I think that these other states clearly have attempted to move in this direction with an objective of trying to improve economic activity and job creation. Whether they achieved it or not is something we can assess.

MR. CLINE: Right, correct.

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

My last question is to you, sir.

Whether or not -- Mr. Cline, do you know whether or not the other states that you focused in on with regard to the net-receipts tax, if they -- which ones have personally income tax, state sales tax, and existing bank and corp. tax?

MR. CLINE: That is a very good question, and it comes back to the point I made --

COMMISSIONER KEELEY: You're so good, telling people they ask good questions.

MR. CLINE: Well, maybe it's a way of saying, I've got a thought about that.

COMMISSIONER KEELEY: I think you described Speaker Pringle's as "outstanding," though, and so I'm wondering if…

MR. CLINE: And justifiably so.

CHAIR PARSKY: Be careful, you're going to be graded.

MR. CLINE: Where were we? We were going somewhere with this, weren't we?

COMMISSIONER KEELEY: I asked if they had the other taxes, the range that --

MR. CLINE: Remember the point I made in passing earlier, the throwaway line almost was, there isn't a lighthouse state to look to, to solve the California problems.

COMMISSIONER KEELEY: Yes, right.

MR. CLINE: And if you really -- and the reason why I was thinking about that a little bit, I was thinking about New Hampshire, trying to come to grips with New Hampshire's dual-tax system and think about it. New Hampshire has no -- am I right? -- no income tax.

CHAIR PARSKY: Right.

MR. CLINE: It has no sales tax; right?

CHAIR PARSKY: Right.

MR. CLINE: That's all they have. And that's why New Hampshire kind of imposes its business tax on all forms of doing business, including partnerships and sole proprietors. So you kind of have to understand, that's a different world.

CHAIR PARSKY: Sure.

MR. CLINE: Texas has no income tax. You've got to understand, that's a little bit of a different world.

Michigan, Ohio, Pennsylvania, that really talked about tax change reform, and North Carolina, most recently, Maryland, are states that look like California in terms of the structure of multiple taxes that you have.

And so I don't know how much weight to give to those outliers of Texas and New Hampshire. Certainly, whatever they're doing is a source of information and insights. But when you think about the system of taxation, now you're back to understanding that every state is unique.

COMMISSIONER KEELEY: Thank you.

Mr. Cline, again, thank you very much. I thought the presentation was very, very helpful and very well presented. I appreciate that.

COMMISSIONER BOSKIN: Was it very good or outstanding?

COMMISSIONER KEELEY: It was -- I'm still wavering whether it was outstanding, absolutely outstanding, extraordinarily outstanding.

MR. CLINE: There is great inflation that you have to deal with.

COMMISSIONER KEELEY: But thank you, sir, very much.

And, thank you, Mr. Chair.

CHAIR PARSKY: Michael.

COMMISSIONER BOSKIN: The Stanford and Cal people on the Commission, we're quite aware of great inflation.

I want to just clarify one thing and then I have a series of my own questions.

So on this regressivity argument, clearly that's going to depend on what, if anything else, you did a stand-alone analysis, the Chairman referred to that. If you replaced the corporate tax, that would be more regressive still. If you replaced the sales tax, it might well be less regressive in a stand-alone analysis.

But this 1.2 percent at the bottom, out to .6 percent, is primarily a reflection that low-income people are consuming, roughly, twice as high a fraction of their income as really rich people are, because most of it is passed forward in higher prices; correct?

MR. CLINE: Because, as you saw, the bucket that was -- we put into consumption before we distributed it to AGI levels, was about 70 percent -- 71 percent of the total of the $10-billion increase from the net-receipts tax that we modeled. Then that is really determining the distribution by AGI.

And it is true, when you look at the consumer expenditure survey -- in fact, at the bottom decile, I think I looked at it before I came out –

COMMISSIONER BOSKIN: They consume slightly more than their income --

MR. CLINE: -- that group had maybe 3.5 times the spending at that level.

COMMISSIONER BOSKIN: At the very bottom, they're consuming more than their income because --

MR. CLINE: Correct.

COMMISSIONER BOSKIN: -- income is increasingly measuring the cost of transferring.

But in general, that's the pattern, roughly 2-to-1, when you get to low, middle-income, to high, which would be about half the dispersion that the Congressional Budget Office estimates, for example, for a carbon tax, where the poor are consuming four times as much carbon-intensive goods as the wealthy as a share of their income.

So to put it in perspective, by being broad on all consumption, basically, or almost all consumption, this will be less regressive than some other consumption-based taxes that are on specific products or a subset, maybe more regressive than others you could conclude that were primarily consumed by the rich, for example, like yachts. So just to put that in perspective. It really depends heavily on the experiment you're performing. And we're going to look in a few minutes or later on at packages where this replaces some other things in a revenue-neutral way. So I want to transition to that.

So all of your thinking about distribution, you have to look at the distribution of the package, I think is the point.

MR. CLINE: Absolutely.

COMMISSIONER BOSKIN: So do you know -- and you're welcome to respond just "yes" or "no" to these questions -- do you know any instance in all of human history, to be bold about it --

CHAIR PARSKY: This is "yes" or "no" now.

COMMISSIONER BOSKIN: -- where a gross-receipts tax, a net-receipts tax, or a value-added tax, in their interchangeable concoctions, was initially implemented, and that other major, other than in a state case, reconfiguring revenue-neutral business taxes, other major taxes, like an income tax or a payroll tax, or a state sales tax were completely abolished? There is the general thing that the Europeans got rid of their turnover taxes for VAT.

MR. CLINE: Right.

COMMISSIONER BOSKIN: Did they abolish income taxes? Did they abolish payroll taxes?

MR. CLINE: Well, as you said, I think as a qualifying phrase there, certainly among the states, they've been substitutes for other major taxes.

COMMISSIONER BOSKIN: Major other business taxes?

MR. CLINE: Major other business taxes.

So now we're -- one thing you need to do -- the reason why this is such a difficult discussion -- it is for me, and I think it may be for members of the Commission -- is that you have to bounce back and forth between thinking of it as a business tax and thinking of it as a consumption tax.

When you're thinking of it as a consumption tax -- and I think some of your questions certainly were leading in that direction -- then you think sales tax versus the net-receipts tax.

If you're thinking about business tax, you think corporate income tax, tangible personal property tax, sales tax on business input purchases versus the net-receipts tax. And I will acknowledge, it's very difficult to bounce back and forth between those two. But because Ohio and Michigan and Texas really were adopting those taxes as business taxes, they tended to make substitutions for existing tax -- major taxes on businesses.

COMMISSIONER BOSKIN: On businesses?

There's no instance you're aware of where a personal income tax or a payroll tax was abolished?

MR. CLINE: Not that I'm aware of.

COMMISSIONER BOSKIN: Okay. The next question: Do you know of any instance where a theoretically pure, or only trivially deviated from theoretically pure base, was implemented originally and maintained with only trivial, if any, departure for a prolonged period of time?

MR. CLINE: I think the Social Security tax system has been extremely stable over time.

COMMISSIONER BOSKIN: No, I'm talking about these.

MR. CLINE: Oh. But I would be careful.

For example, I would say that the gross-receipts taxes on utilities have been as steady and stable and unchanged over time as almost any other state and local --

COMMISSIONER BOSKIN: I'm not asking about a gross-receipts tax on utilities. I'm talking about a general gross-receipts, net-receipts, or a value-added tax that's a major component of revenue, haven't they all had their bases basically whittled away in small or in large measure?

MR. CLINE: I think that is -- I'm not familiar with what's happening to the bases in Europe. I assume that they're being whittled away over time, as almost all the tax bases are.

COMMISSIONER BOSKIN: So then the conclusion from that is, we have to be aware that if we recommend something, while if we were extremely fortunate and it happened to be implemented originally the way we wanted, which is also debatable, whether the political system is capable of doing that -- but if it happened, we might wind up in shortly or medium order with an imperfect value-added or net-receipts tax, replacing our imperfect other taxes. So we ought to be comparing -- so compare -- all I'm trying to get at is, comparing a pure, idealized net-receipts tax to existing imperfect taxes, which have had the pleasure of being whittled away over time for various reasons.

It may be a little -- especially as we think about the 21st century ––

MR. CLINE: But, again, I would say --

COMMISSIONER BOSKIN: -- may be a little bit -- a little bit unfair to the existing tax system, as bad as it may well be.

MR. CLINE: It could be, right.

COMMISSIONER BOSKIN: That we need to take account of the fact that this may happen.

Now, we can't not do -- I'm not suggesting that we not propose a great reform because something might happen to it later, and we just want to be cognizant of it.

MR. CLINE: Absolutely.

COMMISSIONER BOSKIN: And to the extent we can think about ways to build in protections to that, that would be a good thing.

MR. CLINE: And what I would say from the state experience is that it is important how you think about the tax when you adopt it.

As I mentioned, that in Michigan -- there's been this ongoing debate about whether they should have administered it as a subtraction VAT or an addition VAT. And there are people who really think it makes a difference. It makes a difference in your ability to defend the base, and in order to explain what it is you're trying to accomplish and what your objectives are. But I also mention another thing about these taxes. Certainly it was true in Michigan, that the SBT tax rate was never increased in Michigan, it was only decreased. And there are people who would argue that that was because everybody was in the same boat together. Business -- you couldn't divvy -- you couldn't drive wedges in the business community and have the C-corps conflicting with the S-corps, battling with the partnerships. Everybody was in the boat together, and they -- business uniformly opposed changes in the tax rates on the upside. Although, as you pointed out, the base itself will get altered over time consistently.

COMMISSIONER BOSKIN: Let me come back to that base in a minute and then come back to the type of how to do this also.

So in the base, the chairman and others have alluded -- and you sort of alluded to the fact that you could think of this as a generalized consumption tax, you're kind of spreading the sales tax, the current sales tax to services, in a sense, is one way to think about this a little bit.

But that implies that businesses are going to be paying -- you might say, collecting because they're going to pass the bulk of the tax forward in higher prices, on a wide range of items that our citizens aren't used to paying taxes on. For example, rent; for example, doctors' services, and things of that sort.

That's correct; right?

MR. CLINE: I believe we excluded medical services. We said --

COMMISSIONER BOSKIN: You said nonprofit medical services.

MR. CLINE: I'll check, but I think we excluded all health care.

COMMISSIONER BOSKIN: Your statement said nonprofit such as education.

MR. CLINE: I'll check that, I could have been – I'll check that because I think the intention was -- well, most of -- we'll check that because I think the intention was not to tax medical care.

CHAIR PARSKY: Right, that was the intention.

MR. CLINE: That was the intention, yes.

COMMISSIONER BOSKIN: Maybe if you could double check that.

MR. CLINE: I will do that.

COMMISSIONER BOSKIN: But the English seems to say only nonprofits, which it's an issue about nonprofits versus profits.

MR. CLINE: Okay.

COMMISSIONER BOSKIN: Do you have any estimate of the total number of new tax-paying entities or, you might say, tax-collecting entities to the extent they pass it forward, that will be paying taxes in California? A new tax in California?

MR. CLINE: I can't give you that number. We are looking at an estimate of that change. We do understand that there will be additional firms beyond the S-corps and the C-corps that are currently -- but that's the role of the minimum threshold, the business minimum threshold. That's barely -- until we know if the Commission has a particular, specific proposal, we'd have to -- that's a key --

COMMISSIONER BOSKIN: Well, it would be really good to just get a quick idea of how many, if there's none, how many, if there are one or two typical thresholds, 250 or 500 or something like that. It would just be a good idea because you can expect that 98 percent of them are going to scream when this is announced, probably some fraction of them should scream because they won't have pricing power. Another large fraction will see that it's substituted for other things they want to get rid of. That may be a good thing for them. But in any event, we ought to get some idea. And also, we have to give some thought as to how this will be administered and where those resources are going to come from and how it's going to be administered. And that's kind of the first step to start thinking about that, it seems to me.

Then it seems to me there are a whole bunch of transition issues. Several were mentioned. You mentioned net operating losses. But we also have a variety of things, for example, that, depending on what other taxes this might substitute for or reduce, there's a lot of income in the future that will either be exempt or subject to tax in the current tax system, that would be taxed if those funds were then consumed later on. And so we're going to have to think about that in terms of the distribution, not just by income decile or income quintile, but by young versus old, things of that sort, for example, it seems to me. And it would be good to get some information, some baseline information about that so we can both figure out -- if you use that to decide how interested we are in this, and also decide if we are interested, what other types of things might be necessary to remediate some of the particular hit to certain vulnerable groups, and also anticipate some of the political reactions, so we have some idea of all that.

So I think just dealing with an abstraction at this level is a good start. But I think we have to flesh it with a lot of these kinds of useful information.

Then just a technical question, why not go straight to something like a credit invoice VAT?

MR. CLINE: I had a conversation with a tax research director in another state yesterday, and the issue came up in that conversation. I think --

COMMISSIONER KEELEY: Excuse me, just for the kindness of all of us, what does that mean?

CHAIR PARSKY: Explain that so we can understand what the shorthand from our professor is.

MR. CLINE: Well, as I --

COMMISSIONER BOSKIN: Credit invoice value-added tax, which is a very common way to implement a value-added tax.

MR. CLINE: Yes. As I mentioned -- again, I might have mumbled or mentioned it in passing -- the border-adjustment issue is really significant. It’s significant on the capital-expenditure deduction, it’s significant on how you determine where value-added is attributable for a state tax calculation. It’s really important.

What we were describing as our understanding of the generic animal to be estimated was a value-added tax apportioned to California using destination sales, where companies make their sales, as the determinant of how you get value-added into the tax base in California. And that resulted in saying the sales coming in are taxable, the sales going out are not taxable.

If you look at Europe, what they’ve done is adopted a credit invoice method, because they didn’t like the old system, which was a gross-receipts tax system, the turnover, they got rid of that, put in their new value-added tax system.

They operated differently. They handled the cross-border issues in a different way. Remember, they were driven by uniformity, by coordination across countries. They wanted to bring down those barriers across countries. So they said to make sure that if a product was sold from France into Germany, it didn't come into Germany with all the taxes embedded from France. Because they wanted Germany to have the right to tax that product at whatever rates Germany wanted to use. It's Germany's decision, not France's decision.

So they set up this credit-invoice method, I think primarily driven by that board or adjustment, which said that the French company gets to not only not pay tax on the product itself, but it gets refunds on any taxes its paid other companies, embedded value-added taxes on prior stages.

And so when that product leaves France to go to Germany, it has no value-added tax embedded in it at all from France; and all the value-added tax, in a sense, gets imposed on the first sale into Germany. I mean, that's the way to coordinate across the countries.

I don't think we have the same perspective within the United States. I don't think we think that products from Michigan sold into California should carry exactly the same taxes as a product that's sold -- that is produced in California. I mean, we just are not ready, I think, to make those kind of border adjustments.

If we did, then the net-worth tax for California would have to say, okay, we're going to tax the value coming into the state, and it's the VAT rate, so we'll maybe get that right. It's coming in, so it's the full VAT rate on California imports. But what will you do about the exports out of California? How are you going to make sure that the companies, at every step of the way in California, that paid that value-added tax on that product, how do you make sure that all of that gets refunded to someone, and removed from the sale, out of California, into Michigan?

I don't think we know how to do that. You'd have to make up ad hoc numbers to say, "Every durable, every appliance that leaves California has 30 percent value-added tax embedded in it." So I don't think we're ready to make those kinds of adjustments.

COMMISSIONER BOSKIN: That's why I asked the question. I thought everybody should understand that it's precisely the border tax adjustments --

MR. CLINE: And --

COMMISSIONER BOSKIN: -- that are at issue, and why we don't go directly to a --

MR. CLINE: But it's more than that. The credit invoice method is thought of as a sales tax, transaction by transaction.

The net-receipts tax and the value-added taxes in Michigan and New Hampshire were not thought of as transaction taxes.

You didn’t keep track of every transaction and the tax embedded. I mean, that’s for the sales-tax world, it’s not the business entity world.

At the end of the year, you total up your total sales, you subtract your total purchases, or you total up your compensation, interest paid, dividends, et cetera, and you send in the tax return. That’s -- I think, fundamentally, those are different systems from an administrative perspective.

COMMISSIONER BOSKIN: I agree with that. But I think the way to think about them administratively is other than the border-tax adjustments, which you did a good job of doing, all you’re doing is simplifying a state transaction VAT by having it administered, by having it withheld at the company level, and paid at the company level, presuming the companies will pass it forward.

MR. CLINE: I think that’s a working assumption, that’s correct.

CHAIR PARSKY: If each commissioner doesn’t feel like they have to ask questions. If anyone has some additional questions, I’m going to ask Richard Pomp to be the last questioner. But proceed ahead.

Becky?

COMMISSIONER MORGAN: Yes?

CHAIR PARSKY: Proceed.

COMMISSIONER MORGAN: Thank you.

I would like, just for clarification, why the net-receipts tax calculations was added to existing state and local taxes? Wouldn't we want to look at it as net receipts? You know, take the gross tax and subtract whatever we chose to? If you assume we're going to continue to pay all of these taxes, then we are, in fact, increasing the tax burden.

MR. CLINE: You're absolutely right. And I may have made a statement that was misleading. I think it was.

COMMISSIONER MORGAN: On page 16, where you said it's *"added to."*

MR. CLINE: And the right -- maybe the accurate statement is, we looked at the net-receipts tax in isolation, not as part of a package that might involve the increases and decreases. But when we came to trying to estimate who bears the burden of the tax, we had to start from somewhere. So we started from the assumption that the current system of taxes in California is there, and we added the net-receipts tax on top of it.

COMMISSIONER MORGAN: Okay. So that's not --

MR. CLINE: So we were really trying to look at it in isolations without the package.

COMMISSIONER MORGAN: And Michael is right, based on what was in here, it is the nonprofit medical services --

MR. CLINE: Yes, I'm going to check on that.

COMMISSIONER MORGAN: -- therefore, partnerships, whether they be doctors or lawyers or any of those, would come under the net-receipts tax; right?

MR. CLINE: I'm going to absolutely verify that health care was either in or out of that estimate.

COMMISSIONER MORGAN: Well, if it's nonprofit or profit; because if it's a partnership of doctors, they hope to make a profit. They don't always, but…

And, Mr. Chairman, I guess this is a process question. I had understood that the Commission was to take to the Governor and the Legislature proposals of reforms; and that the Speaker and the President Pro Tem had agreed that they would take it to the Legislature for a vote, up or down. Certainly, a net-receipts tax or any other changes in taxation take a two-thirds vote in the houses. And I, therefore, wonder, something as complex as a net-receipts tax, certainly can't go on that up-or-down vote, it would appear to me. Therefore, what will our recommendation relative to this three hours that we've spent on this be?

CHAIR PARSKY: I wouldn't attempt to presume what our recommendations would be.

COMMISSIONER MORGAN: I mean, how can they go for --

CHAIR PARSKY: But -- but the operating assumption we have, is that the reform will be a package. And as you will -- of tax changes. It may include a new tax, it may not include a new tax. But that package of changes, we're going to measure on the basis of revenue-neutrality. We're going to measure that, as you will see, starting as soon as this presentation is completed.

And in that context, the Legislature has indicated a willingness to address this with an up-or-down vote. So we're not suggesting that there would be a vote on one particular package -- on one particular tax, which may cause an increase or a decrease, but on the package of changes.

COMMISSIONER MORGAN: But a vote on the changes themselves ––

CHAIR PARSKY: Yes.

COMMISSIONER MORGAN: -- that would be proposed?

CHAIR PARSKY: If we can reach agreement.

COMMISSIONER POMP: Without a bill.

CHAIR PARSKY: No. Let me clarify that.

If we can reach agreement, we would seek, at the request of both the Governor and the Legislature, we would seek assistance to craft a bill that would be -- we would take our recommendations, and we would convert them into one or more bills that would be addressed by the Legislature. That's the objective, if we can reach agreement.

COMMISSIONER MORGAN: And just for my understanding -- I've been out of Sacramento a while. I assume anything to deal with --

CHAIR PARSKY: I've never been in Sacramento. That's okay.

COMMISSIONER MORGAN: That's probably a good thing.

It is a two-thirds vote?

CHAIR PARSKY: Well, we can have a discussion about this. But if it's revenue-neutral and the package is considered, it is not a two-thirds vote.

COMMISSIONER MORGAN: Okay, that's the clarification that I think is helpful.

The other possibility, is it not, is that we could take things that would more easily get through the Legislature for an up-or-down vote, and have a second list of things that they should consider in the next year?

CHAIR PARSKY: We have every option open to us.

COMMISSIONER MORGAN: Good.

CHAIR PARSKY: We can do the most difficult or the least difficult, let’s just see in the context. But, again, this presentation, I just want to indicate one more time, this presentation of a new tax is complicated. And any change in the tax system will be a complicated exercise. But I do think, since other states have really gone at this and since there have been a number of suggestions coming from commissioners and others, that we need to look at how we can do a combination of things. Potentially broaden the base of taxation, lower the rates. That’s coming there. So you have to step back and say, “Well, how can this be accomplished?”

This approach is one component of how you can accomplish that. It’s not the only one, but it is one.

Chris?

COMMISSIONER EDLEY: I’ll pass, Mr. Chairman.

CHAIR PARSKY: John?

COMMISSIONER COGAN: I’ll pass.

CHAIR PARSKY: Bill?

COMMISSIONER HAUCK: No.

CHAIR PARSKY: Jennifer?

COMMISSIONER ITO: No.

COMMISSIONER COGAN: We’ll give our time back.

CHAIR PARSKY: Don’t worry. I don’t know whether this is the right side or the left side. However, that side will not give it up permanently.

COMMISSIONER HALVORSON: I will pass.

CHAIR PARSKY: Okay, Richard?

COMMISSIONER POMP: It’s good to see Bob again. Bob and I actually have litigated some cases together, and this is nice to see him wearing a different hat.

The chart on page 18, if we were to do the same chart with the existing sales tax, I assume the curve would be more or less the same?

MR. CLINE: I believe it would be very similar. We did some initial runs that showed that similarity, depending -- and so the shape would probably be similar.

COMMISSIONER POMP: When Charlie McLure, who is, of course, a colleague of some people on the Commission, a friend of others, was here, he talked about how -- and, again, we can only compare an ideal value-added tax to an ideal retail sales tax, and he said that the base is the same; that really, the difference is in the administration of it. And I wonder if you would agree with that.

MR. CLINE: Well, I think that -- with all of the qualifications one could make, it’s a useful starting point for understanding what the net-receipts tax is.

In a closed economy, if you could remove all the pyramiding from the retail sales tax --

COMMISSIONER POMP: No, he said an ideal, so that’s the assumption.

MR. CLINE: You would have a net-receipts tax.

COMMISSIONER POMP: Right.

MR. CLINE: So it, in fact, would be the same base. And so we know in concept that you could -- you might use a net-receipts tax to achieve an objective that you haven't been able to achieve under the sales tax. And it has two pieces, you want to tax more of household consumption, and you want to remove the sales tax on business inputs.

COMMISSIONER POMP: Right.

MR. CLINE: And if you accept those as your objectives, then the net-receipts tax, which should have roughly the same base as an ideal sales tax, might be a way to meet that objective.

COMMISSIONER POMP: An ideal value-added tax and an ideal sales tax --

MR. CLINE: Correct.

COMMISSIONER POMP: -- should, in theory, come out looking the same because an ideal retail sales tax would exempt all business inputs and reach all consumption?

MR. CLINE: Correct.

COMMISSIONER POMP: This net-receipts tax, when it reaches all sales, including services, it excludes business inputs, so that that is how we are reaching the ideal of personal services, just the way we could if we had -- now, I don’t want to put words in your mouth -- but the political will to do it more explicitly in a retail sales tax?

CHAIR PARSKY: You can scratch the word “*political*.” Just *“will.”*

COMMISSIONER POMP: That’s fine, *“will.”*

Now, in other words, the base is the same ––

MR. CLINE: There was a question there?

COMMISSIONER POMP: Right. Do you agree? Always a question, “Do you agree.”

Is that basically the way to be thinking about this? I mean, we could move our retail sales tax in the ideal direction by exempting business inputs and expanding the base to more personal consumption.

MR. CLINE: Right. I think there’s a dimension that your question addresses that’s an important practical one.

What I’ve seen in some of the other states that have looked at alternative business tax bases, whether it’s gross-receipts or value-added taxes, they are thinking of them as entity-level business taxes. They might achieve an objective that’s more of a retail sales-tax objective, which is removing retail sales taxes from business inputs and expanding it to more household services. But they view it as business taxes.

And so when you're scoring a package of changes, the interesting question is, if you put a net-receipts tax in a package that reduced the sales tax, would you be substituting a business tax for a household tax? In which case, business is paying a larger share of the total than households were before the new package? I mean, that's the fundamental way to think about you're challenging yourself to think about this tax. Will it be scored as an increase in business taxes, or will it be scored as an increase in sales taxes?

COMMISSIONER POMP: But do you disagree with the earlier public speaker who said businesses don't pay taxes?

MR. CLINE: Oh, I agree that the taxes ultimately are shifted to households or investors or labor in one form or another. Now, we're talking about kind of the static revenue estimates and how you think about the package.

COMMISSIONER POMP: Once you get into dynamic modeling, we've lost anything we can talk about.

MR. CLINE: Okay.

COMMISSIONER POMP: So we'll stay static.

So the incidence of this is similar to the incidence of our existing sales tax, we think?

MR. CLINE: With the qualification that the current sales tax comes up very short in terms of taxing all household consumption, and comes up too heavy on taxing business inputs. So that's determining the current distribution of the sales tax.

So, again, are you saying, ideal sales tax versus net-receipts tax?

COMMISSIONER POMP: But that's not a structural problem; that's a question of will.

MR. CLINE: It's the current system versus an alternative system.

COMMISSIONER POMP: Right. But nothing inherent in the retail sales tax; so we're talking about having the will -- I will modify it -- having the will to move in a more normatively correct direction.

MR. CLINE: I tend not to --

COMMISSIONER POMP: An adjustment to a normatively correct. I mean --

MR. CLINE: I tend not to answer questions dealing with intentions.

COMMISSIONER POMP: Move in the direction of this tax, which -- and the intention is to reach more personal consumption and exempt more business input.

MR. CLINE: I think it's true that this is being considered as an alternative way to expand consumption taxes to services without carrying with it all of the shortcomings of the retail sales tax.

COMMISSIONER POMP: But those shortcomings which could be corrected? This is a non-transparent way of correcting the shortcomings?

MR. CLINE: They could be corrected within the sales-tax system.

COMMISSIONER POMP: Yes, okay.

MR. CLINE: We haven't seen states successfully doing it, but it's possible.

COMMISSIONER POMP: We've certainly seen a trend to increasing more services under a sales tax?

MR. CLINE: It attempts to, but they're limited at the margin, unless you're extending the sales tax to business purchases of services.

COMMISSIONER POMP: When you say "limited," the change gets made. The revenue may not be there but --

MR. CLINE: The revenue is not.

COMMISSIONER POMP: But the change gets made.

Let's -- I'm curious as to the revenue and the projections. You had sales in California, and some of those sales in California were made by out-of-state companies, because you really don't care; right?

MR. CLINE: Correct.

COMMISSIONER POMP: And so those out-of-state companies, you didn't look at the nature of them, whether they had physical presence here, whether they were a remote vendor? Just whether they made a sale in California?

MR. CLINE: Correct. Because the assumption is economic nexus would be the determination of whether or not you are a taxpayer in California, which is, as I understand it, current law.

COMMISSIONER POMP: So you have resolved a constitutional issue for which the U.S. Supreme Court has not chimed in yet?

MR. CLINE: No, I've simply assumed the current law treatment would be extended to the net-receipts tax.

COMMISSIONER POMP: Well, that current law is what is said in the corporate income tax in the recent changes, and has not yet been litigated. So if this were viewed as a consumption tax, and if *Quill* were viewed as then applying, you would not be able to tax the sales of remote vendors without a physical presence?

MR. CLINE: Not being a lawyer, I don't even --

COMMISSIONER POMP: But you know the *Quill* case --

MR. CLINE: -- know where to begin.

But I will say, certainly that it's been discussed in Michigan and it's been discussed in Ohio.

They understand that it is an issue, and that there will likely be court cases that test economic nexus.

But it's not limited to these new states. We have a lot of corporate income tax states that are going to economic nexus, like California.

COMMISSIONER POMP: Yes, but *Quill* was a case that came up with a sales tax. And the question will be, will this be viewed for constitutional purposes as the type of sales tax that *Quill* would apply to. And if the answer is yes, then regardless of what California says in a statute, the physical-presence rule would apply.

And then I'd like to know, then what do the revenue estimates look like? In other words, if we were to back out -- and maybe this can't be done -- but if we were to back out vendors who, under *Quill*, present day, cannot be made to collect the California sales and use tax, what happens to the revenue projections?

MR. CLINE: I don't know the answer to that at this point.

COMMISSIONER POMP: Is it knowable?

MR. CLINE: Well, with enough work, you might be able to estimate what percentage of those total sales come from a company that doesn't have payroll and doesn't have people in California.

COMMISSIONER POMP: The very company that, today, cannot be made to collect the California sales and use tax – *(telephone ringing)* -- maybe that's the estimate coming in.

The border adjustments -- right now, and I will ask the people in this room, because I assume California does not levy the California sales tax on sales made to other states -- which I assume that's right, which is a kind of border adjustment. So that the California sales tax does not apply to exports.

Now, we don't refund any sales tax on a business input. You know, that's just buried. But in thinking about this and trying to compare advantages and apples and oranges, it is true that we do have a border adjustment, as most states do in the retail sales tax, and that is the very common exemption for sales made in interstate commerce. So I'm not sure we can look at that as a new advantage of this tax.

MR. CLINE: And it's certainly a feature of the current corporate income tax for those who select -- who choose to go to the single sales factor apportionment formula. So it comes with the apportionment process.

COMMISSIONER POMP: Well, it's more than apportionment, if we're talking the sales tax -- you know, the current sales tax.

You know, talking about Ed's question, how to game the system, you were kind enough to attach an article that I co-authored when Michigan adopted their new tax.

And I will simply say to Ed, if you look at that article, while we don't call them *"loopholes"* or *"gaming"* or anything else, there are numerous definitional problems. Every definitional problem to a lawyer is a tax-planning opportunity. It is not simple to simply draft a new tax. I admire our chairperson's insouciance in trying to get a bill before the Legislature. But as someone who has drafted, it is not so easy, especially a new tax. So…

CHAIR PARSKY: We'll call on you for extra help.

COMMISSIONER POMP: Well, which raises another question.

You did a lot of work. Is this pro bono on the part of Ernst & Young?

CHAIR PARSKY: No, Ernst & Young has been retained by the Commission.

COMMISSIONER POMP: We have retained them?

CHAIR PARSKY: Yes. Not you individually, but this commission has retained them.

COMMISSIONER POMP: I'd just like to know how my money's being spent, so…

All right, in terms of -- you know, Ruben asked a question about tax on business inputs, and you were talking about how Michigan really went through various iterations about limiting its incentive to just Michigan purchases and capital investment. And that also raises a constitutional issue. This actually did go before the U.S. Supreme Court in a case known as *Cuno v. DaimlerChrysler*, and was dismissed on standing grounds. So maybe this won't be litigated in the future. But this is a very tricky issue about limiting your incentives to just state-oriented activities. And that has to be sort of when we think about the question that Ruben -- I was going to say the very good question but now you know there's sibling rivalry with Fred who has great questions, too. But, you know, these are all appropriate questions to raise.

I was a little surprised that it was only in response to Fred that you made what are really, to me, quite telling points.

New Hampshire has no personal income tax. They also have -- no broad base --

MR. CLINE: Right. An interest in dividends tax.

COMMISSIONER POMP: And they have no broad base sales tax. But like any tourist states, they will tax hotels and restaurants. But no broad base. They certainly consider that economic development.

And, I mean, how much better can it get? You have no sales tax, no personal income tax.

As far as I knew -- and I was a bit player in this New Hampshire tax -- the reason they went to the form of tax they have is because they wanted to tax income but couldn't do it explicitly with an income tax because, like Texas, you would be, you know, taken out and shot. So you couldn't use the word *"income."* And so that was really the motivation for their form of modified value-added tax, whatever you want to call it. And that explains Texas, too, where --

COMMISSIONER EDLEY: That's called "tax-free or die."

COMMISSIONER POMP: That's right.

And I think it's great, we have New Hampshires in our union. You know, you want to go to a state and not get any services and not pay taxes, that ought to be your prerogative. So that's fine. And I'm not ganging up on New Hampshire. But let's understand that --

COMMISSIONER PRINGLE: Oh, we didn't know what that was.

COMMISSIONER POMP: -- these things evolve from a particular set of constraints. And Texas, of course, does not have a personal income tax and they had a real issue with limited partnerships because of oil and gas.

And that explains why yet they have this -- I don't even know what you want to call it, this new tax they call *"margins tax."* But, you know, it defies easy classification.

I don't mind looking at other states and saying, "Well, that's interesting."

Michigan, it's kind of ironic we should be talking about Michigan in the same sentence with economic development. I mean, my goodness, what a disaster.

Now, you say to me, "Oh, but, God, how can you blame the change in the automobile industry?" But that's the very point that you --

MR. CLINE: I don't think I said that.

COMMISSIONER POMP: But there were suggestions that these changes --

MR. CLINE: I don't think I suggested that. No, I don't.

COMMISSIONER POMP: No, no, I mean, that's an interesting extrapolation, but…

MR. CLINE: You may make the statement, if you'd like, but I did not.

COMMISSIONER POMP: You predicted the effects of taxes -- what state was it on job creation?

MR. CLINE: I said in both Michigan and Ohio, compared to their current tax systems, the different tax systems showed positive economic impacts.

COMMISSIONER POMP: Okay, that's fine.

MR. CLINE: I didn't comment on whether or not there's a third, better system.

COMMISSIONER POMP: It showed for economic impact.

MR. CLINE: It did.

COMMISSIONER POMP: And, of course, completely swamped by changes -- structural changes in the economy, which will always swamp whatever you can do with your state tax system and look at Michigan. So I think we have to be a little cautious in thinking that there will be really severe, significant, important, positive economic development from a change in -- whether we replace a sales tax with this -- whatever we do, you have to remain either cynical, skeptical, or agnostic. But it's a little hard to be too much of a zealot on this issue.

Now, you weren't here, we had a presentation from someone with the National Education Association, that I thought was very balanced and very perceptive on this issue. But you know the literature as well as I do. It's very easy to think that there's a Holy Grail here.

MR. CLINE: Right. I would say, though, that if you remember the slide that I had, it was entitled "What are states trying to accomplish?" It doesn't say, "What have states accomplished?” The objectives were the objectives, like economic growth, and they certainly were making decisions that they thought would improve their economic --

COMMISSIONER POMP: Yes, so sometimes you should go back and see what actually happened.

CHAIR PARSKY: No, but I think that’s -- the recitation of what happened in other states is not intended to be, “Well, we can follow exactly what they’re doing,” but more to see what their intentions were, what the changes were. And there’s no question that, seen in isolation, all these issues need to be addressed. But, again, I want to try to move as rapidly as possible today to take a look at a group of proposals.

It’s important to understand this element because it is proposed to be included in one form or another in all of the packages. And this commission may decide it’s not appropriate.

COMMISSIONER POMP: No.

CHAIR PARSKY: Or we have a stronger will or a different will. It’s perfectly okay.

But, again, I don’t want to spend all of the time just in isolation on this tax. We’re going to need to do a significant amount of more work if we decide we want to potentially include it in an ultimate recommendation.

COMMISSIONER POMP: I don't know of any state that proposes a change on the grounds, "This will hurt jobs and hurt the economy." So every state, when they propose something, obviously hopes it will encourage economic development.

Do I have more time or is that it?

CHAIR PARSKY: You do.

COMMISSIONER POMP: I do?

CHAIR PARSKY: Not too much more, but…

COMMISSIONER POMP: Not too much more? All right.

I wanted to -- I thought the questions that were raised --

In terms of the revenue, Bob, you really had no choice in modeling this to take into account a purchase price; and if that purchase price, as reported, had sales tax embedded in it, that's the way you found the data.

MR. CLINE: Correct.

COMMISSIONER POMP: And so you didn't have the ability to really back it out?

MR. CLINE: We didn't address the issue and attempt to do that, no.

COMMISSIONER POMP: Right. And that was really a short answer to Curt's question.

MR. CLINE: Right.

COMMISSIONER POMP: On the property tax, to the extent it's passed forward into higher rents, then it will work its way into your calculations.

MR. CLINE: Correct.

COMMISSIONER POMP: Okay, just so that we clear that up.

You had mentioned a few times Public Law 86-272, which, again, this is pretty esoteric stuff, but you did not mention that there is a technique called a *"throwback rule"* in the corporate income tax that undoes that public law. That this is not an advantage of another tax that avoids Public Law 86-272. The state is perfectly capable, as California has done, in having a throwback law.

So, again, in comparing, we've got to be apples and apples, and not have apples and oranges or tangerines here.

MR. CLINE: But just remember that the states like Ohio and Texas and Michigan always argue that basically concluded Public Law 86-272 didn't apply to their taxes. That's not dealing with a current taxpayer in the state whose sales you might throw back; that's a new taxpayer you don't -- that's a new company you don't have as a taxpayer. The question is, do you get now to declare that they are taxpayers in your state.

COMMISSIONER POMP: The Ohio -- which group was it that came out with a very favorable report? It was the Ohio --

MR. CLINE: Business Roundtable.

COMMISSIONER POMP: -- Business Roundtable.

The changes in Ohio were very favorable to business; were they not? They eliminated the intangible property tax. They eliminated the corporate income tax.

MR. CLINE: And they reduced personal income taxes by 21 percent –-

COMMISSIONER POMP: Yes, so not a --

MR. CLINE: -- which accrued primarily to household, not to business. So it was a balanced change.

And they lowered -- they actually increased the sales tax rate to help balance the budget. But there were substantial changes in every one of their major changes.

COMMISSIONER POMP: In the Ohio corporate income tax, did they have combined reporting like California?

MR. CLINE: I don't think they did, no.

COMMISSIONER POMP: Yes, and so they had a problem with Delaware holding companies that was really eviscerating their corporate income tax. California, as you know, is sort of the intellectual father of combined reporting, and has been --

MR. CLINE: But I think Ohio, wasn't it the pioneer in add-back of expenses paid to Delaware holding companies?

COMMISSIONER POMP: It's certainly a poor man's second-best solution for combined reporting.

MR. CLINE: Okay, but they had taken that step.

COMMISSIONER POMP: No tax lawyer worries about that statute, so…

All right, Mr. Chair, in deference to lunch, I will be -- I never get in the way of lunch, so…

CHAIR PARSKY: Thank you.

I think -- first of all, Bob, I want to thank you very much. We will have some follow-on analysis that we will want done.

I think what we ought to do is to take a brief lunch break now. I apologize for not getting to our morning break. A brief lunch break, come back -- we'll be -- let's start again at a quarter to 1:00, and we'll move right into a presentation of the packages. And then we'll come back around and see if we can't pull some of this together.

Thank you.

(Lunch recess from 12:13 p.m. to 12:53 p.m.)

CHAIR PARSKY: We're going to try to now move into a discussion by Mark and Phil, leading the discussion on some packages that we thought that the Commission should be considering. And we're going to try to pass, if you will, each of the packages through the prism of our goals, once we understand what these packages entail.

And I want to start by saying, none of these packages are the recommendations of the staff. These are not staff recommendations. The staff has been asked to prepare these packages for analysis.

COMMISSIONER COGAN: These babies have no mothers?

CHAIR PARSKY: Well, there's this godfather floating around here; but they have no direct mothers or fathers. But we had to figure out some way to get some specifics before the Commission. So this is an attempt to do that.

And I will say that before getting into the specific packages, we wanted to have a discussion, if you will, of the concept of revenue-neutrality, make sure people understood the way in which the staff approached the issues of a distribution of the burden or the regressivity/progressivity issue. And then we're going to apply those to each of the packages themselves.

We also have done -- or they have done an analysis, outside of the context of the packages, but as indicated on our Web site, analysis of the capital-gains tax independently, and how that impacts some of our goals.

Those, if the Commission decided that you wanted to address that separately in the context of any package, you can put that forward. Similarly, there's an analysis of the carbon tax, a tax that has been suggested for discussion. That tax could be included, or not, in any package. And I know a few of the commissioners have some other thoughts that might fit into the category of additional options.

So with that, Mark, why don't you take us through your slides?

And what I thought would be helpful is if we let Mark and Phil get through their entire presentation, and then we'll come back, and we'll go at general concepts, and then each package.

MR. IBELE: Thank you, Mr. Chairman.

While none of these packages are staff recommendations or staff packages, there are certainly aspects of each of the packages that we would look favorably upon. But we'll present our material --

CHAIR PARSKY: You may get pressed if you keep saying that. That's okay, they may.

MR. IBELE: We'll present our material; and then, obviously, if there's any questions, Phil will answer them.

I wanted to spend just a little bit of time --

we've talked about these three issues before: the progressivity of the tax system, the volatility, and the revenue-neutrality concept. I'll go through the first two a little bit, and then Phil will handle the revenue-neutrality aspect before we tackle the packages and describe what's going on with each of those.

The first slide here is, I think I've used *"Tax Structure Alternatives."* This is the fourth meeting where I've used that phrase. I'm looking for something else. But this is something you've seen before. This is the California state revenues by source. And the blue bar shows personal income tax -- I'm sorry, retail sales and use tax over time. And I think that goes back to '93. I don't have the years up here. This was a last-minute addition. And the red bar is the personal income tax.

So one of the first things to note is that California's tax system, the tax structure itself, has become more progressive over time. And the basis of that is simply because we've moved from a sales and use tax, which is largely regressive, as we talked about throughout the Commission's duration, to a personal income tax, which has a progressive impact on taxpayers.

CHAIR PARSKY: Just pause one more second there. Pause a little bit on the distinction between progressive/regressive and the percentage of the burden shared by each of the taxes -- or contributed by each of the taxes --

MR. IBELE: Sure, sure.

CHAIR PARSKY: -- and the economist's definition versus other definitions.

MR. IBELE: Well, the definition of *"progressivity"* has to do with the effective rate that you pay as your income changes. So a progressive tax would be the effective tax rate, considering all taxes, would go up as your income increased. The tax burden -- and that gets at sort of this concept of the ability to pay.

The tax burden -- that is, we've seen these charts where the proportion -- I should say, the portion of the tax paid by decile, by income group, changes. But what that doesn't reflect is whether there's been any underlying change in the amount of income that is used to pay that. So they're related, but they are separate.

Go ahead, you can interrupt me.

MR. SPILBERG: Just a clarification on this chart. These are five-year intervals, starting with 1950-1951, being the first bar chart. And the last bar chart is 2007-2008. So they're five-year sort of intervals, what are sort of the distribution across taxes in California.

MR. IBELE: And that brings me to my second point, which is, this shift in the progressivity, the relative progressivity of the tax system has not occurred because of any policy change or, largely, not because of any policy change; it's related to the change in the economy, it's related to how income is distributed, it's related to how people earn their income. So this was not a policy decision on the part of the state.

COMMISSIONER POMP: This does not show progressivity?

MR. IBELE: No, it does not.

COMMISSIONER POMP: Okay.

MR. IBELE: No, I should make that clear. This is simply the portion of the entire tax revenues attributable to each of these taxes.

And to get to the progressivity, I made an assertion that the personal income tax is progressive and the retail sales tax is regressive. And we've moved to a progressive tax and away from a regressive one.

CHAIR PARSKY: But I think the thing to focus on, on this slide, in part, is the way in which the system, as it has evolved, has increased the dependence on the personal income tax as part of generating the sources of revenue.

MR. IBELE: I think that the second point I'd like to make here is that because of this shift, there's nothing particularly right or correct or good about the particular -- it’s obviously a value judgment, whether you like the current distribution or you don’t like it. There’s nothing particularly magical about it because we have evolved, because the economy has changed.

In sort of traditional public-finance theory, going back to Musgrave and Wallace-Oates and so forth, distribution is usually not something that states were considered as part of their regular activity. They were involved in resource allocation but not typically distribution. And it has to do with the aspect of factor mobility, particularly capital mobility.

Having said that, most states do engage in certain redistributive policies. They don’t tax food. The two states that I’m most familiar with, Minnesota and Massachusetts, they both have personal income taxes. Massachusetts has a uniform rate. Minnesota has a progressive –– a mildly progressive rate structure. So although traditional theory would suggest that this is not something that states ordinarily would do, there is certainly leeway there for states to do it, and many of them have.

And I guess the question then for the Commission -- one of its many questions -- is what is the distribution that this state should have.

The next topic I wanted to cover briefly is also a familiar one, the volatility aspect, which is closely related. It's also changed over time. If you look at what we've used in the past to measure the volatility of the system, the coefficient of variation, during the 1963 to 2007 period, this coefficient of variation was under 1 for the entire tax system. And for the 1993 to 2007 period, it was over 1.5. And I think for the last -- the last decade, it's been over 1.7, from your presentation at UC San Diego.

And this is largely due to an increased reliance on the personal income tax and it's due to the nature of the personal income tax itself changing. The way that people receive income, changing from wages and salaries. A much higher role to play for capital gains.

COMMISSIONER POMP: Variable pay, in general?

MR. IBELE: I'm sorry?

COMMISSIONER POMP: The general theory will pay bonuses, things like that --

MR. IBELE: Correct, yes.

COMMISSIONER POMP: -- at a much higher fraction of labor? Those are much more variable than your base and salary.

MR. IBELE: So it's both the shift to the personal income tax, a volatile source, and changes within the personal income tax itself.

So, again, here, like with the consideration of progressivity, this is an area that the Commission should consider. It's a part of the revenue system now, and it's proper to think about whether this should be actively –- as something that should be altered or affected in some way.

And I think before getting into the packages, we have -- as the chair mentioned, we have three packages, the first package of which has two components or two alternatives. And what we did is to look at the revenue-neutrality, we tried to model these over business cycle, from 2012 to 2016. And each package within that cycle was designed, the rates were put into place and so forth, to raise the same amount of revenue over that period.

They, obviously, didn't raise the same amount of revenue each year because they have different components and they grow at different rates.

We've used this forward-casting method. It's something that the Legislature is familiar with on a scoring basis. It's what's used at the federal level. And that's for the revenue-neutrality part.

For the volatility part, to measure each of these packages in terms of what sort of change in volatility, we actually did a back-cast and simulated what these packages would have -- how they would have performed in the past.

I'm going to turn it over to Phil, who is going to talk about the revenue-neutrality calculation.

MR. SPILBERG: Thank you, Mr. Chairman. Thank you, Commissioners.

I am going to just briefly talk -- do I have these things? Okay.

I am just going to briefly talk about just our process that we used for doing our extrapolation and specifically, the results. And the first question to ask is, is our extrapolation process reasonable.

We used a forecast that we received from the State Chief Economist, and we used 2012 through 2016. Because in 2012, we are still towards the bottom of the business cycle. And by 2016, we're getting toward -- at the top or, you know, a good level of the economy.

What this chart shows is basically the growth rates, the annual -- average annual growth rates across the most recent business cycle, going from 1994 to 2003, and comparing that basically to the business cycle, going from 2003 to 2014. And we're looking, in 2003, it's basically the mid-point of the cycle; and 2014 is also the mid-point of the cycle. So we're looking from mid-point to mid-point and seeing if, in fact, the growth rate that we're seeing across those two cycles are reasonably similar. This is just a reasonable test.

And with respect to personal income, we're seeing that the growth rate -- average growth rates are about -- are similar.

Over the earlier cycle, the growth rates have been higher. But if you look at the table below, the averages, it shows that the reason it's higher is because of the high growth rates that we had around '99, 2000.

We're looking at capital gains. And capital gains are substantially higher in the earlier cycle than they are in our projection.

We basically believe that the growth rates that we have observed recently in capital gains are unusual. And we have a recovery of capital gains from where they are right now; but we do not expect capital gains as a proportion of personal income to reach the proportion, the level that they achieved in the recent past. So this is something that we thought quite a bit about, and we thought it was reasonable.

With respect to taxable sales, which is another important variable for the extrapolation, we see that, again, the growth rate that we have for the projection period is lower than the growth rate that we have for the recent past.

And if you look at the table below, you can see why. We had some amazingly high growth rate in taxable sale -- this is taxable sale, this is not income -- around 1999-2000, 2000-2001. And, again, those kind of growth rates maybe are high, historically; and we do not expect those to be again repeated. And that's the reason why we have taxable sales growth, which is lower than we had in the previous cycle.

If you look at basically the last year in the table below, for each of those growth rates, we see that those growth rates are reasonably similar. More similar than the averages. So that's basically our check to see if our mid-point of the business cycle is reasonable.

The next table goes through an income distribution that we have for basically those two mid-points in the cycle. And what we see is, in our extrapolation, is that we have, in essence, a movement towards the middle for the distribution. We have, that last column shows basically the changes in income distribution between those two years. And it shows that we have a reduction of about 4.2 percent in the lower-income categories below $80,000.

And then what we have is about a 7 percent increase, right in the middle. And so some of this reduction in the lower classes was basically pulled in, into the middle class.

And then what we also have is, we have about 4.8 percent reduction in income, in the higher-income classes, from $300,000 to $5 million in annual income. So we have some of that pull from -- into the middle classes, into those higher classes also.

In addition, we do have the 2 percent growth in the over-$5-million class. And that's basically a secular growth that we have observed over the last -- over the last couple decades, that the high-income group is growing.

By the way, these income brackets were adjusted for inflation.

If the commissioners would like to know more about the extrapolation process --

CHAIR PARSKY: We'll give them a chance. Just get through the general discussion, and then we'll come back.

MR. SPILBERG: Yes, okay.

MR. IBELE: This is just a little bit of overview of the tax trends of 1963 to 2008. This is what we simulated and what we based our volatility measures on. And the net-receipts tax is the -- this is actually year-to-year change, growth or decline. And the red line there is the simulated business net-receipts tax, which is -- some of the graph mimics the sales and use tax, but is much more stable during much of the period.

CHAIR PARSKY: Pause on this one because ––

MR. IBELE: Yes.

COMMISSIONER EDLEY: The net-receipts is the more -- of the two reddish ones – is the more stable?

COMMISSIONER BOSKIN: Yes, it is the more stable of the two red ones, yes.

MR. IBELE: Yes.

COMMISSIONER BOSKIN: The other one is corporate tax.

MR. IBELE: Correct, right.

You don't like my colors, I guess.

CHAIR PARSKY: Well, your colors may be a little confusing.

MR. IBELE: Okay, well…

COMMISSIONER EDLEY: I think the green one's a mess.

MR. SPILBERG: We're going to have a debate on the colors.

CHAIR PARSKY: Okay, okay, we can't debate over colors. All right.

MR. IBELE: This next one, you'll like.

Okay, these are the packages -- and we can come back. But this is really just sort of a visual presentation of how, with the current law and you're starting off at a lower level and with faster growth in the out-year and with packages -- and I'll sort of foreshadow this a little bit -- Packages 1A and 1B have a flat tax -- a uniform tax component, start off at a higher level but don't grow as fast because they don't have the structure of the current law.

CHAIR PARSKY: Okay, before we go into the packages themselves, any questions about the general methodology?

John, you're okay on this approach to neutrality?

COMMISSIONER COGAN: Yes, it strikes me as pretty reasonable.

It would be nice to -- you said that you were going to back-cast the volatility numbers. Are you going to back-cast the revenue-neutrality numbers back to 2003, just so we have sort of some extra confidence?

MR. SPILBERG: We can certainly do that.

CHAIR PARSKY: I think that would be a good idea.

MR. SPILBERG: Yes.

COMMISSIONER BOSKIN: That would be very helpful.

The one assumption here that looks kind of strange is how slowly taxable sales are growing relative to income.

Do you want to defend that?

CHAIR PARSKY: Do you have a comment about that?

MR. SPILBERG: It’s just derived from the economic forecast. And we didn’t really go behind the economic forecast to see why it’s doing what it’s doing.

It does look a little bit low compared to personal income. But just keep in mind, this is taxable sales, so it assumes, in essence, that we will have higher growth rate in nontaxable sales, because you will assume that consumption remains a fairly constant proportion of income.

CHAIR PARSKY: Chris, did you have a question?

COMMISSIONER BOSKIN: It’s higher, but startlingly higher to account for that. I mean, your base is almost cutting in half the propensity to consume taxable items.

MR. SPILBERG: I did also observe that. But we didn’t really go behind the economic forecast to see why it was coming out of those kinds of --

CHAIR PARSKY: We could look at it.

COMMISSIONER COGAN: You know, you said this was a Department of Finance forecast; right?

MR. SPILBERG: This is from the Department of Finance forecast. It's through 2012. And this just goes a couple years more than that, which is not something that we published, but it's something that is -- it comes from the same source.

COMMISSIONER COGAN: Yes, so I'm sure their economists have an explanation that you could probably get pretty readily.

CHAIR PARSKY: I think you should circulate the explanation.

MR. IBELE: We can follow up with them and get more of an explanation for the taxable sales component.

CHAIR PARSKY: Yes, why that looks so odd.

Chris?

COMMISSIONER EDLEY: Can I just -- I think I probably asked this before and I just can't hold the answer in my head, so I apologize. For purposes of the way Sacramento scores and for purposes of the way we deliberate, when we say revenue-neutrality, are we thinking year by year or are we thinking over a longer accounting period?

MR. IBELE: Leg. Counsel does the actual scoring. And what I've learned -- and I think we have the letter from Leg. Counsel on this, too, on the Web site -- but I think they go out three years or five years for revenue-neutrality. And it's within that period of time that they determine whether or not it's raising revenues, in which case it would be a two-thirds vote, or it's revenue-neutral.

COMMISSIONER EDLEY: I'm sorry. But within that window, though, is it year by year within that window or is it --

MR. IBELE: No, it's the entire window.

COMMISSIONER EDLEY: Cumulative over that window?

MR. IBELE: It's cumulative.

COMMISSIONER EDLEY: Great. Okay, and is that what you feel, that that's the interpretation that we should assign to our charge?

COMMISSIONER BOSKIN: I think it's really important to do that. Otherwise, you would never be able to deal with volatility because you'd be having to reproduce lower revenue in recession years and high revenue in boom years.

COMMISSIONER EDLEY: Oh, no, I totally agree with using a longer accounting period. Totally. I just want to make sure that three is the right thing.

COMMISSIONER BOSKIN: The common sense is you aim for revenue-neutrality -- the simplest way to think about it is in a typical year, like 2003, not a recession like 2007, not a housing bubble like 2007, or going forward.

COMMISSIONER EDLEY: I would heartily endorse that, but that is not three years. Because a typical year, you would even out throughout the business cycle, if you mean a typical year. But --

CHAIR PARSKY: But if you look at a period of time and then you go from there to, say, what would be the typical year over that period, you would come out with these two years.

COMMISSIONER BOSKIN: Yes, I think the way to square the issue with how Sacramento does things is, the thought is implementing this several years from now, when the economy is going to be in some kind of random year in the business cycle, not in the current recession. And geared to that, I think that if we were dealing with it right now, we would have a whole other set of concerns to deal with.

COMMISSIONER EDLEY: Got it. That's --

COMMISSIONER BOSKIN: So I think that's why they're doing 2012 to 2016, and saying, well, if we average out about the same there, then if this were implemented in some hypothetical several-years-in-the-future date, we would design a tax code, if we come up with a new tax code, one of these plans or something else, that would raise the same revenue as the current one would in that hypothetical kind of business-cycle neutral year, then -- and if that code was more -- was less volatile, there would be a lot less risk of them having to make drastic changes around it. But it still wouldn't remove the issue or the temptation or the possibility of them raising the rates or lowering the rates or doing something else with respect to their own value judgments, spending desires or business-cycle conditions. There would just be a lot less need for it than there is now and have these big swings.

COMMISSIONER EDLEY: Let me just drop a footnote then because I agree with everything Michael just said. It's not obvious to me, however, that if we were thinking about implementation at a date into the future, it's not obvious to me how one connects that with the legislative scoring rules.

COMMISSIONER BOSKIN: Right.

COMMISSIONER EDLEY: Because it sounds like their window for analysis might not be the same as our window for analysis. And as an analytical matter, we might not care; but when we get to thinking politically, we probably ought to care. So that's a footnote for later thinking, I suppose.

CHAIR PARSKY: Okay. Curt?

COMMISSIONER PRINGLE: If I could. I do think, though, we should all be talking somewhat the same language because there's a lot of audiences for our product, and one of those is the Legislature. And I think we should talk in the language they do.

As one who certainly isn't excited about increasing the revenue volumes to the state, I know, and I think everybody knows, they will be. And part of what our mission is, though, is addressing tax policy for the 21st century economy; right? Therefore, just the principle, even if every -- if we're exactly the same generation of revenue under one plan, as the present plan this year, maybe next year, because the budget is really done in two fiscal years, anyway, and they add a third year, we know the economy is changing. Therefore, what we really are asked to address is how do we address that future change in the economy's makeup of the state. So by its very nature, there may be a change that brings in additional revenue.

And I don't think that's scary, but I think we need to live by the established practice in the Legislature; or else if we extrapolate that out to a full business cycle ten-year discussion, I think that gets pretty tough. And I don't necessarily think then bringing it back to a legislator's reality, that's going to be how they score it.

And it's not necessarily something that's happened once or twice. This whole discussion happens not only at budget time, but in scoring all other tax proposals and other principles.

COMMISSIONER EDLEY: That's right.

COMMISSIONER PRINGLE: So I think we really should adhere to what the practice is as opposed to maybe -- maybe that's a better way and a smarter way, but that's not necessarily the way it's being done. So we should do it the way it's being done. And I think it's a safer place.

COMMISSIONER EDLEY: But then how would we do that -- I'm sorry, but then how would we do that if our proposals would not become effective until outside the window?

COMMISSIONER PRINGLE: Well, you take three years -- you create the window -- the window's open when the window's open if the proposal's established at this point in time.

COMMISSIONER EDLEY: But is that the way it would be scored?

MR. IBELE: We're going to have to -- I mean, this clearly is evidence we're going to have to cross-walk these. Because from our perspective, we want to make sure that we're capturing the business cycle for revenue-neutrality purposes. We're going to have to figure out a way to translate that into what the Legislature looks like and --

COMMISSIONER EDLEY: What's weird about this is, if the legislation that we draft -- strike that.

If legislation is dropped now, presumably it's going to be scored for fiscal '10, '11, and '12. If what we draft becomes effective in fiscal '12 and out, then I'm just a little bit confused about how we -- do you see the --

MR. IBELE: Yes.

COMMISSIONER EDLEY: One issue is, "Is it three years," and the other issue is "Which three years," and "Is it the same three years that leg. counsel would use," so…

MR. IBELE: I see the dilemma. Unfortunately, I don't see the way out right now. But clearly, we're going to have to --

CHAIR PARSKY: Fred, did you have a comment?

COMMISSIONER KEELEY: Yes, I do.

I think on Mr. Edley's point, following up on Mr. Pringle's point, at least when I sat on the budget committee for six years, the way the budget committee saw things was in three years. And these years made sense to them, about how they would think about things. There's the year that they're in literally now with an adopted budget. And that gets dealt with in terms of revenue estimates and caseload estimates and the variation from those in the actual year for which there's an adopted budget through a process at the Joint Legislative Budget Committee of the administration submitting certain letters to the budget committee which make adjustments, up, down, or sideways, both on the revenue side and the caseload side and so on. They have a whole process for how they deal with that.

For the year that they're in right now, they then are working simultaneously on a budget proposed in January to go into effect the following July 1st, all the way around the horn to June 30th of the next year; and they use the Department of Finance forecast that, all the way back in about November, before the Governor even submits the budget in January, which is why then there is a forecast revision of both revenues and caseloads in May, the so-called "*May Revise*." That's for what they call the *"budget year."*

Then in budget year plus 1, which the departments and agencies are literally preparing budgets now, not for '09-10, but '10-11, and they are given certain assumptions by the Department of Finance in terms of projections of revenue and caseload. So that's the established world in Sacramento.

If you understand, like, how do they see it? They see it the year they're in, the year for which they are budgeting, and budget year plus 1. And they have a long history of being comfortable with those numbers and those processes. And the true-up occurs in three different places. During the year where you're actually operating within an approved budget, you have the section 27, section 28, like we've got all this business that allows you to make adjustments going along. In the budget you're planning for, you get the May Revise. And for budget year plus 1, the departments and agencies are given assumptions, as is the Legislature, through a combination of the Department of Finance, Franchise Tax Board, Board of Equalization, and the Legislative Analyst's Office.

The reason I say all that is, that's the fixed system in there. *"Fixed"* meaning agreed-upon and used historically.

So for the purposes of looking at this, I'm not sure it's as important -- as Mr. Edley would say, "strike that." My sense is that it's fine to pick -- to use that practice of the three years, because I don't think it's our call on -- if we come up with a package, I don't think it's our call. It's going to be the Governor and the Legislature's call on if and when they were to try to adopt that package. And then they'll have the opportunity to do their own forecasting in whatever way they want to do it. If they want to do it outside the context of a recession, then they can do that. If they want to see -- if they are desirous of a tax system which has significantly changed because they like what they see of the benefits of the proposal we send them, they may want to drop that in right away. So I don't know that we ought to get real hung up on that issue about reconciling the two things that we were just talking about.

I think it may be fine to work within the established custom and practice that both the executive and the legislative branch use for doing business with each other about revenue and caseload projections.

CHAIR PARSKY: Since we have the Director of Finance here, do you want to make a comment, Michael, about --

MR. GENEST: Yes. It's actually going to be a little bit simpler than all that. Because what's going to happen is, this bill, at least as I understand it, would take effect in '12-13, or '12.

So what the Leg. Counsel will do is they'll get FTB and Finance and others to analyze the revenue stream from the law as changed by this bill, from ‘12 forward, three to five years, and then they’ll look at the current law in the same period. And if the current law generates more revenue, it is a tax cut. If it generates less, it’s a tax increase.

COMMISSIONER PRINGLE: Or it’s neutral.

MR. GENEST: So the only thing is that this bill --

CHAIR PARSKY: Right, and it was in that context that this analysis was prepared.

MR. GENEST: Right.

It would be quite -- as Mr. Keeley says, it would be quite different if the bill was to take effect July 1 of this year. Then you’d be into a budget thing, and it wouldn’t make much sense. But since the bill is going to take effect in the future --

CHAIR PARSKY: And the underlying concept is, it wouldn’t take effect in the current year. This is looking forward. So we’ve picked the years that would be naturally looked at by the Legislative Analyst’s Office.

COMMISSIONER EDLEY: That’s good, that’s good. So we would have time to get out of town, is what you’re saying?

CHAIR PARSKY: Or to adopt a transition, whatever you want to say.

COMMISSIONER EDLEY: Okay. Good.

COMMISSIONER HAUCK: Well, it's related to -- correct me if I'm wrong here, Mike, but all of this is related to the forecast for the state budget over the next three years or so, all of which is negative. So you wouldn't want to start this during that period of time.

MR. GENEST: Well, in some sense, it doesn't matter because all you do is, whatever period of time, you model the new bill versus the existing law. And in the same period, they'll each have different effects. And then the question is, does this give you more revenue, it's a tax increase, two-thirds; if it doesn't, it's not.

So it almost -- from that perspective, it doesn't matter what part of the business cycle you're in.

COMMISSIONER BOSKIN: From our perspective, if we're trying to decide something that is less volatile over the business cycle, and we're kind of roughly designing this to be business-cycle-neutral, that would have -– that replacement, if it was less volatile, would raise more revenue in a recession year and be called a tax increase. So we just have to be aware of that, that's all.

COMMISSIONER COGAN: Yes, the point of these calculations, as I see it through 2013, is that 2013 is, in fact -- it looks like the middle of a cycle, which is a nice feature of this.

CHAIR PARSKY: Exactly.

COMMISSIONER COGAN: Having said that, at the end of the day, when we make our recommendations and have a budget-neutral package, by the time the Legislature gets around to enacting it, all of the economic forecasts will change, and there might very well be a net tax increase or a net tax reduction in it. But that's sort of -- that's outside of our purview.

CHAIR PARSKY: Our purview. Right.

Okay, let's move to the packages so that everyone can kind of understand.

And what I'd like you to do on this, we have Package 1A and B, Package 2, and Package 3. So why don't we make sure that we get through them, and then we'll come back and examine each.

Okay, proceed ahead, gentlemen.

MR. IBELE: Each of the packages has a personal income tax component. And we thought it would be useful just to go through with the definition of *"adjusted gross income,"* which is the basis for the calculation on the personal income tax.

You start with gross income, income from all sources, unless it's exempt. This would include salaries, wages, commission, tips, dividends, interest earnings, pensions, realized capital gains, et cetera. And deducted from that would be contributions to individual retirement accounts, Keogh plans, 401(k)s, self-employed health insurance payments. And that would give you AGI, which is, again, the basis for -- the starting point for the personal income tax component.

All the packages, based on what we heard from the Commission members during the hearings and with individual commissioners, seek to lower the rates for the existing taxes. They all bring in, to a greater or lesser extent, a new business net-receipts tax. And they all -- because of that, they all move towards a -- some more than others -- move towards a consumption basis for taxation.

And when we go through these packages, keep in mind that the distributions that we'll show you are all relative to –- we're comparing this package -- the distribution under the package with the distribution under current law.

COMMISSIONER MORGAN: A quick question.

CHAIR PARSKY: Becky?

COMMISSIONER MORGAN: Give me an example, if you would, please, of income that would be exempt.

MR. IBELE: Federal securities -- interest on federal securities. We can't tax that.

COMMISSIONER MORGAN: Okay, and bond money from munis?

MR. IBELE: I'm sorry?

COMMISSIONER MORGAN: And income from municipal bonds, for instance, that kind of thing?

MR. IBELE: Yes, under the state, California Lottery winnings.

COMMISSIONER MORGAN: There are so many of those.

CHAIR PARSKY: But the last point that Mark made I think is important to bear in mind, because the analysis that will be done on both progressivity/regressivity, volatility, is in comparison to the existing system. And we start with a presumption or an assumption that the existing system is something we're trying to reform. And we'll see whether we get there at the end, but that's what we're operating from.

Go ahead.

MR. IBELE: And we did model the incidence and the distributions for the purpose of lowering expectations and hoping to exceed them.

California doesn't have an incidence model. It would be nice if the state did have an incidence model. We've relied on the Minnesota incidence study in attributing taxes to households, taxpayers, and then using the Minnesota incidence model to attribute the business portions of the sales tax, the business net-receipts tax, and the corporation tax.

So what you'll see in that is a reflection of, I think, probably what has been used by many states in lieu of their own incidence model.

So for Package 1, we called it Version A, this is a uniform income tax, at a rate of 6 percent. There are no deductions, no credits.

This particular package would also eliminate the corporation tax.

Feel free to chime in whenever you feel like.

CHAIR PARSKY: He will.

MR. IBELE: I know.

It would also eliminate the state general fund sales tax, the 5 percent rate. And it would institute a business net-receipts tax. This would be -- if you go back to the slide -- this one right here, this is Package 1A. It would raise a little bit more -- it would raise more in the first year and less in the final year than the current law.

With this particular version, Package A, it would be raising about 20 billion more dollars under the personal income tax than under current law. And we'd have a business net-receipts tax of about 1.56 percent based on the tax base that we were provided by Ernst & Young.

COMMISSIONER KEELEY: Question? Mr. Ibele, I want to make sure I understood what you just said with regard to the personal income tax.

So on Tax Package 1A, "Effective Tax Rate, Share of Total-Selected Taxes," so on this, the entirety of all the changes in Package 1A are reflected on this graph?

MR. IBELE: On this graph?

COMMISSIONER KEELEY: That graph, right there.

MR. IBELE: Yes.

COMMISSIONER KEELEY: And that --

MR. IBELE: And so --

COMMISSIONER KEELEY: I'm sorry, please go ahead.

MR. IBELE: I was just going to say, this is not a full incidence of all the state's taxes. This is showing the change from current law under the taxes that we are changing, corporation taxes.

CHAIR PARSKY: That are in the packet?

MR. IBELE: Yes.

COMMISSIONER PRINGLE: Can I ask a question on that point?

COMMISSIONER KEELEY: Please do.

COMMISSIONER PRINGLE: So the green line, which reflects current, doesn't take into account the bank and corp. tax; is that right?

MR. IBELE: It does take into account the bank and corp. tax.

COMMISSIONER PRINGLE: So is there a similar formula that is applied, or is it a different formula to the business --

MR. IBELE: The business net-receipts tax.

COMMISSIONER PRINGLE: The business net-receipts tax?

MR. IBELE: We use the incidence that's basically the retail sales and use tax for the incidence of that, which is a combination of the consumer portion and the business portion.

COMMISSIONER PRINGLE: I see.

MR. IBELE: The corporation tax has a slightly different incidence.

COMMISSIONER PRINGLE: But both of those taxes are applied here and distributed to each of the income groups; is that right?

MR. IBELE: Yes, yes. What this doesn't include, and the reason why it's different from other distributions you've seen, it doesn't include property taxes, it doesn't include excise taxes, which are --

COMMISSIONER HALVORSON: Gasoline taxes?

CHAIR PARSKY: No taxes that aren't changed.

MR. IBELE: No taxes that are not changed.

Gasoline --

CHAIR PARSKY: They would be not in this.

COMMISSIONER COGAN: That was too many "nots."

CHAIR PARSKY: I'm sorry, this only includes the taxes that are changed, namely the personal income tax, the corporate tax, the sales tax, and now the net-receipts tax are incorporated.

MR. IBELE: Right.

COMMISSIONER HAUCK: Mr. Chairman?

CHAIR PARSKY: Yes, Bill?

COMMISSIONER HAUCK: I think not necessarily a question for Mark. But when you eliminate the five-cent state sales tax, the immediate question would be in terms of the bill that might be proposed, are you going to authorize local government to relevy by vote, perhaps, any portion of that five-cent reduction in the state sales tax? The difficulty here, you have state and local taxation so intricately intertwined, and never reconciled since the passage of Prop. 13, that it's hard to look at these questions without also understanding the interaction and the impact in terms of local governments. And that would immediately be a question that would be raised in the Legislature.

MR. IBELE: Well, this proposal would not touch the local portion of the sales tax, the Bradley Burns or the special-district taxes.

Obviously, the Board of Equalization, which administers the general fund portion and the special funds and the local taxes and so forth would have to continue to administer this. And there would be additional costs for local governments.

COMMISSIONER HAUCK: I understand.

And I'm saying that when you already have local governments in the state that are screaming about not having adequate resources to do largely what the State has required them to do, that's particularly true when it comes to counties. And so they would immediately see the potential for a revenue source here. Even if it would have to be imposed by vote, it would probably be a two-thirds vote if it was for specific purposes. And if that were true, you would have some counties that probably would enact some additional sales tax, let's say. And you'd have many counties, any number of counties that never would because they never could get the vote.

And that's the point I'm trying to make with respect to -- I understand you haven't included that here. But one of the first questions that would be raised in Sacramento would be, are you going to permit some or all of this reduction in the state sales tax to go back to local government? And I think we'd need to be prepared to answer that in some fashion.

CHAIR PARSKY: You mean, by allowing them to increase the taxes they now charge?

COMMISSIONER HAUCK: Yes, yes.

COMMISSIONER HALVORSON: Through the mechanisms ordinarily used to do that?

COMMISSIONER HAUCK: Yes.

COMMISSIONER KEELEY: Mr. Chairman, I think I still have the floor.

So, Mr. Ibele, the chart that we're looking at, what I thought I heard you say was this package, in its entirety, Package 1A, is revenue-neutral as previously described.

MR. IBELE: Yes.

COMMISSIONER KEELEY: And the effect of it with regard solely to the personal income tax is that it would increase the personal income tax revenue to the state by $20 billion.

MR. IBELE: Roughly.

COMMISSIONER KEELEY: Although the package in its entirety is revenue-neutral. And so where that would happen is, from looking at this bar chart, it would happen by pushing down the income scale, the payers of that personal income tax. So, for example, the $200,000 and over, the $100,000 and $200,000, those groups of taxpayers, although individual taxpayers within that -- who knows what they would do -- but those groupings of taxpayers would pay less as a group. And then when you got into the $75,000, $50,000, $20,000, in those bars, those folks would pay more as a group. Not as individuals, necessarily, but as a group.

CHAIR PARSKY: Their share would be higher.

COMMISSIONER KEELEY: Mr. Chairman, I value your opinion, but I'm asking the question to Mr. Ibele.

CHAIR PARSKY: Go ahead.

MR. IBELE: The share of the tax burden for those four lower groups would increase and their effective tax rate would increase, if you look at the red line, which is the effective tax rate. It's not surprisingly a little bit higher than 6 percent. It's a uniform tax.

Keep in mind that, you know, we tried to approach this in ways that would get at many of the goals of the Commission.

COMMISSIONER KEELEY: I understand, I understand.

MR. IBELE: And one of the them was this --

COMMISSIONER KEELEY: I understand. Thank you very much.

Thank you, Mr. Chairman.

CHAIR PARSKY: We're going to need to go through those goals just with respect to each package so that everyone understands.

Now, the other thing I think you should bear in mind, Mark mentioned it, but the rate that would be applied on the business net-receipts tax to maintain neutrality would be 1.56 percent. That's not on the screen. Obviously, the rate could be different.

Inherent in this proposal is a proportional rate, or a one uniform rate, and the elimination of the corporate tax and the general sales tax as part of the package.

COMMISSIONER POMP: Mr. Chairman.

Just so I understand, Mark. The red is PIT plus the net-receipts tax; is that right?

MR. IBELE: That's correct.

COMMISSIONER POMP: And the green light is PIT plus corp. plus sales?

MR. IBELE: Right. PIT, corp., sales, yes.

COMMISSIONER POMP: And when the chairman was trying to clarify -- let's just take the lowest group -- that their share of total taxes goes up –- well, it's hard to say, but let's just say 2 percent to 4 percent, you were trying, I think, to distinguish that observation with the statement that taxes will increase on people in that group?

CHAIR PARSKY: Right.

COMMISSIONER POMP: And explain why that won't be true.

CHAIR PARSKY: Well, no, I wasn't -- I was saying that if you look at the bars, you will see, as indicated by the title, the impact of the share of total taxes borne by different groups.

COMMISSIONER POMP: Right.

CHAIR PARSKY: That's a little different analysis than the economist's analysis of the progressivity/regressivity issue, which is much more applicable to the marginal rates that are being paid.

COMMISSIONER POMP: Okay, but you don't disagree that the taxes on these groups will increase in these lower level –- that you agree with?

CHAIR PARSKY: Inherent in a decision to alter or to address the way in which our system has moved to a dependence on the personal income tax as currently structured. Or said another way, a desire to address the fact that a small percentage contributes a high percentage of the personal income tax would be a move in this direction. That's inherent in wanting to address those issues.

You may not want to do it as dramatically; you may want to do it differently. But if you believe that part of the problems created -- or said another way, part of the issues relating to volatility and some of these other issues is a combination of the over -- of the reliance on the personal income tax and the nature of that tax, you'll have to make changes in that of some kind. That will move the contribution made by groups from right to left.

COMMISSIONER KEELEY: I couldn't have said that last part better.

COMMISSIONER POMP: I think that's a very clear statement.

This has nothing to do with progressivity, so is there an equivalent chart?

CHAIR PARSKY: Well, the effective tax rate does.

COMMISSIONER POMP: Well…

MR. SPILBERG: Yes.

MR. IBELE: Yes.

CHAIR PARSKY: The effective tax rate does.

COMMISSIONER POMP: Oh, yes. That's right.

So the break-even point is about a hundred and what then?

COMMISSIONER EDLEY: 105.

COMMISSIONER POMP: I don't know, you know the --

MR. IBELE: The scale? I'll get the exact figure for you.

COMMISSIONER POMP: Okay. Now, this is no better, of course, than the assumptions on incidence. And where do we learn what those assumptions are?

MR. IBELE: I can --

COMMISSIONER POMP: I mean, you don't have to do it now, but I mean, that is very important.

CHAIR PARSKY: Circulate --

MR. IBELE: I can give you the incidence assumptions that we used.

COMMISSIONER POMP: And we are relying on what the state of Minnesota assumed to be true about, what, their sales tax?

MR. IBELE: Yes.

COMMISSIONER POMP: And then we adjust our sales tax for their sales tax differences? And you've done that?

MR. IBELE: We've done that.

COMMISSIONER POMP: And you do the same thing, corporate tax?

MR. IBELE: Well, ideally we'd have the California incidence study, but we don't.

COMMISSIONER POMP: But we don't. So we take their incidence study, which was done by whom?

MR. SPILBERG: Minnesota.

MR. IBELE: Yes, I think it was originally done by the economics faculty at the University of Minnesota, and I believe it’s done in-house now.

COMMISSIONER POMP: I see. And they do that every year now or periodically?

MR. IBELE: Every two years.

COMMISSIONER POMP: Every two years. So this is complicated.

MR. IBELE: It’s very ––

COMMISSIONER POMP: You take our sales tax and you sort of compare it to theirs.

And how do you make an adjustment? Do you use their assumptions and --

MR. IBELE: We’ve used their incidence assumptions and made adjustments for rates and so forth; but nothing more elaborate than that.

CHAIR PARSKY: Just so we get everybody through these packages, take Package 1A, measure it against, in no particular order, volatility. Give some indication on the issue of volatility.

MR. IBELE: Let me skip ahead if this doesn’t make you dizzy.

CHAIR PARSKY: I’m sorry, did you want to ask a question?

COMMISSIONER ITO: Sure. And it's just a clarifying question about these graphs.

At the bottom, when you had these income distribution -- these income brackets, maybe I missed this, but is this by household and by business entity? Or is this just the household?

MR. IBELE: This is by ––

COMMISSIONER EDLEY: It's got to be by household.

MR. IBELE: This is by household.

COMMISSIONER EDLEY: Right, because your incidence in analysis was to get it to pass through to the household.

MR. IBELE: Correct.

COMMISSIONER ITO: Okay.

CHAIR PARSKY: Okay, I know you skipped ahead a little bit, but I think each of the proposals, let's measure against volatility, efficiency, potential for economic growth, simplicity, and shifting the tax burden.

MR. IBELE: Okay, I think we've --

COMMISSIONER EDLEY: These are great charts, by the way. A lot of stuff.

MR. IBELE: Thanks.

CHAIR PARSKY: The staff has done a lot of work in this area.

But go ahead.

MR. IBELE: Volatility.

Let me skip ahead.

Here’s the volatility measure that we’ve used, the coefficient of variation. Package 1A, not surprisingly, substantial percentage drop from the current system, from 1.47 to .91.

COMMISSIONER POMP: And the source of that is really in the PIT?

MR. IBELE: That’s the PIT at the flat rate. And it’s the net-receipts tax, too.

COMMISSIONER BOSKIN: A combination

MR. IBELE: You know, if you go back to the --

COMMISSIONER BOSKIN: Services are much more stable than goods.

MR. IBELE: You know, if you go back to this chart, right here, it’s really --

CHAIR PARSKY: That will get you dizzy, but…

MR. IBELE: Sorry.

CHAIR PARSKY: Okay, efficiency. What’s your view of efficiency on Package 1A?

MR. IBELE: Well, I think you’re lowering rates, in an economic sense. On the PIT rate, you’re lowering the top end. You’re getting rid of -- or you’re lowering dramatically the sales and use tax rate.

We've heard before, from an economic standpoint, you're disproportionately lowering the inefficiency of taxation by lowering those rates. I think it would score reasonably well in those areas.

I think in efficiency, bringing in services with a net-receipts tax, treating businesses equivalently in that regard, it would score higher on the efficiency.

I think simplification, which we've talked about periodically. You're getting rid of, under this proposal, deductions, credits. You've got one rate. You've got potentially a large number of taxpayers that would simply be getting income from wages. And it would have simplified returns.

CHAIR PARSKY: Can you just pause on that for a minute?

Phil has done a little bit of analysis of that that might be of interest to the commissioners.

If all of your income under this proposal was from wages, about what percentage of California taxpayers would be in that category?

MR. SPILBERG: Well, if you adjust it just a little bit, by allowing taxpayers $100 of non-wage income -- $100, just $100 -- then you would have over 50 percent of the taxpayers would basically not have to file a tax return because their withholding would be sufficient to meet their tax liability.

CHAIR PARSKY: Keep going.

COMMISSIONER POMP: So you said no interest, no dividends above $100?

MR. SPILBERG: Right. That's right. So about 50 percent of the tax returns do not have more than $100 of non-wage income.

CHAIR PARSKY: In California.

COMMISSIONER POMP: Yes.

CHAIR PARSKY: Go ahead.

MR. IBELE: I think on the --

CHAIR PARSKY: You've covered the distribution, so I think we're okay there.

MR. IBELE: Yes, we've covered the distribution.

Economic growth, I'm not going to venture a guess on what it would do. But you do have the immediate expensing on the business net-receipts tax, which is a plus. You're getting rid of a corporate income tax rate, which is a pretty high rate.

So do you have anything more you want to add?

MR. SPILBERG: No.

COMMISSIONER KEELEY: Mr. Ibele, could I ask –-

CHAIR PARSKY: Sorry.

COMMISSIONER KEELEY: Mr. Chairman, would you prefer I not?

CHAIR PARSKY: I'd just like them to get through 1B.

Now, inherent in 1A is taking on whatever interests may be involved in not permitting itemized deductions for interest on your mortgage, property taxes, charitable contributions, or some extension of that.

One comment back from some people I've talked to was, well, allow those battles to be fought at the federal level, not at the state level. That may not be an answer, but, obviously, Package 1 does not allow itemized deductions.

Package 1B. Go ahead, Mark.

COMMISSIONER BOSKIN: It also deals with the distribution in 1B. The exemption, at the bottom, dramatically lowers the tax rate on lower and lower middle-class.

CHAIR PARSKY: And that exemption could be shifted to 1A to as well as 1B?

COMMISSIONER BOSKIN: Yes.

CHAIR PARSKY: Okay, go ahead.

MR. IBELE: And that actually is a good lead into Package 1B, which we fashioned -- you see the dramatic shift in the Package 1B effective rate. We've modeled something that includes a $5,000 exemption for non-itemizing taxpayers. And the way we did that is, if we gave them the $5,000-per-person exemption and had them not itemize unless it was better for them to itemize under our simulation.

And then as the Chair mentioned, we included in this deductions from mortgage interest, charitable contributions, and property taxes.

This also included the elimination of the corporation tax, and it eliminated the state general fund sales tax, and a business net-receipts tax.

You give up a lot more money, a lot more revenue in this particular package, obviously, because of the additional deductions and credits. So the -- and, again, we're using the net-receipts tax as kind of a balancer here. The rate is about 2.77 percent for this particular package.

COMMISSIONER HAUCK: That's back on the income tax on this one?

MR. IBELE: The income tax --

CHAIR PARSKY: About plus 10 billion. About half.

Is that right?

MR. IBELE: Right, it's about $10 billion more than under current law.

CHAIR PARSKY: Right.

Okay, go ahead.

MR. IBELE: You know, I think some of the take-aways here are similar to the first one, with perhaps --

CHAIR PARSKY: Shift over to volatility charts.

MR. IBELE: Yes, the volatility is actually very similar. There's a little bit of increase over Package 1A. It's just about 1, the coefficient of variation. But substantially below where we are now.

CHAIR PARSKY: Efficiency, any differentials?

MR. IBELE: You know, you had these additional deductions and credits and so forth. I think that means you're putting more emphasis on a higher business net-receipts tax if you're keeping the personal income tax at 6 percent. So it's probably not as an efficient system.

There's probably more distortions going on there. You lose some of the simplicity. Potentially, for some taxpayers, you lose quite a bit of the simplicity.

COMMISSIONER POMP: Does the cost of adopting and administering a new tax enter into efficiency? Or has that entered into the category?

MR. IBELE: Well, it doesn't enter into, I guess, how I've been using the term, which is economic efficiency.

COMMISSIONER POMP: Which --

MR. IBELE: It's an administrative efficiency question.

COMMISSIONER POMP: What's the definition of *"economic efficiency"?*

MR. IBELE: Well, it's basically defined as, you know, are the right price signals being sent and received in the market? And the taxes, by their very nature, in an efficient market, create a wedge and create a difference between the perceived price and the real price. And that's where you get the inefficiency.

COMMISSIONER POMP: So in that definition --

MR. IBELE: Unless there's some other corrective tax.

COMMISSIONER POMP: So in that definition, any lowering of a tax rate is going to be more efficient because the wedge will be smaller?

MR. IBELE: In traditional theory, that's correct.

COMMISSIONER POMP: Well, in terms of the definitions you are applying.

MR. IBELE: In terms of the definition that I am applying, that's what I'm assuming.

COMMISSIONER BOSKIN: And the greater the -- there will be more relatively efficient to the extent that rates are lowered on things that are most responsive to taxes and less improvement in efficiency if they're lowered on things that are not very responsive to taxes or tax-inclusive prices, like cigarette consumption, for example.

CHAIR PARSKY: Right.

COMMISSIONER BOSKIN: On the administrative side, remember that in 1A -- in some of these proposals we're abolishing other taxes. So you have to net -- I mean, you'll have to -- the cost of setting it up and the cost of shutting it down. But at some point, you don't have the apparatus for some of the taxes you've had to shut down.

COMMISSIONER PRINGLE: Mr. Chairman, could I ask a quick question?

CHAIR PARSKY: Yes.

COMMISSIONER PRINGLE: In both of the presentations on Tax Package 1A and B, what -- how does this modification change existing capital-gains treatment?

CHAIR PARSKY: You all can answer it. Go ahead.

MR. IBELE: It doesn't change the treatment of capital gains. It treats capital gains the way all other income is being treated.

CHAIR PARSKY: But inherent in 1A would be, at a 6 percent rate, it would be lower.

COMMISSIONER PRINGLE: So it does modify the rate?

CHAIR PARSKY: The rate would come down for all personal income, including capital gains.

COMMISSIONER PRINGLE: Okay.

COMMISSIONER POMP: So the reduced volatility is, in part, just a lower rate on a volatile base? It's going to give us less volatility?

MR. IBELE: That's true.

CHAIR PARSKY: Becky?

COMMISSIONER MORGAN: This is more political, perhaps, but…

CHAIR PARSKY: These two people are not political.

COMMISSIONER MORGAN: I know, but if you take this, is there any consideration on if you're going to deduct mortgage interest doing something for renters? I just know that that's an issue usually in Sacramento.

Maybe they're not the ones to answer, but I think it's a question we have to deal with.

CHAIR PARSKY: It was not included in this alternative. But people have suggested that if you're going to allow interest on your mortgage for –- obviously, on a home you own -- that you should allow a deduction for rent on your primary residence as a parallel. That is something that can be considered.

There are a number of people that would advocate that.

CHAIR PARSKY: John?

COMMISSIONER COGAN: Curt, you asked a question about capital gains, and a question about homeowners, the sale of a house. How is that treated under this proposal?

MR. SPILBERG: It would not be changed from current law.

COMMISSIONER COGAN: It would be changed; right?

MR. SPILBERG: It would not be changed from current law.

COMMISSIONER COGAN: Not changed?

MR. SPILBERG: Not changed. So you would still recognize a capital gains on the sale of your house if your increase in the price of the home is over a half a million for a joint return.

COMMISSIONER COGAN: Okay.

CHAIR PARSKY: Okay, let's keep going.

CHAIR PARSKY: Tax Package 2.

MR. IBELE: Tax Package 2 is a package that's probably -- of the three packages, the most similar to our current system. We lowered the brackets, reduced the number of brackets, put in a zero bracket amount, up to $10,000 for joint filers. The remaining brackets are 4 percent for joint filers up from -- up to --

COMMISSIONER EDLEY: That's got to be individuals up to 50?

MR. IBELE: Joint filers up to 50, and 7 percent for those over 50.

We also put in an investment tax credit which is similar to something the state had some years ago, a manufacturer's investment credit, but it's broader. It doesn't just cover manufacturing equipment, but also vehicles and other investment purchases.

COMMISSIONER DE LA ROSA: Like what? Computers, software?

MR. IBELE: Computers is probably after vehicles and other machinery, the biggest -- those are the three biggest components.

We reduced the corporation tax rate to 7 percent, or equivalent to the top rate under the personal income tax, and also instituted a business net-receipts tax.

COMMISSIONER BARRALES: Where was that?

MR. IBELE: That was at -- again, as a filler, that was at 1.16 percent.

COMMISSIONER BOSKIN: Is the investment tax credit for such things wherever purchased from or from purchases from California? I mean, is it designed to offset the sales tax on business purchases?

MR. SPILBERG: Yes. The investment tax credit would be basically a --

COMMISSIONER BOSKIN: A California --

MR. SPILBERG: Yes, a refund of the sales tax, that would have been paid on those purchases. So it would be only for purchases in California.

CHAIR PARSKY: Under this proposal.

Okay, okay, and proceed ahead in terms of --

MR. IBELE: The distribution, not surprisingly, is very similar, at least in profile, to what we have now, except at the top end. And there's a shift in the tax burden towards the middle, if you look at the effective rate.

Again, I mean, it does some of the -- it accomplishes many of the same things that we saw in Packages 1 or 2, but to not as great a degree. We've reduced the higher rates somewhat.

It is somewhat more stable. Less volatility.

COMMISSIONER BOSKIN: Very slightly less.

MR. IBELE: Very slightly less, yes. Not a lot because of the graduated rate structure. And under this particular package, the personal income tax would raise about $4 billion less than it does under current law.

CHAIR PARSKY: But the 1.16 gives you the neutrality fill-in; is that what you're saying?

MR. IBELE: Yes, that was used as a balancer under this.

CHAIR PARSKY: Okay.

MR. IBELE: It doesn't do much for simplicity. One thing to keep in mind here is it does add a tax without getting rid of any taxes. So it does arguably, for some companies, actually add to the complexity of the existing system.

COMMISSIONER COGAN: A question.

CHAIR PARSKY: John?

COMMISSIONER COGAN: Mark, a question, on the personal income tax change, the zero-bracket amount, is that on top of the current deductions and credits for all taxpayers?

MR. IBELE: Yes, that's for all taxpayers. So one way to recoup some of that would be to either phase it out or to have it only for non-itemizers.

COMMISSIONER COGAN: Right.

MR. IBELE: And we have to do that calculation, to see how much we could recoup. So that does go to the higher income as well.

COMMISSIONER COGAN: Right, okay. And then how much does the reduction of the corporate tax rate lose?

MR. IBELE: About $1.4 billion.

CHAIR PARSKY: The overall corporate tax

contribution under current law is a little under $10 billion; is that right?

MR. SPILBERG: Yes, that's right.

COMMISSIONER MORGAN: And so a company would have to calculate the corporate tax of 7 percent, and then also go back and calculate the business net-receipts tax?

MR. IBELE: Let me correct something. The reduction in the corporation tax would be $2.4 billion.

COMMISSIONER COGAN: 2.4?

MR. IBELE: $2.4 billion.

The investment tax credit is about $1.4 billion.

I should not have changed to the smaller font.

COMMISSIONER POMP: And that's leaving in place elective single-factor apportionment and everything else?

MR. IBELE: That's under current law, yes.

COMMISSIONER MORGAN: So my question was, so the corporations would calculate two taxes?

MR. IBELE: Yes.

COMMISSIONER MORGAN: The corporate tax and the net-receipts tax?

That's complicated and expensive.

CHAIR PARSKY: That led to his comment about how it's more complicated.

COMMISSIONER MORGAN: I see.

CHAIR PARSKY: Okay.

MR. SPILBERG: It's definitely more complicated. However, it would be done basically in the same -- can be done on the same tax return. The same kind of information that you would need for your income tax would also be needed for calculating this net-receipts tax. So it does increase complexity for corporations. It wouldn't be another order of magnitude of complexity. It would be an increase in complexity, though.

COMMISSIONER PRINGLE: I have a noncomplex question, though.

What is the current corporate tax rate? 8.7?

CHAIR PARSKY: It's 8.8.

MR. SPILBERG: It's 8.84 percent for C-corporations, and it's 1.5 percent for S-corporations.

COMMISSIONER PRINGLE: Thank you.

CHAIR PARSKY: Okay, Package 3.

MR. SPILBERG: Should we talk about efficiency, though, or just go on?

CHAIR PARSKY: Oh, I'm sorry. No, no, you should cover everything.

Efficiency.

MR. IBELE: Go ahead.

MR. SPILBERG: In terms of efficiency, it does improve efficiency some because, first of all, it reduces the wedge between taxation on the sales tax of tangible sales and services if you think of the net-receipts tax as sort of a consumption tax. It also reduces the top rates across the board. So that, in itself, increases efficiency.

COMMISSIONER BOSKIN: But a lot less than 1A or 1B?

MR. SPILBERG: Yes. Less so than 1A or 1B.

CHAIR PARSKY: Increased -- what about economic growth, or potential for economic growth? Any thoughts on that goal in this context?

MR. IBELE: Well, I mean, I think that the investment tax credit is kind of going after this idea that the Commission has been interested in, in not taxing business inputs; and it's a way to do it without putting as much revenue in play. And that would certainly help in that area.

COMMISSIONER POMP: What's the rate of the credit? I didn't hear before.

MR. IBELE: We put that in at a 6 percent rate.

CHAIR PARSKY: Okay, and I think you've commented on simplicity. And we understand the shift in tax burden.

Okay, let's go to Package 3.

MR. IBELE: Package 3?

Similar to Package 2, the biggest change here are that the changes in the brackets -- the slight changes in the brackets. This issue with giving this zero bracket for both high-income and low-income is still in there; but we can get a number for you.

The biggest change is in the change in the exemptions and the deductions. This would have deductions just for mortgage interest, charitable giving, and property taxes.

Another big change is that this particular package gets at, I think, one of the areas of interest for a lot of members, which is eliminating the sales tax for business purchases. This would not eliminate it for all business purchases but for capital investment.

And similar to Package 2, it would reduce the corporation rate to the top PIT rate, putting pass-through entities in equivalence with C-corporations.

The business net-receipts tax would be imposed at a 1.4 percent rate.

This also has -- let's go back to the -- I'm not sure how the distribution here compares with 2. It's a little bit better at the low end because of the exemptions.

Similar in the middle and at the upper end in terms of distribution.

I think the strongest parts of this, or the things that work in its favor are the exemption for the business investment purchases, and it does retain what some of you might consider the essential deductions on the personal income tax side.

CHAIR PARSKY: Okay, and on volatility?

MR. IBELE: Volatility, it’s very similar to Package 2.

CHAIR PARSKY: Okay, and on the other indices here, on efficiency? Economic efficiency?

MR. IBELE: Efficiency, it is very similar to 2. It’s an improvement over our -- again, using Commissioner Pomp’s admonition, compared to where we are, in looking at the market as a basis for efficiency, it’s certainly an improvement. You’re getting rid of some of the higher rates on the corporate income tax side and on the personal income tax side. And the business net-receipts tax is imposed at a very low rate.

COMMISSIONER POMP: Is there a lot of complexity from multiple rates in an income tax? Is that a great simplification, when you go from three rates to one rate, or…

MR. SPILBERG: Well, certainly, if you have, in 1A, when you can actually have a system that would work automatically for people with just wages, that is a major simplification. Beyond that, the additional deductions and the other sort of elements of the tax code are more complicated to deal with than having more than one tax rate.

COMMISSIONER EDLEY: If you have a flat rate, TurboTax charges you less.

May I ask a question?

CHAIR PARSKY: You can elaborate on that if you want, or ask a different question.

COMMISSIONER EDLEY: Well, I do.

Do we have any way of thinking about what the effect on volatility would be of income-averaging?

I mean, let me spell out what I'm thinking. These strategies largely revolve around trying to reduce volatility by reducing the share of revenue attributable to highly volatile high-income -- I'm sorry, highly volatile sources of income for high-income taxpayers. So let's just focus on capital gains, for example, and as the underlying volatility of those sources of income that then drive volatility of the revenue.

So just logically, smoothing the reported income, the taxable income, rather than focusing on revenues would -- focusing directly on revenues would give us at least half a loaf.

So if you took a long-enough accounting period for these capital gains -- and maybe it's just impossible to avoid the gaming that would be invited by that sort of structure -- but do you have any reactions to that?

MR. IBELE: I don't know about the gaming. I mean, I think this came up at our initial meeting. And I think there are issues with just the record-keeping, potentially.

It would certainly -- depending upon how long a period you chose, it would certainly smooth things out.

I think it's -- you know, the volatility is not just -- it's people moving in and out with a lot of capital gains and its reliance on the personal income tax itself, so it's not –- you know, in fashioning these, that may have been the result. We were trying to move away from the personal income tax and also move the rates down, but…

MR. SPILBERG: Just to elaborate on that, I think there's two problems. I think there's really a transition problem and an administration problem.

The transition problem is that you lose money in the first couple years, depending on how long an averaging you have.

Let's say you started averaging, and you have someone that his income goes up from let's say $50,000 to $1 million. Well, if you start off averaging at that point in time, for people that have increases in income, then you, obviously, lose revenue from that particular tax return in the first year. So that's a transition problem.

The administration problem is that what happens to someone who basically leaves the state and they still have some averaging income left over? You probably don't have really the ability to continue taxing that person once that person leaves the state.

I mean, you should be able to average by basically saying, well, even though you may have now zero California income when you left the state, you should average that with the income that you had when you left because you're sort of averaging income. But being able to actually administer that --

COMMISSIONER EDLEY: Let me be clear, for example –- and I hope I'm not wasting everybody's time here -- but conceptually, for example. If you focus on the capital-gains component of individual income and you just straightforwardly said, "Look, what you're going to pay is the average of the last three years of capital gains as reported on your federal income tax."

MR. SPILBERG: Right.

COMMISSIONER EDLEY: No matter where you lived, whatever, just what you reported on your federal income tax.

COMMISSIONER BOSKIN: I don't think you can do that because you have people who have moved to California in year 2.

MR. SPILBERG: Yes. And also, you have --

COMMISSIONER BOSKIN: And that includes year 1 -- includes year 1, where they paid somewhere else.

MR. SPILERG: And you have a starting --

COMMISSIONER EDLEY: But so what?

COMMISSIONER BOSKIN: They will let them average.

COMMISSIONER EDLEY: I mean, even if they paid somewhere else and we -- if they filed a federal tax -- unless they moved from out of the country, from outside the jurisdiction of the U.S., they had a federal tax return, they filed something for capital gains.

COMMISSIONER BOSKIN: You’re going to get --

COMMISSIONER EDLEY: There’s no constitutional prohibition on --

COMMISSIONER BOSKIN: But you’re going to get into a jurisdictional battle with other states.

MR. SPILBERG: Yes, he would.

COMMISSIONER EDLEY: Wait a minute. I’m not taxing them in -- I’m only taxing them in a year in which they are in California. I’m varying the rate applicable to you, admittedly, in part based upon where you used to live.

Did you live in California? Did you live in Utah? But I don't see -- I don't see that that's --

MR. SPILBERG: Yes, I see these issues now.

Now, back to the transition problem. Let's say you started in year 1. And in year 1, you have capital gains of, let's say, a million dollars. But in year -- just before that -- year zero, let's call it -- you had a capital gains of $10 million, but you paid the tax in year zero for that capital gain, you're not going to tax that person again by averaging the capital gain he had in the year zero with his gain in year 1. So you have to basically start your averaging in year 1.

COMMISSIONER EDLEY: Well, you'd have to have a transition rule. You'd have to have a transition rule ––

MR. SPILBERG: And you would lose ––

COMMISSIONER EDLEY: -- where you would smooth that kind of gap.

MR. SPILBERG: Yes, and you would lose revenue during the transition. Just -- the mechanics of the transition, we've worked with. And we could go through with examples -- in the transition, you lose revenue.

COMMISSIONER EDLEY: Okay, let me just say, I think a lot of these transition issues are going to be complicated no matter what. That's point number 1.

Point number 2 is, so we have to compare the complexity of different transition rules that's point number 1.

Point number 2, though, is, I have to say that when I look at these charts and I see, towards the left-hand side of the chart, lots of gold bars that are taller than the blue bars -- and I like the blue and gold, by the way -- but lots of gold bars.

MR. IBELE: It was intentional. I'm a Berkeley grad.

COMMISSIONER EDLEY: Lots of gold bars that are bigger than the blue bars, I get a little bit agita, both personally and politically. And if some transition complexity is the price to pay for reducing kind of the systemic agita, that it might be worth thinking about. But, again, I'm just -- people are going to ask, well, instead of just saying decrease the tax burden on capital-gains, they're going to ask, did we consider a strategy for smoothing the income flow so that revenues wouldn't be bouncing up and down.

CHAIR PARSKY: Well, that maybe --

COMMISSIONER BOSKIN: It would have to be more general because stock options are very volatile in every large --

COMMISSIONER EDLEY: It would have to be more general than capital gains. A lot of it would have to be --

CHAIR PARSKY: That may be a good way to segue into making sure everyone understands that also contained in this package is an analysis of capital gains, and it will lead us to a little bit of a discussion --

COMMISSIONER EDLEY: I'm sorry, you're right.

CHAIR PARSKY: -- what component of the personal income tax on volatility --

COMMISSIONER EDLEY: Right.

CHAIR PARSKY: -- is oriented around capital gains and what is the nature of those gains. So just spend a few minutes on the analysis that you did on capital gains.

MR. IBELE: Sure.

This was one of the options that we looked at. And I think, you know, we can skip through this very substantially. Everybody knows that, increasingly concentrated, et cetera, et cetera. This just shows how variable it can be. This is the share of capital gains in personal income over the last 25 years or so.

This is an indication of the concentration of capital gains by income class, and how it's shifted.

I think one thing that, in terms of the volatility, the one thing to keep in mind here, as I indicated, it's not just the rate that's applied to capital gains, it's that capital gains are volatile, they go up and down. So you don't get a huge reduction in volatility simply by reducing the rate. We reduced it from -- looking at different steps, for example, a 3 percent decline was a 7 percent decline in volatility. A 5 percent decline was a 13 percent decline in volatility. So you still had a great deal of volatility simply because the income goes up and down. So it doesn't matter a lot if you tax it at 8 percent or 6 percent.

CHAIR PARSKY: Now, what do you think the impact of what Chris suggested? Put aside the difficulties of administration. But I gather what you are suggestion is, instead of focusing on applying whatever rate you wanted to a given year, you would permit the individual to average before the rates apply over a period of time; is that what you were suggesting?

COMMISSIONER EDLEY: Yes. I don't know if I would make it an option or if I would require it and then impute. But something -- but, yes, something along those lines.

MR. IBELE: Well, that would certainly move the income --

COMMISSIONER EDLEY: It'd smooth it.

MR. IBELE: -- spread out the income. Yes.

COMMISSIONER EDLEY: Right.

COMMISSIONER POMP: Well, it's a rate reduction. Then the question is, how much reduction do you get for that rate reduction. How much reduction in volatility for that rate reduction.

COMMISSIONER EDLEY: But it's not a rate reduction. It's just a --

COMMISSIONER POMP: If we have progressive rates. I'm thinking the existing system with the progressive rates.

COMMISSIONER EDLEY: Right.

COMMISSIONER POMP: And you're saying we'll smooth it out, so maybe you're not in the highest bracket.

MR. IBELE: I see, I see. You would be doing two things if you did that. If you spread it out, you'd be spreading out the income. And if it puts you in a lower bracket, you'd be lowering the rate as well.

COMMISSIONER POMP: Right. It would be like slightly --

COMMISSIONER BOSKIN: For many people, it would be a slight cut.

COMMISSIONER POMP: Yes, that's right. That's right.

A reduction rate, that helps a little bit.

CHAIR PARSKY: Okay, we'll come back to the capital-gains component.

COMMISSIONER EDLEY: Okay.

CHAIR PARSKY: Just mention what you have done on the carbon tax, and then we'll come back. I'd like Michael to make some comments, because I know he has to leave before others.

MR. IBELE: The carbon-tax option we looked at. We simply modeled this as a $20-per-ton carbon tax, which was suggested at the hearing in Berkeley by Severin Borenstein. This would raise between $3.2 billion and $3.3 billion annually over our forecast period.

The reduction -- we looked at sort of what we could reduce the rate by if we had this additional source of revenue. And under current law, we could reduce the top rate by about 1.65 percent, just as an example.

And under Package 3, we could reduce the top rate by about .7 percent.

COMMISSIONER EDLEY: How much could you expand the zero bracket?

MR. IBELE: We can look at that. We can look at that.

THE VIDEOGRAPHER: Could you put the slide up?

COMMISSIONER EDLEY: Do you have a guesstimate? I mean, that's just like, can you make something up?

MR. IBELE: We're trying not to make anything up.

COMMISSIONER EDLEY: Well, let me ask Boskin. He could make something up.

No, but seriously, I'm just wondering if I could get -- if I could deal a little bit with the relative size of these yellow and blue bars, if I spent it at the zero bracket or at the lowest marginal rate rather than -- okay, that's what I was thinking.

CHAIR PARSKY: Well, I'm not quite sure how much revenue you're getting at the lowest rate, anyway, because --

MR. IBELE: Yes, yes.

CHAIR PARSKY: -- you may reduce it, but it doesn't make up a big component of the tax.

MR. IBELE: I'm very uncomfortable doing that on the fly, Commissioner.

COMMISSIONER EDLEY: I'm looking at Tax Package 2, for example -- or maybe 1B. If you look at 1B, and you invested the $3 billion of a carbon tax in providing some kind of tax relief at 50K and below --

COMMISSIONER BARRALES: So the people that are paying these taxes on carbon are getting it back?

COMMISSIONER EDLEY: Well, you get it back in a different way. So you're still maintaining the energy incentive.

MR. IBELE: 1B? I'm sorry, 1B?

COMMISSIONER EDLEY: I was looking at 1B. And, again, just looking at the blue and gold bars there. So the idea would be to do something tinkering with -- tinkering with the PIT.

CHAIR PARSKY: Well, the other thing you may want to think about is either 1A or 1B does not have a dramatic exemption.

COMMISSIONER EDLEY: You've added --

CHAIR PARSKY: You could add an exemption at a higher level that I don't think you would find would have a dramatic impact ––

COMMISSIONER EDLEY: On revenue.

CHAIR PARSKY: -- on revenue.

COMMISSIONER EDLEY: But it would help the distribution.

CHAIR PARSKY: But would help the distribution.

You can do that in either way, with or without the carbon tax.

COMMISSIONER EDLEY: Right. And I was just thinking that the $3 billion is not a huge amount of money, but you might, in distributional terms, get a lot of bang for the buck if you put it into the lower end of the --

CHAIR PARSKY: Okay, well…

MR. IBELE: Can we look at that?

CHAIR PARSKY: You can.

The capital-gains component option and the carbon-tax option are options that could be incorporated in or not incorporated in. A different treatment of capital gains, adding a carbon tax, that could be incorporated in any one of the above options. And this concept of increasing an exemption to affect the yellow/blue bar impact can also be incorporated in any of the options.

Michael?

COMMISSIONER BOSKIN: Let’s take a few comments on all these things and then raise one other issue if you’re looking for some other source of revenue that would be controversial and not on economic grounds, would be the only source of revenue I know of that no taxpayer would complain about.

With respect to the carbon tax, I think it would be -- I know people have strong feelings about this for environmental reasons, so it would be kind of strange to be saying some people should be shielded from taking their environmental responsibility in that regard. But if the distributional thing is overwhelming, you could jerry-rig something on top of it, and I think that’s correct.

With respect to the carbon tax, I think that it is important to understand, we already have AB 32. And while it may or may not make any sense to have either of those things, it certainly doesn't make sense to have them both.

Third, the third thing I would say about a carbon tax is that anything we do where we're contemplating doing something on our own in California de novo, even things I might generally oppose or generally support, we ought to build in the flexibility to meld it with or merge it with what might happen at the federal level so we don't wind up with a mess later on where we're kind of in great conflict, et cetera.

I think economists would say, if you're going to have a carbon tax, it should be broad. It shouldn't be -- it should be on all sources of carbon. That's the issue, carbon. And it shouldn't just be narrowly confined to a small number of things. That gets into all the issues these guys have been talking about for the last hour and a half, about the inefficiencies of differentially taxing different things. In this case, it's a source of potential externality. So that's with respect to that.

There is one thing that has not been considered that I think needs to be mentioned, it's going to be very controversial, and I don't mean to get into an environmental argument, I just think it's something we ought to at least think about a little bit. And since I have to leave, I'm just going to throw it on the table. Don't argue about it now, but it's something we ought to get materials on it, the staff has started to work something on it. People have very strong reactions to it. But we are about the only place on earth that doesn't utilize our energy resources, and actually prohibits utilizing them. Such environmentally friendly places as the British and the Dutch and the Norwegians are progressively pursuing their energy resources.

We have, by very ancient estimates, with low oil prices relative to today and all being projected into the future, and relative to using old technology, 12 billion barrels of economically recoverable oil sitting offshore California, a modest amount on state land, a larger amount on federal land. The Feds have just instituted a program several years ago to substantially share the royalties on federal oil in the Gulf, with the Gulf states. And so there's really -- we're talking about conservatively $150 billion, maybe much more than that, of oil royalties potentially available for divvying up over the next twenty-some years.

It's something we ought to think about. And one way to go about it is, if you're thinking about a carbon tax, we're basically saying we're going to have an infinite tax on this stuff you can never get at. And it seems to me that's kind of a silly thing to do.

Modern drilling technology has a much smaller imprint. You have one rig that goes out 7 miles in all directions horizontally. It should -- if it was done, obviously it should be done under extremely restrictive environmental care. But it just seems for us not to even discuss that, it seems to me to be kind of a little off-limits to -- a little off-balance to not even discuss it.

We may decide that we're too -- the state is too environmentally sensitive to think about that possibility, whatever it happens to be. But it's the only source of revenue for the state that I can think of that the payers of the revenue would not complain. And you should think seriously about that if you're a serious tax commission, in my opinion.

COMMISSIONER POMP: And we could combine it with a severance tax.

COMMISSIONER BOSKIN: That's right, the state could get a lot of revenue that way. It could accomplish a lot of these other good things, with or without a carbon tax. It doesn't preclude having a carbon tax, but…

COMMISSIONER EDLEY: Just for the record, I'd like to note, Mr. Chairman, that Professor Boskin has recommended a crime against nature. And I agree with him completely.

CHAIR PARSKY: Okay.

COMMISSIONER BOSKIN: It's something we ought to think about either in the context of our proposals or in the context of a set of other things that the state ought to seriously consider in general, let alone its fiscal condition.

Let me just say something in general to make sure I get my comment in, in general.

You heard my comments about the net-receipts tax in my questions. It has a lot of conceptual appeal in an idealized form by a general tax on consumption, more neutral in that sense than the existing tax, et cetera. It is a new tax. It is not well understood. It will be complicated for people, let alone the Legislature, to get their hands around exactly what it is.

The presentation that we had from the Ernst & Young expert was kind of bouncing back and forth like a pinball machine between calling it a business tax and a consumption tax. And so you can imagine the typical legislator having to deal with that can be kind of rough. But, in any event, I think, in general, it's conceptually very appealing. I think we ought to give it the most thorough scrub we can in the next week or two with answering some of these additional questions and getting this additional material. And we should all kind of search ourselves, do we want to do something -- do we want to have the centerpiece of our Commission's report and proposal be introducing a new tax?

I, myself -- the only way I could go there is if other major taxes were abolished. I couldn't add this on without getting rid of the administrative and other automatic growth of government potential issues if we just scaled the other ones back and let it rip.

I would be happy to have the state have a better tax system that, again, on balance, raises around the same rate of revenue. But I'm very, very nervous about the idea of just tinkering with the other taxes and adding this. I think we could wind up with a lot of problems in doing that. And I think we do have, among California, which has a lot of great things going for it, among our major disadvantages is, on balance, our tax system worsens our competitiveness. We can argue how much, but I think that's for sure, whether it's a little or a lot, and which components of it we disagreed with in our hearings.

So I think that Packages 1 ought to be on the table.

I myself would have a very hard time going for some of these other things, going to all the trouble of introducing a new, complex, not well-understood, major revenue source, just playing around the edges of the other taxes. I think it would only be worth the gain if we were really doing something major, like abolishing some of the other taxes.

CHAIR PARSKY: I think maybe before Michael leaves, then we may take a little bit of a break and then come back here.

Commissioners, any questions of Michael's last comments?

COMMISSIONER EDLEY: I have one short one.

Michael, would you agree -- you said that it would be -- we'd be knuckleheads if to --

CHAIR PARSKY: He didn't quite use that word.

COMMISSIONER EDLEY: -- to adopt a carbon tax alongside AB 32. But wouldn't you agree that that's true only if we think, just in economic terms, that's true only if you think that AB 32 alone or the carbon tax alone would actually produce efficient market signals? In other words, if both of them –- do you see where I'm going?

COMMISSIONER BOSKIN: I think there's some debate of whether either of them does. You can have too large a tax as well as too small a tax if there's a potential externality, for example.

COMMISSIONER EDLEY: Right. But I think that, at least my sense was, that the commentary was that neither AB 32 nor anything likely to emerge from Washington would have a sufficient impact on prices to arguably incorporate the externalities. I mean, the experience in Europe is that they were too timid to actually force the price changes big enough to do anything that --

COMMISSIONER BOSKIN: This isn't a place to be arguing about how large --

COMMISSIONER EDLEY: You made an extreme statement that given AB 32, we shouldn't even think about doing the carbon tax. And it's not clear to me that --

COMMISSIONER BOSKIN: It's less about that, than the fact that we have extremely high electricity prices, which has been helping, among other things, to drive manufacturing out of the state. And I think it's very difficult to be a low middle-income, middle-income factory work type in California, and it's getting harder and harder. And the more of this we do, the harder it's going to be. You'll see it's a big hit to manufacturing.

COMMISSIONER EDLEY: Okay, all right.

COMMISSIONER BOSKIN: Our manufacturing has been declining. We have a large number of our enterprises say they would not, for tax and regulatory reasons, expand their production in California. Every Silicon Valley chip producer says that, for example. So I think there are a lot of negative economic consequences of driving up those prices --

COMMISSIONER EDLEY: Okay, but that's a general argument --

COMMISSIONER BOSKIN: -- whatever those potential environmental benefits may or may not be.

COMMISSIONER EDLEY: But that's a general argument against California having its own energy policy, its own global-warming policy.

COMMISSIONER BOSKIN: Yes, that's correct. That's correct.

Well, let me just say, its own policy in that regard that dramatically worsens the competitiveness of the state. I think being on record as to how important this is and pressing the federal government to do things, I think that's all great.

CHAIR PARSKY: Curt?

COMMISSIONER PRINGLE: Actually I was asking the question if this proposal on the carbon tax was exclusively a fuel-based tax or a broader carbon tax discussion. And Mr. Keeley told me that this proposal is just a fuel tax; is that correct?

CHAIR PARSKY: Yes. As requested, it is.

COMMISSIONER PRINGLE: Thank you.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

With regard to Mr. Boskin's comments, I tend to agree with some and disagree with others.

I actually -- I very much agree with the idea that as you go through the package and you look at the coefficient of variation, that as you get higher and higher on that scale as you go through the packages farther and farther, it is an awful lot of gymnastics and reengineering of the entire California revenue-collection system and so on for relatively small gain, if any. And I think that Packages 1 and 2, I think, are a good basis for our further discussion.

Where I part company with Professor Boskin is on the issue of the so-called carbon tax, which I did propose at our first meeting, and have been proposing it at every meeting since then. And I do appreciate Professor Borenstein having been at our meeting at Berkeley to present on that issue.

It isn't -- purely speaking, of course -- a carbon tax. And I think you're right, Professor Boskin, that it's a fuel tax for those fuels that are carbon-based, maybe is a better way to say it.

I had at one point considered suggesting that we have a broader carbon tax involved, which would, for example, include natural gas, which is one of the major generators of electricity, and use that in the base. And that would broaden the base. My issue there was, I think, quite similar to yours, which is having been in the Legislature during the energy crisis but not in the Legislature that voted to, quote, *"deregulate electricity"* in California, I was left with others to accomplish, shall we say, part of the cleanup on that.

I'm not interested in seeing electricity rates increase, although I'm interested in seeing the fuel that produces electricity changed. I'm not sure that the tax system is the way to do that. So the extent to which I'm interested in a carbon tax at this point is as a fuel tax.

I do think that in the same way that California took a very bold step with regard to Assembly Bill 32, and enacted that, and is now going through the steps of implementation -- and I think it's fair to say that it's the single-most significant legislation in the nation on the topic. Whether it's good legislation or not, we --

COMMISSIONER BOSKIN: It's substantial, there's no doubt about that.

COMMISSIONER KEELEY: It is very substantial legislation on that topic. There's a lot of it, and it's very aggressive and very ambitious.

My own sense is that what is going on, both in

Sacramento with regard to the Western Climate Initiative, with several states and a few provinces in Canada, as well as what's going on in Washington, D.C., both of those relating to cap-and-trade systems, that I think it's unlikely that those come about very quickly; or if they come about, that they will look anything like people have envisioned them in the past, because it's not going to be essentially a trading floor which was the initial thought on cap-and-trade. It will be something quite different and, I think, not nearly as effective.

So in that part of the Governor's order to us to have a tax system that reflects the 21st century economy, and if it is true that the Legislature and the Governor, in terms of having a direct impact on shaping the economy going forward, have sent a message that they would like to see California be a place that both by our tax structure, our policies, the quality of our higher education system, the concentration of intellectual capital in the Silicon Valley and elsewhere, that we want to be a part of the greening of the world's economy, then I think we'd lead in a couple of ways.

One of the ways you would do that is leading by example in terms of how we conduct ourselves as a state. And I do think that a fuel tax with a carbon base as the foundation of it does make sense to include in here.

I like the idea that Dean Edley suggested, which is, is there some portion of a carbon tax that could be used to offset both -- to some extent, not completely -- but to reduce the regressivity of these packages, 1A and 1B, in terms of their shift of the current tax burden from a progressive tax burden, to a less progressive tax burden by quite a bit, shifting it into the middle and lower-income groups. Is that something possible to do? And I think there's some real merit to looking at that.

And, Mr. Chairman, I'll just close with this. I'm really happy that we are at this stage of the Commission's work, because my guess is, in a few minutes where we're going to go is, we're going to start that part of the Commission's work where we are providing direction and asking questions for the purpose of assembling a package, as opposed to what we've talked about in the past, the expanding universe of what are all possible options on the table, and now we're narrowing that.

CHAIR PARSKY: Exactly, exactly.

COMMISSIONER KEELEY: I'll say that I'm not thrilled by taking an existing tax structure, having it be revenue-neutral, and in order to try to solve this problem of volatility, saying that what we're going to do is push things down the income ladder. That's basically the effect of these two packages.

I do think, though, that having said that, that there are some real merits to this. I think this is at least potentially a game-changing proposal. I think this is absolutely worth examining and seeing if we can balance it right.

I would reiterate something I've said before -- and I apologize to the Commission for repeating it at virtually every Commission meeting -- but I don't believe that the issue of revenue volatility, which is treated at this commission as if it is purely a tax issue, if that is really what revenue volatility is about. I would argue that, instead, it is about 25 percent a tax issue and about 75 percent a lack of political discipline and will on the part of the Legislature and the Governor to set aside money on the upside of the business cycle, so that you can cushion yourself on the downside of the business cycle. So I don't think we ought to wrap ourselves in too many contortions about trying to solve revenue volatility through the tax code, as if the tax code is the problem. But I do think that it prevents -- this whole tax commission opportunity presents us with the opportunity for a game-changing set of decisions that could, in fact, at the end of it make California a more competitive place.

I'll say this, too, if I could, Mr. Chairman, while Mr. Boskin is still here: There is not, in my view, a solid body of evidence which shows -- not anecdotal information, but a solid body of evidence which shows that upper-income folks are fleeing California in huge numbers to avoid California's tax system. In fact, there are several reports out within the last 18 months which show that the opposite is true, is that the outmigration in California has to do with folks who can no longer afford to buy a house here, who can't rent a home here, who the higher education has gone out of their reach or the medical system is outside their reach and there's not sufficient coverage. There are a whole range of issues of why people leave California. But there's very little evidence that this 144,000 upper-income wage earners and capital-gains beneficiaries are somehow leaving California because of our tax system. It has been made a part of California's political mythological dialogue. But it is, I think, not borne out by actual evidence and thoughtful academic rigorous research.

I think, in fact, it tells you the opposite when you look at that. But even that's okay with me. If we want to pretend that that's why we're doing this or we're pretending that we're doing this because it's going to get rid of tax and volatility, that's okay even with me, provided that the end product here is one which we are the counter-side of what is going on in Sacramento right now. We are the counter-side of the tact of the -- what is going on in Sacramento right now in my view is this: Is that there is a complete dismantling of the last 40 years of building up a health and human service system, building up a public education system, building up a higher education system, building up a transportation and transit system; and there is an exercise going on there to take four decades of work and dismantling it.

And I think our commission has the opportunity, while they are doing that, to offer a very positive way that you can end up with a California that people, in fact, want to live in.

And I'm willing to suppress some of my political beliefs and values in this in order to accomplish that. And I would hope that's what other folks are going to be willing to do at the remainder of this meeting and our meeting next time, is to do exactly that. That this is -- Mr. Pringle as Speaker and Senator Morgan, all three of us have served in the Legislature. And the perfect is the enemy of the good all the time.

And so what I'm asking for is, and committing myself to, is, I'm committed to making a principled compromise here. Nobody should ever be asked to compromise their principles, but I'm asking that people reach for a principled compromise.

And, Mr. Chairman, thank you for your forbearance. I know I've gone on too long.

Mr. Boskin, thank you so much for your usual, keen, thoughtful insights.

CHAIR PARSKY: Thank you.

Becky, you had something you wanted to say?

COMMISSIONER MORGAN: You had asked a question about people's response to Professor Boskin's ideas. And I just --

CHAIR PARSKY: I do that regularly.

COMMISSIONER MORGAN: I know. And so here you go. And I think it also maybe starts the informal voting process that you may be leading into.

But I would agree with Professor Boskin, that if we're going to try a new tax system with net-receipts tax, that that not be additive; that it be in place of current corporate tax. Because that's, I think, the only way that I could accept it. I'm open to new ideas and a new tax policy, but not if it's on top of.

COMMISSIONER HALVORSON: Mr. Chair, if I could?

CHAIR PARSKY: Yes, George.

COMMISSIONER HALVORSON: A comment on the carbon tax -- and I agree, I think having an additive tax would be a mistake. But relative to the carbon tax, I don't think we should be thinking about a carbon tax if we think about -- we should be thinking about a gasoline tax. Because an overall carbon tax does too many bad things to the economy, does change the nature of the electricity bill in California. And if we had a higher gasoline tax, use that money to help subsidize cars for low-income people, it would change the economy of purchasing cars, change the economy of purchasing, and ultimately actually give us less-expensive electricity. Because we'd be spending -- there would be less competition for the energy source on the streets and roads, I think the nature of that -- I don't think we can get there and I don't think this Commission can get there. And the whole cap-and-trade sorts of things are so complex and remote, they actually have no immediate impact on anything that's relevant to us. But in terms of something that is relevant, the opportunity to do -- change the price of gasoline and then use that money to subsidize cars for low-income people I think could change the economy and be better for all of California.

CHAIR PARSKY: Okay, Curt?

COMMISSIONER PRINGLE: If I could just add one thing in regards to what we're going to talk about after our break and what Dr. Boskin brought up.

But I think that your point of if you do establish a new tax, the elimination of taxes has to be something as opposed to just a tinkering of reduction. I don't think it has as much impact. I don't want the Commission to be misled, though, by the words that were accurately portrayed in proposals regarding sales tax. The life of the sales tax in California, even with the elimination of the state sales tax, there will still be a sales tax.

There is a constitutional requirement, Prop. 172, which is for public services -- or public safety services. The local sales tax is 1 percent. And in many counties, there's -- self-help counties, there's the transportation sales tax component.

So, all of those –- so, one, those people who may be concerned about the proposal, none of those would be affected by what we're talking about. It would be the elimination of the 6+ percent state sales tax component that is within the State Legislature's jurisdiction, not any of those other elements.

But still, we would have an apparatus to collect the sales tax in each of the jurisdictions, and that would still be in place. So I think it would be good to eliminate the state sales tax component, but it doesn't mean that we will not have sales taxes in California because those local taxes are established.

And Mr. Hauck's point, as he referenced earlier, I think there's always a pressure that local governments may seek to find ways to augment their budgets. And as he suggested, if there's a reduction of 5, 6 percent on a state sales tax, would local governments clamor to impose sales tax to fill that different -- to take up some of those dollars.

First off, statutorily, there's only so many places where a sales tax can go, like transportation and other purposes. So the Legislature would have to act. But also there is a two-thirds requirement of the local body and the voters before that could be imposed. And those principles would still be in place.

So I don't necessarily think that that 5 percent, plus or minus, would be consumed by local governments. That, picking that up, one, they can't right now. But, two, even if the Legislature allowed them to pick up a few pennies of that, they certainly would not be able to do it without a vote of the people to a two-thirds level.

COMMISSIONER HAUCK: That's what I said.

COMMISSIONER PRINGLE: Just to reiterate what Mr. Hauck said.

CHAIR PARSKY: Edward, did you want to say something?

COMMISSIONER DE LA ROSA: Mr. Chairman, I just wanted to quickly say that I agree with some of the comments that were raised about volatility being only part of the problem -- or part of the challenge, the way I would put it. And it's interesting -- I know that we've been focusing on the tax structure. But in several of the discussions that we've had, we've come up with various approaches which possibly we might all have a consensus on this already, which is the idea of budgeting around the 12-year time-line, or spending one-time revenues for one-time expenditures, or even the establishment of a rainy-day fund. And so I was going to ask that perhaps we can set aside some time at the end of today's session or at the next meeting to address that side of our challenge.

CHAIR PARSKY: Well, I think I said, as part of my introduction, that I think it is important for the Commission to keep focused on what the Commission was established for.

But with respect to those issues and some other elements of reform, it would be quite appropriate to include in our report a reflection of the Commission's views as to those issues that need to be addressed.

And I think I mentioned California Forward is an organization that we have some representatives on. They are going to specifically address some of those reform issues. The Commission really wasn't established to address that. But we have every opportunity to include in some section of our report a recognition that those issues need to be addressed.

Let's take about a ten-minute break, and then let's come back and see if we can pull this together in some form.

(Recess from 2:59 p.m. to 3:26 p.m.)

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

CHAIR PARSKY: I think we've had a busy day, with a lot of analysis. And let me see if I can perhaps make some suggestions in terms of future work, to see if we can't get to a proposal that we all can ultimately agree on.

Although I think that there have been a number of questions -- serious questions -- raised about what we've referred to as the business net-receipts tax as a new form of tax -- and there are risks involved in making any proposal for a new tax that we haven't experienced -- I would suggest that we not abandon this concept. That we ask the staff, with perhaps the help of, if I can twist his arm, Richard Pomp, to assist us in exploring in some depth -- and we obviously will want to ask Bob to continue in his effort, to see if we can't, in much more detail, describe out how this tax would work. And so I would strongly recommend to the Commission that we not abandon this concept.

Commensurate with that, it seems to me, my suggestion would be, we focus in on all the packages that we looked at -- one package that would include the business net-receipts tax. And I'd focus us in on Package 1B. 1B does eliminate the taxes -- eliminate the corporate tax, eliminate the state general fund sales tax, and include the business net-receipts tax. It would have a uniform rate for purposes of discussion at the 6 percent level, but it would have an exemption amount -- I'll come back to in a minute -- deductions for mortgage interest, charitable contributions, and property taxes.

COMMISSIONER MORGAN: And then some.

CHAIR PARSKY: We probably want to take a look at what impact it would have to also allow a deduction for rent if the rent was off of your primary residence.

COMMISSIONER POMP: On 1B, could I ask you, what is the sum of the increases on people up to the $100,000, and what is the sum of the decreases on everyone else? That seems to be a pretty critical bit of information that's missing from each of these charts.

CHAIR PARSKY: While they're looking that up, I just wanted to also mention that there's the -- I think we should look at various levels of exemption, perhaps increase the levels of exemption to address some of the concerns that commissioners have expressed about the significant impact on the lower-income groups.

Now, do you have -- I know that the package itself as a whole would have increased by $10 billion, approximately, the contribution in a revenue-neutral way of the personal income tax, about $10 billion --

MR. IBELE: About $10 billion.

CHAIR PARSKY: -- and would have assumed a 2.77 percent rate on the business net-receipts tax --

MR. IBELE: Correct.

CHAIR PARSKY: -- to make it revenue-neutral.

MR. IBELE: Correct.

CHAIR PARSKY: And I guess your question, Richard, is within the brackets --

COMMISSIONER POMP: That 10 billion, 10 billion could be 90 and 100, it could be 20 and 10.

How does it break down, Mark?

MR. IBELE: For those in AGI brackets, zero to 100, there's a total increase of $8.7 billion. And for those --

COMMISSIONER POMP: 8.7 billion?

MR. IBELE: Billion.

COMMISSIONER EDLEY: This is in 1B?

CHAIR PARSKY: 1B.

MR. IBELE: 1B.

And for those 100 and above, it's a decrease of $11.8 billion.

COMMISSIONER MORGAN: That doesn't come up to 10.

CHAIR PARSKY: Yes, well, I don't think --

MR. IBELE: No. The 10 is just off the personal income tax, this personal income tax and net receipts.

COMMISSIONER POMP: Everything?

MR. IBELE: Yes.

COMMISSIONER POMP: Gotcha.

CHAIR PARSKY: And the exemption that was assumed?

COMMISSIONER PRINGLE: 5,000.

COMMISSIONER COGAN: 5,000 exemption?

MR. IBELE: Yes, right, per person.

COMMISSIONER POMP: That's the standard deduction.

MR. IBELE: Yes. For non-itemizers.

COMMISSIONER POMP: So it's like a standard deduction? Or is it ––

MR. IBELE: Well, it was –– yes. That's a way of --

COMMISSIONER COGAN: Yes, yes. It's just a standard deduction that varies with family size.

MR. IBELE: Right, that's correct.

COMMISSIONER PRINGLE: Mr. Chairman, could I ask specifically on that? So you were contemplating increasing -- or at least modeling the increase in that exemption; correct?

CHAIR PARSKY: Yes. I'd like to --

COMMISSIONER PRINGLE: And that exemption is a universal exemption that would take place -- or would take place if you have a non-itemized return; correct?

MR. IBELE: Yes.

COMMISSIONER PRINGLE: So if you do itemize your deductions, then the assumption is that you have more than $5,000 worth of --

MR. IBELE: We're presuming that people look at that and say, "I'm better off itemizing."

COMMISSIONER PRINGLE: So the same theory would be applied to what you are looking at. Therefore, you were talking about rent being a part of that?

CHAIR PARSKY: Well, with the itemized deductions.

That package, unlike 1A, allowed certain itemized deductions. You start with adjusted gross income, but you allow deductions, itemized deductions for mortgage interest, charities, and property tax.

COMMISSIONER PRINGLE: So you're asking that to be modeled so we can see it?

CHAIR PARSKY: See it, yes.

COMMISSIONER PRINGLE: Only because it's an interesting concept, as we are trying to flatten this out, we're creating new deductions that the Legislature in their wisdom over the last 56 years have not put in place; we're creating one for them.

CHAIR PARSKY: Well, that is a different one, that's true.

COMMISSIONER PRINGLE: I see.

No, no, no. I just wanted to see what the definition of flat --

COMMISSIONER POMP: But there is wisdom in 1A, for that reason.

CHAIR PARSKY: Yes. 1A basically starts from scratch after all this history up in Sacramento of the need for certain itemized deductions, that's true.

MR. IBELE: May I ask a question about the rental deduction?

CHAIR PARSKY: Yes.

MR. IBELE: I mean, for the mortgage interest, there is a -- I see the economic argument there. For the rental deduction, if the goal is to address the regressivity at the low end, we could increase the exemption. I'm missing the link to the rental deduction.

CHAIR PARSKY: I think you make a good point. There is a view floating around that one shouldn't be penalized because he or she has decided to rent the home versus buy the home if it's your primary residence.

I'm not quite sure that logic extends. But if the primary focus of the Commissioners on the issue of rent is to deal with the lower-income groups, that can be dealt with with an increase in the exemption.

Would that be all right from --

COMMISSIONER MORGAN: I think I raised the rental question, and that trade-off would be fine. I just think that the low-income, both psychologically, politically, and actually, should feel somewhat equally treated.

COMMISSIONER POMP: You can phase these out, like the Feds do.

CHAIR PARSKY: Okay, is that okay then?

COMMISSIONER PRINGLE: It's okay with me.

CHAIR PARSKY: So, I mean, there's a lot more work that needs to happen on the business net-receipts tax, and we want to look at various levels of exemption. But my suggestion is, with those caveats, we leave 1B alive and kicking.

COMMISSIONER KEELEY: Mr. Chairman?

CHAIR PARSKY: Yes, sir?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

Mr. Chairman, I know we are still doing things informally, without motion.

CHAIR PARSKY: Right.

COMMISSIONER KEELEY: So what I would like to do, I'm very comfortable with the way you've outlined that. And so I'll just refer to my previous comments about how much I don't like the regressivity. But I think that there's enough merit in this. I would like to add a couple of items to this.

CHAIR PARSKY: I was going to add another alternative. But if you want to add it within that package, that's fine.

COMMISSIONER KEELEY: It's that package.

CHAIR PARSKY: Okay.

COMMISSIONER KEELEY: So Package 1B, I wonder if we could add the following, and have this modeled?

A tax levied at the refinery level on the refinement to gasoline, diesel fuel, and jet fuel, at refineries in California at the equivalent of $20 per ton of CO_2; that those revenues would be general fund revenues, with a direction to staff to explore if some portion of those revenues could be used to offset the regressive impacts of the lowest end of PIT, personal income tax payers.

Secondly, that we direct staff to include, when they come back with us on Package 1B, a $25-per-recordation fee or tax on all recordations on real property, 100 percent of the proceeds after the cost of collection and administration, to be directed to the Resources Agency for their public trust stewardship responsibilities.

CHAIR PARSKY: I was going to suggest -- I hadn’t in my mind focused on that last point.

I was going to suggest that concept applied to -- potentially applied to each of the two suggestions that I was going to make that would stay on the table.

So it would -- this, as an alternative, would apply -- what impact would it have on 1B; and then I was going to suggest one other package which you just said would apply to, as well as an option. So I was going to have it apply to both, not just to one.

COMMISSIONER KEELEY: Okay. Let me see if I understood what you just said.

Is that, to you, Mr. Chairman and to other members of the Commission, is that agreeable that those two elements -- one on what we’ve been referring to as a carbon tax, but admittedly is a fuel tax on three fuels, and the recordation to support the public trust responsibilities of the Resources Agency, is that agreeable that that could be, at this stage in the process, included?

CHAIR PARSKY: Yes. I think -- I would say it could be included. I would urge everyone to think of it perhaps more in the context of what I will say about the second alternative. But it could be included in either.

COMMISSIONER KEELEY: Okay, Mr. Chairman. Thank you, sir.

COMMISSIONER COGAN: Gerry, I was just going to say that I think Fred's first idea is a very good one.

I'd like to have it couched a little bit differently -- that is, I'd like the staff to maybe explore for us the efficacy of imposing a fuels tax at the refinery level relative to at the retail level. They are two different -- one way you can have a fuels tax, of course, is at the refinery level. The other is at the retail level.

And I'd like you to at least maybe get somebody from the Department of Finance or from the resources group to educate us a little bit on the efficacy of the two.

MR. IBELE: You're thinking about just the administrative aspects of it or --

COMMISSIONER COGAN: Uh-huh, and the revenues raised.

MR. IBELE: Yes, yes, right.

COMMISSIONER COGAN: Because they're going to be different.

MR. IBELE: Right. Right now, our gas tax, the way we levy it, is at the point of first distribution -- at the rack, as it's known, as opposed to at the pump. But this would be moving it one step further back then.

COMMISSIONER COGAN: Right.

CHAIR PARSKY: Maybe let me just finish one -- because I wanted to suggest that that -- Package 1B doesn't have to be looked at just this way, would be the package that contained one or two, but I was focusing on one new form of tax and the elimination of several existing taxes. That's one possibility.

The second possibility would be to take Package 2, and eliminate from Package 2 the business net-receipts tax. As a new form of tax, we would eliminate that from consideration there -- again, for purposes of discussion here -- we would eliminate for the moment the investment tax credit component and we would include the fuels tax as you described it.

Again, it is a different form of new tax, but it would retain a more simplified and lower personal income tax rate, you would reduce the corporate rate but not eliminate it; you would reduce the sales and use tax, but you wouldn't extend it to services; and you would have a fuels tax. And you would use the revenues off of the fuels tax to, in part, address some of the distribution issues.

COMMISSIONER KEELEY: Mr. Chairman, let me make sure I understand the very last thing.

So the fuels tax rate would be determined by netting out the reductions everywhere else, and then you would set a fuel tax so that the revenue-neutrality goal is achieved; is that what you're suggesting?

CHAIR PARSKY: Exactly.

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

COMMISSIONER PRINGLE: Mr. Chairman, therefore, a lot of the available funding that would be generated -- Mr. Keeley, in his previous proposal, wanted to ensure that that was directed to the lower-income brackets to take care of regressivity. And since the fuel tax is the most regressive of all these taxes, how high does that have to be to correct that level of regressiveness?

CHAIR PARSKY: How high would the –- it would be --

COMMISSIONER PRINGLE: That probably, too, was a rhetorical question.

CHAIR PARSKY: We're still smiling. I like that.

COMMISSIONER KEELEY: He smiles a lot.

COMMISSIONER PRINGLE: No, no, no. I would like to see how, in fact, that does play out if the purpose is to ensure that you're addressing the regressive nature of the other elements of the tax structure.

CHAIR PARSKY: John?

COMMISSIONER COGAN: Gerry, one other thought on Tax Package 2. Right now, the way it's structured, there's a little bit of ambiguity on what the zero bracket -- to whom the zero bracket applies.

CHAIR PARSKY: Right.

COMMISSIONER COGAN: And in Package 2, we're retaining all of the current deductions and credits.

CHAIR PARSKY: How would you clarify that first point on the zero bracket?

COMMISSIONER COGAN: Well, it seems to me that any zero bracket should only apply to non-itemizers; right?

MR. IBELE: Right.

COMMISSIONER COGAN: Everybody who itemizes gets their deduction, it's a variable deduction. So I would say keep whatever zero bracket you have or exempt amount to the non-itemizers, just as you did in Package 1.

It also seems to me that maybe it's worthwhile to consider, under Package 2, to eliminate all of the deductions and credits except for the big three that we retained in Package 1, and then replace those, in effect, with an exempt amount, as we did in Option 1, and clean up the tax code, if you will -- simplify things quite a bit.

So modifying Package 2, we would do so by saying we would retain only the deductions from mortgage interest, charity, and property taxes as we did in Package 1.

CHAIR PARSKY: Well, you're getting close to Package 1.

COMMISSIONER COGAN: Right.

CHAIR PARSKY: Would you move to one proportional rate?

COMMISSIONER COGAN: No, keep the variable rates. Keep the variable rates. Because I think we're going to have less of a distribution problem that way, and have an exempt amount.

CHAIR PARSKY: Okay, we can certainly --

COMMISSIONER COGAN: So it will affect the two-rate structure as opposed to the one-rate structure.

CHAIR PARSKY: So the variation would be not having the new form of tax, keeping the variable rates, eliminating the itemized deductions -- or reducing the itemized deductions to a limited number, reducing the corporate tax rate, reducing the sales and use tax rate.

COMMISSIONER COGAN: I would not, in this option.

CHAIR PARSKY: You would not?

COMMISSIONER COGAN: It just seems to me that if the focus is on economic growth, the focus should be on reducing the corporate rate and the personal income tax rate. Those are the two that pare economic growth the most.

It seems to me that reducing the sales and use tax by 1 cent is kind of a waste of revenues.

CHAIR PARSKY: But since it is the most regressive, how do you address the regressivity with this package?

COMMISSIONER COGAN: With the zero-bracket exception, more progressive rates than we have in 1. That's sort of the idea.

COMMISSIONER POMP: I would like to add a severance tax. We are the only state in the country -- we may be the only jurisdiction in the world that does not have a severance tax. And I would like to see what that would raise, and that's another source of money to deal with the regressivity issue.

And we have also lost our interest in cleaning up tax expenditures. And I don't know if you read what I had Mark distribute. Real briefly, nine corporations will receive tax cuts averaging $33 million due to the adoption of elective single-factor apportionment. 80 percent of the benefits go to 1 percent of California corporations with gross incomes over a billion dollars. And this is scandalous. This is all a source of potential revenue for lowering the rate. And we seem to sort of have ignored our list of tax expenditures along the way.

COMMISSIONER MORGAN: But isn't that covered by the net-receipts tax?

COMMISSIONER POMP: If you eliminate the corporate income tax, but we may not.

CHAIR PARSKY: Well, but Package 1B would.

COMMISSIONER POMP: Yes, but that may not be the package we adopt. We may decide to be a corporate income tax.

CHAIR PARSKY: Well, we want you to be an advocate of one or the other, that's okay.

COMMISSIONER POMP: An advocate of one that has not been tested and tried yet, is really -- and then to talk about -- I have to disagree that we at ought to be bold and replace what we have with a new tax whose revenue estimates are soft at best; that hasn't really stood the test of time, which Michigan adopted only because they have a constitutional cap on their sales tax.

This is really not –- this is shooting crap.

We’re the seventh largest economy in the world, so go slow.

CHAIR PARSKY: Now, now, but we’ve been going slow for about 30 years and we’re where we are.

The whole purpose here is to --

COMMISSIONER POMP: Not make things worse.

CHAIR PARSKY: -- move a little faster.

COMMISSIONER POMP: There’s always a downward spiral.

COMMISSIONER COGAN: Gerry, if I understand Richard’s suggestion, as a generic suggestion, we would reduce the corporate tax rate to 7 percent, and we’d take a look at all of the credits and deductions that apply to corporate -- in a corporate code, just as we’re doing on the individual side?

COMMISSIONER POMP: Yes, but we’ve got to get into this elective single-factor apportionment, too. Which as these statistics show, what, do you just give away money to three corporations? I mean, that’s not efficient spending.

COMMISSIONER COGAN: Well, for my part, I’m certainly willing to keep that on the table. I don’t see any reason to take one particular little corporate tax provision off the table at this point.

COMMISSIONER PRINGLE: 1B takes it off the table.

COMMISSIONER COGAN: Pardon me?

CHAIR PARSKY: 1B does. But you're talking in Package 2 --

COMMISSIONER COGAN: In Package 2.

CHAIR PARSKY: -- to take a look at the --

COMMISSIONER COGAN: Rate reductions and broaden the base.

CHAIR PARSKY: Of the corporate tax?

COMMISSIONER COGAN: Of the corporate tax.

CHAIR PARSKY: Okay, let's include that analysis.

COMMISSIONER ITO: Just another comment or a request.

CHAIR PARSKY: No, that would be my suggestion, that we fully go at analyzing those two packages as something that we would bring to this group to decide in July.

Jenny?

COMMISSIONER ITO: And just another request. I can't help but be concerned about the overall shift of the burden for the lower and middle-income. So I think what would be helpful is just some kind of analysis about per-income group, the percent of taxes, overall taxes in each scenario as a share of the income on each one of those.

CHAIR PARSKY: I think that's a very good point. And I should have mentioned, I think we need to include the impact of all taxes, not just the taxes that we are proposing to change, in terms of its impact on various income groups.

COMMISSIONER PRINGLE: Of all state taxes. All state taxes.

CHAIR PARSKY: Phil?

MR. SPILBERG: Yes.

CHAIR PARSKY: Don't look with consternation at me.

MR. SPILBERG: No, no. That's just the way --

CHAIR PARSKY: Only because -- it is important just to look at the taxes we're changing. But then you have to step back and take a look at, if you make these changes and you have the existing state taxes also impacting people --

MR. SPILBERG: I see.

CHAIR PARSKY: -- what impact does it have?

COMMISSIONER EDLEY: If Minnesota doesn't help you, try North Dakota.

MR. IBELE: You're going in the wrong direction.

MR. SPILBERG: And such things will not change very much over the analysis we've already done because about 95 percent of the revenues for the state general fund comes from the personal income tax, the sales tax, and the corporate franchise tax.

MR. IBELE: It would be slightly more regressive. We'd be including basically the excise taxes.

COMMISSIONER COGAN: Mr. Chair?

But the change will still be the same.

MR. IBELE: Right, right.

COMMISSIONER COGAN: Would you be looking, in effect, at disposable income, which is really what we want to look at, income after taxes?

COMMISSIONER BARRALES: Mr. Chairman, is staff also looking at -- and I don't know how they get this -- but the effects on job retention or creation in the state?

CHAIR PARSKY: With each of the packages, it's -- I think comments that were made about the ability to quantify or analyze people leaving the state, coming to the state, businesses come in-state are somewhat problematic.

COMMISSIONER BARRALES: Right.

CHAIR PARSKY: But we do need to make a comment with respect to any proposal that we put forward on how we feel about its impact on potential job creation. That's part of our -- we will have set out all our goals. It would be important to come forward with at least somewhat of a judgment on that subject.

COMMISSIONER BARRALES: Okay. Well, it seems as though there's a lot of research that has been done and that's been requested.

Mr. Keeley has mentioned a number of times that there's no actual evidence that people are leaving the state or high-income earners are leaving the state, or necessarily for that matter, jobs are necessarily leaving the state. And one of our charges is to try to develop a 21st century tax structure that encourages job creation and retention here in California. So I'd like to be able to get at that as realistically as possible.

Also, I know staff is just dying to dive into all this and get working on this. I assume then --

CHAIR PARSKY: I wouldn't put it that way with them.

COMMISSIONER BARRALES: I assume, though, with the fuels-tax proposal, is that somewhat modular in the sense that Package 1B and Package 2 will be -- you'll look at those and then you'll look at those with and/or without the fuels-tax component; is that the idea?

CHAIR PARSKY: Yes. Well, I would focus heavily on Package 2. But we could adjust it for either.

COMMISSIONER KEELEY: Well, Mr. Chairman, if I might on that point. We had talked about -- if I understand where the bidding is at this point, you had outlined a modified Tax Package 1B.

CHAIR PARSKY: Right.

COMMISSIONER KEELEY: Then you had outlined a modified Tax Package 2.

CHAIR PARSKY: Yes.

COMMISSIONER KEELEY: I want to make sure that I understand where we are.

With regard to both of those on the issues that I have raised, you have agreed that the staff would put in to that package, to both of those packages, the fuels tax as we've described and talked about earlier in both of those packages. We would also put in both of those packages this proposal for the recordation charge for the Resources Agency. We would also -- as I recall, you made some other amendments to it, and that's fine, I'm agreeable to all the amendments that you made. That somehow we are going to deal with both the renter question in terms of fairness relative to how housing is treated with regard to a deduction or an exemption, that we are somehow going to deal with that; that the staff is also going to deal with the regressive nature of it overall in response to Commissioner Ito's question, which may involve a way to do that, would be to increase the zero-obligation folks, that that may be a way to do it, but there might be other ways.

CHAIR PARSKY: I would make an amendment in that. Everything you said up until “the renter,” I took that off the table because I thought --

COMMISSIONER KEELEY: Oh, because you can deal with it --

CHAIR PARSKY: -- I can deal with it in the context of the exemptions.

COMMISSIONER KEELEY: Okay, fine. Fair enough.

And then if I could continue with this. With regard to Commissioner Barrales’ comment about sort of the component-part nature of this, I would see that being the case in every component part. That what we will see for every component part --

CHAIR PARSKY: Yes, we would.

COMMISSIONER KEELEY: -- is that. And so then we can adjust dials and knobs as to rates and bases and pulling things completely out or not; right?

So you weren’t singling that out?

COMMISSIONER BARRALES: No.

COMMISSIONER KEELEY: You meant, everything can be looked at that way. Fair enough.

COMMISSIONER BARRALES: No.

COMMISSIONER KEELEY: I’m fine with that.

Now, as to Mr. Spilberg’s looking -- what was the word that was used? He looked…

What did they say, Phil? What was it?

MR. SPILBERG: Consternation?

COMMISSIONER KEELEY: Consternation.

CHAIR PARSKY: Consternation. He was looking at me with consternation.

COMMISSIONER KEELEY: No, no. I'll just say, because I know Mr. Genest -- if you'll look at Mr. Genest, that he has same look. It is required, to be employed by the Department of Finance. You have to have that ––

Is that right, Mr. Genest?

MR. GENEST: *(Nodding head.)*

COMMISSIONER KEELEY: That's what I thought. Okay, thank you, sir.

COMMISSIONER PRINGLE: Mr. Parsky?

CHAIR PARSKY: Yes?

COMMISSIONER PRINGLE: I really don't know what we're doing here. I thought that you started to try, after a few hours' worth of discussion of four proposals that were presented, to ask staff to dust a couple off, take one similar to how it's presented in our book, 1B ––

CHAIR PARSKY: Right.

COMMISSIONER PRINGLE: -- craft another one that addresses many of the myriad of other suggestions other people have, and have two proposals. It's hard to have every proposal fluid, so there will be two proposals with valuations there. It can't be the dials are all turned for every one of them.

CHAIR PARSKY: Right.

COMMISSIONER PRINGLE: And then in fact have other proposals and ideas that could be added or taken out of different things. But you have to have two things to be able to compare, to start with, to see which path we walk down.

CHAIR PARSKY: Right.

COMMISSIONER PRINGLE: Am I too far off of what you were saying?

CHAIR PARSKY: No, that's exactly what I had in mind. And I guess the only thing I would ask Fred -- the only amendment I would suggest to Fred's commentary would be that the -- I hadn't contemplated under Version 1B that in addition to having the business net-receipts tax, it would have the fuels-tax component.

COMMISSIONER KEELEY: I think I see what both you and Mr. Speaker are saying.

So you would have essentially Package 1B the way it was presented?

CHAIR PARSKY: Exactly.

COMMISSIONER KEELEY: And then all of the other ideas that have been surfaced and around which we've gotten enough nods that, yes, those have sufficient support on the Commission to be considered, those would be considered and presented as parts of a newly reconstructed Tax Package 2?

CHAIR PARSKY: Exactly.

COMMISSIONER KEELEY: Is that correct, sir?

CHAIR PARSKY: Yes.

COMMISSIONER KEELEY: I'm fine with that.

COMMISSIONER POMP: And is Package 2, adjusted gross income or adjusted gross income minus those deductions? I lost track.

CHAIR PARSKY: We were going to remove the itemized deductions.

COMMISSIONER POMP: I think that's a great change.

CHAIR PARSKY: Okay, yes, Chris?

COMMISSIONER EDLEY: I didn't quite follow all of that. But it does seem to -- there will be something that looks like 1B that has -- with Gerry's fixes, where we fold in the fuels tax and spend the money to fix the regressivity or something. I mean, we'll get a presentation with a chart that shows what the distributional --

MR. IBELE: *(Nodding head.)*

COMMISSIONER EDLEY: Okay, fine.

When I look at Chart 1B, at the graph in 1B, and I look at sort of the better-off/worse-off, the BO/WO factor at $100,000 and above, it strikes me that this is dead on arrival in Sacramento.

And let me make the same point a different way.

I think a proposal which has the air of volatility reduction as stalking horse for rate reduction is just very problematic. So in that spirit, I'd like to propose a variant here, sort of 1B2 or maybe it's 1B3, that would take 1B but introduce a higher bracket at 100, 150, something like that, and do income-averaging for the amounts at that bracket level.

And so here's my thesis: My thesis is that this troubling wedge that you see on the graph here for 1B will narrow substantially, which I think will improve both the fairness and the politics of the proposal; the volatility will reduce substantially because of the income-averaging on things like these highly volatile elements of income, like capital gains and bonuses and so forth, and then do as much rate reduction as you can do. So that's sort of where I'm going.

CHAIR PARSKY: Well, I would -- again, in order to keep us on a path of some clear alternatives --

COMMISSIONER EDLEY: Yes.

CHAIR PARSKY: -- if you wanted to impose different brackets, Package 2 is a different bracket approach.

COMMISSIONER EDLEY: Fine. But I mean, it's just a question of -- I'm happy to make it sort of 2A or 2B; but in which case, I like the business net-receipts tax.

CHAIR PARSKY: Right.

COMMISSIONER EDLEY: Eliminate the corporate tax and the state sales tax.

CHAIR PARSKY: But what is troubling you is that the package, as a whole, is creating this shift in burden on the overall package? That's what is bothering you?

COMMISSIONER EDLEY: Yes. Because remember, you guys can't have it both ways; right? You can't say the thing that we're really trying to deliver for the Governor is --

CHAIR PARSKY: Wait a minute now.

COMMISSIONER EDLEY: -- volatility reduction for the people of California.

CHAIR PARSKY: No, no. We're delivering for the Governor and the Legislature and the Democratic leaders and the entire state.

COMMISSIONER EDLEY: Great. Well, if we're delivering for those folks, too, then I don't think we can give them a proposal that looks like 1B at the top end, because there's just a -- this is a shift in tax burden from the very high-income to middle-income.

Fix the exemption, right, that's going to take care of the lower-income. Very happy with our discussions of that. But we'll still be left with a package that is going to have the optics, and I think the underlying reality, of being a substantial reduction in taxing paid at the higher income, in favor of the middle income.

Now, I know there are a lot of people who think that's very good public policy because a small fraction of taxpayers are paying a very large share. That's not an argument about the 21st century and that's not an argument about volatility; that's an argument about not liking the distributional character, the progressive character of today's tax system. So I'm trying to kind of split the difference here: Provide a lower rate, but at the same time, not have a package that looks like such a, frankly, crass transfer of burden from the 200K-plus folks to the middle income.

CHAIR PARSKY: Well, to some extent, maybe the staff can help out here because, in looking at the shift, you have to look at the shift over time, not at the point in time -- this chart compares current law on a static basis with the change.

COMMISSIONER EDLEY: Right.

CHAIR PARSKY: If you look at what has happened over time, and you say, well, let's take a look at what this burden shift would really look like, pick a date that was less -- closer in time to the average, or something there, I think you may be more comfortable.

COMMISSIONER POMP: But we don't know.

CHAIR PARSKY: We don't. I think we've got to see it.

Because I think what is clear is that we have, in California, had an ever-increasing dependence on the personal income tax and, as a result of the way the tax is structured, a heavy increasing dependence on a fewer number of people. That's over time.

So you're right, I mean, if you pick one specific point in time, the year two-thousand-and-X, you will see that. But the concept of income-averaging is a concept that the staff may have some comments about. I have no objection to work being done on it. But I'm not -- I wouldn't say necessarily that the challenges we are faced can be addressed without recognizing there needs to be a shift in the other direction.

COMMISSIONER EDLEY: I appreciate that. I appreciate that very much. But I suppose where we part here is that analytically, I think -- or perhaps I should say logically, I think the way to deal with a shift that you mention, secular increase in the burden on the income tax, while having overall progressivity, is to put wealth back on the table, and that means property taxes.

But if we're taking property taxes off of the table because of the third rail of Prop. 13, which I understand most of the commissioners want to do as a political matter -- if you're taking that off the table, going after wealth, then I don't think that liberals are going to let you decrease the overall progressivity of our system.

COMMISSIONER POMP: Because of really a false issue of volatility.

COMMISSIONER EDLEY: Exactly.

Do you see what I mean, Gerry? It's like, I agree with you that there would be kind of growth gains, efficiency gains, et cetera, by decreasing reliance on the personal income tax. But for overall progressivity, I would want to replace -- I'd be willing to cut your taxes -- your income taxes -- if I could get more out of you on your property taxes. But you're not giving me that option. And, therefore, what I'm suggesting instead, is that we do the rate reduction that we can, we reform the business taxes, but that we deal with the volatility issue by having a top bracket and some averaging.

COMMISSIONER POMP: Or lock it up, so it can't be spent somewhere.

COMMISSIONER EDLEY: Yes, that would be an alternative to averaging, but…

CHAIR PARSKY: Well, I do think one thing: I don't think -- I don't think the issue of volatility is a false issue. I mean, you can't have lived in California over the last X-period of time and not feel that there's volatility in the system.

COMMISSIONER POMP: States would love the problem. I would love it as an individual. I'd love my income to spike several years. What I won't do is spend on the assumption it will always be that high. That's the problem here.

CHAIR PARSKY: It's not the only problem.

COMMISSIONER POMP: Otherwise, it's wonderful. You've got wealthy people with a lot of income, and it fluctuates. That's not a bad problem.

CHAIR PARSKY: But your answer -- your answer to your issue -- put aside the property tax -- is income averaging?

COMMISSIONER EDLEY: Yes.

COMMISSIONER MORGAN: Just for the top quartile or decile or whatever?

COMMISSIONER EDLEY: Yes. I don't know what the specific parameters would be. I want to get some -- I do want to get some reduction in the rate for most people. Got that.

But I want to -- but then I want to retain the requisite amount of progressivity by having a top bracket as Option 2 tried to do. And I want to reduce the volatility created by that top bracket by doing averaging.

Now, if you don't want to average the income, I'd be happy to let the rates fluctuate countercyclically.

COMMISSIONER ITO: Can we look at different income brackets?

CHAIR PARSKY: Well, in one sense -- in one sense, maybe -- and, again, let's think a little bit about it. But the original Package 2 had business net-receipts tax in it and it had brackets and it had some reductions.

It didn't eliminate -- the reason I suggested moving off of that was the concept which is certainly worth -- it's got some merit to it –- of if you're going to really go at this new form of tax, it ought to replace other taxes.

COMMISSIONER EDLEY: I'm with you on that.

CHAIR PARSKY: There's some merit with that.

COMMISSIONER EDLEY: I'm with you on that, right.

CHAIR PARSKY: But let's see if working with the staff -- I'm just not sure how to deal with this income-averaging concept.

Do you have any thoughts, Phil, before we --

MR. SPILBERG: I'm not sure how to do it, either. So that's something that I would need to talk over with Commissioner Edley or the Chair, however the Chair would like to handle this.

CHAIR PARSKY: No, no. I think we should talk with Chris, for sure.

MR. SPILBERG: Okay.

COMMISSIONER MORGAN: Can I raise another issue?

CHAIR PARKSY: Yes.

COMMISSIONER MORGAN: Mr. Chairman, I'm just wondering, for those of us that would like to merge the two tax agencies and set up an appeals court, when is that an appropriate discussion?

CHAIR PARSKY: Well, I think there was a comment, and we should include it in this report -- there was a comment made that in addition to forms of tax, and how the tax -- the nature of the taxes, our report should include not necessarily in the same piece of legislation --

COMMISSIONER MORGAN: No.

CHAIR PARSKY: -- but in a recommendation form, suggestions about tax administration.

COMMISSIONER MORGAN: I hope so.

CHAIR PARSKY: And we're going to circulate, based on comments that have been made, suggestions for tax administration. That would even be included in the report.

COMMISSIONER MORGAN: Okay. And my second thing that hasn't been talked about much was the most volatile within the personal income, as we all know, are the capital gains.

CHAIR PARSKY: Right.

COMMISSIONER MORGAN: And I have heard some support from commissioners about trying to lock in the reserve more strongly than it has been in the past, perhaps.

What would the reaction be for the state to take the capital-gains tax and put it into the reserve up to a certain percentage of the annual budget?

CHAIR PARSKY: Well, again, I would strongly recommend that given the fact that, to date, the Legislature hasn't been able to agree and the voters seem to have rejected the concept, that the notion of a reserve -- which has merit, and probably a number of commissioners would want to include in a suggestion for others to address, it's not really the charge of this Commission. The charge of this Commission really is to address the tax system and the generation of revenues.

We can, and should, suggest that organizations like California Forward are addressing this, and need to. But I think we've got our hands full in trying to come up with a coordinated tax package.

With the challenge left to me on how to deal with Chris' last comment, if it's all right, we will move forward on these two packages.

COMMISSIONER EDLEY: I'm sorry, Gerry, I didn't understand the thing that Fred mentioned about the –- there was a recording fee and a Resources Agency earmark for them or something? What are we doing? Why are we doing this?

COMMISSIONER KEELEY: At the meeting --

COMMISSIONER EDLEY: Can we change it to the university? That the revenue go to the universities instead of… We're a public resource.

COMMISSIONER KEELEY: When the Chair asked commissioners at our second meeting if we had ideas or suggestions that we wanted the staff to examine, I put eight suggestions together and submitted them, and the staff has provided responses on all of them. One of those was this notion of the Resources Agency.

And the issue here from the tax commission, from my perspective, the way that this fits in, is that we have an exercise going on in Sacramento, which has been going on for quite some time -- not just this year, not just the last few weeks, but for some time -- which is dismantling various parts of fundamental, basic government as we've come to understand it in California. And one of the areas that the public has made commitments to, time and time and time and time again, has been the resources issues in California that are all, at this time, covered under the Resources Agency of the state. And these are public-trust resources for which the state has both accepted and encouraged an intergenerational responsibility for stewardship.

And so in that regard, in discussions with the Secretary of the Resources Agency, and others in the Administration, the idea is that there -- this has been something that for over a decade, over two Republican administrations and one Democratic administration, there has been discussion about how to accomplish this. And it seemed to me that if we're looking to the state's economy in the 21st century, that one of the quality-of-life issues that this state is very proud of has been its stewardship of its natural resources.

The park system, for example, is the second largest park system in the United States, second only to the United States federal park system. The same is true with regard to forestry and fire protection, fish and game, and the other entities that are under that umbrella. They receive virtually no funding from the general fund of the state, and have been dying on the vine.

And so my sense is that in keeping with the Governor's direction here, which essentially has some aspirational quality to it, about what kind of California we would like to see, I think for a very de minimis amount we can keep that pledge that we have made intergenerationally.

I would point out that President Teddy Roosevelt visited Big Basin Park in Santa Cruz County and said that we should preserve this place and these places in California for our great-great-grandchildren.

We are that generation. That is who we are. We are the great-great-grandchildren of the Teddy Roosevelt generation.

And so my thought is that we should have a de minimis fee tied to recordations on real property, because the public trust resources and stewardship responsibility are about real property resources that are in state ownership.

Thank you, Mr. Chairman.

COMMISSIONER EDLEY: So I gather, Mr. Chairman, each member of the Commission gets an earmark in our recommendation? Because I have some other programs I'd like to suggest that are critical to the future of California.

CHAIR PARSKY: But before we are finished -- before we finish, we will give voice to any individual requests that are made.

Again, I'd like to have us focus in on the proposal we want to make, convert it to legislation that we want Sacramento to act on, and other recommendations that we want Sacramento and the entire state to consider, and other ideas that we may have for generations to come, all of which can be included in our report. And this is not to denigrate any of those categories.

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

CHAIR PARSKY: And with that, I'd say we're adjourned.

(The meeting concluded at 4:20 p.m.)

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REPORTER'S CERTIFICATE

I hereby certify:

That the foregoing proceedings were duly reported by me at the time and place herein specified; and

That the proceedings were reported by me, a duly certified shorthand reporter and a disinterested person, and was thereafter transcribed into typewriting; and

That the foregoing transcript is a record of the statements of all parties made at the time of the proceeding.

IN WITNESS WHEREOF, I have hereunto set my hand on the 18th day of June 2009.

DANIEL P. FELDHAUS
California CSR #6949
Registered Diplomate Reporter
Certified Realtime Reporter