STATE OF CALIFORNIA

COMMISSION ON THE 21st CENTURY ECONOMY

REVENUE AND TAXATION

OVERVIEW AND PERSPECTIVES

PUBLIC MEETING

Thursday, January 22, 2009
9:05 a.m. – 4:07 p.m.

University of California, San Diego
Rady School of Management
9500 Gilman Drive
La Jolla, California

Reported by: CAROLE W. BROWNE, CSR #7351
Registered Professional Reporter

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

A P P E A R A N C E S

COMMISSION ON THE 21ST CENTURY ECONOMY

Commissioners Present

GERRY PARSKY, Commission Chair
Aurora Capital Group

RUBEN BARRALES
President/CEO
San Diego Regional Chamber of Commerce

MICHAEL BOSKIN
Professor
Stanford University

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

JENNIFER ITO
Research, Training, Policy Director
SCOPE

FRED KEELEY
Treasurer
County of Santa Cruz

MONICA LOZANO
Publisher/CEO
La Opinión

RICHARD POMP
Professor of Law
University of Connecticut

CURT PRINGLE
Mayor
City of Anaheim

A P P E A R A N C E S

COTCE Staff Present

MIKE GENEST
Finance Director, State of California
Commission Executive Director

MARK IBELE
Board of Equalization
Commission Staff Director

MICHELLE QUINN
Staff Writer

MARGIE RAMIREZ WALKER

ASHLEY SNEED

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Public Testimony

ROGER GORDON, Ph.D.
University of California, San Diego

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Presentations

PHIL SPILBERG
Chief, Financial Research
State of California Department of Finance
"Overview of California's Tax and Revenue System"

MAC TAYLOR
Legislative Analyst
California Legislative Analyst's Office
- and -
JED KOLKO
Associate Director and Research Fellow
Public Policy Institute of California
"Perspectives on California's Revenue Structure"

SCOTT PATTISON
Executive Director
National Association of State Budget Officers
- and -
JIM EADS
Executive Director
Federation of Tax Administrators
"Overview of Tax and Revenue Systems in Other States"

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BE IT REMEMBERED that on Thursday, January 22, 2009, commencing at the hour of 9:05 a.m., thereof, at the University of California, San Diego, Rady School of Management, 9500 Gilman Drive, La Jolla, California, before me, Carole W. Browne, a Certified Shorthand Reporter in the state of California, the following proceedings were held:

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CHAIR PARSKY: Thank you all very much. I want to welcome everyone to our first meeting of the 21st Century -- Commission on the 21st Century Economy.

And I want to pay particular thanks to all of our Commissioners. I think all of the Commissioners are here except for Becky Morgan, who has indicated that she was -- had a conflict, but I've talked to her extensively and I know she will be at our next session.

Also, I want to -- all the biographies of all the Commissioners, I think, are available to everyone. I hope all of the public agrees the quality of this Commission to deal with this important issue is extraordinary. I think most elements, if you will, of the California economy are represented here.

I'm sorry. One other Commissioner -- I know Ruben Barrales said he would be a little bit late, but he will be here.

I also want to indicate to the public and to everyone that we will have free and open discussion, if you will, throughout the course of this agenda.

Our plans are to try to put forward a series of recommendations on or before April 15, and we plan to have a minimum of three public hearings. The public is invited to listen in to the deliberations, to the presentations, and also come forward and make public comment.

And then, if we -- we all feel that it is necessary and appropriate, we'll have a fourth session that we will hold in early April. So we've reserved the dates in -- one in Los Angeles at UCLA, one at Berkeley, and one at UC Davis if we all deem it to be necessary and appropriate. In all likelihood, that will happen, given the input that I know this quality group of Commissioners will have to this process.

I also want to thank and make sure everyone is aware of the staff that we've been able to put together in connection with the work of this Commission.

First, Mike Genest is here, in the back of the room. Mike serves as Governor Schwarzenegger's finance director and he has agreed to serve as executive director of the Commission and has helped us organize the Commission, and a very small budget, thanks in part with the help of the University of California, who has nicely agreed to have our Commission hearings at various UC locations.

In addition to that, Mike has also made certain members of the -- his staff available for administrative matters.

Our staff director, Mike -- Mark Ibele is here, I think, too.

Mark, are you here?

MR. IBELE: Here.

CHAIR PARSKY: Mark is on loan from the Board of Equalization. He's a Ph.D. economist with extensive background in tax policy, and he's going to serve as our staff director.

In addition, we have serving as staff writer Michelle Quinn, who is here. And they will be working extensively with this Commission in trying to produce our final report. Mark has also been working very hard at organizing our presenters.

Margie Walker is here. Margie is on loan also from the Governor's Office and has helped us set up this meeting and will help us set up the other meetings.

Ashley Sneed is here. Ashley has -- is helping us in connection with the media on all the work of the Commission.

The expertise and analysis from the Department of Finance will be well-represented both this morning and throughout the process. Phil Spilberg is here and he will be presenting this morning and will be working with us throughout the process.

And so I think we have a very experienced staff to help us with the work of this -- of this Commission.

The only other thing by way of introduction before we ask our public speakers to come forward, I think everyone has the -- both the Executive Order of the Commission as well as the comments made by Governor Schwarzenegger, Speaker Karen Bass and Darrell Steinberg, in connection with the announcement both of the Executive Order and then the announcement of the Commissioners. And it lays out really the task at hand for the Commission.

And after the public comment period is over, I'll ask any of the Commissioners to make comments as we enter this process.

But I think the only thing I would say in beginning, the Commission is -- has not been established to help resolve the current budget process. Whether or not we could do it, we haven't been asked to, thank goodness. Our task is to try to take a look at long-term reform and focus on how revenues are generated for the state.

The tax laws of our state haven't been reformed, if you will, or upgraded for a good number of years. The economy has changed. The needs have changed. And we've seen in connection with the current budget crisis the impact that volatility in our revenue stream can have on decision-making.

And so we will want to step back and say how can we go about recommending reforms that would -- that would help future policymakers and future generations avoid some of the pitfalls of the volatility that has existed over the past few years.

We'll have a number of other things to say, but I think it's important to kind of refer continuously to the basis upon which the -- this Commission was established as we look to make our recommendations.

Generally speaking, I think we all want to make sure that we have an understanding and are fairly well grounded in terms of the nature of the problem, and we'll have some discussions about that.

Also, we may -- I think it would be useful if we understood how other states have gone about dealing with similar problems. It's not that we have to copy them, but it will give us some background. And I think that our ultimate report we'll want to make available to the public at least some presentation on both of those two matters, and then we can step back and work our way through what kind of recommendations we would make.

The only other thing I would say in introduction is that at the announcement of the members of this Commission, the legislative leaders indicated that they would be prepared to take to the legislature for an up or down vote all the recommendations that come from this Commission. I think that was a positive step.

Now, there are a number of things that may require specific legislation that wouldn't be contained necessarily -- the details of which wouldn't be contained in the recommendation, but the notion that our legislative leaders are willing to, number one, feel that the makeup of this Commission is so highly qualified that they would take it to their body I think is a positive. We'll have to make sure that the recommendations we come up with warrant that. But I think that is a positive.

And hopefully we can garner the support in that up or down vote of the vast majority, maybe more than two-thirds majority of the legislature that would send a signal to the public that reform can really occur.

That's getting a little ahead of how we come out, but I thought it was indicative of the fact that the legislative leaders, all of the leaders take the work of this Commission very seriously. And so I think we have a large task at hand, but at least I think we have the support of our policymakers.

So with that kind of introduction -- and I'm -- I will give every Commissioner an opportunity to make any introductory comments.

I'll say that we have two public speakers that have signed up. Any members of the public that haven't had an opportunity to sign up and would like to come forward, please indicate that to the staff and we will make that available.

And I think our first speaker -- I'm not quite sure, Margie, we have two speakers here. I think I have one name, but two speakers.

MR. BOSKIN: Public speakers?

CHAIR PARSKY: Public speakers. Yeah.

Did anyone here sign up to be a -- to speak? I know Professor Gordon has, and we'd like to give him an opportunity to speak. I just have -- I have Professor Gordon twice. Now, I know he's very valuable.

Margie, did we have one other speaker besides Professor Gordon?

MS. WALKER: Yes.

CHAIR PARSKY: Do you have that person's name?

It looks like there's Roger Gordon twice. But I may have it wrong.

(Discussion off the record.)

CHAIR PARSKY: Okay. Well, there's no other speaker than Professor Gordon.

Why don't you come forward and make some comments for us, and then we'll -- we may pause a little bit and give the Commissioners a chance to have a dialogue and make some comments.

PROFESSOR GORDON: That's fine. Should I speak from here?

CHAIR PARSKY: You can, or you can sit down at the table if it's more convenient. Either way.

PROFESSOR GORDON: I'll sit down.

CHAIR PARSKY: If it's easier there.

This isn't quite -- we have -- we have certain guidelines we have to live by, but as Chris Edley and Monica Lozano know from experience with me, I don't try to be overly formal here, so we want to try to get as much information, do the quality work. So please, go right ahead.

PROFESSOR GORDON: Just as identification, I'm a professor of economics here at UCSD. My research area specializes in tax policy, so it's hard not to take advantage of the opportunity to speak to the Commission.

To provide the perspective of an academic, I've been lucky in a way not to have been in an administrative position trying to deal with all the details of implementing tax policy, but I certainly know well the academic literature on these questions.

As I see it, there are two key issues that the Commission faces in thinking about changes in the tax structure in California. One is the volatility of revenue leading to quite costly volatility in expenditures on a wide variety of state programs.

The other key problem is that tax rates currently in California are extremely high from the perspective of states in the U.S. generally, under the personal income tax, under the corporate tax, under the retail sales tax. All of these rates are very high.

Given the mobility of economic activity across state lines, we'd expect that these high tax rates are very costly, and there's a concern in particular about implications of these high tax rates for future growth of economic activity in California.

So the question is what alternatives the state faces in raising revenue to try to ease each of these problems.

Let me start with the volatility of revenue. An easy proposal, too easy proposal, I think, is to try to implement rainy day funds. A number of states have this. All states do for specific programs such as unemployment insurance, where there's a trust fund that accumulates over time, that expenditures from it when the unemployment rate is high and accumulations when the unemployment rate is low, and this shows an example of how these programs can work.

The trouble, I think, in trying to extend this approach is that business cycles are not easily forecasted. During the middle of a boom, it's easy to think that this boom will continue. And given the difficulties in making such forecasts, I think, trying to implement more broadly a rainy day fund is not likely to work that well. Obviously, some move in that direction could help.

I think better is to change the type of tax base, sources of revenue that the state has. The natural choice here would be to have the tax revenue linked much more closely to consumption rather than income.

If the state's collecting revenue from consumption, then public expenditures and public consumption, private consumption move together so that any loss due to business cycle is shared equally between private and public spending and any boom is also shared equally.

There are a variety of ways to implement a tax on consumption. The state at this point already has a retail sales tax. Trying to shift from the income tax to get more weight on the retail sales tax I don't think is a good idea. It's a very hard tax to enforce well. Inflation rates are high. It includes only a moderate fraction of overall consumption. By national law it excludes Internet sales. It's virtually impossible to impose it on cross-state shopping. And sectors like housing, again, are very hard to include. And so there are sharp intersectoral distortions from raising the retail sales tax rate. And the tax politically can look regressive. So I think this is not the natural direction to go.

A more ambitious proposal would be to think about trying to implement a value-added tax within the state. This I don't think is a feasible option. To do it requires measuring sales by firms across state lines, so exports from California firms to customers out of state should be exempted. Imports to the state should be taxable.

Since this tax doesn't exist at the -- even at the national level, I don't think even firms have this information, and for the state to try to impose a requirement on firms to report this I think would be a huge administrative and enforcement problem. So I don't think -- European countries have had to abandon measurement of cross-border trade within Europe and have come up with arrogant administrative ways to try to approximate a tax base across European countries, so this I don't think works.

What -- the way the tax assumption I think would be more effective is to change the tax base under the personal income tax towards one that approximates consumption. The consumption just by the individuals' budget constraint equals earnings plus net withdrawals from savings, minus net contributions to savings.

There are a variety of very detailed proposals that have been worked out in the past for what this tax base specifically would look like. There was an economist at Princeton, David Bradford, who spent his year trying to refine these proposals, started with a document "Blueprints For Tax Reforms" that was issued under the Ford Administration, from the Treasury. He developed it later as an X tax.

There's an economist at Stanford, Charlie McClure, who has an alternative similar proposal called "Simplified Alternative Tax." These proposals have been worked out in great detail.

The key issue is that if California is to implement it, it would be important to have the information needed in doing so available readily. California doesn't have the administrative apparatus to try to measure things that aren't already on the federal tax form.

The proposals that Bradford had through the blueprints are things that California could implement very easily. What it would involve is simply exempting from tax interest dividends and capital gains and not having interest deductible under the personal tax.

It differs from a full tax on consumption because savings that don't occur through 401(k) plans, IRAs, pension plans, wouldn't be immediately deductible, but the withdrawals wouldn't be taxable.

So this approach, I think, would make revenue more stable and it still allows for exemptions for dependents, it allows for a progressive rate structure to the degree that the state uses it, so it maintains the flexibility we currently have under the income tax, but shifting to a tax base that's more stable.

In terms of the distortions from high tax rates, let me start by focusing on specific distortions that I think can be addressed individually. The one that economists have focused most on is the distortion to capital investment in California.

The academic literature here has focused on the same issue but in a national level, arguing that even from a country's perspective, it is really a price-taker in the international market for capital, and as a price-taker, it loses from taxing the return to the capital. It makes it harder to attract investments, and with -- and to attract investments, other costs the firm has to drop in particular wage rates, and so the burden of the tax ends up being shifted to workers because the state is a less attractive place to invest in.

And even from the perspective of workers in the state, according to this academic literature, it's better not to tax return to capital. The wage rates will be higher, and in -- there would be more investment in the state. The state would be more productive.

How would the state shift towards a tax that doesn't distort investment? Here again, there's a large academic literature. The key issue is to shift from depreciation of capital to expensing, allowing it to be deductible immediately.

That's not the only way to do it. The problem of allowing immediate expensing is a person would have tax losses in a year of large investments and that high taxable income later.

This is an issue that has been addressed at length in the academic literature. There was the Gami Commission (ph) in the European Union trying to explore alternatives. Its recommendation was to continue to depreciate capital but allow firms to add to the basis -- tax basis for capital toward interest on it, so that the basis would grow with the market interest rate. And if that were done, then there's no loss from the deferral of depreciation deductions into the future.

Now, the other, more detailed changes that would be needed under the corporate tax to avoid distortions to investments, changes in the tax treatment of inventories, allowing immediate deduction when inventories are purchased rather than when they're used, no deduction for interest payments from taxation of interest income. But I think all of these would be beneficial to the state and to workers in the state, and the state becomes a more attractive place to invest.

Another distortion that I see is attracting individuals who are net contributors to the state budget. And one easy example is the elderly, who aren't making use to the same extent of public services, particularly the schools.

Under a consumption tax, they pay much more than they do now, and the state becomes yet less attractive as a place for the elderly to come. With the Baby Boom retiring, I think it would become a more important issue. The state should be very attractive for the elderly, and yet at this point I believe is not.

What other states often do is to have circuit breakers or other specific provisions trying to reduce the taxation of the elderly. And I think there will be increasing competition among states to attract elderly residents who are net contributors to the budget, and I think it would be valuable for California to be aware of this and to try to respond.

The third issue is taxation of capital gains. If somebody has undertaken a -- set up a new business here and is thinking of selling their shares in the business, there's a strong tax incentive to move out of state before doing so, so that the capital gains are realized elsewhere.

But an issue in European countries, where capital gains vary across country. I think if we shifted to a consumption tax base, this issue disappears, because you're not taxed very heavily in the one year in which you realize a capital gain, you're taxed based on your normal rate of consumption.

So this current distortion I think would largely disappear if there were a shift towards a consumption tax.

The other specific distortion I'd like to highlight is in this state. I was startled in reading through some of the documents that were made available for this meeting about the adverse treatment of tax losses for both noncorporate and corporate businesses relative even to the federal law, that operating losses cannot be carried back, they'd be carried forward for a shorter time than under national provisions. And even there I think there's a problem.

To the extent that -- when individuals undertake risky investments, they could do well or badly. If they do well, profits are taxable. If they do poorly, the losses aren't easily deductible. And that discourages risk-taking, given the high tax rates here, can discourage risk-taking a lot.

So the question is what to do to try to -- to propose a more generous treatment of net operating losses I think would be administratively hard because it requires recordkeeping of past profits linking -- or carried forward, linking terms across time.

The alternative I suggest is to broaden the corporate tax base, business tax base generally, by reducing or eliminating deductibility of payroll, but --

so that payroll is, to begin with, taxable under the corporate tax, but then offsetting this by reducing personal tax rates on labor income, so that the two changes together are a net wash.

It accomplishes two things. One is that business losses can then be deducted against payroll and so there would be fewer cases where firms can't save taxes when they have business losses.

The second is that individuals on their W-2 forms would be receiving labor income net of the -- of tax. And so what shows up in the federal tax forms is not gross pay, is net pay. And that reduces federal taxes for California residents under both the income tax and the payroll tax. And those savings can be quite important.

And so I think there is a further advantage from trying to broaden the tax base, both to encourage risk-taking and to save taxes for -- under the federal tax for California residents.

This type of proposal would -- you know, no deductible of payroll, is basically a value-added tax but without the taxation of imports, without the exemption of exports. So it's one that can be much more easily implemented but has all the other advantages of a value-added tax.

And it serves the additional role of implicitly taxing the returns to entrepreneurial activity to the extent that they are successful, which would be exempted under the proposal I described for personal income tax with capital gains being exempted.

I have a couple more minutes. One, the further question is, is there anything that can be done to address the high tax rates more generally, which would discourage labor supply, savings, discourage people coming to the state who are particularly well paid.

Here I think the key problem is that California relies much more on income tax and sales taxes relative to the property tax, which is an implication of Proposition 13. I don't see that changing. And so these problems are not so easily addressed.

I think that the main response, unfortunately, will be to try to control spending. Easy to call for. I think where this might be addressed more specifically is to think through the -- what I think is an institutional bias toward spending rather than taxes.

It's very hard, given legislative rules, to raise taxes, but much easier to enact spending programs. Trying to enact rules to limit spending to overall revenue as is done at the federal level would be an interesting procedure, set the overall budgets for departments so that the budget is balanced, and then within each department have tradeoffs between one form of spending and another to the degree that spending is enacted outside these rules. It would have to be -- have to include sources of revenue, so that, again, it's self-financing.

When there are ballot initiatives, they would need to be more explicit about sources of revenue. And I've been startled here at initiatives on the ballot that involve huge revenue costs with no explicit description of how voters will be affected by the resulting costs.

So trying to link spending to the ways in which they'd be financed so that people can perceive to what degree they would pay costs in exchange for the benefits, I think, would make it harder to raise spending. I think that would be ultimately the best way to control spending.

In some -- even though I'm a tax economist, I realize that taxes are by no means the only factor affecting economic activity. I know from international conferences that the California economy is very much the envy of other countries, other cities, and Silicon Valley in particular is viewed as what other economies would like to imitate.

We have a similar biotech sector around UCSD. These sectors, I think, really reflect the strength of Stanford and other academic centers in the Bay Area, spillovers from UCSD here, and so the key strengths of the California economy, but I think that these centers of activity are fragile.

I grew up in Massachusetts. There, there was a Root 128 computer sector that was at that point the equivalent of Silicon Valley. It made the wrong bet where technology would go.

And tax differentials here could easily lead new entrants to think about the research triangle in North Carolina or locations in Texas, other states, so I don't think we can presume that the strengths in the California economy will remain in place.

So I do urge the Commission to try to think through how best to reform the tax system to try to preserve this activity in California and generate future economic growth.

CHAIR PARSKY: Professor, thank you very much.

I will say that I was a little bit worried about whether we would be able to use up the entire public comment period. You've satisfied that. Thank you very much.

And I would -- and I would say that many of your thoughts the Commission ought to hold and keep in mind as we get to the recommendations part of our discussion, but I think a number of things that you said obviously we will take into account.

I think -- why don't you wait there for a minute?

I think maybe we'll just go around -- any kind of opening or general comments any of the Commissioners would like to make? Recognizing that some of the things, obviously, that Professor Gordon, as a representative of the public here, might need to wait until we fully comprehend the nature of the problem we're facing.

But please feel free to ask any questions of Professor Gordon. He's a terrific economist and has certainly laid out a number of interesting ideas. But any other comments any Commissioner would like to make? Maybe we'll just go around. Don't feel you have to say anything, but if you'd like to, please go ahead.

George?

MR. HALVORSON: I'm just curious, how do you collect a consumption tax? What's the actual mechanism for collecting it?

PROFESSOR GORDON: To be implemented under the personal income tax, the issue is trying to measure income that's not saved. Income can either be consumed or saved. And so you take income minus net savings.

So if we do this -- and it's -- the treatment that would be used is what we now do with pensions. When you contribute to a pension plan, the contributions are deductible in full; when you withdraw money from a plan, they're taxable in full. So if that were done with all savings, then we would have a consumption tax. We do it for most savings already. And so if we -- so the issue is what to do with remaining savings.

And so the proposal worked out by Bradford and McClure would be to either try to shift other savings into this what they call registered accounts with a deductible when you contribute, taxable when you take it out, or to exempt the return to savings.

I think for California to be able to implement this easily, what they would do would be to exempt interest dividends and capital gains, maintain the current deductibility of contributions to IRAs, 401(k)s, pension plans, but full taxation of all withdrawals from these accounts.

MR. HALVORSON: Thank you.

CHAIR PARSKY: John?

MR. COGAN: Mr. Gordon, thanks for coming by. I'm a great admirer of your work. You've had a terrific year.

Let me ask you a question about volatility and growth. One of the sources of volatility is the progressivity of the code, tax code. But when we have a progressive tax code, revenues grow faster during a period of economic growth or over the long-term than they do under a -- sort of a flat tax or a flat consumption tax. Yet under a flat consumption tax you would get a larger growth in the economy, presumably.

So our Commission has a, I guess, a goal of not raising taxes, so we would like to have some sort of budget-neutral revenue policy or a policy that generates the same amount of revenues over the long-term as the current code but gets rid of the volatility.

And so I'm wondering, how would you factor in -- how would you advise us to factor in the higher economic growth that might come about because we move from a high-tax-rate state to a lower-tax-rate state, if we went to something like a consumption tax or a tax that had a broader base?

PROFESSOR GORDON: The specific proposals I made of trying to implement a tax on consumption under the personal income tax shift to a -- basically, a cash flow tax under the corporate tax should involve little change in revenue at current rates, and so it wouldn't lead to reduction in rates but wouldn't lead to an increase in rates. At least -- I, with co-author Joel Slemrod, have looked at implementing this at the national level. At least on the national level that's the implication. So it doesn't reduce rates, but it does reduce the volatility of revenue.

You're right that we have a progressive tax under the personal income tax, and that can lead to remaining volatility in revenue. However, the top rates phase in at a quite low level of income, and so I think it's easy to exaggerate how progressive the system is.

And yes, there is a tradeoff between reducing volatility but shifting the tax burden onto lower income individuals, and there I don't think I have expertise.

MR. COGAN: Mm-hmm. Mm-hmm. In terms of any growth aspects that might come out of our policy recommendations, your sense is that if -- if we have a set of recommendations that really don't change marginal tax rates that much, we don't have to worry so much about the growth impact; if we do have proposals that change tax rates considerably, then we should worry about it or not?

PROFESSOR GORDON: What I'd focus in thinking about growth is on the taxation of risky activity. What we'd like to do is encourage new entrepreneurial activity, new startups in California. And these firms are very risky. And so to encourage that activity, we like to treat losses generally -- generously relative to profits.

We currently do the opposite. Losses cannot be carried back, be carried forward for a short period of time. Many businesses fail. You never make use of them.

And so it's there that I focus in either trying to improve the ability of entrepreneurs to save taxes, since they do have losses, by carrying them back, or to -- what I was proposing, to broaden the base, shifting from the personal tax to the corporate tax so the losses can be deducted against payroll.

MR. COGAN: Right. Terrific. Thanks.

CHAIR PARSKY: Jennifer?

MS. ITO: Thank you for your comments, Professor Gordon.

You had mentioned one of your ideas was around how to attract individuals who are net contributors to the budget. You had mentioned as an example the elderly. Are there other sectors of the population or society that you also see as being potential net contributors?

PROFESSOR GORDON: Of course. I mean --

MR. COGAN: Academics.

MR. EDLEY: Incalculable.

CHAIR PARSKY: Focusing in on Stanford.

PROFESSOR GORDON: The presumption would be that higher wage individuals pay proportionately more in taxes, but they receive the same services, at least if they have the same number of kids, as lower income individuals, and so it would be attractive to the -- the state could well gain by having a less progressive tax structure, attracting more high-wage individuals in response.

While the state tries to be equitable through its tax structure, I would think the academic literature would argue it really doesn't succeed much in distributing from rich to poor because of the mobility of individuals across states.

If tax rates are high, on the high scale in California, they'll move here only if it's attractive, which means the wage payments have to be higher to compensate -- pretax -- to compensate for the higher tax rates. And then that means the wage rates for others are lower if firms are going to be profitable here.

So I don't think on net the state succeeds much at redistribution through a progressive rate structure and yet does distort individual choices, makes it more expensive for sectors employing high-skilled workers to locate here, because they pay more in taxes.

So it's -- I would urge rethinking of the extent to which the tax structure is progressive, because I don't think in the end it does succeed at redistributing from rich to poor.

CHAIR PARSKY: Richard?

MR. POMP: The ideas about encouraging investment like expensing, that would be limited to California investment?

PROFESSOR GORDON: Tricky with -- okay. With multi-state firms, to have a full cash flow tax would be hard to measure all of these line items for activity in California in particular. It's easy for firms to rearrange their accounts or their actual economic activity in response to this.

So my first instinct would be to try to measure this tax base at the national level, as is done now, and then to continue to use formula apportionment to allocate it across, to California in particular. I would rethink the formula.

MR. POMP: But before we get there, you would allow expensing regardless of what state the investment was made in?

PROFESSOR GORDON: That would be my first instinct, thinking that it's hard to measure the activity in California in particular.

MR. POMP: So California benefits because a rising tide raises all ships? Is that the idea?

PROFESSOR GORDON: To the extent that a firm locates in California, with this shift in the tax base, its taxes in California will be lower, its taxes in other states aren't directly affected, and so locating in California becomes more attractive. What matters in the end is how much it pays in taxes a year.

MR. POMP: Taxes will be lowered by an investment being made in Connecticut or New York, because that'll be expensed. That will reduce taxable income. California will get a portion share of that. Taxes will go down, but it will be because of an investment made in another state.

PROFESSOR GORDON: True. But the extent that it has in --

MR. POMP: I didn't hear that. I'm sorry. That is true?

PROFESSOR GORDON: That is true that its tax base in California would be reduced to the extent that it has capital in other states, but that makes California a more attractive place because locating there is cheaper.

It -- California could consider, as you're describing, trying to measure the corporate tax base, use separate accounting for capital investments even if it tries to use formula apportionment for inventory accounting or interest payments. I think the complexity there doesn't justify the gains.

The base I'm describing, again, the state can make use of the federal forms to a large extent to measure the tax base, whereas, to try to treat separately investment in California versus investment elsewhere means collecting information beyond what's on the federal form. But it's -- I mean, that's an alternative that I think is worth considering.

MR. POMP: And is what you're describing about expensing, is this not what we tried in 1981 at the federal level when we moved to much more accelerated forms of depreciation?

PROFESSOR GORDON: We moved in that direction, but, I mean, there are a variety of issues that arose at that time. We continued to have interest deductions for new investments, and if firms traded capital, got depreciated again, what we ran into in '81 was that some investments received so many deductions that the tax savings would pay for the investment itself and we were forced very quickly to modify the generous provisions in

'81 -- ultimately, the '86 tax reform -- to deal with the resulting distortion. So I don't think it was done well in 1981 because the changes weren't implemented as a group.

MR. POMP: But philosophically, it was the same objective, to increase capital investment.

PROFESSOR GORDON: Yes.

MR. POMP: I don't want to monopolize, Mr. Chair. I have a lot more questions, but in the interest of time . . .

CHAIR PARSKY: Thank you.

Monica, any comments or questions?

MS. LOZANO: Yeah, if you don't mind.

Professor, very informative, and I thought an important way to open public comment.

I don't have any questions, so if you don't mind, Mr. Chair, actually, I would like to make some comments --

CHAIR PARSKY: Sure.

MS. LOZANO: -- and perhaps move up a little bit higher in the discussion and lay out what I think are perhaps some critical objectives of the Commission.

So having said that, I think all of us recognize that we are in a very difficult time and that the challenges that we face, in fact, provide an opportunity for us to look at innovative ways to face this particular challenge.

I do believe that we should be focused on long-term solutions, ones that avoid the volatility and the economic cycles that we have faced in the past. It also gives us an opportunity, I think, to retool and to think of new and innovative ways to face these challenges of revenue growth.

But having said that, I wanted to just lay out what I think are some values that would certainly guide my thinking as we put forward recommendations.

And, in fact, I think it might be important for this Commission to perhaps elaborate a set of objectives that we can all find common agreement on.

One of them is to recognize the economic disparities of this state and to be very careful, in my opinion, to not shift the burden to those who are least capable of shouldering that burden.

The second would be to be careful not to saddle our future generations with massive levels of debt, to stimulate investment in human capital and new technologies and to protect and grow our small and minority business communities which serve as the backbone of innovation and growth in this state. Obviously, providing more flexibility and looking for a balanced and fair approach is critical.

And finally, I'd say, Mr. Chair, that I understand that the nature and the scope of this Commission cannot tackle all the related issues. I would suggest a set of governance reforms be considered that would work hand in hand with our final recommendations. The budget process and its management must be evaluated for its effectiveness or not and be reformed accordingly.

CHAIR PARSKY: Thank you.

Anyone can make those general comments or ask the professor.

MR. KEELEY: Thank you, Mr. Chairman.

Good morning, Professor. Thank you for your testimony. It was quite helpful, I think.

If I could ask you a couple of questions? One is, a basis of your testimony seems to be -- and help me if I missed this -- seems to be that it's based on the concept that California is a high tax state, and so because of that, there are a number of recommendations you've made, quite thoughtful recommendations.

I think reasonable people might disagree over whether or not California is a high tax state. The Leg. Analyst's Office has done work over the years, including a document that's in our packet, seems to me to indicate that, overall, California's about average. There are a number of states higher, a number of states lower. California's about average when you look at the total tax burden. When you look at specific taxes, might be a little higher here and a little lower there, but overall, California doesn't appear to either be badly out of sync with other states or appear to be certainly the highest tax state or anything close to that. So I'm wondering if I'm misunderstanding your testimony or you think the Leg. Analyst's Office maybe isn't looking at the right metrics or indicators. It interests me.

PROFESSOR GORDON: Where California looks different, I think, is in the composition of revenue, much less collected from the property tax, given the -- you know, the assessment based on original purchase price and the cap on the tax rate, and then much more from the sales tax and the income tax, both personal and corporate.

Where I was focusing was on the tax rates under those three, income, sales taxes, those are very high, and so the more revenue collected from those sources, but offset by less revenue from the property tax.

The academic literature I think would suggest more reliance on the property tax. I don't see that happening. And so I was trying to think through what could be done with the other taxes to lessen the distortions that are created by the high tax rates.

MR. KEELEY: Thank you. A couple of other questions. One is, you opened on the issue of -- or opened fairly early on on the issue of the so-called rainy day fund as a way to -- there's multiple ways to deal with this notion of tax or revenue volatility. One of the ways that the legislature and the Governor seem to have come to an agreement on is the so-called Ashburn Constitutional Amendment that was adopted as part of the legislative action in sending the budget to the Governor 70 days late, that held up for two weeks as a solid document, and now we're back to a place where it isn't.

In that, the Ashburn Amendment, as I understand, is, in effect, the lockbox idea where what you would do is, rather than going to the volatility of revenue itself, you would go to the effects of volatility of revenue, the two major drivers in the general fund, sales tax and the personal income tax.

What you would do is agree to some metric established by, for example, the Department of Finance and forecasting revenue.

Revenue above that forecast -- above a certain percentage above that forecast would then be put in a --

sort of an Al Gore lockbox, and that -- it would only be available on the down side of the business cycle to cushion against the appearance of deficit.

CHAIR PARSKY: Mentioning Al Gore may take us a little bit awry here. Lockbox is fine.

MR. KEELEY: Lockbox is fine. Strike the Al Gore reference.

But I am interested in your -- in your thought on that, because you said that it was too easy.

Quite frankly, simplicity is one of the things we're supposed to be striving for. It says it in here. So I'm not a foe of simplicity. But if it's simple-minded, then that might be a different issue.

But I am interested in, seriously, in what objection you might have to that. Why is that not a good way to go, in your view?

PROFESSOR GORDON: Okay. In principle, it is a fine way to go.

MR. KEELEY: Okay.

PROFESSOR GORDON: The trouble is coming up with a successful forecast so that the -- what you contribute to the lockbox is sufficient to cover the withdrawals during a downturn.

And I think that the business cycle is very erratic and very hard to forecast, to the point where I think that -- and what rule is used in forecasting, there's a wide variety of rules that can seem plausible with, in the end, very large implications for the likelihood that this lockbox will run out of funds, and so the state will again face the type of cutbacks in spending that we now face.

MR. KEELEY: Let me ask this question. That may or may not be true, depending upon the either robustness of the economic growth or the seriousness of the downturn, so that could be right or wrong in that regard.

But what it -- I don't mean to get into a -- I understand your -- let me ask you one other issue. In response to an earlier inquiry or question by another Commissioner, a notion of revenue neutrality was raised, and I understand that concept. I think it's probably a lot harder actually to achieve than virtually anything else we've talked about that's been mentioned today.

Also, I would point out that the concept of revenue neutrality does not appear anywhere in the Executive Order or the charge of this Commission. We are not charged with coming up with something that's revenue neutral or recommendations that are revenue neutral. That's something the Governor said at a press conference, but it's not something the Governor put in the Executive Order. It's not anything that the legislative leaders who appointed -- at least the Senate, who appointed me, or appointees of the legislature were given as a direction.

So I wonder if your thoughts are -- if you have thoughts about that notion -- would change, or were you under the impression that we were somehow engaged in a revenue-neutral exercise here?

PROFESSOR GORDON: In the design of the tax structure there are two issues: One, the tax base, the other, the tax rate.

MR. KEELEY: Understood.

PROFESSOR GORDON: And together they result in the revenue. I was focused on the tax base and then the separate decision of what tax rate to apply to that base.

But I think that the arguments I was making about a -- I think it would be a beneficial change in the tax base are independent of what tax rate is then chosen and what revenue then results. So I think it's really a separate decision how much revenue to seek, how large a government sector to have --

MR. KEELEY: Fair enough.

PROFESSOR GORDON: -- from what tax base to use.

MR. KEELEY: Absolutely. Fair enough. Thank you, Professor.

Mr. Chairman, that leads me to at least try to now put in a couple of comments based on that.

I do think that in section 2-a through f of the Executive Order, that is our charge here, and it is not some other charge. It's that charge that's contained in there.

I do think that on 2-a, which goes to the issue of establishing a 21st Century tax structure that fits the state's 21st Century economy, that as a Commission we can read that language many, many ways.

One way to read that is to believe that you're looking essentially in the rearview mirror for how the economy -- what the composition of the economy has been and evolved to in the last decade or so and try to look forward and project that out into the future. And that would answer the question of what kind of economy are we likely to have in the 21st Century or at least first two or three decades.

Another way to look at it would be to read that sentence to say that there is a more active engagement as a result, for example, of the legislature and the Governor's very profound actions on global climate change with regard to AB 32. And it will have a -- it is a signal by the state of California that California -- that this Governor and this legislature believe that California should be one of the centers in the world for investment in global climate change solutions, which would potentially cause us to look at our task in a somewhat different way.

I also think that it's worth at least noting that, although we are the -- fill in the blank -- sixth, seventh, eighth largest economy in the world, at least for the time being, we are still part of the United States.

And Chris -- we were kidding around about the idea that maybe secession might work. But we still are part of the United States. And I think it's pretty clear that the incoming Administration has a view of the future that triangulates the concepts of national security, global climate change and economic growth and development as tied to each other and that that may imprint significantly on California and what kind of economy we'll have in the 21st Century when you put together California's leadership on global climate change together with what the new Administration seems to want to do on the topic.

So the reason I mention that in my opening comments is that I think that goes to the task of the

Commission with regard to what choices we may want to be making that are somewhat -- well, choices we might be making in terms of recommendations.

Mr. Chairman, thank you for your forbearance and kindness. Appreciate it.

CHAIR PARSKY: Thank you very much.

I'd just make a couple of comments before we continue on, and that is that I think, Fred, you are right that the text of the Executive Order did not discuss this issue of revenue neutrality. That is true.

However, in announcing the Commission, first by Executive Order and then later by members, all three of the people that were there, the Governor, the Speaker, and Senator pro Tem, did make it clear that from their perspective they thought the Commission should be operating on the understanding of trying to first understand what revenue neutrality meant and then trying to address a series of recommendations aimed at what the professor said, which was the tax base, and to leave to the legislature decisions on whether they wanted to raise taxes or lower taxes.

Now, that doesn't mean that we can't have a free and open discussion cutting across the charges that you mentioned in this Commission, but I do think that in announcing this they did indicate revenue neutrality was a clear objective.

The only other comment that I would make, you're also right that understanding the changes that have happened in the California economy and some of the policy objectives that might lead you to address climate change and other things clearly can be discussed and should.

I think we, however, ought to stay focused as well on the revenues that will support the general revenue base of the state, because that underlies some of the concerns that have been expressed by the policymakers given the volatility there. But we certainly are not restricted in terms of talking about achieving some of the other objectives as well.

MR. KEELEY: Mr. Chairman, two thoughts on that. One is, thank you for your comments, first of all.

Secondly, I don't mean to be argumentative about this. It is probably -- you know, we are what we eat. And I have, you know, been eating legislation for a very long time in my life. And so --

CHAIR PARSKY: Thank goodness I didn't digest or try to digest that.

MR. KEELEY: Yeah, I don't suggest it as a regular diet. Term limits are an advantage in that regard.

I do, however, believe that words on paper mean something, that the Governor -- excuse me --

CHAIR PARSKY: Sure.

MR. KEELEY: -- that the Governor had an opportunity to write "revenue neutrality" into this if that's what he wanted. If this is a major concept that the Governor intended, those two words aren't hard to put into a resolution that's two pages long and -- if that's what they want.

Mr. Crane, Mr. Genest and I have been over this ground together and we have the same disagreement. They believe that the Governor had that intent. And I don't doubt that that might be the Governor's intent, but it's not what he said.

And I think that we should not try to divine what the Governor meant or didn't mean by press conferences or press releases or statements. I think we should divine what the Governor meant by reading the Executive Order.

Secondly, the reason I raise the issues of what the economy might look like in the future is because that's what our charge is. And I do believe that it is not -- I do believe that this goes to the core issue of at least what is at least potentially our problem here.

We have a 1930s, '40s, '50s, '60s tax structure, built over the years, built over what the economy looked like, built over what people thought it might become. And our task is, as it says right here, try to build something for the 21st Century.

And so I do think that with regard to, for example -- and we'll get into this later -- examining the concept of how carbon is treated is a completely fair and appropriate issue for us to raise, because I think it will become -- it is already internationally, it will become nationally and I believe on a state basis a complete rearranging of the basis upon which we tax. And we'll go into this philosophical debate later. But I do think that that's fair.

This is not a narrow issue about global climate change. It's a broad-based issue about where I believe tax policy, consumption issues are addressed from a tax policy point of view going forward, and that's our task is try to divine to some extent what the future might look like and structure a tax code accordingly.

Thank you, Mr. Chairman.

CHAIR PARSKY: Thank you.

Michael?

MR. BOSKIN: Thank you, Mr. Chairman.

And fellow Commissioners, it's a pleasure to be here and serve with all of you.

I wanted to do three things very quickly. I want to ask Professor Gordon two or three questions that might fill out some of the implications of some of the things he had to say. I then want to address the general charge, the way I think we ought to be thinking about it. And then third, I want to say a few words about what -- what's going on in other states. We've got some presentations coming later. I just want to ask Professor Gordon about that.

So, Roger, you indicated a -- one concern we ought to have is the mobility of capital and labor in and out of state, particularly highly successful, skilled people, high-paid people, because people have the opportunity to work or invest in other states as well as other countries. So would you say that that mobility has been increasing over time?

PROFESSOR GORDON: There's certainly a presumption that capital is more mobile internationally. I have not seen argument that it's even more mobile within the U.S. than before, but the mobility is very high. And so it -- it has been high for a long time.

So I think that, not just now, but in the past, California has lost from discouraging investment in the state, and if anything, the increased mobility of capital internationally has exacerbated that cost. I think that cost has been there for a long time.

Mobility of people, again, I'm not sure I can think of evidence that mobility of individuals within the U.S. are now greater, but they're high. And so I do think that the state has to be very conscious of the problem of trying to attract skilled workers to the state.

And the high tax rates that the state imposes not just on labor income but on income from savings will discourage those who have more assets from locating in the state as well as good workers from locating in the state. So those pressures are very much there, but have been there for a long time.

MR. BOSKIN: I think many people believe that Internet technology, for example, has made it possible for a larger faction of activity to be disbursed. Does that accord with your at least casual understanding?

PROFESSOR GORDON: I'll accept that.

MR. BOSKIN: So we're a Commission on the 21st Century. And you talked about risk-taking and risks before. And you, I think, wisely mentioned the demise of Root 128.

I would add to that that Cleveland used to be the high technology center of the United States due to the technology and skilled construction for the automobile industry.

So if we want to look at those examples, I think one of the things you were warning us about was not being complacent in the face of intensifying competition around the country and around the world.

So I guess one thing we should think about is what might happen not just in the short run to our tax revenue, our tax base, a variety of other things for any tax changes we might make, but where the economy may be headed and what would be necessary to preserve the incentive for entrepreneurial activity to take place in California. Would you agree with that?

PROFESSOR GORDON: Yes. In terms of the tax effects on entrepreneurial activity, it is an area I've done research myself, focusing on the federal rather than the state rules, and have found quite substantial effects of the tax incentives and risk-taking in the data.

Now, I've been tempted to do it at the state level, have not had the chance to do it yet, but I would expect that the effects would be even larger at the state level given the mobility of location of new businesses across state lines. And so I think it would be important to try to focus on the tax treatment of new businesses in particular in the design of the tax base.

MR. BOSKIN: You talked about the distortions from tax rates, they drive a wedge between before and after tax activity and cause people -- businesses and workers and investors to change their behavior. Here at UC San Diego, like at Stanford, you teach that to your introductory economics students and you teach that the harm from these distortions goes up more than proportionately to tax rates. How does it go up with tax rates?

PROFESSOR GORDON: Undergraduate class, it goes up -- it goes up to the square of the tax rate.

MR. BOSKIN: So doubling the rate quadruples the harm?

PROFESSOR GORDON: Exactly.

CHAIR PARSKY: Some of us are a little bit under the undergraduate level.

PROFESSOR GORDON: That's why I didn't include that in my initial remarks.

MR. BOSKIN: In any event, just that the -- it can go up more than -- quite a bit more than proportionately to the tax rates, so doubling the tax rates can quadruple the harm. It's important for us to keep that in mind.

You also mentioned a variety of issues with respect to California's own tax structure about how we're taxing our own firms and their competition in the U.S. and globally. And one of the things you mentioned in the business tax, you're talking about moving towards more of a cash flow basis, et cetera.

We have a particular apportionment formula for our corporate tax. Are you aware of how that works? I mean, it's a special thing, so if you don't . . .

PROFESSOR GORDON: I have written on the effects of formula apportionment, but I have not had a chance to study the California formula in particular.

I know that most states use a combination of capital payroll and sales, and states have been shifting the weights among these factors over time to the degree that capital or sales are included in the formula. That does result in some discouragement of locating capital in California.

So my instinct is to suggest more of a shift towards payroll, thinking that workers ultimately bear the tax anyway, and so we should reflect that through the design of the tax structure.

The literature here, trying to examine the effects of the choice of the formula on location of activity is limited. There are few papers, so I don't think I can say much based on the academic literature other than these instincts.

MR. BOSKIN: I want to just switch for a moment and come back and ask you one last question. I just want to give you -- state my view of what the Commission in general should be trying to do from reading the charge in the Executive Order, from the statements the leaders made and so on.

We undoubtedly, among ourselves, wouldn't agree on what the proper size of the California government is. Some of us want it bigger, some of us want it smaller, some of us want it to do some things and not others and vice versa. And I think that would be kind of a hopeless thing for us to try to do among ourselves what the legislature should be doing and the Governor over the years in the budget process.

But what we can know for sure is we have had three horrific episodes in the last two decades in California of revenue surging. That, and sometimes more being spent. And then when the inevitable economic correction occurs, as you said, difficult to predict, but we know the economy's not going to boom forever, there being a wrenching, wrenching readjustment. And often the people that are hurt the most by that are the least fortunate in California when services are cut by the way. So I hope we would have a broader view of who benefits and who -- and who pays in California.

But it seems to me that we ought to be thinking about what would a better tax structure be, on average, over the course of booms and busts, and raise about the same amount of revenue as the current tax structure. And if the legislature likes our new thing and enacts it and wants more revenue, it could raise the rates. If it wants less revenue, it could lower rates.

But if we raised about the same, we would decrease the distortions because the volatility would require less adjustment in taxes, and it seems to me that it would require less wrenching adjustment, less kind of foolish additional spending on everything seeming affordable during a boom and then nothing being affordable in a bust and everybody scrambling to try to preserve.

So I would hope that we would try to come up with a tax structure that is more stable as our main function.

To that -- and I think it's in the charge, it's repeated in the charge. We can quibble about -- around the edges about what it means, but it seems that's one of the main charges we have.

Mathematically is there a way to do that other than by shifting the composition of the taxes to more stable revenue, to more stable bases from those that are highly unstable, or by decreasing the progressivity?

And you correctly mentioned that California, by the time we get to $40,000 of taxable income, we have the highest income tax state. So we're very progressive very early. So it's very progressive, but then it kind of flattens out and we get the extra one percent at the top. But is there any way other than doing one of those two things or both to make the tax code less --

PROFESSOR GORDON: I mean, in addition to --

MR. BOSKIN: -- volatile?

PROFESSOR GORDON: -- rainy day funds, without adjustments in the source of revenue, the only alternative I can see is adjusting the tax rates, aiming at a given ratio of revenue to GDP or consumption in the state.

So during periods when the progressive rate structure leads revenue to go up, rates could fall; and conversely, when revenue falls short, those adjustments in rates change incentives to shift activity over time to periods when rates are low, away from periods when rates are high. The delays in implementing such changes in tax rates I think makes that a difficult proposal in practice. But, I mean, that's certainly one other alternative and there are probably others.

MR. BOSKIN: Thank you.

CHAIR PARSKY: Thank you very much.

Chris?

MR. EDLEY: Thank you, Gerry.

First I want to say I -- this is a terrific group, I mean, at least -- at least so far.

CHAIR PARSKY: We'll get better.

MR. EDLEY: Well, we may have a little regression to the mean, starting with me.

But let me make a couple of at least what I think of as analytical points and then maybe a couple of points in principle, in no particular order.

I think the first is, I want to jump up and down to emphasize something that was embedded in what Michael just said, and that is, it would be an accounting-period problem. I mean, if you're going to reduce volatility and accept revenue neutrality as either aspiration or constraint, then you've got to have an accounting period that's longer than one year.

I mean, you squeeze down the volatility, there are going to be some years where we'd be generating less than currently and some -- so we have to think about what the accounting period is.

And let me just drop a footnote here. At some point I'd like to understand the legislative rules with respect to majority versus two-thirds vote and what kind of accounting period and forecasting analytics are involved in that as compared to what we want to adopt for our own substantive or tactical purposes. So that's my first point is that I think the accounting period thing is critical.

I think, secondly, it seems to me that -- I want to associate myself with -- with the idea that I think Monica first raised, that -- thinking about budget procedures, et cetera, as an accompaniment, a delightful accompaniment to our main course could be useful. For example, this issue of can one design a lockbox that we think is -- is credible and workable.

That's also important, it seems to me, with respect to this issue of a rainy day fund because you can't construct it so that it's not a matter of predicting and saving. It could be a matter of borrowing and then amortizing what you borrowed before the next cycle kicks in. It's a different kind of prediction.

But I think a lot of conservatives, for example, would say it's not such a great thing for the government to be building up huge savings and then doing what, and then making decisions about the uses to which the savings would be put. Better to borrow the money and then just focus on repaying the taxpayers or the bond holders.

Now, maybe that requires a constitutional amendment. But my guess is a lot of what we're going to talk about might require a constitutional amendment.

So I simply want to point out that fundamentally the issue here that's driving a lot of this discussion is not volatility because we care about volatility of revenues but it's volatility because of the human hurt that results and the chaos that results from volatility in spending.

So while there may be some independent economic injury that's associated with the volatility, distortions and the like, by and large, if you want to -- if you want to be countercyclical, you would expect to have some volatility. It's really on the spending side, I think, that is tragic.

So I think we've got to focus on this issue, on the lockbox possibility, the rainy day fund possibility, and I would just suggest this possibility of borrowing and then -- and then trying to amortize it away before you get into the next cycle and -- would be -- would be one approach. That's my second point.

Third point, analytical point is that, again, it seems to me that if we want to at least maintain, hopefully improve the progressivity of the current tax structure and reduce volatility, that means we've got to look beyond the income tax in terms of the base of that.

And for my -- my view is that we ought to be -- everything ought to be on the table with respect to the base.

I also think, analytically, that the measures that are -- that our sense of vertical equity, horizontal equity, economic distortions, whatever, can't just focus on the income tax but has to focus on aggregate tax burdens.

And the last analytical point I'd make is with respect to the privileging of economic theory in the discussion, which concerns me quite a bit, and with all due respect to the wonderful people on the panel who have advanced degrees in economics or for whom some of their best friends are economists.

CHAIR PARSKY: They have other best friends, too.

MR. EDLEY: We just -- we just have to make sure that if we're going to -- you know, that it's not a theological discussion. Otherwise, we ought to have people from the faith community on the Commission as well.

The standard models -- I mean, everybody appreciates that there are flaws and everybody appreciates that there are assumptions about the way markets work which are sometimes at odds with reality.

But I think it can be too tempting and indeed perhaps seductive to think about, for example, what happens if you tinker with marginal rates on a particular tax in California and not think about what in the broader perspective is the result if you factor in federal taxes, international taxes.

If you're thinking about mobility of labor and capital, well, I mean, I'm in the business of hiring people. They care about the weather, not just the tax rates. They care about lifestyle and they care -- lots of stuff goes on.

And I think that -- so I would just say that we need to be -- we need to be cautious about the extent to which we take economic theory as opposed to empirical research, empirical research about the impact on mobility or distortions.

I think we just have to take the theory with a grain of salt. I mean, it's better than guessing, to be informed by theory, but it is not a substitute. It's a poor second best to actually having empirical findings that are applicable to our circumstances.

Okay. Now, let me just say two quick things about principle and the level of principle. I want to associate myself very firmly with what Monica and others said about progressivity. And I appreciate it's not as progressive as sometimes advertised, California, the California tax system.

But I hope that our staff, the Department of Finance and so forth, will -- either has or will develop the analytical capacity to give us quite a bit of information about the incidence of the -- the alternatives that we come up with, their impact on productivity. We really want to press that as strongly as possible.

And then finally, as a matter of principle, I want to second the idea of thinking ambitiously about things like carbon taxes, things that -- and I have for 25 years been a huge fan of a cash flow consumption tax, so I want to stipulate that I think it's feasible. I think it could be done in a way that's progressive.

As to whether or not it's administrable and whether it makes sense for California to do it without the feds doing it, that I'd like to learn about.

But again, at the level of principle, I think -- I think really talking about the economy in the 21st Century would mean, it seems to me, looking at things like carbon taxes, looking at things like fuel taxes, looking at things like a cash flow consumption tax of some sort.

CHAIR PARSKY: Thank you.

Ruben.

MR. EDLEY: And property tax is on the table.

MR. PRINGLE: Is that from you, Ruben?

CHAIR PARSKY: That was just an addendum. Chris puts these little addendums in regularly.

MR. BARRALES: As one of two San Diegans, I think, on the panel, welcome to San Diego, everyone. And sorry I was late. I had a previously arranged meeting earlier that I had to be at. But I'm glad to be here.

Thank you very much for your comments. I missed the very beginning, but I do appreciate your focus on encouraging investment and risk-taking.

And the comments, Monica, yours related to values and progressivity I think is important as well.

And just remember, we are on the down side of the S curve here, in a sense, so -- I just have a couple of things.

The R&D tax credit in California, I understand, is not permanent. It is -- it needs to be renewed, as I understand. If that's the case, I assume a permanency in R&D tax credit, from your perspective, would be helpful in terms of encouraging investment, risk-taking and the like?

PROFESSOR GORDON: There's certainly empirical evidence that the R&D tax credit affects the amount, the location of R&D activity. And so yes, I think that it has important economic effects. And California, I think, appropriately, should be a locus of R&D activity, given the intellectual strengths coming from the universities.

MR. BARRALES: Thank you. Not net operating losses, you had mentioned allowing more flexibility, retroactive and the like. I think what I understood you saying, though, you thought it would be difficult to administer? Is that right? You had mentioned that difficulty administering. I think you referred to the net operating loss as your accounting for . . .

PROFESSOR GORDON: I mentioned it as probably not a major consideration, but to offset losses in one year against profits in other years, the state has to match tax returns over time.

MR. BARRALES: Mm-hmm.

PROFESSOR GORDON: And that requires some extra effort. The proposal I had was instead to expand the tax base maybe one year so that losses, negative profits can be offset against the firm's payroll, and so there's no need to match tax returns across time.

In addition, I think that even if you can match tax returns over time, many firms fail with -- and never have profits, and so for them you never get a deduction of losses if you simply add carry-backs to the current legislation. But if you shift from the personal to the corporate base, then even for those firms, they can reduce the taxes that they now pay on other sources of income to the extent that they have losses while trying to get established.

MR. BARRALES: Thank you. On the apportionment of corporate taxes made up, I think, through capital or property, payroll and sales, those are the three main factors there. Do you think that -- and you mentioned a preference or you thought a focus on payroll might be most beneficial potentially. What are your thoughts on apportionment based on sales or single sales factor?

There's -- some have argued that that would encourage investment for particularly in-state companies or companies with a large presence, physical presence in California and encourage investment or not -- or not encourage investment in other states like Oregon or Arizona, for example, physical plants and payroll.

PROFESSOR GORDON: I've done research on formula apportionment and found the analysis remarkably complex.

MR. BARRALES: If you found it complex, I'm sure I . . .

PROFESSOR GORDON: Let me not try to assert something with confidence.

My concern, in part, with the sales factor is trying to monitor the location of sales. You can sell to a subsidiary in another state, they can then sell to California, and unless the two parts of the firm are consolidated, then the sale, while taking place in California, would not show up in the firm's corporate tax base in California. And that requires keeping the joint ownership below 80 percent, I believe. Easy enough to do.

And so I think trying to implement the sales factor in practice is hard. Payroll, I think, is much less manipulative across state lines.

In addition, the effective tax rate on sales, capital and payroll is an additional effect of the corporate tax. The effective tax rate depends on California's rate relative to the average rate in other states that now is clearly positive. And so there's an additional tax on sales from firms in California or investment payroll in California from the corporate tax due to the use of any of these factors.

I think ultimately the tax base falls on payroll, and to make that exclusive in the design of the corporate tax I think is an advantage since to the extent that the tax legislation is based on capital or sales, ultimately it falls back on payroll anyway. And so it -- that extra complication doesn't change the incidence but does add additional distortions to the effects of the corporate tax.

MR. BARRALES: Does it -- but taxing payroll, in essence, doesn't it create an incentive for then companies to have their payroll in another state? In other words, employ people in other states rather than in California and then --

MR. EDLEY: Or countries.

MR. BARRALES: -- and then sell their products or services in California?

PROFESSOR GORDON: Any tax on labor, whether through this mechanism or another, will force people to think about whether to locate in California.

For the individuals, they not only pay taxes, they benefit from the public services. The state's collecting more revenue, it's spending more on services that hopefully these individuals gain from. And so the tax less discourages these locational decisions for individuals than it does for capital, where they don't -- the investment is made regardless of -- decisions don't depend on spending on schools or other activities.

MR. BARRALES: My focus in this particular discussion relates to that investment, the corporate decision-making process, understanding that if you have your chips for computers or other software services, in essence, under that scheme, if you will, it does not create an incentive, obviously, for locating in California.

PROFESSOR GORDON: What you'd expect is that to the extent that the firms are paying tax, that to be willing to locate in California some other cost of business has to be lowered.

MR. BARRALES: Right.

PROFESSOR GORDON: And you'd expect that other cost to be payroll. And so the tax is shifted to workers. And that's what the academic literature theory would forecast.

I actually have a project underway, but I can't quote you results now, trying to test this. But that's certainly what the theory would lead you to expect.

So ultimately it's paid by workers anyway. And to make that more explicit in the design of the legislation I think is an advantage, and that's where the tax is regardless, but it avoids introducing other distortions simultaneously if the tax is directly linked to payroll.

MR. BARRALES: Thank you. Appreciate your input. Thank you very much.

CHAIR PARSKY: Curt?

MR. PRINGLE: Well, thank you.

First off, Mr. Chairman, I appreciate the opportunity to be here. I did think at the time that it would be a good idea to be on the Commission. After --

CHAIR PARSKY: Don't rethink that.

MR. EDLEY: Join the crowd.

MR. PRINGLE: First quiz of the single public presenter, I think we will have plenty of time to be together, so I don't really worry about us having that yet.

I think I have a question and maybe a couple comments. One question to you, Professor, is, you suggested the state -- it may be better if the state had a greater reliance on property tax than some of the other sources of revenue to the state. Did I hear that right?

PROFESSOR GORDON: That certainly is what other states have chosen. One difference is that in most states the property tax payments go to local governments and are spent there and so that towns, cities with a high tax rate also have high spending, and so they're competing for residents with other cities. And then that competition will keep -- will provide incentives to provide the goods that people would like to have.

That competition at the state level is less clear. And so the argument, I think, is weaker here because the property tax goes to the state, but I still think the argument is an effective one.

And certainly other states, by relying more on the property tax, have lower income and sales tax rates than California does and so encourage economic activity to shift to their states because of the lower rates.

And we can lower the rates here if we can shift the tax structure away from the income and the sales tax to the property tax.

MR. PRINGLE: Was that a yes or was that a no?

PROFESSOR GORDON: That was a yes. I think we would gain by relying more on the property tax and less on the income and sales tax.

MR. PRINGLE: Because?

PROFESSOR GORDON: The lower marginal tax rates under the income and the sales tax would encourage economic activity to relocate to California.

The property tax, particularly the residential property tax, more becomes a user fee for enjoyment, enjoying the public services funded by the property tax payments.

MR. PRINGLE: Which I believe the property tax in California is still a locally contained tax. Even though you suggested it goes to the state, it is a locally contained tax in all regards. Doesn't go into the state general fund.

PROFESSOR GORDON: I mean, it finances, but the main local spending is education and that is set at the state level.

MR. PRINGLE: Okay. 38 percent, approximately, I think you will find, of property tax remains for local educational services outside the general fund and the balance goes to local government operation.

But that being said, I -- I do, with Commissioner Keeley, want to have reference towards every single word in the Governor's Executive Order. And I certainly respect everyone who wrote every one of those words, and so -- I know Genest is back there, so he probably did most of that, so I don't want to in any way be critical to those words.

But, in fact, I have had the opportunity to maintain a personal business all through my elected life, and I look forward, Mr. Boskin, to those months where we suffer horrific episodes of revenue surges. Those are the months we as a family celebrate and we as business people celebrate, and -- and I believe every state legislator, and I know Mr. Keeley, I believe, was still in the legislature in the 1999 and 2000 budget year and the 2000 and 2001 budget year, those last two years of horrific surges of revenue I think every education community participant celebrated, all the labor unions in the state celebrated, and most people --

MR. BOSKIN: And we had quite a hangover afterwards.

MR. PRINGLE: So, therefore, I respect the fact that we will have surges. I respect the fact that there's volatility. But I -- from my limited perspective, even though the words put a lot of emphasis on volatility being a bad thing here, I don't think volatility is bad thing at all.

I think under whatever structure we look at -- and I am very open to look at every structure, because our economy has changed since the corporate tax code was written or the personal income tax was written. I look -- think it's important to look at everything in this new economy and where we're going in it.

But I really personally will have as my guide that volatility shouldn't be the bad thing. Volatility is going to happen. It's going to happen in any code, any system, any plan that we come up with.

The definition of volatility can be different, but because of where we are, volatility is captured in the California revenue stream as not really personal income but more the capital gains component of personal income, and that single sector is what really hit its peak in '99 and 2000 and 2001.

I guess I -- I don't worry about volatility of revenue. I worry about consistency of expenditure and that the consistency of expenditure within the state is captured at the highest point of revenue income to the state. Therefore, it's not that we have a surge of revenues, it's that we build the base to expenditure based on those highest points. We don't have one-time expenditures. We don't use those one-time surges as ways to build capital improvements in the state. We use them as building the base and the floor for continual levels of service. And therefore, any drop, any modification from those high points will be met with a lot of suffering, because you're taking as opposed to having those years of benefit.

I really did like the Commission concept because it was focused on revenues and really the new economy in revenues. I personally would be very well-prepared if that was our directive, to look at budget reform, how to reform the legislature, how to reform overall governance in California, and more importantly, how to reform the expenditure patterns of the state and how to ensure that we don't get ourselves into a spending problem as we face revenue problems, because there's problems in both categories.

But really, the way that order -- and with all due respect to everybody else that was standing there at the dais, I put much more emphasis on the Speaker's words than anyone else's. That's a personal bias. But her words were specifically dealing with revenue neutrality, specifically dealing with revenues, specifically talking about revenue structures in a new 21st Century economy. So I listened to her with some, of course, concern about the Governor. But the bottom line is, I heard that from everybody.

And so I'm going to keep my focus on really looking -- because it's a big enough task at hand -- at all of those revenue components within this new economy and see where the heck we're going to go from here.

It is interesting to hear from you, Professor, also. I believe that someone suggested it's easier to spend money than to raise new money. And I totally disagree.

I believe that the way our state government is set up is every single year the legislature and the Governor have to decide how to spend money. And by the exact same voter -- or vote requirement it takes to raise taxes, they have to vote with a two-thirds vote on how to spend money, but only once do they have to vote to raise taxes.

Maybe there's a discussion in the overall context of how to balance those things, require a two-thirds vote every single year for a budget with an expenditure plan and a two-thirds vote on a revenue plan.

We don't have to put legislators up, Governors up, anybody up on making that challenge every year to say, "How are you looking to pay for these programs?"

In fact, they have to do it once and they never have to address the issue of that tax rate again.

Historically, prior to Prop 13, every local government had to confront what their local tax rate was. And those were, I think, some of the more lively hearings in the state from a local government perspective. I probably could beat them on a couple doors -- a couple meetings we've had in Anaheim.

But with that set aside, those were lively meetings, because the governments were confronted with their tax rates and their -- and their requirement to meet a certain expenditure level every single year.

Today in California, the state legislature certainly doesn't have to confront that on an annual basis. They have to confront how to spend money. And even then, they spend money beyond the levels that they know they're going to take in.

So I do challenge a bit the fact that it's harder to raise money than to spend money. I think it's harder to spend money; they've just gotten accustomed to doing it in a very aggressive and annual pattern.

And I also believe volatility isn't all that bad. It's the volatility of revenues counter to the consistency of an expenditure plan that's the challenge.

So thank you, Mr. Chairman. I will continue to look forward to the Commission's discussion.

CHAIR PARSKY: I'm grateful that you will do that.

Edward?

MR. DE LA ROSA: Am I on?

CHAIR PARSKY: You are.

MR. DE LA ROSA: Well, thank you. I promise to be the last speaker. Since the last two Presidents I heard address the Nation and sum up the problems of the World in between 15 and 18 minutes, I'll try to be much shorter than that.

I want to, by way of introduction, just give a little bit about my background. Since 8th grade, when I was the director of boys activities at Balboa Junior High School in Ventura, I have not spent a minute in government. So if I sound like a novice when I speak up, it's because I am.

I'm a businessman. I have a securities firm in Los Angeles. We've been in business for 20 years. And my entire year has been spent trying to raise more revenue. And believe me, Curt, it's hard. It's hard. And so expense control, I leave that to other people.

And -- but what I think about because of my experience is really the goals, what I -- I think ought to be the goals or some of the goals here, which is to find ways to encourage and generate risk-taking, entrepreneurship, and a growing stable of businesses in California. And in my opinion, if we can do that, then we're not revenue neutral. Revenue is growth, not because we tax more the existing citizens or businesses, but because we're the beneficiaries of a larger economic pie.

And so, given that that's my orientation, I've been wondering about a couple of things that have come up today, one of which is, you know, just how much of a role does the tax rate play in a highly skilled worker's decision to come to California or in the decision of a business to locate in California. And I think it doesn't play much of a role.

One or two percentage points on your revenues, after deducting all of your employment expenses and your deductions for, you know, meals and automobiles and computers and electronic trading platforms, like, for example, for our firm, it ends up making not much of a difference.

In my opinion -- in my opinion, things that make a much greater difference are the proximity of institutions like UC San Diego, where you can recruit talented people to work and produce value for you, or where the families of your employees want to live, or where your market is.

I mean, we do business in California. Fifth, sixth, seventh, eighth, ninth largest economy in the world happens to be a great place for us. You can reduce the tax base to zero and I would not move to Ohio, because most of our business is in California.

So I think that it would be wise of us to take a look at really what are the things, how does the tax rate affect business and business generation and business growth? Point number one.

Final point, with respect to volatility, you know, I like volatility, especially in an up cycle. But, you know, Cal PERS uses a smoothing mechanism, because, you know, all of their returns are generated from investment returns. And so when cities and counties make their normal payments, those requirements are based on -- I believe it's a five-year smoothing on investment returns.

And I'm just wondering if there are other states or counties or countries or cities that use some kind of accrual method that recognizes that there's a trend line based on a five-year history and that that trend line governs, you know, what expense -- you know, what -- you know, what expenses would be in a given years for purposes of balancing the budget. And I'd be interested in seeing that kind of information, if anybody -- if any staff person has access to it, or if you do, as well.

So thank you very much. I'll conclude my comments there.

CHAIR PARSKY: Any other comments?

John?

MR. COGAN: If I might, just very briefly, I wanted to come back to the revenue neutrality report.

It seems to me that it's very important for our

Commission to impose some restraints on ourselves if we're going to be successful.

As Gerry said in the beginning, the legislature has told us that we're going to have an up -- they'll have an up or down vote on our report. The prospects for our report being successful in that vote are enhanced incredibly if we could get unanimity among ourselves.

My worry is that if we don't adopt revenue neutrality, we won't get a unanimous Commission. We won't have chance of it. Because as Michael said, some of us think we need more government, and I'm sure some of us think we need less government.

And so the constraint, my reason for raising it is, the constraint is really one that hopefully will help us get to at least a chance of a unanimous recommendation to the legislature, because I do think that if we don't have that unanimous recommendation, our report's just going to sit on a -- on the sidelines and people will not pay attention to it.

So I think we need to give that a lot of consideration, because -- and each one of us has to answer that question, do we think we can get a unanimous report if we open ourselves up to this question, are we going to raise taxes, are we going to lower taxes.

Now, revenue neutrality can be a fairly elastic concept. I mean, there's no hard and fast way that I know of to measure it. Okay? So there can be judgments as to what one means by revenue neutrality.

But I do think it's going to be very, very important for us if we're going to get a unanimous -- we have a chance of getting a unanimous report, and that's why I raised this.

CHAIR PARSKY: Well, let's put aside that question for the moment. And I do think that in the course of this discussion, and perhaps at the beginning of the next hearing, we'll have a discussion of what revenue neutrality may mean, and I think everybody can kind of step back and try to understand what that means before we get into the question of whether it was -- it's something that we have to agree on or not agree on.

I do think the comment about trying to see if we can't all come together is a good comment. I'd like to re-raise that after we've had a couple of sessions so we can get out on the table the issues.

But I do think that, without necessarily trying to decide that issue, I think, as John said, it's not a -- it's not an exact definition, I think, that you will find. So I think we need to kind of understand what we may mean before we decide whether we can come together around it.

MR. HALVORSON: Mr. Chair, can I make one very quick comment on that point?

My sense is that we need to look at two streams of thought, and one stream of thought is expenses. The state obviously needs to spend money. In the 21st Century, there's going to be a whole array of expenses the state is going to need to spend, and I think we need to figure out a process to figure out what that expenditure should be, and a process -- not that we would figure out the number, but we need a multi-year budget, we need more stability, we need to have a sense of where California is going, we need a strategy for where California should end up, we need to begin with the end in mind and figure out where we want to end up.

Having figured that out, we need to figure out how to fund it, and we need -- that's the second stream of work. So the second stream of work is what is the combination of revenue sources that will give us an adequate amount of money to fund wherever it is we want to go.

And I think we need to make recommendations on both. I think we can be agnostic on the exact degree of taxation, but we should be explicit on the structure of the taxation, and that we should attempt to accommodate and link those two schools of thought. We should be linking the source of the revenue to the use of the revenue.

So I don't think we should be jumping in right now and talking about raising spend or decreasing spend. I think we need to have a process to figure out spend and then another process to figure out how to fund spend. So I would recommend we end up there, and I think we could maybe get unanimity if we take that approach.

CHAIR PARSKY: As I think someone said, no approach is preordained here. I do think we ought to continue to keep our eye on the fact that the focus for the Commission was the revenue side of the equation.

And I do think, on this issue of neutrality, part of Phil's discussion this morning -- this morning -- will be -- we'll begin to talk about that.

Okay. Well, that was a rather extended public comment period for one -- for one public comment.

But joking aside, I was very well aware that Professor Gordon is a terrific person and a great expert, so I thought that if the public was not really prepared in San Diego to comment, that someone from the UCSD community could help us get started.

Thank you very much, Professor.

PROFESSOR GORDON: Thank you for your patience.

CHAIR PARSKY: Okay. Let's continue on with our agenda. And we've asked Phil Spilberg, who's the chief of financial research, to give us an overview of the tax and revenue system. And built into his presentation I know will be some thoughts about this whole concept of revenue neutrality which will give us, I think, some good background.

So Phil, why don't you proceed ahead and we'll try to advance the process.

I really do think that the discussion that took place, although it was rather extended, was a good way to set a base for how the individual Commissioners are looking at things. Let's see if we can't now build some background for everybody.

MR. SPILBERG: Thank you, Mr. Chairman.

Thank you, Commissioners.

I'm going to speak a little bit about this concept of revenue neutrality at the very end of my presentation. I'm going to start off with an overview and I'm going to try to shorten my presentation a little bit. But I do have three cartoons over here and I am going to go through each one of those.

CHAIR PARSKY: I wouldn't want you to leave those out, no matter what.

MR. SPILBERG: So the first one is a picture of a -- of what I think is the first Tax Commission. And for those of you that don't see the caption, it says, "For want of a better word, I call my idea taxes, and here is the way it's going to work."

Okay. So my presentation is actually going to be in three parts. The first part is going to be to talk a little bit about volatility, the second part is a broad overview, and the third part is going to be an overview of the four major tax revenue sources for California state and local governments. And that will be the sales tax, the personal income tax, the corporate tax and the property tax.

So starting off with volatility, this chart just shows what we've been talking about in terms of volatility.

Over the last decade, volatility in California has been very high and -- as demonstrated by this curve, which the blue line is personal income, the green line is revenues, and the red bars -- and they are red -- are basically the changes, year-over-year changes.

And you can see that we've had -- this is general -- major revenue changes of -- in double digits, 20.3 percent in 2000, we have a 17.2 reduction, we have other very large changes in our revenues.

Another way of showing this is by just looking at year-over-year growth rates. And the orange line is personal income growth rates, year-to-year growth rates. And I guess it's a green line or whatever line is revenues. And you can see how much more jagged the revenues are as to personal income.

Over time volatility has increased actually quite dramatically, and that's demonstrated in this chart.

The green line is -- shows the coefficient of variation, which is a -- which is a way of comparing volatility across samples and across time in this particular application. And it can be interpreted proportionally.

So in other words, if the coefficient of variation is twice as large, volatility is twice as large. And it shows that -- and this is -- this chart looks over ten-year periods. So for each ten-year period you have a coefficient of variation.

And you can see that in 1999-to-2008 time period the coefficient of variation is 1.66, which is over 50 percent higher than it was in the previous ten-year period and more than double the size over what it was in the previous ten-year period.

The blue and the red charts are -- show the average growth rate during that time period and standard deviation.

The way a statistician -- which I'm not one -- the way a statistician would interpret this is what is sort of like -- use it to construct sort of a confidence interval as to what would be the growth rate, what will be the expected growth rate in that -- in a time period, the way I'm showing this over here.

And for the 1999-to-2008 period, what a statistician would say is that the growth rate would have been about $4.2 billion per year, plus or minus $14 billion. That's 4.2 plus or minus $14 billion, with a 95 percent confidence. And that's just, you know, another way of showing the volatility.

CHAIR PARSKY: In Chris's words, is that empirical data or is that theoretical?

MR. SPILBERG: Theological.

Okay. So the next graph shows revenues and expenditures during this forecast period, and you can see that growth in expenditures -- this is without introducing any new programs or changes in revenues -- the growth in expenditures was 1.6 percent and 1.5 percent and 6.3 percent over those three years. And so really, the deficit problem that we had in this period was due to revenues.

We have a forecast of a, well, a $16 billion drop in revenues in 2008-9, and it stays depressed for 2009-10. And that's the cause of those green negative bars in this chart.

Where do general fund revenues go to? This is just one chart that I have in my presentation on revenues. A very large chunk of our revenues go toward education. 41.9 percent is going to kindergarten through 12 and another 13 percent is going to higher education. The next highest category is health and human services and then corrections.

Okay. So what are the possible remedies? And we've already talked about this a little bit. One is to reduce volatility and the second is to establish a sufficiently large cushion reserve to deal with volatility.

The one thing to keep in mind is that both remedies have costs. With respect to establishing a reserve, well, you have to establish a reserve. And if you have a high level of volatility, you need a larger reserve. And in this environment you may need a reserve of $30 billion plus. And there is an opportunity cost to establishing a reserve that large. You have less volatility in the system, you need a smaller reserve to maintain basically steady expenditures.

The cost to reducing volatility may be a loss of some progressivity.

MR. BARRALES: Can you repeat that last sentence?

MR. SPILBERG: The cost of reducing volatility may be the loss of the progressivity of the tax system.

MR. EDLEY: Especially if you continue to rely on income and sales, because of the volatility of those; right?

MR. SPILBERG: Right.

CHAIR PARSKY: One other quick question. The $30 billion number that you indicated, where does that -- how do you come to that number?

MR. SPILBERG: The $30 billion?

CHAIR PARSKY: No, you indicated in this environment of high volatility --

MR. SPILBERG: Oh, I don't have it anywhere in my report. Just keep in mind we have this -- we have that interval, the confidence interval is plus or minus $14 billion.

Well, depressed revenues can -- in fact, they do occur in series. You don't have just one down year and then an up year, a down year, an up year. You generally have, like, a recession and then you have an upturn. So you have to calculate basically what would be the need, what is the likelihood of having several down years in a row --

CHAIR PARSKY: Right.

MR. SPILBERG: -- and then prepare for that.

CHAIR PARSKY: Okay.

MR. SPILBERG: Okay. The next slide just shows the principles of a good tax system, and that just comes from the Executive Order. And that gives -- that basically concludes my presentation of the volatility.

And now on to the high level overview. And the first slide is just where do we rank relative to other states. And this chart shows that -- using census and U.S. Bureau Of Economic Analysis data that for 2006, which is a high revenue year for us, we ranked 18th nationwide.

The thing that I found actually quite interesting out of this chart was that if you look at where do we -- where do we stand relative to the U.S. average in terms of personal income, our revenues divided by personal income is 17.6 percent and the national average is 16.9 percent, so it's actually pretty darned close.

So that implies to me there is a lot of bunching around the middle. There's not a big difference between where we are, 18, and the middle.

MR. BOSKIN: That's averages?

MR. SPILBERG: Yes.

MR. BOSKIN: Marginal rates, we have the highest income tax rates and the highest sales tax rate and one of the highest corporate income tax rates and --

MR. SPILBERG: Right, right. And that sort of implies to us -- and I don't know about in terms of the property tax rate, but it may be that actually property tax as a portion of personal income may not be all that low, because our property values are high. So that sort of implies to me that our tax bases are somewhat narrow relative to the national average.

MR. BOSKIN: High rates and low rates.

MR. SPILBERG: Yeah. Okay. The next chart just shows a breakdown between state and local -- I'm sorry -- between -- for the state and local taxes. And we see that we have about $164 billion in state and local taxes that are collected.

The other sources, many of those -- we just don't really think of those as being -- being revenues for the state. Insurance trust including -- that includes PERS and STRS. Utility revenues, that includes public utilities. Current charges includes fees from universities, you know, what they collect from the students and things of that sort. And the largest taxes are the ones that I had mentioned before.

Okay. In terms of the breakdown --

MR. BOSKIN: Can I just ask one quick question?

MR. SPILBERG: Sure.

MR. BOSKIN: Can you go back to that slide?

So the utility revenues include the -- just utility revenues collected by government; right?

MR. SPILBERG: Yes. The states.

MR. BOSKIN: The very large revenues collected by utilities, private utilities, publicly regulated private utilities are not included?

MR. SPILBERG: Right.

MR. BOSKIN: So when the state bought all this high-priced energy during the crisis, we then had all these things anyway; it was then bonded to the utilities. That's now showing up on the utilities' books; right? We're paying that in our rates to private utilities?

MR. SPILBERG: Right. Right.

MR. BOSKIN: So kind of a generic point that there's an elasticity to what is a tax.

MR. SPILBERG: That's a good point.

MR. PRINGLE: I'd like to understand that point. I missed it. And so what do you have -- what have you captured here? Are you capturing the debt service component that is on all private utility payers' bills that pays for the cost of the bonds that we used to buy the power during the crisis or are you capturing here --

MR. BOSKIN: No, that's excluded. This is just stuff that's collected, local government -- LA has its own utilities. This is what's collected by Los Angeles, not what's collected by PG&E or Southern Cal Edison.

MR. PRINGLE: So this is a utility tax?

MR. SPILBERG: This is a -- if you live in the Sacramento area, you pay your utility to SMUD, which is a public utility. Similarly, in --

MR. PRINGLE: Okay. So this is all public utility paying for the cost of service?

MR. SPILBERG: Right.

MR. PRINGLE: And the --

MR. BOSKIN: Okay. Then you didn't answer my -- the first question was, is this just collected by governments, and you said yes. But now you're saying it's also including revenues collected by private utilities.

MR. SPILBERG: Public utilities.

MR. COGAN: Municipal.

MR. BOSKIN: Private utilities is excluded. So my PG&E bill is not in there.

MR. SPILBERG: No, it's not.

MR. BOSKIN: Okay. But that is now a lot higher because I'm paying -- I'm paying for the high-priced electricity that we bought.

MR. PRINGLE: But my Anaheim public utility, the third largest utility in the state, is in there, and what -- so California state and local revenues --

MR. EDLEY: On the expenditure side, too, though. If you have the expenditure chart, then what Anaheim spends --

MR. PRINGLE: This screen over here and the slide -- and my eyes aren't good enough, so now I'm smart and turn -- so you do have this on the -- but this slide you presented was a general fund expenditure; right?

MR. SPILBERG: Yes.

MR. PRINGLE: So it had nothing to do with capturing the expenditures of local government?

MR. SPILBERG: Right.

MR. PRINGLE: But here you have all of the revenues that come into local government, even for the cost of service that was paid for, like a utility, it went to that local government utility?

MR. SPILBERG: Yes. And that's the way it's reported in federal statistics.

MR. BOSKIN: But just to the clear, in the example I mentioned, it does not include the private spending we are doing now to pay for -- pay off state spending that was done earlier and now is pushed onto the books of the utilities, private utilities.

MR. DE LA ROSA: I can comment on that because I actually worked on that deal. And Fred, you know about it, as well. Those bonds are paid off by customers of the privately investor-owned utilities, and they -- and this incorporation doesn't show up in those numbers, because it's incorporated in their gas costs.

MR. PRINGLE: And I understand the difference between those two things, but I was just kind of wondering why on revenues it would be on this chart of the public utilities is all, so it kind of threw me off. It's not really a revenue to government; it's paying for -- I mean, almost 90 percent of the cost of our charge for public utilities we just pay by power with, so, I mean, it doesn't necessarily -- I mean, it's not necessarily -- but anyway, okay. I figured it out.

Sorry about that --

MR. SPILBERG: Right.

MR. PRINGLE: -- slight diversion.

MR. SPILBERG: Okay. So the next chart just shows a breakdown between state and local revenues. And this chart shows a breakdown of local revenues and it just shows that the bulk of the local revenues are from the property tax. And there's also the sales tax there, too.

And there is some -- it also includes some of the fees we were talking about, including for hospitals. And actually, the second largest current charge was sewerage, which I didn't know was a word.

MR. EDLEY: Where are my parking tickets?

MR. PRINGLE: So Mr. Chairman, just so I can understand, so where is the public utility charges on this chart? I mean, is this -- or revenues? These are revenues derived from local sources, so that local source would be the public utility charge as well. So is this in one of those categories or . . .

MR. EDLEY: Or is this municipalities?

MR. SPILBERG: I don't have the answer to that right now.

CHAIR PARSKY: Well, we'll make a note. Let's make sure that you find out.

MR. SPILBERG: Okay. I'll find out.

Okay. Going to the next slide, this shows the state -- state revenues. And most of the state revenues go into the judicial notice fund. However, there are revenues that go into also special funds. And the bulk of the special funds go toward transportation projects.

The next chart focuses on the general fund, and it shows that, again, that the most important revenue sources for the general fund are the personal income tax, sales tax, and the corporation tax. There is another 6 percent that comes in from other sources for the general fund.

MR. BOSKIN: May I ask one additional question? Very helpful summary. One thing that's left out of this is all the money that comes to California and local governments of California from the federal government.

MR. SPILBERG: Yes.

MR. BOSKIN: Do you have any information on that for us?

MR. SPILBERG: That is a large chunk. And let me just see if I had put this -- yes. In the chart that shows all the revenues, it's the pie chart with that bar next to it.

MR. BOSKIN: Yeah.

MR. SPILBERG: It shows that we have $56.4 billion in 2005-6 that came from federal government. That's federal funds. It's in a blue pie, and it's on page --

CHAIR PARSKY: Page 10, I think, or 11.

MR. SPILBERG: Page 10, I think.

MR. BOSKIN: And that is out of the total of, it looks like, about 300 and -- about 400 billion. Okay. Got it.

MR. SPILBERG: Okay. So the next chart is sort of interesting. It shows the mix of revenue sources over time. And the thing that's striking in this chart is the shift away from the sales and use tax to the personal income tax.

We had -- in 1951 we had 59 percent of our general fund revenues were from the sales and use tax. And that was -- and that's five times the amount that was coming in from the personal income tax, and that by 2007-8 we have only 26.3 percent that has come in from the sales tax, and we have 65 -- I'm sorry -- 53 percent coming in from the personal income tax.

MR. KEELEY: One final question. Is this the result of a change in the relative tax rates or a change in income disparity between wealthy people and not-so-wealthy people?

MR. SPILBERG: It really is more a story of the sales and use tax than the personal income tax. The tax rates -- and I'll get -- I'll go into more detail about each of the revenue sources a little bit later on. But the tax rates for the personal income tax have not really gone up all that -- have not gone up over that time period in general.

What has happened is that the sales tax has fallen. And the reason it's fallen is because the mix of consumption has moved away from goods towards services, which are non-taxed and -- toward the very end of this time period because of remote sales, because of sales coming in from outside of California.

I'm going to -- here's a definition of "progressivity," which we use the term a lot. And it's -- basically what it says is that the effective tax rate -- for something to be progressive, the effective tax rates go up with income; "proportional" is it stays constant with income; and "regressive" means that it goes down with income.

Okay. So that's the general overview. Going over now to each of those largest revenue sources, starting off with the sales and use tax, everyone knows what a sales and use tax is. It's collected by vendors, by retailers. It's often itemized on the bill.

However, if you don't pay a sales tax but you buy something that is subject to the sales tax, you actually owe a use tax, and that use tax is something that we are responsible ourselves to collect and remit to the state.

In terms of the tax rates, of the sales tax, 5 percent goes into the general fund. There are other state taxes that are collected through the sales tax, and then there is also a -- up to 2 percent additional that could be collected by local governments. The average sales and use tax rate in California is 7.95 percent.

Sales and use tax collection compliance is very high with respect to the sales tax. It's quite low with respect to the use tax. And because of a U.S. Supreme Court decision, California really cannot collect sales tax from vendors who don't have a presence, who don't have nexus in California. That's the Quill decision.

And that's one of the problems that we have with the sales tax is that remote sales, sales from outside of California as a consequence of the Internet are growing.

MR. KEELEY: Mr. Spilberg, if I could ask you a quick question? Have you taken a look at the decision that came down from the state of New York on the issue of Internet sales for those entities that have brick-and-mortar facilities or that have an associate relationship in New York?

MR. SPILBERG: I've only read about it. You're talking about the Amazon decision, having to do with -- Mr. Pomp probably knows a lot more than I do.

MR. KEELEY: Well, Mr. Spilberg, I think that would be -- if I could, Mr. Chairman? I think getting information on that from our staff would be quite helpful --

MR. SPILBERG: Okay.

MR. KEELEY: -- because it's a very current case and I think it would be very helpful.

Thank you, Mr. Chairman.

CHAIR PARSKY: Sure.

MR. SPILBERG: Okay. Taxation of services. California is below average of the states in terms of taxing services. Only nine states in the survey that was conducted by FTA, Federation of Tax Administrators, tax fewer services than does California.

One thing I should say, however, is that adding services to the affected industries could be sort of painful to the affected firms, because suddenly you have a fairly high price increase for the services that they provide, given that our tax rate is close to 8 percent.

MR. POMP: Should a sales tax be taxing business inputs in the first place?

MR. SPILBERG: Oh, I'm talking not about business inputs; I'm talking about just a -- just on the consumer.

MR. POMP: Just on the consumer. So if I go to amusement parks, skiing --

MR. SPILBERG: Right. Right. Suddenly that is going to cost you more.

MR. BOSKIN: But the answer to your question is no?

MR. SPILBERG: I actually get into this a little bit later on.

Okay. It's -- the kind of goods which are consumption goods which are -- which are subject to the sales tax are broad.

In addition to consumption goods, we also have business services, which -- or I'm sorry -- business purchases which are taxed. And economists would pretty much agree that that's not something that should be taxed. And in California it represents about 35 percent of the purchases.

MR. PRINGLE: Mr. Chairman?

CHAIR PARSKY: It's pretty dangerous to use the word "economists" and say "all." At the very least, say "some."

MR. PRINGLE: On this slide, could I ask, is this the calendar year of '07 or is this the '07-08 budget year? Where does this breakdown come from?

MR. SPILBERG: I think it's 2006-7 fiscal year, but I'm not --

UNIDENTIFIED AUDIENCE MEMBER: It's a calendar year.

MR. SPILBERG: It is the calendar year 2007.

MR. PRINGLE: I will just share an empirical point of reference. You have fuel pulled out as a separate item on this. So that is sales tax on gasoline; is that right?

MR. SPILBERG: Yes.

MR. PRINGLE: Okay. Most of the definitions of transportation have fuel as a component within transportation, so you separated it out here, but I know on the reporting categories it is all fuel and auto purchases, used and new as well as auto parts were all lumped into transportation. So did you specifically pull fuel out to demonstrate that or . . .

MR. SPILBERG: No. This was -- this was reproduced from a -- I think it was a -- was it a federal table or -- we didn't pull it out. We just basically copied down the table that we had. So we can get you the source of the information later on.

MR. POMP: But there's no double counting?

MR. SPILBERG: No.

MR. POMP: It's just how you categorized it?

MR. SPILBERG: Yeah.

Okay. The next slide shows the ratio of taxable sales and tax revenue. And this sort of demonstrates how the mix of purchases has changed over time. And it shows that at the beginning of this time period that's studied over here, 1968, that we had over 50 percent of personal income which was basically subject -- which was -- which was within taxable sales. And that basically has dropped to 35 percent in -- by the end of this time period.

Similarly, with respect to the amount of tax revenue from the sales and use tax, that has substantially dropped as a proportion of personal income.

The next chart basically shows the variability of the sales and use tax rate -- tax -- sales and use tax. And it shows -- this chart, relative to the other ones that I will show, at least personal income tax and corporate income tax is very smooth, but even here you see a certain amount of volatility.

We do have growth rates of 11 percent in one year and we have reductions of 7.3 percent in another year. So even the sales and use tax is not totally smooth. There is some volatility to that.

Okay. That's basically my overview of the sales and use tax. In terms of areas that have been looked upon with respect to changes of the sales and use tax, people have looked at tax expenditures, and those will be addressed in more detail later on today. But this just reproduces the largest tax expenditures for the sales and use tax.

Note that services are not included anywhere over here, and that is because the sales and use tax is only for tangible property.

Some other options that have been included --

MR. KEELEY: Excuse me. If I could ask you, if I could, Mr. Spilberg, stay on this for a second, on the tax expenditure issue. It is an issue that I suspect the Commission will get into at some length.

So, for example, where you have food products, where food is largely exempted, dependent upon, you know, if you buy it in a grocery store or consume it in a restaurant, you treat it differently for that purpose. So are you saying that because services are exempted, you don't put it in -- I understand why you wouldn't put it in as a tax expenditure on here.

MR. SPILBERG: Mm-hmm.

MR. KEELEY: But you do have someplace where we can -- where you've analyzed the notion of the composition of the California economy and the service component to that, there was an earlier slide on that, and so you can provide us with information as to the size of the service sector which is exempted from sales tax; is that correct? You have some information on that or your best estimate of that?

MR. SPILBERG: We can -- we can develop that information.

MR. KEELEY: Okay. So that will be something I suspect, Mr. Chairman, that we will want to develop.

So on the tax expenditure side here, what you are saying here, for example, on food products, gas, electricity, prescription medicines, et cetera, these are the sales tax exemptions.

MR. SPILBERG: Right.

MR. KEELEY: And from a budgeting point of view, at least when I was in the legislature -- and I see the immediate past chairman of the Assembly committee on the budget sitting here, Mr. Laird -- good morning. Good to see you, sir.

I have to say that in part because Mr. Laird succeeded me in the Assembly, and we now -- we both live in Santa Cruz and tell tall tales about what great work we did in the legislature.

But on this -- on this point, from a budgeting point of view, I'd like to understand how you define a tax expenditure, because the difference, for example, between a deduction and credit and how you're putting this -- how you're using that phrase "tax expenditure."

MR. SPILBERG: Okay. It's -- well, first we start off with the basic law, and the basic law is, for the sales and use tax, is that it's tax on -- on the purchases of tangible property.

A tax expenditure would be an exception basically to that rule. And the way that it's reported on this table is basically the revenue that would have been collected in that year if it wasn't exempted.

MR. KEELEY: Thank you. And we will then revisit this with regard to these -- this is an interesting chart, and, I think, quite helpful.

Obviously, it would be -- it will be a very different chart, both in its cumulative impact, if and when we get to the business of services and that component of the economy where a sales transaction -- for example, when I buy my shirt, I pay sales tax on it.

MR. SPILBERG: Right.

MR. KEELEY: When I took it to the laundry so I'd look nice for everybody today, it was a sale as far as Vapor Cleaners in Santa Cruz was considered -- considered it a sale, but it wasn't a sale for tax purposes.

MR. SPILBERG: Right.

MR. KEELEY: And my guess is that from a tax expenditure point of view this would be a very significant component part.

MR. SPILBERG: Services would be. Certainly.

MR. KEELEY: Services, the one I just described, for example. Thank you, sir.

MR. POMP: If I could just follow up, because not all exemptions are equal in a tax expenditure. Take the exemption for farm equipment. This is a business input. I mean, this is properly an exemption of sales tax. You don't have the purchase resale exemption up there because it is properly part of the structure of a -- of a sales tax.

MR. SPILBERG: Mm-hmm.

MR. POMP: So that -- I'm not sure what the definitional criteria was. But Fred makes a very good point. If the idea of a sales tax is to reach consumption, then you shouldn't be constrained by the fact that the statute says tangible personal property in putting together a tax expenditure budget. It should be consumption and you should be identifying categories of consumption that are not within the base. So that I think he's quite right to say that's properly a tax expenditure, and I would go further and say an exemption for farm equipment should not properly be in a tax expenditure budget.

So it's certainly useful, what's here, but I think we have to, you know, not be constrained by someone's definition or miscategorization.

MR. IBELE: Mr. Chairman?

CHAIR PARSKY: Yes.

MR. IBELE: I just wanted to add, there are -- at the request of some of the Commissioners, we attached tax expenditure reports from Department of Finance, Board of Equalization and the Franchise Tax Board, all of which -- there are slightly different definitions that they use, but the primary basis is the statutory one. Thank you.

CHAIR PARSKY: Thank you.

MR. PRINGLE: Mr. Chairman?

CHAIR PARSKY: Go ahead.

MR. PRINGLE: Again, we'll get what -- what we are looking at here is your interpretation of the present statutory authorization of the sales tax on what it would apply to, and these are the exemptions to that statutory authority of the sales tax. Not to suggest that that statutory authority of collecting taxes could change, but you believe these are the things that are explicitly exempt from the current statutory authority for the sales tax?

MR. SPILBERG: Right.

MR. PRINGLE: And these exemptions, in all cases are they statutory exemptions or are they constitutional exemptions? One of which is a constitutional exemption, I know, the snack tax one. But are any others constitutionally exempting, for example, food? I don't know. Is food constitutionally exempted?

MR. SPILBERG: I don't know. We'll have to get back to you on that, too.

CHAIR PARSKY: Well, the purpose here of this chart is to show the loss of revenue attributable to each of those categories --

MR. SPILBERG: Yes.

CHAIR PARSKY: -- if the definition of the tax were altered to cover them; is that the purpose?

MR. SPILBERG: Right. It's -- what it -- it starts off with sort of the broadest definition of the tax under -- under law, which is -- for the sales tax it's taxation of tangible property, and then it looks at exceptions or exemptions that have been made to that.

CHAIR PARSKY: And those capture those exemptions or . . .

MR. SPILBERG: Yes.

CHAIR PARSKY: Okay.

MR. KEELEY: Let me pursue this, because that does raise a question. So what you do is that you, in assembling the sales tax revenue forecast, for example, you know what is expressly contained in the statutory definition of a sale; correct?

MR. SPILBERG: We basically know what is -- what are the revenues that are coming in from the law as has been defined.

MR. KEELEY: Okay. And this may be more appropriately addressed to Mr. Genest when he has an opportunity to speak.

So, Mr. Genest, when you come up, we will have, I suspect, a conversation about how this chart is put together then, because the forecasting on sales tax is based on the statutory authority to collect that tax.

MR. SPILBERG: Mr. Commissioner, I'm actually sort of in charge of the area that does the revenue forecast. And --

MR. KEELEY: Okay.

MR. SPILBERG: -- with respect to the way the revenue forecast is done is that we basically look at historical trend of revenues that have come in and we associate, basically, the revenues that have come in with economic variables, and then we project the economic variables and use the relationship that we have developed on historical data in order to project the revenues into the future. So as long as the law does not change, that method is used.

When the law is changed into the projection period, then we take into account the revenues that are either generated or lost as a consequence of the change in law.

MR. KEELEY: Fair enough. So without beating this poor horse to death, let me go back to the question then.

When you give us a sales and use tax expenditure, which is to say those component parts of the economy which are statutorily or constitutionally exempt from a sales and use tax, because they would otherwise be considered a sale or a use; correct?

MR. SPILBERG: Mm-hmm.

MR. KEELEY: You've listed here then for us all of those that are either statutorily exempt or exempted by the constitution --

MR. SPILBERG: Yes, sir.

MR. KEELEY: -- from the sales and use tax.

MR. SPILBERG: Mm-hmm.

MR. KEELEY: Except that it does not contain the exemption for that 40 or so percent of all sales in California which are sales by everyone else's definition, but they are not sales for purposes of the application of the sales and use tax. Am I right?

MR. SPILBERG: Yes. You're referring to services?

MR. KEELEY: Right. That's the word I used. I said "services."

MR. SPILBERG: Yes.

MR. KEELEY: So this chart is everything that are sales in California to which the sales and use tax does not apply, with the single exception of services.

MR. SPILBERG: Yes, sir.

MR. KEELEY: Thank you very much.

MR. POMP: I don't know that that's quite true, because where's the purchase and resale exemption, which is probably the largest exemption? I mean, it is not there --

MR. SPILBERG: Right.

MR. POMP: -- and it shouldn't be there. But under what you just said, it ought to be there.

MR. SPILBERG: Okay. So let me modify what I said. The broad -- the broad law with respect to the sales tax includes a resale exemption, so it -- it's considered as part of the broad principles that have been laid out for taxing sales.

MR. POMP: Mm-hmm. Because you shouldn't be taxing business inputs. And I would agree with that. That should not be there. But I can't in my own mind distinguish between that and the presence of an exemption for farm equipment, which one would have thought would be excluded by the principle of not taxing business inputs.

MR. SPILBERG: Well, it's -- the resale exemption has been part of sort of the sales tax law for a long time.

As far as taxing business inputs, however, such as the purchase of computers and purchase of equipment, basically, cars, things of that sort that are used by businesses, that has -- that has -- that is not part of what is considered this -- it's taxable in California in general. There is an exemption that was made -- there are some exemptions or exceptions to that, but in general, those things are taxable in California.

MR. KEELEY: Mr. Chairman, if I might?

Mr. Spilberg, I'm -- I'm certainly not and I don't think the Commission is attempting to be difficult here. It's that what I think we would like is -- I'll speak for myself. I think what would be helpful would be if this chart, which deals with tax expenditures, that the definition of "tax expenditure" for our purposes, relative to the sales and use tax, would be all sales transactions in California which are exempt from the sales and use tax, that that would be -- because that's what this purports to be, and then it doesn't include some, it does include others.

Now, whether it is good public policy or not to exempt business inputs, I'm certainly willing to stipulate that it's a good -- it's a good thing to exempt them. Fair enough. But then we have some in here, we don't have others in here.

So not today, but at some future time, in order for us to understand how to build a tax structure for the 21st Century, understanding the component parts of the current California economy that are sales and that are exempt seems to me to be a critically important not only notion, but then putting dollar figures and trend lines on that would be enormously helpful to us. In fact, I don't know that we can do our job without having a pretty good feel for what that is.

Thank you, Mr. Chairman.

MR. PRINGLE: If I could? I mean, I understand the concept. You're -- there's ways to expand the sales tax beyond the statutory definition of sales tax. Expand it to wholesale sales, if you wish, or expand it to services and all that. What you're trying to capture, though, is what is in law today and what the explicit exemptions are.

So looking at this, it's interesting for me to see just this chart and why certain things were -- you picked. Maybe it's because the legislature wrote legislation just to exempt these.

Could you just maybe give me a little understanding of why rental of linen supplies is on there? Of course, growing up in a laundry and dry cleaning household as our family business, we didn't do many linen supplies, but I did dry clean a lot of drapes.

So is there a -- do we charge a sales tax on rental of party equipment or rental of tables and chairs or rental of office equipment or rental of cars or -- I could walk down that list. Is that a sales taxable item in California, therefore, the only exemption to rental law is linen supplies? I just want to know who those lobbyists are, because they're very powerful.

MR. SPILBERG: I wish I had known that this was going to generate this much comment. I would have excluded it.

CHAIR PARSKY: Well, you know, I do think -- I think you had some help here. But I do think it is important to understand, if we really are trying to take a look at what has happened to the economy over the last

28 years, and we're being told to focus heavily on the move to a service-oriented economy, and it seems to me we do have to try to understand what part of that economy now is not subject to taxation and what impact that could have. And if that's what is being -- trying to be captured in part here, then we should keep going and make sure we understand it.

MR. PRINGLE: Or maybe we should have this as an item on a future agenda.

CHAIR PARSKY: Maybe.

MR. PRINGLE: Because it is the whole discussion of sales tax, what applies, what doesn't apply, and where would we like to consider any potential recommendation. I mean, I don't believe this gentleman has the background on any of these to the degree that he feels comfortable with answering certain things. But I certainly would like to know, as others, you know, what's there and what's not there. This doesn't really paint the picture.

MR. EDLEY: I mean, what I would prefer analytically going forward -- I don't have any problem with saying that the sales tax as California has traditionally done it is a tax on tangible property as opposed to services and feeling that a decision to tax services is a more substantial public policy choice and economic choice than a decision to alter one of these existing exemptions. So I don't have any problem with distinguishing between a sales tax for tangible property and a sales tax for services just as I don't have any difficulty distinguishing between a real property tax and a chattel property tax. We have a real property tax to fund schools, et cetera. We don't tax chattel. I wouldn't call that a tax expenditure because chattel isn't covered. But I would certainly entertain an analysis to see, well, how much money would be raised by taxing certain chattel, like Gerry's yacht or something, so . . .

CHAIR PARSKY: That doesn't exist.

MR. EDLEY: What's curious about this list, for example, is the rental of linen supplies. That jumped out at me, because I wouldn't have thought it would need an exemption because it seems to me if you rent linen, there's been no change in the ownership of the linen, so I wouldn't have thought it would constitute a sale of tangible property. But I'm just a lawyer, so what I do know?

MR. POMP: As a lawyer you know that if a rental would not be taxable and sales are, we'd be renting everything.

MR. EDLEY: It's called the apartment-house distinction.

CHAIR PARSKY: I think -- I think it would be helpful to take this general subject matter and move it to kind of a specific item on our agenda, because I do think that a number of the Commissioners want to make sure that we understand where things stand now if we're going to consider at all making some recommendations to alter it.

MR. EDLEY: And to alter the base more generally. It's a base-broadening option.

MR. COGAN: One additional thing we might consider if we go down this road and that's the incidence of a services tax. It seems that if we're going to be assessing what the revenue consequences are and we're concerned about distributional issues, we've got to worry about the incidence of that tax. So I don't know whether DOF has the capability to assess the incidence, but it's going to be extremely important for us, so you should try to include it in the analysis.

MR. HALVORSON: Mr. Chair, I don't know if we have the resources to do this, but other states have different definitions of what they tax in a sales tax.

CHAIR PARSKY: Right.

MR. HALVORSON: It might be very useful to get a list of what other states tax specifically in addition to the generic idea of services.

CHAIR PARSKY: We're going to have some discussion of --

MR. HALVORSON: There are some services taxed in other states, and it would be interesting to know what they are.

MR. DE LA ROSA: Mr. Chairman, one further point. Do I read this correctly? It's a -- basically a $110 million exemption on a $115 billion revenue stream, or so?

MR. SPILBERG: Excuse me?

MR. DE LA ROSA: It looks to me like it's, you know, just eyeballing it, you know, $120 million there in the linen supply exemption.

MR. SPILBERG: Oh, linen supply.

MR. DE LA ROSA: Right. And so the state revenue stream is what, $115 billion or so?

MR. SPILBERG: Dependent on how you count it.

MR. DE LA ROSA: Right. So even if we eliminated the exemption or doubled it, it wouldn't really make any meaningful difference on the entire system of state revenue; is that right?

CHAIR PARSKY: I don't think we should dwell on that item, despite Curt Pringle's family's involvement in that. But we'll come back on this subject.

MR. SPILBERG: All right. Okay. So moving right along, so here are some other ideas that have been brought forth on the sales and use tax: Broaden the tax base to include more services, eliminate the sales tax on business purchases, as Mr. Pomp has mentioned, explore methods to better collect the use tax on remote sales, explore methods to extend nexus to firms with substantial sales to customers in California, supplement sales tax with a low tax rate, gross receipts tax, and -- or supplement or replace the sales tax with value-added tax. Okay. So that's the sales tax.

The next one, the next thing should be a lot less controversial. That's my second cartoon. And this is as an introduction to the personal income tax. Estimated taxes and final taxes actually have a long history to it.

Okay. Personal income tax. First of all, a definition of "income." And I put down a definition which economists have accepted for quite a while -- some economists have accepted for quite a while.

CHAIR PARSKY: Very good.

MR. SPILBERG: What it is, is that it's basically the change in your wealth from the prior period to the current period plus your consumption during that time period. You add those things up and that basically is a broad definition of "income."

If you look upon it this way, certainly capital gains belongs within a definition of "income." There has been talk about capital gains, and one of the reasons that it -- people have said it's inappropriate to file -- to include capital gains is that it may -- the capital gains may be the consequence of inflation. And that's true.

That is, if you have, let's say, inflation of 10 percent and the price of your assets went up by 10 percent, you haven't really gained anything. It's just basically inflation that has increased the value of your asset.

That is true really with respect to the whole income tax system in its entirety, because if you think about interest income, well, interest income has an inflation component. So does business income. So it's basically a more sort of pervasive problem of income taxation.

My next chart looks at personal -- what is personal income tax divided by personal income. And you see that there is a sort of growth in that percentage over time.

And it puzzles me a little bit of why we have that growth, and -- because tax rates really have not gone up during that time period. So what that means is that there is basically three components possible to this, this explanation.

One component is that the income tax has become more inclusive. The base has increased. And that could be due to basically some of the deductions that are included in the income tax have become a smaller proportion of the amount of income.

Another reason for this increase would be capital gains. Capital gains are not included in the national income and product accounts of personal income, but obviously are part of the tax base. And the income distribution matters. That is, to the extent that you have an increase in the income to the high-income people, your tax rate, overall effective tax rate is going to increase.

Just a -- just a couple of slides on the personal income tax. One thing I should just note on this is that conformity to federal law is sort of important. And the reason for that is that, first of all, the IRS is an important partner for tax compliance. They have -- they expend quite a bit of resources on enforcing the personal income tax. We benefit from their enforcement. And second of all, it substantially reduces the complexity to California taxpayers. So just one thing to keep in mind out of this slide.

This is just basically a layout of our tax return. It starts with federal adjusted gross income, then goes through some adjustments, exemptions and -- deductions, exemptions and credits.

One difference that is sort of important is that for federal tax purposes, for exemptions, you receive a deduction. For California, it's a credit. So that it's -- people in high income brackets receive basically the same benefit from a -- from an exemption as do low-income people.

Personal income tax contains six brackets, from 1 percent to 9.3 percent; plus, there is this mental health services tax which is levied on income -- taxable income over $1 million.

Also, there's an alternative minimum tax for California, but it's indexed, so it's not the same problem that it is for federal tax purposes.

We're talking about progressivity and this is one sign of progressivity. If you were married with two children and you rent, you don't own your own home, you are not taxable until your income exceeds over $49,000.

When we think of tax rates for the personal income tax, we should take into account the deductions and exemptions and the credits, because conceptually the tax is on gross income, so the deductions and exemptions are really part, in a sense, of the tax rate of the progressivity of the tax.

This is a more direct look at the progressivity of the tax. And the top line shows the top 1 percent of California returns, 1 percent -- there's 14.4 million returns for 2006, 1 percent is 144,000 -- had income of over $480,000, represented 24.9 percent of adjusted gross income and paid almost 50 percent of the tax in California.

This shows basically what has been the trend over time for people with the highest 1 percent of income. And what it shows is that the two lines -- the bottom line is for -- for income and the top line is the tax. Okay? The tax liability and the proportion of income.

And interestingly enough, this -- the change over time of the two lines are -- they're virtually parallel. So most of the increase in -- or most of the change in the amount of tax borne by the top 1 percent is really due to the concentration of income within the 1 percent rather than in changes in the effective tax rate.

MR. COGAN: Phil, this does not include capital gains?

MR. SPILBERG: This does -- this does include capital gains.

MR. COGAN: In the tax side. What about the income side?

MR. SPILBERG: Also the income side. This is adjusted gross income.

MR. COGAN: Okay.

MR. BOSKIN: It would seem from that chart as if in 2006 and 2005 the percentage points by which the share of tax exceeded AGI was the highest in this period. There's been a widening from 19 percent higher to 23 percent higher, so -- or, you know, the ratios have probably been pretty stable.

MR. SPILBERG: Yeah. You know, Mr. Boskin, I also took a look at the top 1 percent, you know, over the entire time period, and over that time period income, the income concentration -- the income of the top 1 percent went from 14 to 25 percent over here, which is an increase of 79 percent, and for tax it went up by 45 percent. So the income concentration actually over that whole time period went up by more than the tax concentration.

MR. DE LA ROSA: Do you know -- can I ask you, do you know what -- if the top 1 percent is a stable group or did the composition of that top 1 percent change dramatically over time? Or year to year?

MR. SPILBERG: I have not examined that. I presume that there is a substantial amount of shifting. And the reason is that some of the -- some of these earnings in the very high level of income are occasional. Somebody sells a business and they receive a lot of money in the year of sale. So I suppose that there is quite a bit of shifting in that group. It's a pretty high income.

CHAIR PARSKY: One more time, the 144,000 number on the chart before includes capital gains as well as personal income tax?

MR. SPILBERG: Well, capital gains is a part.

CHAIR PARSKY: Is a part, so it includes capital gains?

MR. SPILBERG: Yes, it does.

CHAIR PARSKY: Okay.

MS. ITO: Another question. Have you also looked at the number of the returns, the trends of the number of returns in the higher income brackets over time as well?

MR. SPILBERG: That's a different sort of examination. Over here we look at the top 1 percent and that is always going to be the top, you know, a similar amount to the extent that the number of returns are approximately the same. But in terms of looking, for example, how many returns have income over, let's say, a million dollars, we can do that.

MS. ITO: Mm-hmm.

MR. HALVORSON: This chart says that the top 1 percent earn 25 percent of the total revenue.

MR. SPILBERG: Total income.

MR. HALVORSON: Total income. Total income. Right. And pay 48 percent of the taxes.

MR. SPILBERG: Yes.

MR. HALVORSON: And years ago it was 14 and 33?

MR. SPILBERG: Right.

CHAIR PARSKY: That's exactly what it's saying.

MR. HALVORSON: Okay.

MR. SPILBERG: Okay. The next slide is just showing the sources of tax from the various components of income, so it's tax-weighted. It's the amount -- it's not measuring income, it's measuring the amount of tax coming from the income. And it's showing that about 53 percent for 2006 came from wages and the next highest category was capital gains. And some of this volatility that we have in our tax structure is due basically to this property of our tax system.

The next chart looks at basically the volatility of the -- of capital gains over time. And

I'm just going to read off the percentages: Growth rate, start off, 22 percent, 58 percent, 39 percent, 24 percent. I could just keep on going with this thing.

The growth rates from -- I mean, this -- this is a definition of volatility. This is pretty amazing.

MR. BOSKIN: There's a minus 30.

MR. SPILBERG: Okay. And the next chart basically just looks -- it provides the same kind of observation for the income tax in total. It's also quite volatile. It's volatile because of capital gains. It's also volatile because of other sources of income that we have for the top 1 percent and because the top 1 percent is so important in California.

MR. HALVORSON: On capital gains, do you have even a remote guess as to what the '08 number is likely to be?

MR. SPILBERG: Yeah, we have. We have a --

MR. HALVORSON: A round number?

CHAIR PARSKY: Stay remote.

MR. SPILBERG: We're assuming a reduction from -- from 2007 of 55 percent.

CHAIR PARSKY: You'll add to this chart?

MR. SPILBERG: (Nodding head.)

To the volatility of this chart.

MR. HALVORSON: It wouldn't hurt to add that to the chart, I mean, just for focus, as an estimate. Put an asterisk on it and just say "best estimate as of now."

MR. SPILBERG: Yeah.

MR. POMP: So the reduced volatility we could exempt the top 1 percent.

MR. SPILBERG: Yeah.

CHAIR PARSKY: Like John said, we're seeking unanimity here.

MR. POMP: I'm just making a point here.

Earlier you said that one of the costs of reducing volatility is a reduction in progressivity, as this very nicely shows, but it's also a reduction in absolute tax dollars, isn't it?

MR. SPILBERG: Well, it -- one way of reducing volatility is moving more to consumption taxes or as a sales tax.

MR. POMP: But just looking within the income tax itself, if you wanted to reduce volatility by doing something about exempting capital gains or lowering the rate, you'd give up both progressivity and absolute tax dollars.

MR. SPILBERG: Well, unless you --

MR. POMP: Unless you increase rates.

MR. SPILBERG: If you broaden the base, you can increase -- reduce the rates and bring in more dollars.

MR. POMP: Well, what would you think of as broadening the base? What is now the major component that's missing?

MR. BOSKIN: You're going to see in a moment a list of all the expenditures.

MR. POMP: Yeah, the deductions. Go ahead.

MR. SPILBERG: Actually, I was going to skip the expenditures.

MR. EDLEY: What's this linen thing?

CHAIR PARSKY: Linen is part of the core of this analysis.

MR. EDLEY: It's in the constitution.

MR. PRINGLE: Mr. Chairman?

CHAIR PARSKY: Curt.

MR. PRINGLE: The previous chart to this shows capital gains representing in the tax year, I guess, '06 21 percent.

MR. SPILBERG: Yeah.

MR. PRINGLE: Has that, too, been a volatile component --

MR. SPILBERG: Oh, yeah.

MR. PRINGLE: -- within the personal income tax? So do you know generally what it was in '99 and 2000 tax years, which were the peak, right, of capital gains as collected value?

MR. SPILBERG: I think we have an estimate of that. I don't have it with me, but I can provide it to you.

MR. PRINGLE: What is the range that you -- can you -- within the last ten, you know, ten years or so, do you know about what that range is? Are we at a high point on capital gains now in this '06 representation? We'll be at a low point probably this year, but --

MR. SPILBERG: Yeah. '06 is very high. '06 is very high. And '07 is actually going to be even higher than '06. We have some growth between '06 and '07. So they're very -- they're quite high.

MR. PRINGLE: But you don't -- maybe it'll come to you.

CHAIR PARSKY: It's coming to him.

MR. SPILBERG: Oh, okay. So I have a chart in front of me that's from the budget and it shows percentages, capital gains as a percent of revenues. Is this -- this is a revenue.

UNIDENTIFIED AUDIENCE MEMBER: Right.

MR. SPILBERG: Okay.

MR. PRINGLE: So it wouldn't be personal income.

MR. SPILBERG: Yeah. But it basically -- so revenue. So this is a different observation. But you can sort of get the sense that in 1999 -- well, let's take the peak. 2000. 2000, it was 14.8 percent of revenues. Then by 2002 it dropped to 4.5 percent of revenues.

MR. PRINGLE: And that's all state revenues, you're saying?

MR. SPILBERG: Yeah.

MR. PRINGLE: Or general fund, anyway?

MR. SPILBERG: Yeah.

MR. PRINGLE: Okay. Just -- maybe you could put together a little chart on the side or a list of what percentage of that was -- what percentage of personal income tax over the last ten years was capital gains. For me that would be of benefit.

MR. SPILBERG: Sure. We can do that.

MR. PRINGLE: Thank you.

MR. SPILBERG: Okay.

CHAIR PARSKY: We're going to try to move this along now, and we'll come back. I'll make some suggestions on how we can get through our agenda in a timely way this afternoon. But proceed ahead.

MR. SPILBERG: Okay. So let me skip the next chart on tax expenditures and go directly to the next one. Some of the other things that have been suggested on the personal income tax side, for both simplicity and for efficiency, economic efficiency, simplicity, piggybacking of the federal income tax, which is that basically you would take a proportion of your federal tax liability, that that would be your state tax liability.

You have -- and we'll discuss this at another time, I guess. Broaden the tax base.

If you eliminated all exemptions and deductions, you could set the tax rate between 4 and 5 percent and raise the same amount of revenue.

Revised taxation of business income, there have been several proposals, basically, to separate business income.

MR. BOSKIN: Can I ask a question about that?

MR. SPILBERG: Yeah.

MR. BOSKIN: So if we eliminate all those, we could have a flat 5 or 6 percent or --

MR. SPILBERG: Yeah, 4 or 5 percent.

MR. BOSKIN: 4 or 5 percent. And if we wanted to maintain some progressivity, let's say if we wanted to have 2, 4 and 6, something like that would be feasible then?

MR. SPILBERG: Yes. Yes. Absolutely. You'd have 4 or 5, yes.

MR. BOSKIN: That's an interesting guidepost. Maybe you didn't want to go all that way, but maybe any interesting way to think about it, that if we wanted a progressive income tax base, 2, 4 and 6, virtually all of the -- basically broaden the base to almost everything, and the more things we include as exemptions and deductions, the higher those rates have to be.

CHAIR PARSKY: Well, and I think Phil has kind of put some options after each of these sections he's talking about. I think we're going to -- we're going to try to bring back those options as something we can discuss and put it on the agenda.

MR. BOSKIN: Good.

MR. SPILBERG: Okay. So let's move -- there's a couple more over here, but we can just move along.

CHAIR PARSKY: Yeah. I would just keep going through your presentation. We'll take a break for lunch after you're finished, but I'll come back and see how we can combine what should have been completed before lunch to after lunch. But keep going.

MR. SPILBERG: Okay. Going -- moving on to the corporate franchise tax, corporate franchise and income tax. Interesting thing about this graph is that the percent of personal income that is corporate taxes remain -- is actually fairly similar now that it was in

1965, which is between .6 percent and -- around .7 percent. It increased during the 1970s and 1980s, and it's since dropped down a little bit. But interestingly enough, it's ended up at about the same point as it was in the 1960s.

Okay. This just -- this slide just goes over the corporate franchise tax, how it works, and I'm going to skip this slide right now.

This is another slide that basically talks about how it works.

Apportionment, that's an important component of the corporate tax. There's been a lot of interest in how income should be apportioned.

One thing to keep in mind, at least initially, when it was set up, that it was a mechanism to attribute income to the point where it was earned, where that income was created, so -- and that's where the three-factor formula, in a sense, came from, where that income was created. So just one thing to keep in mind when we go through this further on, in the future.

So California, by the way, right now has a double-weighted sales-apportionment formula, so if you have opportunity later on to go through these examples, it's -- basically what it does, it uses sales, property and payroll as the factors, but then it double-weighs.

It gives a double weight to sales relative to the other factors.

There has been interest in moving to a higher sales-weighted formula. Keep in mind a couple of -- a couple of items on that. One is, there aren't many winners and losers when you move to that higher sales-factored formula. There are quite large employers in California that would actually wind up to be losers from a shift to a higher weighting of sales.

Also, back to that principle, the apportionment formula is designed to allocate value to where it's created. And it's difficult -- it's difficult to -- on economic grounds, to justify that all the value is created at the point of sale as it would be in the case of a single-weighted sales or single-factor sales formula.

MR. BOSKIN: Phil, as I understand it, there are many other states that are moving in this direction.

MR. SPILBERG: Yes, they are. Yes, they are.

MR. BOSKIN: We're still heavily taxing employment and plant in California.

MR. SPILBERG: Yes. I have -- on this chart I show that ten states use a three-factor formula, 20 states use a formula similar to California, and 13 states now use a single-factor sales formula. And the trend is to a single-factor sales formula, because it helps California net exporters.

MR. BARRALES: Phil, you say that it would penalize some large employers?

MR. SPILBERG: Well, yeah, to the extent that you are basically a net importer in California, you may still have a large labor presence in California. And to the extent that you went to a formula which had a higher weight on sales, if you're a net importer, you would pay more tax.

MR. BARRALES: Mm-hmm.

MR. POMP: We should add, if we're going to look to empirical evidence rather than theology, there's really no evidence moving to a single factor increases economic activity in the state. You can look at the Center on Budget and Priorities to see the latest study on that, but interesting the states are moving in that direction.

MR. BOSKIN: I guess then that would create a new environment, so it's unclear what would actually happen.

MR. EDLEY: But to the extent everybody's doing it, there's even less reason to think that it would help us competitively; right?

MR. BOSKIN: No. Exactly the opposite.

MR. EDLEY: Oh, I see. Because everybody else is --

MR. BOSKIN: Our exporting businesses are even less competitive relative to other states, because other states are taxing their exporting businesses less than we are.

UNIDENTIFIED SPEAKER: Is there a rabbi in the house?

MR. POMP: No, but there's tax lawyers. It's a tax lawyer's dream is the ability to manipulate, so . . .

CHAIR PARSKY: Phil, proceed ahead. Proceed ahead.

MR. SPILBERG: All right. One important aspect of the corporate franchise tax is the increase in the use of credits within the corporate tax. This chart shows the large increase in credits that we've had since the late 1980s.

What we have, just for the R&D credit, the research and development credit, it has gone up from $39 million to $1.2 billion in 2006. That's the credits that have been actually applied.

In addition to that, corporations have a stock of unused R&D credits of over $5 billion.

MR. POMP: Is there a risk-cost benefit

analysis with respect to these credits?

MR. SPILBERG: If that's been done, I'm not aware of one.

MR. POMP: So all this money and there's -- no one's asking the question what you're getting in return?

MR. SPILBERG: Well, I wouldn't go that far. I'm sure people are asking, but . . .

MR. POMP: I'm asking. There's at least one person. But no answer to the question.

MR. BOSKIN: Is our R&D tax credit designed similarly to the federal R&D tax credit, which is basically giving you an incentive for expanding rather than just --

MR. SPILBERG: It uses the same -- it generally is very similar to the federal credit.

There are some important differences. One difference is, it only covers -- it covers R&D in California. Another is that there was some changes that were made to the R&D credit at the federal level, including the use of the -- of a base year, how the base year is calculated, that we have not conformed to.

MR. POMP: But the question is whether it has induced that expansion.

MR. BOSKIN: Yeah. I agree with that. I'm just saying if you have something that's focused on increment, at least it doesn't waste the money on the intra-marginal stuff that would have occurred anyway. You can argue whether the expansion is --

MR. POMP: The increment might have occurred anyway, so . . .

MR. BOSKIN: Okay. Well, but in any event, it's at least targeted to increment. So the better chance of being worth something than somebody that's giving you the first dollar you would have spent anyway.

MR. POMP: You have the same zero chance.

MR. SPILBERG: Mr. Commissioner, it depends on the base year, also, of course. I mean, that's very important to the calculation. It's not a year-to-year change. It's a comparison to a base year.

MR. KEELEY: Mr. Chairman, if I might?

Mr. Spilberg, we -- as you know, later in our meeting today we will be going over the tax expenditure report for 2008-2009. And I do think that that's -- because it's on point on this, that how we actually measure and evaluate the effectiveness of tax expenditures, tax credits and so on in the state, shall we say, charitably, is uneven in terms of how we -- the ability we have to measure those.

And when we get there, I think it will be a good exercise for the Commission to look at those, because oftentimes the legislature and the Governor will enact a, through statute, a tax expenditure, because there have been folks who claim that unless that happens we're going to lose all our No. 2 pencil manufacturers in the state and they'll go to Arizona and so on. So a tax credit or exemption or expenditure is created in the law.

There is not -- in my understanding of it, anyway, there is not a corresponding obligation for the state to measure that -- the effect of that, once that privilege has been granted.

And secondly, there's not, as a matter of state policy, either in statute or anywhere else, a requirement not only for reporting that and trying to evaluate that, but no uniform requirement for sunsetting, which would give policymakers the opportunity to review whether or not the No. 2 pencil manufacturers that stayed or gone or whatever it might be.

Thank you, Mr. Chairman.

CHAIR PARSKY: I think, Phil, if you could move to the options on the corporate tax, and then I'd like you to get through the property tax discussion and then we'll break for lunch and I'll make some comments.

MR. SPILBERG: Yes. The options that have been considered, that have been -- that have been mentioned include revising the apportionment formula. There is a chart that I just -- that I just bypassed that shows that there has been a large increase in the pass-through entities that have limited liability in California. And -- but -- and these pass-through entities are taxed in different ways. They're not uniform tax law with respect to those pass-through entities, so there's been talk about making that -- making those rules uniform across pass-through entities.

And the last one over here is, again, like I did in the personal income tax, going to a value-added tax.

Okay. The property tax -- this is sort of interesting. This -- before Prop 13, the portion of property tax from personal income, that ratio was 5 percent, which is higher than any tax that I have previously looked at, including the personal income tax. So that probably is one of the reasons that Prop 13 was as popular as it was. Since that time, it's --

MR. BOSKIN: Can I just interrupt for one second? Do you have any data going back before 1975? Of course, you've got this now in the high inflation years, which is part of how the tax got so high.

MR. SPILBERG: I'm sure I have it before.

MR. BOSKIN: That would be helpful to know.

MR. EDLEY: That would be interesting, yes. What's the long-term --

MR. BOSKIN: In the '50s and early '60s it was lower.

MR. SPILBERG: I'm sure I can extend this chart.

MR. BOSKIN: I'm sure it wasn't as low as 2.5, but I doubt it was anywhere near 5.

MR. SPILBERG: Okay. So since that time it's been sort of in the range of 2 percent to 2½ percent or 2.6 percent.

MR. COGAN: It's grown at the same rate as personal income tax, personal and property tax.

MR. SPILBERG: Yes. Yes. Isn't that interesting?

Okay. The next two charts are basically a discussion of how the property tax works.

MR. BOSKIN: Actually, risen as a share of personal income.

MR. SPILBERG: Right.

MR. BOSKIN: Risen as a percentage of personal income since Prop 13.

MR. SPILBERG: The next two charts just

describe how the property tax works, and I'm going to bypass those.

And so moving to the chart that has the bar chart in it, and it just shows basically the source -- the sources of the property tax, which is -- 38 percent is homeowners, and you have the other categories that the property tax is composed of.

The type of proposals that have been -- proposals and options that have been discussed are split roll, where a business property would be taxed differently than homeowners, and modify reassessment rules for changes in ownership, especially for business property.

And in Prop 13, the maximum assessment increase from one year to the next is 2 percent, and that increase, that maximum has been considered.

MR. DE LA ROSA: Mr. Chairman, can I make one comment here? One observation I would make about property taxes is, it is -- it does represent one of the least volatile sources of income for all levels of government, because in almost every case except for the newest communities, assessed valuations are far lower than market valuations, or have been until recent years, so even when there are significant declines in market valuations, property tax revenues to governments remain stable.

MR. SPILBERG: Okay. Yeah.

Okay. Well, this is my next-to-last slide. My last slide is a cartoon. I don't know if it has made sense or not.

CHAIR PARSKY: Well, we will ultimately try to make sense out of it. Thank you very much for giving us that.

(Applause.)

CHAIR PARSKY: What I'd like to suggest is that -- and I apologize for making everyone work through our break that was on the agenda. I'll try not to do that this afternoon, in the future.

We have -- we had another presentation of 45 minutes and -- on the perspectives of California revenue structure and a second presentation on the same subject. We're going to try -- my suggestion is we try to combine that -- those, one after the other, right after lunch, but we'll need to shorten them. They were each going to be about 45 minutes. We'll have to work with our speakers to shorten each of those, to try to get it covered within approximately the break that we had identified this afternoon, and then we'll try to get back on our schedule so we can adjourn at or before 4:00. So with that, let's take a break for lunch.

Thank you all very much.

MR. BOSKIN: Gerry, maybe you should define the lunch break.

CHAIR PARSKY: Oh, I'm sorry. One hour. We'll be back by 1:30. Oh, you'd like 45 minutes? Is 45 minutes -- is that all right with our technical people? Okay. 45 minutes.

(Lunch recess taken, 12:32 to 1:21 p.m.)

CHAIR PARSKY: If we could have everyone please take their seats, we're going to try to get started.

What I'm going to suggest for us, we're going to take about 10 or 15 minutes on a subject that I hope does not create two hours, but I just want to have Phil -- Phil's not going to be available at our next meeting because he has to be in India, but I would like him to talk very briefly about the concept of neutrality, tax neutrality, just so people can kind of have a framework, and then let's take that away and think about it -- or revenue neutrality, not tax neutrality. Sorry. Should have said revenue neutrality.

And then I'd like to have Mac and Jed combined to give a presentation on perspectives on California revenue structure. We'll hold questions for them until they both finish, and we'll try to get through this and get back on our agenda.

So Phil, I know you had intended to cover this a little bit, but the concept of revenue neutrality, why don't you lay that out a little bit and then we'll move on?

MR. SPILBERG: Okay. Well, revenue neutrality -- well, one way of thinking about revenue neutrality is that revenue -- that there is basically a historical trend, and to stay on that historical trend with respect to -- so basically follow into the future what was -- what's in the historical period would be revenue-neutral, and so -- we're trying to find a presentation.

CHAIR PARSKY: Okay. I know you have a couple of charts.

MR. SPILBERG: It's not this one. It's -- it's not this one at all.

Okay. So there's a couple of charts that I had put together, and basically what I had done, in order to start this discussion, is that I ran the regression equation, which is a way of basically creating a relationship between what variable you are interested in, and which in this case is revenues, and a predictor of revenues, which, what I had used was personal income.

And it turned out to be a very close fit if you use a relationship where basically you're looking at percent changes. It's a log normal formula that I use.

The way that the log normal is used is that the coefficient of that equation is basically -- you can think of it as a percent change; that is, if you have a coefficient of one, then the percent change in your -- your independent variable, which in this case is personal income, predicts a 10 percent increase in revenues.

And that's basically what I had found when I had run this regression equation, and it turned out that basically personal -- when you looked at revenue as a fraction of personal income, it turned out to be approximately 6 percent. 6 percent of personal income, general fund revenue, very predictable, around 6 percent of personal income.

Now, of course, there is a fluctuation around that 6 percent. During -- during boom times, revenues were a higher percentage of personal income, and during recession, they were below that 6 percent of personal income.

CHAIR PARSKY: Phil, is there any chance that it's in that machine or not in that . . .

MR. SPILBERG: It would be in a different file.

MS. WALKER: It's not on there.

MR. SPILBERG: Oh, it's not on there. Do we have the paper? Do we have those?

CHAIR PARSKY: Let's see if we can't get --

MS. WALKER: In the very front of your binder. The very front.

MR. SPILBERG: It looks something like this.

Okay. So the first chart was basically the regression equation, and the line in purple was what was predicted for revenues. The green line is what actually occurred during that time period.

The orange line just shows you what -- where we are actually coming up into the forecast period, which, because of the downturn in the economy, we are below the trend line.

The second chart basically takes the first -- the first page and divides by personal income. And that's where I'm getting that 6 percent, roughly 6 percent of your revenues are roughly 6 percent of personal income.

And where we are right now in the forecast period is on that orange line. We're below 6 percent.

But one way of thinking about revenue neutrality is staying on -- basically, staying on this purple line. That has been the historical trend. And just following that historical trend, one would sort of think would -- that once we get out of this recession, we're going to have revenues which are going to be greater than that 6 percent. And basically this regression sort of suggests that we'll get back to the 6 percent historical trend.

CHAIR PARSKY: So, again, this is not for anything definitive at this point, but as you think about this concept -- this is the thing I hope that all the Commissioners will think about. As you think about this concept, if we decided that we wanted to make recommendations for changes in the tax system, but we wanted to achieve some revenue neutrality, you can't be exactly precise, one way to look at that would be to take a look at a line like this, this trend line, and say, "Well, we want to measure the recommendations and what it would produce against this trend line."

Now, that wouldn't result necessarily in the high point of revenue generation, but it also wouldn't result in the low point of revenue generation, so that if it was applied to the -- to the high point year, it would result in a lower amount of revenues, and if it was applied currently, it would be a higher point of revenue. Therefore, some people might interpret that as a tax increase or others might view it as a tax decrease.

So again, rather than get into an overall discussion of whether or not revenue neutrality is right or is wrong, I just think it's important to kind of take a look at it definitionally so we can see whether or not we can come together on a common approach. That's the main purpose here.

MR. EDLEY: Let me make three quick points. One is that I think that -- I'm still interested in knowing, if you know, Phil, or if anybody knows, or if we have a lawyer on the staff, which -- got to have a lawyer on the staff, at least one -- so -- but then you'd need somebody for the other side.

CHAIR PARSKY: Yeah. You've got to have two lawyers.

MR. EDLEY: No, but seriously, so this makes perfect sense to me, but I'm also very curious about what the concept of revenue neutrality means or revenue increases means in terms of the legislative process. And so there's kind of a political, slash, policy sense of revenue neutrality, but then there's also the technical legal sense of revenue neutrality. I just want to know. So that's one thing.

The second thing is, this is great in terms of a looking back, but it's -- do we have the -- do we have the capacity to actually model this prospectively if indeed we change the composition of the -- of the base and the rates? Do you see what I'm saying? Do you have a micro model? Do you have a micro simulation model like the feds have or something, so that we -- does that make any sense?

MR. TAYLOR: Yes, I think we do.

MR. EDLEY: And does that include looking not just at the personal income side, but tax burden, tax revenues as a whole, so that we could also model it with respect to shifting the revenue mix?

MR. POMP: Well, I think it's important to see that what is at least shown on this chart is general fund major revenues in relationship to -- as a percent of personal income so that you stay with the top part first. You ought to be able, if the Commissioners said, "Well, can we achieve this trend line if we make the following changes in the tax system going forward?" you ought to be able to give some indication as to whether that could be achieved; right?

MR. TAYLOR: I think so.

MR. POMP: Well, doesn't it depend on change? I mean, you may not have any data whatsoever for, let's say, a consumption tax. I mean, if it's -- if we eliminate this and you know how much that is and who takes it, that's relatively straightforward, but something you have really no data on?

MR. TAYLOR: It's certainly something you would add. That would be more difficult, whether it was Mr. Keeley's, you know, carbon tax or a new consumption tax that was very different, or a VAT tax. That would be more difficult.

MR. POMP: That would be.

MR. COGAN: But you would give the same information to the legislature as you would to us; right?

MR. TAYLOR: Oh, of course.

MR. COGAN: And any proposal that we model could turn into a legislation model exactly the same way as in some areas that you would --

MR. EDLEY: That's correct. So you can make stuff up. That's good.

CHAIR PARSKY: Well, without degradating the legislative process, that happens at times, with all due respect.

MR. KEELEY: That was done with all due respect.

CHAIR PARSKY: Okay. Well, again, I didn't want the Commissioners to leave the meeting without being able to think about what this concept may mean and take it out of the -- out of the idea that we're really talking about whether we raise taxes or lower taxes, to see it in the context of this kind of concept, then that we can come back and try to apply it. Okay.

Phil, thank you very much for all that you did in preparation for this meeting.

Okay. Let's now see if we can get back on schedule, and Mac and Jed will go through their presentation a little bit more rapidly than they might have intended. Let's hold questions for both of them until after they have both finished.

MR. TAYLOR: I'd be happy to start. I'm Mac Taylor. I'm a legislative analyst. And if I could just start off by answering Mr. Ebley's question?

Legislative counsel, the body's lawyers, are responsible for tagging bills as to whether they are a tax increase. And I believe the rule they use is that there has to be a net increase -- no net increase not only in the first year but in the next three to five years, no net increase in tax revenues resulting from the passage of a bill.

MR. EBLEY: Is that a year by year --

MR. TAYLOR: Yes.

MR. EBLEY: -- or over the window?

MR. TAYLOR: Well, each year over that window.

MR. BOSKIN: And it's for the whole bill.

MR. TAYLOR: For the whole bill.

MR. BOSKIN: So if we were revenue neutral, what they were forecasting or whatever they were doing, that would satisfy the criteria?

MR. TAYLOR: This is my understanding.

MR. BOSKIN: Then we might be raising some taxes and lowering others.

MR. TAYLOR: That's correct.

MR. EDLEY: And is it revenue to the general fund or is it -- in other words, if there's a -- if there's a switch between -- on property tax flows versus --

MR. TAYLOR: Well, again, it would be state tax revenues which would include, I think, special fund taxes. Mr. Keeley and Mr. Pringle, they may recall differently. They were probably even more closely involved with certain bills being tagged than we were.

MR. EDLEY: Thank you.

MR. TAYLOR: I can be very quick because much of what I was going to cover you've already touched on, so I really will want to focus on a couple of things. But let me go through quickly.

In determining what your problems are, I guess you first have to operate over what you think a good tax system is. And Phil did put up some things, and I think a lot of economists would agree, are -- they're fairly general, but certain criteria. And there's a reliability aspect that you have monies that are there to support your governmental services on a year-to-year basis. There's some growth. We can argue over how much is appropriate and necessary, and that there is some notion of stability, that because your expenditures tend there be there every year that you need that.

Economists tend to like broad-based taxes because it shares the burden. It doesn't pinpoint certain activity or certain businesses. They don't like distortions. All taxes will distort. Except if you talk with an economist long enough, I guarantee you they'll bring up a head tax, because the only way that you can get away from a head tax is if you kill yourself or leave the country. So they like things that don't distort personal behavior. So they love to just charge everybody a thousand or two thousand dollars each, because there's no distortion.

Equity considerations. And by this I don't mean some general sense of fairness but more horizontal and vertical equity that had been mentioned earlier. People in similar situations should be taxed similarly. People who have more ability to pay or achieve more benefits from governmental services, you know, there should be some relationship there, so that that's what's meant by vertical equity.

And then administrative feasibility I think is an important one, too. It shouldn't be too hard. People should have some trust and confidence. There shouldn't be too invasive, intrusive a tax-collection system so people have confidence in it.

So, you know, how do we gauge -- and again, this is -- it gets very subjective, but I would say we have a couple of very important positive aspects to our system.

First of all, it is very robust. And the numbers that Phil just gave you were in line with what we had. Personal income and revenues have tended to grow over the long run. If you did a long-run elasticity, for you economists on the Commission, it's about one. It's pretty much unitary. And so over the long time this government revenues, state general fund government revenues tend to grow with the economy.

Now, whether that's adequate enough in your view, that's another thing, but, you know, that's a pretty good revenue structure. And we'll get into some problems, though, with shorter run elasticities.

And we have very broad-based taxes. We tax income, both corporate and personal. And economists again can argue whether you need a corporate tax. But we do tax income. We tax consumption in our sales tax, even though it's not all consumption. And even though the property tax is not a state tax, it is a local tax that stays within each county, we do benefit from a portion of that, over a third, by it offsets some of our school expenditures. But that is a wealth tax and that is another broad-based gauge of ability to pay.

So I think we merit actually very highly on certain key attributes of a good tax system.

Now, what are the negatives? Well, I think you've already raised in your questions or in Phil's presentation, we do have a lot of volatility, as you'll see. It's not only high, but it's gotten considerably worse in the last 15 years. We have very high marginal rates that Mr. Boskin had mentioned. And then we have the challenges to the tax base, that even though they're broad, because of exceptions, exemptions of the tax expenditure issue, they're not as broad as they could be on sales taxes we have, the service issues that have been talked about, the Internet and other remote sales that have been talked about. Tax expenditures eats into your base.

Tax gap, which I'm not going to be talking about a lot, but tax gap is just what people owe that we don't collect, either because it's underreported, people don't file, underreporting income, overreporting deductions, et cetera.

And we have made a lot of efforts in recent years as a way to -- without a two-thirds vote, because you can increase your compliance efforts, since that's not increasing a tax liability but only helping you collect an existing tax, and -- but I think that's appropriate. I think tax gap compliance is really important for all -- everybody else, the 95 percent of people who pay their taxes, that they have confidence that everybody's bearing their fair share.

Again, this is just a simpler chart showing you the capital gains and the fluctuations. And you can see that after going along at about $20 billion in net capital gains, we peaked at six times that level at the beginning of the decade, we dove down, we went back up in the '5-6 period. In both of those periods we did not do well in managing our new added resources.

And if you had put -- if we had put stock option income on top of that, it tracks this chart very well, also, so that I think it was almost $160 billion in the two combined, that we had gone from roughly 20 to 160 billion in a relatively short-term period. We do not cope with that well at all.

This is a chart we actually put in as a part of a report we did back in 2005 on revenue volatility. And these are really the short-term elasticity I was talking about. And it just reinforces what you've already been told.

But if you look at the first column, in the '80s, our overall relationship in the short run of revenues to personal income was pretty close. And what that meant was, as revenue forecasters, if you could forecast the economy, you could basically forecast revenues, because there wasn't a lot of variability.

Then look what happens in the '90s and the early part of the 2000s, especially on PIT. What that means is that for every 1 percent change, either plus or minus, you could have as much as six times the change in your personal income tax revenue. And what that meant is you could hit the economy exactly right on what personal income, jobs, employment, everything was going to do, and you could still be way off on your revenue estimates, and as we, finance and everyone else was.

Okay. So what did that mean on the budget? Well, as we were going along in the 1990s, we --

MR. BOSKIN: Can I quickly just say this exactly coincides -- you mentioned stock options -- the general movement to variable pay. It started in the early '90s. Besides the one you just mentioned, it's a huge increase in the fraction of pay that's variable.

MR. TAYLOR: So what happened is these -- that chart, as you were going up from 20 to 140 billion in capital gains, each of those years, we didn't know what was permanent and what was one time, because it kept going up. So at some point it stops looking like, you know, you've got this money for good.

And so even when we were advising legislature, it's kind of of like, well, we're not sure, so be cautious. You know, at that time, either spend them on one-time things or sock it away in a reserve.

We didn't do a very good job of that. And as it turns out, at least in the short run, it turned out not to be ongoing. We had made commitments in ongoing spending. We had made some one-time expenditures, which is better than ongoing, but it still means that you didn't sock away any reserve that you could use to balance out that 6 percent line that Phil just showed you.

Because, again, if you like your revenue structure, and as Mr. Pringle suggests, you're willing to live with the volatility, it means you've got to sock everything above the line so that you can then maintain the spending when you're below the line. As a result, we had some huge operating deficits.

Now, I don't want to suggest -- we -- we never really solved our operating problem from the 2000s. We borrowed our way out of it. We used one-time solutions. We never really got out of it altogether.

The problem we're in right now is due both to never having addressed that initial operating surplus, plus, obviously, we've had a precipitous and rapid decline in the economy that probably swamps our inability to have solved that operating deficit resulting from these one-time capital gains revenues.

Okay. So we get to the point of how do you want to address volatility. And Mr. Pringle nearly sort of stole some of my thunder, because what we said in the report is we think you should look first at managing it through your budget.

And clearly, if the volatility is not too great, we think you can do a lot of that by having better reserve requirements, of socking the money away, spending it on one-time things. And we have taken steps that go down that road.

The voters passed Proposition 58, which, in good times, takes 3 percent off the top, to go -- to put into a reserve. Now, that's 3 percent. That's not necessarily enough when you have really big increases.

So what now the voters -- the legislature has put on the next ballot would be to beef that up, to try to build up to a 12½ percent reserve and make it more difficult to take monies out of the reserve except to get back up to that kind of spending line that Phil showed you.

That strengthens our reserve requirements. It still, in many people's view, is not adequate enough to address the volatility. And I might have to agree with them. But we would first say, try to do as much as you can through managing it budgetarily.

Let me just ask you a question. If I was your employer and was going to pay you over the next ten years and I offered you two plans: I was either going to pay you 6 percent on average a year, but I wasn't going to guarantee how much you'd get in any one year, or I was going to give you perfect stability. I was going to give you 1 percent each year growth. Well, which plan would you pick?

Well, I think most people would pick the former. We'd want the income and we'd be willing to deal with the volatility because we'd have more income.

And I think that's what you have to think about as we talk about alternatives to managing volatility.

As Phil and others have said, you give up something. You either give up the robustness of your revenue structure or you give up, in some cases, progressivity, which is not necessarily good or bad, it just is. And so you have to realize what the tradeoffs are in just saying we wanted to reduce the level of our volatility.

As you can see, you can do other things, even from managing it from a budgetary perspective. And one thing that's being talked about in Sacramento right now by some of the caucuses would like to see a spending cap. And that's one way. It's inflexible, in my view, but it is one way of ensuring that you never spend above the line that Phil showed you. You could have it based on personal income. You never spend above that. Revenue's coming above, you put it aside in your reserve, and that evens out in the good years.

People have, though, talked about, if you don't think you can do it all through the budget side, okay, what do you do with your revenue structure? I'm not going to go over all of these, because they've been talked about.

You can reduce your PIT rates on capital gains. You can do it like the feds do, give preferential rates. We modeled that if you cut our capital gains rates in half, you might be able to do away with as much as 25 percent of the volatility you've experienced in the '90s.

You can reduce the progressivity of the rate structure. With fewer rates, flat tax, whatever you want, you can -- so there are ways then that will reduce somewhat that volatility. You can rebalance the mix of your taxes, don't rely so heavily on PIT.

And then one thing we threw out, you could try to income-average on capital gains. I think this might be very complicated, make taxpayer compliance very difficult.

But it's kind of a smoothing effect that was mentioned earlier, that people could, just like we used to be able to income-average in this state, personal income tax payers. You'd maybe require people in their capital gains to do some averaging over a three-year period so that you would have fewer highs, fewer lows. I don't know how practical that is, but conceptually it seems to have some appeal.

Going to base-broadening problems, again, this is just a simpler chart of, I think, what Phil showed you on the services issue Mr. Keeley had raised some questions about, and you can see the kind of long-run secular decline from 50 percent; half of our, in effect, personal income was in taxable sales down to just above 30 percent.

On base-broadening issues with regard to the PIT, again, you've talked about tax expenditures issues. This pie is kind of interesting. This is if you taxed everything without any exemptions, and you were able to collect every single dollar of tax liability, you can see how much we've kind of taken off the table through tax expenditures or our inability to collect it.

Now, the tax expenditures again, we don't call those loopholes. These are legitimate things the legislature has decided that they don't want taxed. And just like direct expenditure programs, some are better than others, but they're conscious decisions to do certain things to promote certain types of activity or to subsidize certain people.

But you can see this is a tradeoff of, the broader the base is, the more that the piece on the left takes up of that total income tax base, the lower your rates could be, the more you could do to reduce the higher level of rates or to reduce some volatility.

This is just really Mr. Boskin's point he was making, that even though we have broad-based taxes in concept, we still have very high marginal rates, the highest PIT rate in the country. It also starts at a fairly low income level.

If we were to adopt the Governor's approach that he's put out for an additional 1½ cent sales tax increase, we would have the highest average sales tax rate in the country and we'd have one of the highest corporate tax rates in the country.

All right. So how do you address base-broadening? And this is really where I wanted to spend the most time on, because there's been a lot of discussion about, well, we need to extend the sales tax to services. And this is where Mr. Pomp and Mr. Keeley had an interesting exchange.

I think it's important to remember that this is a tax on -- a transactions tax on tangible products. It is not a tax on services. That doesn't mean we don't tax services, because much of the tangible products that we tax incorporate services within them.

If you buy a book, you're in effect paying $30 for a hardcover book, $28 essentially for the service that the writer put into it. We do tax services; we just don't tax all services. The tax is a tax on the final consumption of a tangible product.

So, Mr. Keeley, I would say it's not appropriate in that case to put services as a tax expenditure because they're not intended to be covered.

They're not part of the tax base.

And similarly, Mr. Pomp's point, well, why are we putting agricultural machinery on there? I would argue that economically I would probably agree with him, but from the tax base as defined, it is a tax expenditure, because we tax other machinery used by businesses in the production of goods, and farm machinery, we exempt it. So within the logic of that tax base, it is a tax expenditure, in my view, whereas, services are not.

Now, what people who are talking about expanding the base to services, it's a very legitimate issue for you to be looking at. And I think Mr. Pomp categorized it properly, that what I think people are talking about is moving away from a sales tax, a transactions tax, to a tax on all final consumption by individuals, by consumers, by households.

And in that kind of a world, you would not want to tax any business input. There's no need to tax it, because you will capture it when it's finally -- the price is finally paid by either the purchaser of the goods or the purchaser of the service. That is a true consumption tax.

Economists tend to like consumption taxes. It would do away with a lot of distortions of different treatment of how much of a service was taxed in a good or not. So it has a lot of positive attributes, in my view. It would result in a lower tax rate, which is also good.

But I think people need to go into this with their eyes wide open about what it means to have a consumption tax or what it means to extend services -- the taxation to services.

For instance, are you going to tax housing services? Well, I would suspect if you all thought about it for a while, you'd probably say, "Well, I'm not sure I want to do that one."

Do you want to tax medical services? Well, one of the -- one tangible sales tax services that is exempt by, I think, every single state is prescription medical bills. You're going to stick a sales tax on all the medical services we now do?

Are you going to tax school services and other services provided by government?

You have a lot of very tough choices. And what you have to be careful about is if -- even if you decide you want to go to a broad-based consumption tax, what are you going to have to -- or what is it going to be difficult to levy on people?

And the experience in other states, such as

Michigan, Florida, when you try to extend taxes to professional groups, for example, it has not been good.

So I think, again, you just need to have your eyes wide open on this. It seems like, gee, wouldn't that be easy? Just extend this tax to a few services. You're going down a road that may be very appropriate for you to go down. Have your eyes wide open on this one.

And then I'll very quickly -- you can broaden your base -- we've talked about this -- by, you can reduce tax expenditures, you can eliminate them.

We think that's a good thing. We've pushed for that. We've always said that the more you do in tax expenditures, the lower your overall rate can be.

And I think Phil showed you the sales tax ones, and the top three were food, utilities, and prescription medicines. All very difficult to tax.

And if you think those are tough, look at the top ones. The most expansive tax expenditure is the personal income tax area. Mortgage interest, pension and health plans, capital gains on principal -- I mean, these are all big-ticket items that can be very, very sensitive. So again, go into it with your eyes wide open. You know, I'm just throwing out . . .

As opposed to tackling each individual tax expenditure, what you could do is say, look, what we'd really like to do is have a simpler tax system with lower rates.

You could still have -- not involve federal conformity issue. You could start with adjusted gross income or gross income and just not allow hardly any adjustments below the line, the adjustments that you make to get to adjusted gross income, all the deductions -- the calculations you make on the back page of your 1040 which involve standard deductions, itemized deductions, credits, et cetera. You can have a very simple system with much lower rates. And I would definitely get rid of the alternative minimum tax, one of the more bizarre things, I think, that we do.

So in conclusion, a lot of people think we have -- kind of question our tax base. And I happen to think we have a pretty good tax system. And that doesn't mean that you shouldn't consider ways to improve it.

And I think the key things that you've spent time on already and I would spend time on are how you either reduce volatility or deal with volatility, as Mr. Pringle noted, and keeping those bases as broad as possible.

CHAIR PARSKY: Thank you very much.

Let's hold questions.

That was excellent.

Go ahead.

MR. KOLKO: Thank you very much. I'd just like to thank the whole Commission for the chance to let us be here today.

What I'd like to do is essentially get across one main point, and that is, tax policy is never just tax policy. It's economic policy. And the reason for this is that taxes almost inevitably change behavior. Often this is bad. Sometimes it's good. Always it is essential to understand.

And to echo Mac's theme of eyes wide open, I think this applies especially in keeping in mind the way that any tax change is likely to change behaviors of households, businesses, or others in the economy.

At the risk of doing what Mr. Edley cautioned against earlier today, I'm going to once again privilege the economic view, but I'm going to try to do it with a bit more breadth and try to cover a larger set of types of policy goals that the Commission might want to keep in mind that all really apply to the 21st Century economy.

To do this I'd like to very briefly talk in an abstract way about the goals of tax policy, much of which has already been discussed today, and then I'd like to apply the framework of thinking about how taxes change behavior to a set of actual taxes and discuss those in relation to a set of potential policy goals for California.

I won't be making any recommendations. All of these are simply for the sake of illustrating how to apply this framework and how it might be incorporated into discussions of what types of taxes to change as part of our revenue system.

Very briefly, again, many things potentially go into a good tax system. We've spoken a lot today already on volatility, somewhat on administrative simplicity or feasibility. I do like to focus for the next few minutes on the efficiency side.

And economists -- and I'm going to again break the rule of not referring to economists as an undifferentiated lump, because sometimes we are an undifferentiated lump -- tend to refer to efficiency in a couple of particular ways. And when it comes to taxes, economists refer to efficiency as minimizing or attempting to minimize distortions to free market outcomes.

Now, it may seem a little hard to believe, given some of the events of the past months and years, but most economists and lots and lots of noneconomists, when cornered, tend to agree that free market outcomes tend usually to be right in the sense that typically the right amount of goods are consumed, and free markets basically maximize the "well-offness" of people in society. Take that at least as a theoretical concept for a starting point.

An efficient tax, also referred to as neutral taxes, don't push us away from these free market outcomes. The ideal efficient tax wouldn't change what households buy, whether businesses hire, whether households save, where businesses locate, what -- and whether employees decide to work or not.

I'm going to spare you an example that might give you some unpleasant flashbacks to a first economics course, just get to the punch line, and that is that typically a tax, when it changes behavior, will change the quantity of something consumed in a market.

A tax on wine will almost certainly reduce the amount of wine bought and sold. Some mutually advantageous trades that would otherwise have happened in the absence of the tax don't.

This is what economists refer to as a distortion. And as we heard earlier today from Mr. Boskin, this distortion -- the magnitude of this distortion depends not linearly with the level of the tax rate but with the square of the tax rate, which is why you hear again and again the exhortation to focus on broadening the base and lowering the rate in order to minimize the distortion.

But importantly, the distortion of a tax also depends on the elasticity, which is to say, the sensitivity of behavior to that tax, how much households or businesses change their behavior with regard to that tax.

The narrow economic implication, if we're focusing only on the efficiency of the tax, is that one would want to focus on taxes that change behavior the least. So you'd want to tax either what or who is least responsive.

How do you decide then what behaviors are elastic? Again, more elastic means behaviors are more sensitive to price. Behaviors are more elastic the more possible it is for households or businesses or others to substitute their behaviors.

If it's possible to substitute a similar product for one that is taxed, your behavior changes more than if it's not possible. If it's possible to change your behaviors over time, choosing, for instance, to buy the flat-screen TV next year instead of this year, something that probably wouldn't be sort of a crisis or necessity decision for most households, the elasticity to that purchase with regard to the price change induced by a tax might be higher than something for which it's much harder to shift over time, like prescription medicines.

Importantly, when thinking about California or other states, the elasticity also depends on the ease of shipping over states. How easy is it for a company to move back-office functions to Nevada? The question for California is very different than it is for a much smaller state or for a city or county within a state.

The response also depends over time. I don't want to take the example that we experienced over the last year or so of gas prices. The short-run responses and the short-run elasticity of a behavior to a price can be very different from a long-run elasticity.

Let's take the example of gas prices. In the short run, if gas prices go way up, the way that people might respond would be to shift more to transit, to carpool, to telecommute.

In the medium run, over a longer time period, people will change their behaviors in other ways. And the distortion, if you will, of this tax potentially grows larger, if they switch to a more fuel-efficient car, if they move closer to work or other activities.

In the longer run, there may be broader changes that happen because of a tax. We might see denser construction of housing in response to where people want to live. We may see changes in industry-wide fuel efficiency based on what the industry sees households demanding.

Part of why I'm mentioning this is, it goes to the difficulty of looking empirically at what the effect of taxes on behaviors are likely to be. It's complicated in part by what time frame we're looking at. And you can see from this example how different the effect might be in the short run versus the medium run or the long run. So that's in part a justification as to why I'm keeping this for now at a very theoretical level.

It's come up several times already that there is potentially a tradeoff between efficiency, by which we mean minimizing distortions, and equity.

What I've described so far suggests that minimizing distortions in a tax system favors, first of all, taxing necessities more than luxuries, since people are less likely to change their consumption of necessities with respect to a change in price than they are luxuries.

Taxing immobile factors more -- in factors that are mobile, this is the theory that underlies the concept that, you know, one of the best taxes, at least theoretically, would be a tax on land, given that land isn't produced or destroyed, without setting aside questions like landfill, there's a fixed amount, and therefore, you can't distort behavior.

This is, again, the reason behind lump-sum taxes. As Mac mentioned, you can't change the number of people that you are. And this is ultimately the argument behind the broad base with low rates.

The challenge across almost all four of these is the lower distortion the taxes are, it tends to be more regressive. And sometimes it gets politicians in serious trouble. Just ask Margaret Thatcher after her poll tax in the '80s, which was an attempt to do something very close to a lump-sum tax that was maximally efficient but perceived to be quite inequitable.

So far, these are all explanations for why we would think of taxes that wouldn't change behavior, yet at the same time, we can think of reasons why taxes might have economic benefits that -- in other words, the way taxes change behavior might not be things that introduce distortions, it could be that there are some markets for which distortions exist inherently and taxes might be used to reduce those distortions.

The classic example that economists give tends to be around externalities, the most palpable being pollution. That is described in the textbooks.

There may also be markets which people have sort of imperfect information. This quickly gets to be a question of opinion or ideology rather than science as to how much imperfect information people actually have in terms of how dangerous cigarettes or alcohol is for you.

But some make arguments that we want to use taxes to correct what would otherwise be suboptimal market outcomes. These come up often in discussions around sin taxes, against cigarettes, alcohol, environmental taxes. And I'll return to questions of carbon or gas tax in a few slides.

And at the same time, it might be used to encourage other behaviors, such as subsidies for charitable giving.

When we think, though, about taxes that could encourage behaviors that could have economic benefits, there is, as always, a tradeoff. And that tradeoff is between revenue and changing behavior. You get more revenue from this sort of tax if behavior changes a little.

So if you are using a tax to change a behavior in what you think is a positive way, say, a tax on cigarettes, the more people change their behavior, the more you reduce cigarette consumption, the less revenue you get. The less people change their behavior, the more smokers you have, but the more revenue you get.

So as always, you know, there is this sort of tradeoff between different goals that you might have.

Now, states face a particular challenge in thinking about these tradeoffs between distortions, between equity, and efficiency. It's, of course, much easier to shift activities across state boundaries than country boundaries.

This is relevant more so for small states, much more so for smaller jurisdictions, but nonetheless still relevant for California. It's relevant for where households live, where they shop, where businesses locate. And it begs the question of who or what is most mobile across state lines?

And again, by the theory that you want to tax who or what is least responsive, who or what is least likely to change their behaviors, you might not want to tax those that are most mobile.

Who is most mobile? The rich more than the poor, many industries that produce tradable goods relative to those that produce nontradables. So that's a generalization for which there are lots of exceptions.

And you'd want to tax labor and capital rather than land. Again, this obviously bumps up against equity and distributional concerns. And that's a matter for the Commission to decide how to make those tradeoffs.

But it's essential to understand what will respond to a tax and what are the factors -- again, who or what -- that are likely to be more or less mobile.

The main points so far before getting into some specific taxes and some specific goals are, first, taxes discourage a taxed behavior, unless it's a tax on land or it's a lump-sum tax. Tax systems should, in general, be efficient in the sense of minimizing distortion, but there is this tradeoff between equity and efficiency, and there are times in some markets when taxes correct rather than introduce distortions.

So now I'd like to turn to the second part, which is looking specifically at a set of taxes as well as a set of policy goals.

My choice is somewhat arbitrary in terms of which taxes to look at and which goals to mention. Again, not to recommend that these are the important goals or these are the most important taxes, but rather to illustrate this framework of thinking about how taxes change behavior and provide examples of how to work through this.

So the taxes I'd like to step through very briefly, first there are going to be three that are obviously important in the discussion so far: The personal income tax, the sales and use tax, and the corporation tax. Then three that have gotten a little bit less play so far today but are quite useful in illustrating how taxes change behaviors in ways that could be relevant to California policy goals, and that's going to be the vehicle license fee, carbon or gas tax, and the mortgage interest deduction.

I've mentioned several times California policy goals in this sort of broad, fuzzy way. What I mean by that is the following: First of all -- and this will always be not far from the background -- minimizing economic distortions, as we've described. But there are three other goals.

And again, I'm not recommending that these be your goals or these are my goals, but these have been prominent in recent political and economic discussions in the state.

These three goals are, first, economic

stimulus, second, improving the business climate, and third, lowering carbon emissions.

What I'd like to do is step through now those six types of taxes and describe through illustration how each of these affect whether they contribute -- they change behaviors in ways that either contribute to or detract from some or more of these policy goals.

So first, the personal income tax. As we've talked about already, it is, relative to what it could be, fairly broad-based. It is a disincentive to work and to save, especially relative to a consumption tax.

Now, economists generally feel in the long run there are serious costs imposed by creating disincentives to saving. But if you are very focused on economic stimulus, and depending on how long you think this recession lasts, then focusing on economic stimulus might not be that short-term a policy goal.

It may be less important to worry about a disincentive to save in a recession than it might be at other times. Although we heard very recently how many of our policies discourage saving, and that is generally a bad thing in the long run, so much of the discussion around economic stimulus is trying to think of policies that encourage consumption and steering, whether it's tax rebates or other spending, where people or activities are likely to spend. So depending on the Commission's goals, it's a consideration thinking about these different taxes.

In thinking about progressivity, the effect of the income tax on spending also varies. Economists use the term the margin of propensity to consume. When people have an additional dollar through not having to pay a tax or through a tax rebate, they -- some are more likely to spend a large share of that dollar than others.

Again, if the goal is economic stimulus and getting people to spend, you might think in terms of changing the rates in the personal income tax in such a way that gives more money to those who are more likely to spend.

Again, it depends on how heavily you weigh economic stimulus. I'm not saying you should or you shouldn't. I'm just illustrating ways taxes change behavior that could relate to other policy goals.

Moving on to the sales and use tax. Again, moderately broad-based. Lots of discussion already about how services are excluded.

Taxing sales, of course, discourages new purchases. Lowering the sales tax is a fairly direct example of a way that changing the tax structure would change behavior in a way that would encourage economic stimulus. Higher sales taxes, of course, would encourage taxes or a consumption tax more generally.

And again, it's a question of how you want to balance the short-term needs for economic stimulus and long-term needs for more permanent growth on how you'd want to weigh the incentive or disincentive effects of saving or consuming.

There's been discussion as well about temporary versus permanent changes. Some of the proposals at the state level have focused on temporary changes.

It's believed that temporary changes in the sales tax in particular could shift purchases over time. And it's been a strategy of some other states to introduce temporary sales tax holidays to provide a boost of economic stimulus.

It's unlikely that Vermont's weekend-long sales tax holiday had much of an effect on their economy earlier this summer. But it's still important to think about how this could change behaviors in ways that align or detract from other goals.

Now, corporation tax, I want to say a few things. And again, this is a very selective point of view. There are lots of considerations of all of these taxes I'm not mentioning at all.

But one of the questions around the corporation tax that's kind of come up many times is how responsive, in fact, are businesses to changes in or differences in levels in the corporation tax or other taxes where the incidence falls in whole or in part on businesses.

So this is an area where we at PPIC have looked at in detail in a report on how often it is that businesses actually relocate, and if so, to what places and to what degree.

And our main finding is that businesses almost never relocate across state lines. Even though this has been a very important part of the political dialogue for many years, the fact is that almost no businesses move across state lines in either direction. And the net effect of relocation on employment in California is ever so slightly negative as to be imperceptible.

And so it raises the question of, you know, whether businesses are actually moving across state lines in response to these differences.

Now, of course, there are lots of other business decisions that are made aside from relocation, which is why it's essential to look at the range of sources of job change.

Do we see businesses in California expanding more into other states, even if they're not actually moving jobs there? Do we see the rate of new business formation to be different in California than in other states because of these tax differences?

The punch line, when we look much more broadly, is that despite California's very unfavorable ranking on almost every business climate index that is published -- and these business climate indices focus very heavily on differences across states in marginal tax rates as well as regulatory burdens and other fiscal policy structures. Despite California's very, very low ranking across the board, California's economic performance, as measured by overall job growth over a long period of time, tends to keep up with or exceed the National average. There's clearly a disconnect here between pretty objective measures of what's California's business climate and what California's actual economic performance is.

I mention all this simply to beg the question of what effect the corporation tax or other taxes on businesses have on business location decisions. It is largely unknown. We at PPIC are doing some work, starting some work, not done by April -- sorry -- to get at this question.

Some initial evidence suggests that most of the business relocation that we do see tends to be overwhelmingly within California. It even tends to be within metro areas, which suggests that when businesses actually move, it is not for the sake of a different tax structure or even a different labor market. It tends to be in search of cheaper land.

And given what the relative burden is on a business of land, labor, and taxes, it makes sense if the answer to the story is that there are differences across states that matter much more than tax differences do in determining where businesses locate.

This doesn't mean that taxes are irrelevant. Some businesses are mobile. Some are much more mobile than others. Some activities are more mobile than others.

I'd mention all of this only to say that it's still a very open question as to how mobile, in fact, businesses are and what the effect of changes in the corporation tax or other taxes whose incidence falls on businesses is on California's economic performance.

Moving then to the other three types of taxes that are a little farther afield in the sense that they've gotten less attention so far today, again, through the lens of how they change behaviors, first is the vehicle license fee.

The vehicle license fee, in the short run, probably introduces relatively little distortion, given that the tax falls primarily on past purchases.

Of course, every time someone purchases a new car, their burden with the vehicle license fee would change. But in the very short run, relatively few people, over a short period of time, are buying a new car. For most people it would be very little distortion.

In the longer run, of course, it could encourage people to purchase cheaper cars or to delay car purchases for a much longer time.

What does this mean in relation to environmental goals, for instance? Could work for or against. Hard to stay.

Large vehicles tend, on average, to be less fuel-efficient and more expensive, so a higher vehicle license fee could discourage purchase of these vehicles, yet at the same time it delays purchases of new cars. It could delay people from transitioning to a more fuel-efficient car.

The second example then, a carbon or gas tax. Given that pollution is the classic economic textbook example of a negative externality, you could argue that a carbon or gas tax is one of the clearest examples of a way in which a tax could change a behavior that corrects a free market distortion.

It could possibly, therefore, help meet both environmental and revenue goals at the same time. Yet, as with everything economists ever say, there are tradeoffs, there are potential down sides, two of which are, for instance, it could be that high energy using businesses on whom the burden of this tax would fall could be more mobile than other businesses. An empirical question, a very difficult one to get your hands around, but certainly a possibility.

Second, it is not broad-based. The tax falls very heavily on some industries or users, much less so on others, and could require a fairly high rate such that the distortion goes beyond what we might think the optimal outcome is.

So just because a free market outcome may itself be distorted because it takes into account an externality, one could certainly go too far trying to discourage a behavior so that you go beyond the optimal point into a distortion on the other side.

The last one I want to mention is the mortgage interest deduction. I'm actually going to lump together the capital gains exclusion, both of which are tax expenditures on the personal income tax side at the state and at the federal level.

One of the things that Phil earlier today didn't show us in detail was the tax expenditures on the personal income tax side. His chart, though, shows that these two, the mortgage interest deduction and the capital gains exclusion, I believe are the top -- I believe on his chart were the top two tax expenditures accounting for -- I think it was somewhere around $10 billion a year in California.

Now, there is a very open question as to whether the mortgage interest deduction and the capital gains exclusion introduces or corrects a distortion in a market.

There is a long-running debate onto whether home ownership in general is good for society or not. And there's an academic literature that there are some positive externalities of home ownership which ties very nicely to Larry Summers' comment that nobody ever washed a rental car. People clearly take better care of things that they own.

Yet at the same time it is possible that raising the rate of home ownership and possibly encourage raising the rate of home ownership have helped push us to a situation where there was essentially more demand than too much building in the housing market.

MR. HALVORSON: My wife washes rental cars.

She is one.

MR. KOLKO: I'll e-mail that to Larry.

CHAIR PARSKY: You didn't comment on linen rental.

MR. KOLKO: I actually had a list of three things not to say, and linen was one of them. Al Gore was the second one.

CHAIR PARSKY: You're taking good notes. Larry Summers could fit into that same category.

MR. KOLKO: I'll usually bring him up one way or the other.

So what could reducing the state mortgage interest deduction do? It could raise revenue while correcting a distortion. It could also reduce inequity in the sense that most of the benefits of the mortgage interest deduction approved to higher income taxpayers because it is a deduction, not a credit, and therefore tied to what the marginal tax rate is.

However, again, what's the tradeoff? This change would fall heavily on the construction industry. So in that sense it is not a broad-based change.

And a current concern certainly is that it could seriously slow down house price recovery in California. So this could be exactly the wrong time for a change like eliminating or reducing the mortgage interest deduction with a capital gains exclusion.

Again, I'm not recommending any of these six. I'm merely using them as illustrations to show how they change behavior and to point out that every revenue option can be assessed by what the likely extent of the economic distortion is, what the likely behavioral response is, and whether that behavioral change works for or against any of the broader policy goals the Commission chooses to take into account. Thanks.

CHAIR PARSKY: Well, thank you both very much. I think you both did an excellent job.

Questions and -- over the course of the next ten minutes or so?

MR. BOSKIN: Thank you both very much. I would just ask two questions with respect to your last point.

So if you -- leaving aside, you know, the unfortunate current situation, is your view that we should include capital gains from home ownership in the tax base? Would you also include capital losses, so people write off capital losses?

MR. KOLKO: That level of detail, this is not -- my expertise is not that level of detail, and to make a recommendation for how to make that as broadly as possible. I'm just trying to illustrate what the effect on the behavioral change would be and to throw more things into the mix.

MR. BOSKIN: Would it generically be a principle that we ought to be symmetric with respect to gains and losses with taxes?

MR. KOLKO: Generically, yes. It should be a principle. It should be symmetric.

MR. BOSKIN: We, for example, have very limited capital loss offsets, both federal and personal income taxes. We have millions of Californians with massive losses.

For example, if you want to take a really -- a real illustration, as some of you have done, we have Californians who got into, through no fault of their own, whether through age or when they finally got enough money to buy a home, bought homes, say, in 2005 or 2006; maybe they get transferred on their job to some other state and have to sell their house, lose a couple hundred thousand dollars, maybe are honorable and don't default, paying it off out of the rest of their life savings and may take the next 30 years to use the capital loss deduction.

So that's somewhere I think we could think about -- we should think about our policies, not just as if everything's always going to be going up. Our tax policies do that way too much.

And then I'd come back to both you and Mac, you both -- especially you did, Jed -- but you raise this issue about externality correcting taxes.

And our view is that there's a deviation between social and private marginal costs, pollution being a good example. And the basic idea has always been that if we charge a tax roughly equal to that difference, we would be doing something.

But we already have very high taxes on energy. It's the most heavily taxed commodity outside of, say, cigarettes.

And so at what point do taxes get too high on energy? At what point do they go beyond that and wind up being -- getting back to being a bad distortion? That's another issue we'll have to confront as well.

You can't just assume -- we're not starting from zero, and the distortion isn't infinite, so we have to figure out whether we're there already or a little bit low or a little above or way off, whatever. We have to figure that out to get into that game.

And that's going to be something that would be very hard for our Commission to do, I think, in addition to all of our other things. We might mention it as something that ought to be looked into later, but, you know, very hard for us to figure out how to assess that right now.

CHAIR PARSKY: Yes. Richard.

MR. POMP: You know, listening, it really reinforces something that I think we often know without articulating: It's just how complicated the world is and how little we actually know about it.

I mean, you can't -- not you personally, but, you know, economists can't tell us at the federal level, where the rates are much higher than in California, whether increasing the income tax will discourage me from working or encourage me to work, discourage me because I keep less of each dollar, and so I may be in a position of saying I won't go in the office on the weekend and take on that new client, I'd rather sail, I'd rather play golf.

But if I'm locked into a lifestyle where, you know, I'm really living from paycheck to paycheck, and if you take more out of my paycheck, I have only one real option, that is to work overtime, take a second job, to maintain my lifestyle.

So it's a very tricky empirical question. It's an important one, but we really don't know anything about it.

That's why I can't believe this distortion is equal to the square of the rate. I mean, you can't even tell me on this very basic question whether work is going to be encouraged or discouraged. So to -- I tell you, I've never heard this distortion is equal to the square of the rate. I have to -- that's just an honest answer. What kind of tax? What rate? What base?

So the lesson I draw from all of this is, we're engaged in decision-making in the light of uncertainty. And that's not unfamiliar to many of us. And so what do you do? You hedge.

And I think that's part of your lesson today is you don't put all your eggs in one basket. You sort of spread the risk, just the way I'm sure when Gerry manages a fund, you don't take -- you know, put all your funds into one particular sector. You hedge. You spread it around. You hope to smooth out -- you hope something's counter-cyclical and your portfolio will be stable.

And so the lesson I draw from listening is, boy, you really don't know enough to fine-tune the tax system. We don't even know whether the corporate income tax makes a difference on where businesses locate. There's robust literature that says it doesn't, and you seem to be consistent with that.

And so I am a big fan, if the lesson that I'm hearing is what I think it is, hedge, spread out the risk, low rates, broad base, don't try to get too fancy, and low rates bury all sins, you know. And I think you've just sort of reinforced that with things I had been thinking of.

Now, some random thoughts, which are the ones I mostly get at this age anyway.

You know, the perfect is the enemy of the good. You can't -- because you can't get it precisely right doesn't mean you don't get it pretty good.

And so if we were to think about extending a sales tax to services, maybe we wouldn't want to tax housing or medical, but that doesn't mean we shouldn't think about expanding the tax.

The Florida situation -- and for those of you that aren't familiar with this, Florida spent a lot of time thinking about a sales tax on services. And they actually put it into law and then they abandoned it. And the Achilles heel was because they disregarded a basic sort of principle of sales taxation: You're not supposed to tax business inputs. What do they do? They tax advertising.

Well, for one thing, you never take on an industry that buys newsprint by the barrel. That's a pretty big mistake. But when you start taxing business inputs, you get the pyramiding -- I mean, it's just wrong as a matter of principle.

So Florida did it wrong. It doesn't mean that if we were to do it right we should somehow worry because Florida didn't do it right.

This notion of business climate, you know, the two out of -- I think it's two out of four, but you know which two states have the best business climate in the country, based on what someone thought were objective factors? Alaska and Wyoming. And I don't see businesses flocking to either state, because we know there's more to it than just what some objective criteria would dictate for a good business climate.

And even things like head taxes, which economists claim have no distortions, they might affect my decision on how many kids to have. So even a head tax everyone holds out as a poster child of a tax having no distortion, that could have a distortion. Everything could have a distortion. And we can't let that really stop us. But we should minimize distortions by just keeping rates as low as we can.

And now with Michael's comments about symmetry, you know, if I buy a Prius, and it's a very hot car, at least where I live, and people who buy Priuses can sell them at a gain, believe it or not. That gain ought to be taxed under Hague Simes Bender, under any definition of income.

But if I drive that Prius and then sell it at a loss, there is no principle of income tax that says because of the symmetry I should take that loss. That loss is viewed as personal consumption. That loss was because of my using the car up. And that is personal consumption. That normally is not deductible in income tax. I can't deduct my clothes. I can't deduct my food. This is all part of personal consumption. So I think we have to be careful about rules that look like they should be symmetrical but aren't.

But that's why you sell a laptop, anything personal, at a loss. There is no loss given in the Internal Revenue Code, I'm sure not in California, either.

Anyway, thank you, Mr. Chairman.

CHAIR PARSKY: Thank you.

Fred?

MR. KEELEY: Thank you, Mr. Chairman.

Mr. Taylor, first of all, I don't think I said this enough while I was in the legislature so I'll say it now. The Legislative Analyst's Office I think is one of the great jewels in the public's possession. And the Leg. Analyst's Office, in my judgment, is, especially in the term-limited environment, an office that is seriously underappreciated by the legislature as a tool available to them to be another point of view and another source of information. The executive branch, as the Department of Finance and a number of other sources, the legislature has the Legislative Analyst's Office.

I want to thank you, your predecessor, Liz Hill, you now are in a position of what I think is a very long and very distinguished line of leaders at that Legislative Analyst's Office. Thank you for the fine work and thank you to your staff for the fine work as well.

Mr. Taylor, on the issue on page 8 of your presentation which goes to the issue of the state taking some actions because of the operating deficit issue. The operating deficit, I think it's worth our Commission taking a look at a couple of features of that operating deficit, because that's part of why we're here, obviously.

We don't -- as was pointed out earlier, it's not our job to get this car out of the ditch; it's our job to try to make a better road and a better car going forward.

However, it seems important to distinguish in the deficit problem that we have to not blame it all on the revenue sources and the economy.

It seems to me that we could look, for example, at roughly $9 billion a year of our current problem, which is a result of a political stampede that took place -- my judgment, using that loaded word "stampede" -- I'll depoliticize it and say a political judgment policy choice that was made relative to the vehicle license fee, and that that part of the problem is certainly a curable, solvable problem also by policy setters by flipping a switch. They flip a switch off, they can flip a switch back on.

Now, what effect that has, I think we can actually take a look at that, because I -- I mean, you take a look at the VLF, for those that might argue that flipping a switch back on would have this, this and this effect, what did switching it off have as an effect in the economy?

But I think it's important to look at those things that we did to ourselves as a -- as the institutions of the executive and legislative branch in creating the deficit as opposed to those things which go more to the question of how volatile our revenue sources are and how stable we want them to be and smoothing out the experience over time and so on. Would you agree or disagree with that?

MR. TAYLOR: Well, we clearly made commitments on both sides. We made spending commitments. We also did make a commitment in backfilling the VLF the difference between 2 percent and .65 to locals -- that's roughly give away $6 billion a year -- in order to give tax relief.

And we've done other things. We increased the dependent credits, one thing that the Governor put back on the table, to a level that's far beyond what any other state provides for as a dependent exemption credit. It was basically tax relief for families. And there's nothing wrong with doing that. So we did those commitments on both sides.

But I think the problem is, regardless of whether, you know, you look to the VLF or our spending, we just did not manage our resources well.

Now, had we managed them perfectly, I think we would still be looking at a very big problem right now, because the recession, again, is just so precipitous, so I don't want to suggest otherwise. But we do not have a good record in managing our fiscal situation.

MR. KEELEY: Let me -- that's very helpful, because I -- another -- a related point on that that I'd like to bring into the conversation is, what we've talked about with regard to the deficit does speak to the question -- most of it has been issues around the volatility of the revenue sources.

What we haven't talked much about is that most of the demands on the general fund in the state of California are caseload driven. They're either students in K-12, community colleges, higher education, health and human services, or the prison system.

And it's at least my understanding -- help me if I'm wrong on this -- but that the caseloads actually drive up when the economy is on the down side of the business cycle and the cases tend to go a bit down when we're on the up side of the business cycle.

Students tend to stay in higher education a bit longer if there's not a lot of jobs out there. We experience upticks in crime during the down side of the business cycle.

People who need the human service side of the health and human service spectrum of services, essentially any state is going to run them, where we are delivery systems for choices made at the federal government level for most of what the state operates in the health and human service world.

I'm wondering if you could comment on that, because I think that that's -- that is at least a significant component part of what causes our deficit to take place, because when we use the sort of generalized concept that, well, we've made some spending choices, fair enough, we've made some spending choices, but many of these choices aren't, in fact, real choices.

We're going to run a K-12 school system, have three legs of higher education pursuant to the Donahue Act of 1959, we're going to run a corrections system, and we're going to pull down -- we're going to put our money -- state money on the table to pull down billions of federal dollars to run health and human service programs.

MR. TAYLOR: I think there's some truth to that, but let me tell you why I would caution drawing too large a conclusion.

MR. KEELEY: Sure.

MR. TAYLOR: 40 percent of our budget is Proposition 98. And in recent years we have actually had negative growth; that is, the population has declined.

I shudder to think what our statistical situation would have been had we been in the early '90s when we were growing 3 percent a year and that would have kicked up our 98 obligation.

So you do have big portions of your budget which are not, in effect, driven by the economic situation.

And so even your community college students have typically been funded within 98, so you haven't directly experienced pressure there.

But certainly some of the health and welfare are the kind of counter-cyclical, that you are going to get caseload increases in CalWORKS, which was one of the slowest-growing programs over the '90s after reform was taken by the federal government and the state. You've had very large increases in IHSS, In-Home Supportive Services, but also in large part because of policy decisions we've made, also.

So you have had caseload growths that have gone up, you have a piece of your budget, but there are very large pieces of the budget which I'd say your statement does not apply to.

MR. KEELEY: Mm-hmm. Fair enough.

Two other quick questions then, Mr. Chairman, and I'll be glad to wrap this up.

One is, I believe it was you that made a reference to -- but it might have been Mr. Kolko that made the comment -- about spending caps, that there are folks who are advocates of spending caps.

The voters twice in California have adopted spending caps. We have a spending cap in place right now. The fact that we haven't hit that cap may cause us to want to weigh in in one way or another about whether that cap is too high. Reasonable people can disagree on it. But I don't want it to go unmentioned as if we don't have a spending cap in California. We have a voter-adopted spending cap in California.

MR. TAYLOR: That's very true. The so-called Gann limits that were adopted in '79. There were changes made to it that, in effect, loosened it up and it really hasn't been a factor for some 15 years.

But you're absolutely correct. Both state and local governments have spending caps that are adjusted each year.

MR. KEELEY: My last question is about the -- is about the sales tax revenue question.

And I want to thank you. I think you're absolutely right in pointing out why the service side of the sales tax potential -- those transactions were not in that chart. The way you explained it, Mr. Taylor, was very helpful. And thank you for clarifying that. That was very helpful.

The very, very last thing -- because, see, when you have elected officials on here and they say it's the last thing, they mean it's the last thing unless they want to say something else.

CHAIR PARSKY: You added the word "very."

MR. KEELEY: Very, very last thing.

On the carbon tax I want to very quickly go to the question that Mr. Boskin raised and others have raised, Mr. Spilberg has raised.

I agree. I will stipulate that any significant change in philosophy and policy on the issue of taxation, especially if we move in the direction of a serious conversation about carbon tax, will be compound, complex.

I think that is exactly the reason we should have it rather than the reason we should simply not address it and put it in some way that is stated like, well, maybe somebody else at a future date might want to look at it. I think we're at that future date. We are the people that should look at that.

And when we get about the business, Mr. Chairman, at the end of this meeting of providing direction to staff, I hope that we will all join together in asking for a fairly robust discussion and information and getting work done on that between now and our next meeting. Thank you, Mr. Chairman.

CHAIR PARSKY: You're welcome.

Curt?

MR. PRINGLE: If I could, just on a couple of things.

First of all, following up on what Mr. Keeley said, without -- this is not a discussion on budget reform or expenditure law changes, but, in fact, when it comes to the largest single sector of the general fund budget, that is completely opposite from moving with the economy.

In fact, when the economy is strong and incomes go up, when you're a percentage of the overall revenues that are generated, K-through-12 education, K-through-14 education funding goes up at a more dramatic rate over and above caseload. Isn't that right?

MR. TAYLOR: Yes. It's adjusted for caseload and per capita personal income.

MR. PRINGLE: And, therefore, this year may be the first year since 1990 that, due to the reduction of revenues and the continuing reduction of caseload, that some of the very basic testing of funding for Prop 98 may be considered as opposed to the traditional funding which is you base it on last year plus caseload and cost of living; correct?

MR. TAYLOR: Right. The minimum guarantee is actually going down by roughly $6 million under the Governor's budget. So the people that talk about ballot-box budgeting for schools, it's actually the opposite. It actually builds in some flexibility. But the minimum guarantee adjusts when you have a problem like this. You don't really see that in other state programs.

MR. PRINGLE: But if, for example, because caseload has dropped in this current fiscal year and the budgeted amount of funding does not reflect that, if the budgeted amount of funding is made and checks have been sent before June 30th, in fact, you have re-established a base for funding for K through 14.

MR. TAYLOR: I think what you're suggesting is you do have to go in and reduce the appropriations to go down to your minimum if that's what you desire to do. It doesn't happen automatically.

And that's where some creative things are being talked about to get the minimum guarantee down as low as possible while minimizing the impact on schools.

MR. PRINGLE: So even though we're not going to talk about expenses or anything like that, part of -- at least what you pointed out, we're potentially $6 billion over in what our prescribed funding is in the constitutional guarantee, or at least the Governor may have suggested next year's budget, that reflects a lot of this disproportionality between revenue and expenditures in this current hole, even though we're not going to talk about any of that, really.

MR. TAYLOR: It gives you a chance to at least make some reductions in a big area of your budget.

MR. PRINGLE: And other people can talk about it, but, in fact, the challenge of revenue and expense balancing is that that is one of the single largest points, because that's the single largest point of expenditure.

MR. TAYLOR: Yes.

MR. PRINGLE: It was mentioned sometime earlier about -- I think at the very beginning, Mr. Chairman -- about how to create a revenue-neutral bill, and I think that, in fact, may be a proper one to kind of share a couple points.

I think the legislature -- a tax-increase bill requires two-thirds vote, and there have been times in -- historic times, because I think I authored a half dozen of them -- bills that combined some tax-conformity issues on the federal side and personal income tax or corporate tax, at the same time providing some additional credit or offset; therefore, that bill internally was neutral. Therefore, it was keyed by Finance as a --

MR. TAYLOR: Counsel, counsel.

MR. PRINGLE: -- I'm sorry -- keyed by counsel as a revenue-neutral bill; therefore, only requiring a majority vote.

But we were always pushed at that moment in time to not do an offset in personal income tax where it affected individual taxpayers and have an increase in the corporate tax because we are subject to some challenge on the whole concept of a two-thirds vote when there's such a disproportionality of who is receiving the benefit, what types of taxpayers receive the benefit versus who pays the increased tax.

And, in fact, I believe through the legislative action over the last couple of months, when some of that was done legislatively, before the Governor even signed it, some organizations and individuals sued because of that potential nonconformity of a group getting the benefit versus those that are paying the additional tax.

MR. TAYLOR: Well, that was one possible claim. I think the larger challenge --

MR. PRINGLE: By the way, I like that claim, though. But I think the -- only because I think that claim is -- if, for example, we threw out the sales tax or threw out the corporate income tax as a proposal and increased sales tax onto services, that by its very nature may be a challengeable type counterbalance even though they may bring in the same amount of money to the state; right?

MR. TAYLOR: Yes. Although, again, the more important challenge, I think, was to the debt defining the gas tax as a fee. But you did have the point that she raised. And it's probably more open to challenge because it was dealing with two different taxes. But there were two or three different issues involved in the potential challenge.

CHAIR PARSKY: I would suggest, though, on this point that I think it would be useful for the Commission, as Chris requested, that there be, perhaps at the next meeting, a presentation on the issue of what might require what kind of voter passage. But fortunately, this Commission is not quite constrained by the same legality.

The discussion of revenue neutrality is one that, if we understand it and come to agreement over, we can set a series of recommendations oriented around it, whether it would require two-thirds vote, one-third vote, or majority vote.

So I think it is important that we understand the background, because what we may recommend as a whole might require certain actions taken by the legislature, but I don't think we should feel constrained in approaching changes in the tax system to achieve the concept, as we agree to it, of revenue neutrality.

MR. PRINGLE: And I feel comfortable with that discussion, Mr. Chairman. Actually, some of the other discussion I shared with you at lunch. I don't mind the whole idea of saying what types of taxes should be charged in the 21st Century economy and not worry about the rate, basically saying --

CHAIR PARSKY: Sure.

MR. PRINGLE: -- the rate was X, that would equate to this; therefore, balance out with the reduction here. I don't mind that level of discussion from, you know, my limited perspective.

I just want to make sure we have caution as to if we think we're just going to swap out this for that, we can give that to the legislature and they don't have to worry about a two-thirds vote, that there is worry about a two-thirds vote. And certainly swapping out of or creation of new taxes that have a different group of taxpayers versus this tax that's being reduced, and that that is a challengeable area.

CHAIR PARSKY: And I think that underlined Chris's question and wanting to have a discussion with lawyers -- more than one -- lawyers about that. And we will. We'll put that on the agenda.

One last and then we'll take the break we should have taken this morning for 10 or 15 minutes, and we'll finish by 4:00.

MS. LOZANO: Thanks.

Just a short question, Mr. Taylor. One of your options I'm intrigued by, you sort of laughed and said it may not be feasible, and, in fact, it may not, and I can see a lot of down sides, but it has to do with the issue of income-averaging of capital gains and stock options over a period of time.

Have any states looked at this? Is there any experience that would show us that, in fact, this might be something that is feasible?

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

Phil's shaking his head, too. We can try and check and see if we can --

MS. LOZANO: Theoretically, but empirically it may not.

MR. TAYLOR: Yeah. So I hesitate almost to throw it out. But we had already put it out on the table. And it was similar to things we have done and having income averaging for taxpayers many, many years ago.

CHAIR PARSKY: Okay. With that, let's take ten minutes, and then we're going to have our final discussion and complete by 4:00.

(Recess taken, 2:47 to 3:03 p.m.)

CHAIR PARSKY: Our last presentation of the day, why don't you introduce yourself, Scott, and we'll proceed ahead, you and Jim.

MR. PATTISON: Certainly. And I'll try to be brief and summarize some of these things so we have time for discussion and questions.

My name is Scott Pattison. I'm Executive Director of the National Association of State Budget Officers. NASBO is the acronym.

My brother, when I first was appointed to this job, said NASBO sounded like a dermatological disease. But no, it is an association of finance officers across the country.

Now, what I'm going to do is go through a Power Point presentation. And it has a lot of points and there's a lot of background data that obviously we won't get into today, but I thought it was important to mention some of this. And Jim Eads here, with the Federation of Tax Administrators, also has some.

But the reason I mention that is that there's just a ton of additional information that, should you want it during your deliberations, it's certainly out there.

So I'm going to start by talking about kind of the context and the background from a state budget perspective.

And let me make a couple of points as I begin. And the first is that California is no different than most states in the sense that you have a lot of the same fiscal structural problems that other states have. Obviously, there are a lot more zeros in your situation and it's one of the worst in terms of a structural imbalance. But I do want to mention that other states are experiencing very similar types of things fiscally, and I think it really helps to be aware of that and don't overlook examining how other states deal with various issues.

And I'll make my second point by pointing out that what really well-managed states seem to share are several things. And one is, they look at the long term. They have various structural mechanisms to be aware of ten years from now their capital needs, their debt capacity and things like that. That's huge and I think very important.

A second thing is, they are keenly aware of their neighbors and other states in their competitive environment. And I'll give you an example.

When I was budget director of Virginia, we were very aware of the environment in North Carolina and West Virginia and Maryland and DC.

That might not have made a huge difference in every policy choice, but it was very important to be aware of what's going on.

And I really think knowing what policy choices are being made in Boise or Carson City or Phoenix or Salem have an impact on what happens here.

And then the final thing I'll mention is that other states have an extremely strong culture of caution. And I don't necessarily mean that it falls on the conservative side. What I mean is, they have a financial-management culture imbedded in their state governments that, when they examine things, they're very careful about additional debt, very careful about what programs and how much funds are provided for those. They just are much more cautious than at least my observation of California policymaking has been.

Now, obviously, the initiative process has an impact on that that other states don't necessarily have to deal with.

Now, let me first mention the first slide. And this is the context of the recent state fiscal situation. And none of this will surprise you, so I obviously don't need to spend a lot of time.

We are in an aggregate decline of both revenue and spending across the country, with very few exceptions. We have shortfalls to the tune of tens of billions of dollars across the country.

States are experiencing across-the-board budget cuts, layoffs. The credit crisis has hit states and localities. No one knows that better than you all and maybe a few other states like Illinois and Ohio, and most states, as you know, are in a recession.

This next slide is basically spending in the aggregate since 1980. What I think is so fascinating about this is we had a significant downturn in that early '80s recession when we had unemployment over 10 percent at one point. And you didn't see a huge decline in spending until that post 9/11 period as a result of the huge decline in revenue at the state level, which you experienced like other states. And now we're back to that.

This is the first time, according to our data, that spending has actually, in the aggregate, declined this fiscal year since 1983. And 1983 was the only other time that that had actually occurred.

So I mention this to show the dire situation states are in now, as well as California, and the fact that your structural problems are certainly exacerbated by this unfortunate recessionary period.

Now, let me make a couple of comments about state balances. This is the data we gathered that combines rainy day funds with end-of-the-year balances. The bulk of these numbers are rainy day funds.

The reason I like this slide and I wanted to show it to you, especially since you talked about rainy day funds today, is that this slide shows that, at least in the aggregate, states should get a pat on the back for doing the right thing.

As you can tell, rainy day funds were small. In the early '90s, during that recession, states learned they needed them. It was a pain in the neck to have to raise taxes and cut as much as they did in that early '90s period.

Then they built those rainy day funds up during the economic boom. It rained post 9/11, in the '02 to '03 period. They utilized them to ameliorate budget cuts, and then they built them up fairly nicely in the last few years and they're starting to be used now.

I predict in two years, because things are so bad, that that line is going to be close to zero when we get to FY '10 and '11, unfortunately.

MR. COGAN: Gerry, can I interrupt and ask a question?

CHAIR PARSKY: (Nodding.)

MR. PATTISON: Sure.

MR. COGAN: We get up to 50, 70 -- the balance is 70 percent of a --

MR. PATTISON: No, actually that's the billions. That's the total aggregate figure in numbers. The actual percentage was closer to about 9 or 10 percent.

MR. COGAN: Got it. I see. The blue is the --

MR. PATTISON: Yeah. Yeah. No. Exactly.

MR. COGAN: We got up to 9 or 10 percent and --

MR. PATTISON: Yeah.

MR. COGAN: Until the California initiative passes that would put us at 13 percent or something like that?

MR. PATTISON: Right. Right. I will say, if there's any lesson we've learned at the state level on rainy day funds is, despite the fact I think states, when you look at this, can be praised for doing a great job, at least in a lot of states, of having significant rainy day funds, they're finding they're not enough.

And we thought 5 percent was enough in the early '90s. Now we're finding 10, 12, 15 percent may be more appropriate.

It's -- I am the first to say it's awfully difficult politically to get there. But that amount may be necessary, given the volatility that we've talked about, too.

And speaking of volatility, let me make a couple of points about revenue and volatility. And the first one I want to make is kind of give a background looking at all state revenue sources. And I think Jim will talk about this, too, so I'll be brief.

But I just want to point out this fits with what was talked about by Phil and others earlier, and that is, when you have personal income at 55 percent, it's -- in the aggregate, it's much closer to 40. And when you have sales of 27 percent, you see it's really much closer to a third when you aggregate the other states.

Now, of course, there are nine states without an income tax and there are a few without sales, like Delaware and Oregon, but for the most part you can see that you are much more dependent on the personal income tax than most other states are.

Just a couple of comments about volatility. The first is, forgive me. I was very tired last night when I updated this, and the first bullet should say "most states have volatile revenue," not "most large states."

But some of this we've talked about, and Jim will get into more details. But we are dependent on the wealthiest taxpayers, particularly those states with personal income tax, like California and New York.

In fact, you've probably heard this, but it's fascinating. In New York, there are some zip codes in Manhattan that account for something like 4 or 5 percent of taxpayers in New York state and they pay some ridiculous percentage, like 20, 30 percent of the state income tax.

So a lot of people are always surprised -- not you all; I think you're familiar with this -- but people are very surprised when I give presentations about how dependent states are on the wealthiest taxpayers.

I was shocked -- in Virginia, you wouldn't think that. We were extremely dependent on just a handful of wealthy taxpayers who worked for businesses like AOL in northern Virginia, and that made a huge difference in our income tax.

The other thing -- again, this has been talked about -- but you have a lack of predictability and stability because of the volatility. And then, of course, you have the severe cuts and the pain associated with those large swings.

This is a map based on census data on volatility. And I think it's a pretty picture, but what I'm going to do is switch to the next slide, which really gives you a kind of a synopsis of that.

California was ranked as the 9th most volatile in states. I think that's pretty high.

MR. PRINGLE: You mean in taxes, not in --

MR. PATTISON: Revenue. Yeah.

CHAIR PARSKY: Very common.

MR. PATTISON: That's what I understand.

A lot of the work was done at the Rockefeller Institute at SUNY Albany. Don Boyd, some of you may know. I even recommend you may want to have Don or Bob Ward or somebody from the Rockefeller Institute come and speak with you if you want to get into some of the underlying technical aspects of this data.

But I think what we find, if you look at that map that was right before the slide, is, what's very interesting is, except for California and, frankly, Connecticut on this list of the high volatile states in terms of revenue, what I find very interesting is that most of them tend to be much smaller states with not as broad a tax base.

So Alaska being the most volatile makes perfect sense because they're almost entirely dependent on the petroleum prices, and they don't have that broad sector in terms of revenue.

The least volatile tended to be in the South and Midwest. And I certainly could speculate on reasons for that. I think we can guess. Much more of a -- I would use the term "even" economy, kind of a less volatility in terms of the economic variation.

I think North Carolina is an interesting case to look at, because while they had the exodus of certain manufacturing firms like textiles and furniture, it was evened out over the period by the triangle in technology firms and Wachovia.

And unfortunately, when I visited Raleigh about six months ago they said they were doing pretty well and didn't expect to see a lot of damage from the recession. And then when I was there in late November, it was a much different story.

Let me just finish up with a few points about revenue and financial management. And the first slide I want to show on this, which is based on census and Bureau of Economic Analysis data, and that is that state tax revenue is so heavily influenced by the economy, but this chart I think very nicely explains what's been talked about today, and that is, across the country, not just in California, the way the state revenue tax systems are indicates that it doesn't necessarily exactly capture the economic activity. And you can see it there.

And I think the best indicator there is that post 9/11, post 2001 downturn in which states saw a massive decline in their revenue, much more than you saw in terms of economic activity, it was kind of -- at the time I remember a lot of people in state government being more puzzled. Now we can look back and I think we can understand it more. I thought Mac's presentation, he did a nice job of kind of indicating that. We've had some years to study that and look at that and understand what's going on.

But I do mention that again because states have experienced this volatility, but a lot of times it is because of the structure of the tax system not necessarily capturing economic activity to the extent we might want it to.

Now let me make a few points about volatile financial management, because I think that gets to some of what the discussion has hit upon today.

And one of them is, you do have -- there's been a lot of talk about the spending fluctuations. And this is, again, just related to when revenue fluctuates, the spending, obviously, does, too.

And that earlier slide I thought did a nice job with the up and down in terms of aggregate state spending over many years. That correlates almost identically with revenue. And that would make perfect sense. So if revenue's volatile, obviously your spending on programs is.

But the higher education cycle I want to mention is kind of a symptom of the pain. And you've really seen it here in California, but other states have experienced this.

And frankly, the way it works is, the folks wink at each other and say, "Okay, Higher Ed, we've hit a downturn in revenue. You can make those cuts up with your other sources such as tuition, so we'll wink and you go ahead and do that."

And so they cut the hell out of higher ed, frankly -- and again, this is across the country -- during downturns.

And then we did some analysis at NASBO and we found -- what a surprise -- that higher ed is treated much higher than average in terms of spending when times are good. And so there's this huge cycle.

So I think -- and I probably should have shown a slide. If you see higher ed spending, you'll see a much more volatile spending cycle than you even see in revenue, which is hard to believe.

The other thing, of course, is, the budget cuts during bad times, which cause a lot of pain, and then finally debt, especially in a state like California, where you have to in some ways balance your budget, like almost every other state. And what happens as a result is, you -- because of that, if you use too much debt, you have less money for substantive activities over time. And that's -- that's obviously very unfortunate. And it's really unfortunate right now in a state like California that you had to deal with.

Now, I will say -- I have to make a comment about debt before I finish, and that is what's fascinating to me about that is how variant it is across the country.

And in a state like a Virginia or Minnesota or Utah that are highly rated in terms of financial management, they wouldn't even consider utilizing debt for operating expenses in any way. And utilizing debt for short-term is not even on the radar screen.

And it's been real interesting, particularly since the Lehman Brothers collapse and the other things in September have led to a lot of conference calls among NASBO members. And we have a huge variation among states in utilization of debt. And I think that's probably helpful for you to be aware of, at least in the broader context of financial management across the country.

MR. EDLEY: I'm sorry. Just explain that a little. This is the use of debt for operating expenses?

MR. PATTISON: That's correct. I guess the better way to put it is that about 30 to 40 states, depending on how you measure it, utilize debt only for capital, and they would never -- it's just not used in any way, even a back-door, de facto way for just operating expenditures or cash flow. It's just not even considered that way.

MR. EDLEY: Is this practice or a constitutional limitation?

MR. PATTISON: It depends on the state. Sometimes it's constitutional or statutory. Other times it's just a financial management culture that exists in the state. And so I find that very interesting.

And again, it's not directly related to revenue, but I think it's in the context of you analyzing and looking at the big picture, it's probably helpful for you to be aware of that fairly significant variation in how states approach debt.

CHAIR PARSKY: Let's just hold the questions.

MR. EDLEY: I'm sorry.

CHAIR PARSKY: No, no. That's okay.

But does that complete your presentation?

MR. PATTISON: Yeah. I'll just conclude by saying I have this fun little slide. And the bottom line --

CHAIR PARSKY: Is that in lieu of a cartoon?

MR. PATTISON: Yeah. Exactly. I didn't have a cartoon like Phil. Phil wouldn't let me use his cartoons.

But just to finish up, I just want to point out that it's real important to kind of look -- step back and think about the big picture when you look at revenue.

And with that, I'll turn it over to Jim Eads, who's Executive Director of the Federation of Tax Administrators.

MR. EADS: Thank you, Scott.

Mr. Chairman, members of the Commission, I am Jim Eads. I'm the Executive Director of the Federation of Tax Administrators. We're an organization of the state tax agencies of all of the states as well as the District of Columbia and New York City.

Having said that, I will tell you that the views that are in my paper -- and I don't have a Power Point, by the way. You do have a fairly brief paper from me in your materials. The views in that paper and anything I may say here today are my own and do not necessarily represent the views of my members.

MR. KEELEY: Now you have a job to go back to.

MR. EADS: Now I have a job to go back to.

The most encompassing disclaimer I ever heard I heard on Capitol Hill about two weeks ago when a very senior staff member allowed us to have what he said did not represent the views of any member of Congress living, dead, or in the future.

I will not read what I have in the paper. As I said, it's fairly brief.

It goes without saving, the delivery of state services is dependent on two things: The quantity and quality of the services demanded by your citizenry and the ability and willingness of that citizenry to pay for those services.

You've heard a lot today about principles of a good tax system. I have a set of principles in mine. They're very comparable to what you have heard.

I do believe that taxes should not only be fair, but that it is important for them to appear to be fair.

The principle of most state tax collections is voluntary. We expect taxpayers to fill out returns and send in their money, and if they understand it and perceive it as a fair system, that is enhanced.

I also believe -- and this -- these are just slight deviations from what you might have heard earlier -- tax systems ought to be -- ought not to be, rather, costly to administer. They ought not to cost a lot for the state to administer. They ought not to cost taxpayers a lot to comply with them. I think that, obviously, enhances compliance, also.

I have a list of the principal state taxes that are collected around the country in my paper. It's taken from the census. You have most, if not all, of those taxes.

I'll talk principally about two different sets of taxes, one being the sales tax, that you've already heard a lot about, and the other being business-type taxes, corporate-type taxes, that I will also deal with.

I did hear today when I think Phil was talking about a list of services that are taxed, and you were interested in that. And I have a handout there, because I happen to have -- I brought it with me, I didn't put it in the paper originally -- but there is a list.

We at the Federation of Tax Administrators do a survey every few years, and we just completed a survey in 2008 that looks back at 2007. But basically it's a compilation of the services that are taxed by the states. And we have a list of about 168 services that are on our questionnaire and we ask states to respond and tell us whether or not they tax those services or not.

You here in California, out of that 168 list of services, tax 21 of those services. I tell you that not because I'm here to suggest that you ought to tax it, but because you did ask about that. And so you have two pieces of paper. One is a list of all the services and the other is a list of rankings of how many states tax how many services. So I think it would be helpful as background information to you.

Hawaii and New Mexico have certainly the most broad-based sales taxes. Hawaii taxes 160 out of the 168 services that are on our list. New Mexico taxes 158. So they are -- they're pretty pervasive.

I would point out to you that our most recent description -- and by the way, any detail that you want -- all of this is on our website, but any detail that you want or your staff wants, FTA is glad to provide that to you.

I will point out to you that if there is sort of an analogous situation to what you're going through -- obviously, on a much smaller scale -- with regard to taxing services, in 2002, Nebraska -- we were coming out of a recession. Nebraska needed revenue. They began to look at services. And the way they did it is they looked at contiguous states and said, "What do we tax versus what do our neighbors tax?" And they found a significant number of services that were going untaxed by them that their surrounding states taxed. And so that's sort of the mechanism that they used to go after that. They went from taxing 49 services to 76 in 2008.

Frankly, the other big issue in the sales and use tax area other than taxing services is as, again, you've already heard about, the issue of remote sales, Internet sales, that kind of issue.

I know it's a volatile issue in California. I know that you have -- people in California have a very strong opinion about not taxing sales over the Internet.

I mention it to you only because it is the other subject area that is being widely discussed in the country.

There's a bill that has been introduced in Congress for the last several sessions. It has not passed yet, but it will be introduced again in this session. There is some thinking on Capitol Hill that that bill may actually move a little bit further this time simply because of the economy and the need for -- not just you but every other state -- for money.

The Streamlined Sales Tax Governing Board is in the midst of updating their study that will -- that will produce a state-by-state estimate of how much states would collect, they think. It is a voluntary study. They're seeking -- they're using the generally available economic data, but they're also asking the states to participate in helping them with that data.

And I think your Board of Equalization has provided that, not because California is a streamline state, because we know you're not, but because at least if you're going to consider it as a policy option, it would be helpful for you to know in some sense what you might gain.

The other major part of my short paper is entitled "Innovative Taxes." And maybe "innovative" is the wrong term. It's just "unusual" taxes maybe I should say. But it deals with -- it deals with efforts by four states around the country who have been -- who have faced revenue problems and they've gone in a little bit different direction with regard to taxing business.

Again, I won't go into great detail with them. They are basically forms of value-added taxes. The first is the New Hampshire business enterprise tax. The tax base is the sum of all compensation paid or accrued, interest paid or accrued, and dividends paid by the business enterprise. And there are some adjustments.

But New Hampshire believes that it is a way to deal with volatility and a way to measure business activity and to tax businesses based in some proximate -- an approximation of the services that businesses receive from the state.

Now, I will point out New Hampshire is much smaller. Their economy is not, you know, nearly as diverse as yours. But the advocates for this tax in New Hampshire suggest that it's both economically and politically stable, and the business community has been supportive of it, at least in New Hampshire.

Michigan has replaced its single business tax with something they call the business -- Michigan business tax, business income tax. It's imposed on all the business income of all taxpayers, not just corporations, but all businesses with business activity in Michigan.

The modified gross receipts tax base is defined as gross receipts less purchases from other firms.

And as you may know, Michigan, in an effort to help themselves financially, the Michigan legislature in late last year passed a tax on services and repealed it before it ever became effective, so there is some political downside to going after services.

The innovative or unusual tax that's sort of been around longer is the Ohio commercial activity tax, called the CAT. It's been around since 2005. It was introduced and intended to replace two different kinds of business taxes.

It deliberately moved away from taxing businesses on their profits and tries to tax businesses again on the basis of the benefits they receive. And they basically take gross receipts as a proximate -- as a proxy, rather, for the extent to which a business may receive services from the state.

The proponents of the Ohio CAT say it is explicitly pro exporting. Ohio-based production that is exported to other countries or other states is not subject to the CAT, but imports into Ohio are.

And finally, the revised Texas franchise tax, called the margin tax. It was borne out of crisis in Texas. Texas had been -- there had been litigation in Texas for decades over financing public education. Generally, property tax was the way that public education was financed in that state. There was litigation, litigation, litigation, over it.

Finally, the Texas Supreme Court declared the system of financing public education unconstitutional and the legislature was under the gun to do something. You know what they did? They created a commission.

They created a commission, and the commission did a good job.

One of the main things they wanted to do was -- the old Texas franchise tax just taxed corporations, and LLCs and other kinds of business enterprises escaped taxation under that old form of taxation, and so the base was getting pretty narrow, and tax planning gave a lot of businesses an opportunity to just escape taxation in Texas, and so they wanted to try to broaden that base, again, achieve more stability, and so they came up with this tax.

It is -- this is really the first real data on Texas margin taxes coming in now. Corporations with businesses that were required to file estimated returns, but even now they're just really beginning to build a database to see if it's going to produce the kind of revenue that they thought it was going to.

I want to say just a couple of words about taxes and economic development. I agree with one of your previous speakers who said good tax policy is good economic policy. I truly believe that.

Now, I'm a tax guy, so, you know, I think about taxes basically as you're raising revenue to pay for government services. That's the universe that I think about taxes. But I understand that taxes do influence economic decisions. I don't think that they're necessarily the major reason that businesses make economic decisions.

I mean, you live in California. You know there's a lot of reasons to be in California than just your tax policy. And businesses understand that, too.

I mean, you have these high tax rates. Businesses like to live here. Somebody was telling me one time that corporate headquarters are located on the basis of a single factor: Where the CEO wants to live, you know.

MR. PRINGLE: Or the CEO's spouse.

MR. EADS: I understand that.

So I think, you know, businesses make location decisions on the basis of labor and capital and infrastructure and quality of life and all of those kinds of things.

What I think is that taxes can, at some point in that decision matrix, become a pivot point. I mean, if you're really -- if there are two really good jurisdictions you're looking at, tax policy may be the pivot point that gets the new plant versus not.

Finally, I want to say just a brief word about taxes and public trust.

And I'm indebted to my friend Tom Wolf, who was recently retired as the Secretary of Revenue for Pennsylvania, who gave a speech at the recent National Tax Association conference.

And he said -- his observation was that Americans have come to believe two things simultaneously, and that is, they want a robust array of public services, but they do not want to pay for it. They want someone else to pay for it.

And he said that really is part of -- part of the reason for that -- part of the reason for that is that they don't think the system's fair. They perceive the system as not being one that is fair, and so, "Let that other guy pay for my services. I want my -- I want my good roads. I want my good schools. I want my parks. I want all those services, but I don't need to pay for that. Those corporations can pay for that or those rich people can pay for that or" -- anyway, and it's become sort of pervasive.

And with all due respect to our elected leaders, they contribute to that, because they run on -- they make speeches when they're running for office and they say, "We don't do tax increases, fraud and abuse, we can, you know, we can do this, we can" -- I'm sorry, but that is -- that happens in this state and every other state, frankly.

I do want to say one -- this may not be helpful to you, but a friend of mine defined revenue neutrality for me one time -- he works for a major corporation in this country -- and he said, "Jim," he said, "revenue neutrality is like a poker game." He said, "At the end of the game, the same amount of money is in the room, it's just in different pockets."

And that's sort of the problem that you have. Policymakers are making -- are choosing winners and losers among the constituency that elect them, and that's difficult, even though the same amount of money may be flowing to California.

I have a plaque in my office that sort of chronicles my journey in public policy. The first is -- three quotes. The first quote is James Madison, who said that "People who mean to be their own governors need to arm themselves with power that knowledge brings."

The second quote is -- I use in the paper, actually. It's Oliver Wendell Holmes, who said, "Taxes are the price we pay for a civilized society."

And the third one, and I think probably most appropriate to your deliberations, is the noted philosopher Yogi Berra, who said, "If you don't know where you're going, when you get there you'll be lost."

CHAIR PARSKY: Thank you very much for that advice. Yogi Berra had a number of different expressions.

Questions? John.

MR. COGAN: Let me start with you, Jim. It's a question about getting to a system where you had lower rates and a broader base. One way to do that is to reduce your reliance on income taxes and increase your reliance on sales taxes -- and service taxes, perhaps. There's a lot of problems with doing that, obviously.

But the question I have -- actually, it's the distributional issues that you have to worry about. But the question I have for you is on complexity.

Is a service tax -- does that introduce any complexity that the Commission has to be worried about?

We had one witness tell us that, with respect to the income tax, we piggyback on the feds for a lot of our compliance factors. Well, we wouldn't have piggyback -- such a piggyback system with service tax.

And so I'm wondering, in your experience across the other states, do you see important compliance issues or complexity issues or administrative complexity or not?

MR. EADS: Well, you alluded to that earlier when you were talking about the Florida experience, which was very unfortunate. And I think Commissioner Pomp was correct when he said that the major mistake that Florida made was attempting to pervasively tax business inputs, because you -- because you do exacerbate the pyramiding of taxes through the system, because businesses are paying taxes on the services they buy and then their customers are paying taxes on the customers they receive. And then obviously there's a tax-on-tax component as that flows through.

So I guess, having said that, I believe there's some studies out there that say, with regard to the acquisition of services, businesses acquire about 40 percent of all the services that are out there and being purchased. So if you pull that out of your tax base --

MR. COGAN: Right, right.

MR. EADS: -- there are implications.

You can look at some states that tax services pretty pervasively. I know a little bit about the New Mexico gross receipts tax. It's called the gross receipts tax. It's structured a little, but it's basically a sales tax. It's added on. When you buy anything, the gross receipts tax shows up. It's just like a sales tax. It's added on when you buy. And they tax pretty much everything.

I was working in New Mexico for a tax policy organization there when -- when just one night the then-Governor of New Jersey said on a radio call-in show, "I think we ought to have a gross receipts tax here in New Jersey like they have in New Mexico."

Well, the next day on caller ID I looked and I'm getting a call from the Newark Star Ledger, you know. Why is a New Jersey newspaper calling me in New Mexico? Well, they wanted to talk about service taxes. And the next thing I know, they have me on a conference call with a whole bunch of business organizations in New Jersey.

And the New Jersey Medical Society guy said, "Well, you don't tax medical services, do you?"

I said, "Well, we just stopped. But yes, yes, New Mexico used to tax medical services."

They tax just about everything. And for that state it's the right way for them to go because they don't have a robust economy. They don't have a huge business presence. They have a relatively small economy.

And when they adopted that tax 40 or so years ago, they wanted the broadest base that they could possibly find at the lowest rate they could possibly have, so that's the way they went, and it's worked for them.

And interesting, the key, as I say, it's structured as a gross receipts tax, which means that the tax is imposed on the business. It's not a sales tax, not a consumption tax, not a transaction tax.

New Mexico's economy has a lot of government contractors. Well, if you're taxing the sale to the federal government, you can't tax that sale. But if you're taxing the business that is doing business for the federal government, you get to tax that sale and New Mexico doesn't.

MR. COGAN: I have one question on economics and taxation. I was looking at your list of states here, and there's one state that doesn't tax any services and that's the state of Oregon.

So my economics question is: If California imposed a tax on services, what would you think would happen to land prices in southern Oregon?

MR. EADS: Oregon doesn't have a sales tax.

MR. COGAN: Right.

MR. EADS: So, I mean, that disparity already exists.

And I have a very good friend who moved out here, moved to the Bay Area from Atlanta, and he had a gorgeous house in Atlanta. And he started trying to look for a house in the Bay Area -- this is several years ago. And they told their agent what they had to spend, and she explained to them that that would buy them a small bungalow. And the real estate agent, seeking to assuage the shocked look on his wife's face, said, "But you'll have the California lifestyle."

CHAIR PARSKY: One quick adjunct to that. If you were advising this group to look at an approach taken by another state because it has some comparable characteristics, which state or states would you suggest?

MR. EADS: I think you should look at those four states that I mentioned with regard to the innovative taxes.

I will have to quickly say Texas does not have an individual income tax, so they're not exactly a very comparable jurisdiction. New Hampshire doesn't, either. Ohio, you know, it's a big state, a Rust Belt state, but they had a wide array of taxes and they decided to go this way.

Businesses generally will tell you they don't like gross receipts taxes because they don't like taxes that tax them, you know, irrespective of whether or not they're making a profit, so they don't like pure gross receipts taxes.

But, you know, a form of these value-added taxes at the state level, you ought to take a look at that.

I think one of your earlier speakers alluded today to the fact that Charlie McClure at Stanford has got a model of a state-level VAT.

And, you know, if you're willing to sort of go out there and see what other options might be available to you, you might want to . . .

MR. HALVORSON: What was the fourth state?

MR. EADS: The fourth state -- the four states mentioned in my paper are New Hampshire, Ohio, Texas, and Michigan.

MR. HALVORSON: Okay.

MR. POMP: Really, Jim made the point, you have to be careful when you look at other states, because everyone's got their own unique set of constraints.

New Hampshire, as Jim said, had no personal income tax; therefore, their kind of tax reached income that you're already reaching in California with income tax.

Texas, by constitution, can't have a personal income tax, so they came up with a way of getting around that.

Ohio is having problems with its corporate income tax because they don't have something California has, which is your unitary combined reporting method, which is probably the best in the country. And they, for whatever reason, didn't have the political muster to adopt the California system, so instead they went with this gross receipts tax.

New Mexico is interesting. Jim, when they taxed medical, if you had third-party coverage, I assume it was just built into the insurance, and therefore, the sales tax is actually spread around in terms of premiums, so it's not as terrible an idea as it first sounds. "Oh, we're taxing bad health." That's the slogan against it. But it is sort of the quintessential personal consumption, which is what you're looking to do with a sales tax.

The Michigan tax on services committed the same blunder Florida did. They taxed a whole bunch of business, which is what Jim said, and then they were inconsistent. They taxed skiing but they didn't tax golf, and so they were held up to ridicule, the papers skewered them, and then they ended up abandoning it.

So, again, it's not -- you've got to do it right if you're going to do it. You don't screw it up. And the fact that so many states do it suggests it can be done, so . . .

Oh, just to answer your question -- very good question. What problems does it solve? Well, right now you have a lot of litigation over what's tangible personal property and what's a service. You know, it's software. Am I selling you my service or am I selling you tangible personal property? So lots of things to keep lawyers in business and send kids to colleges and so on. And that kind of distinction gets eliminated in a broad-based tax on services.

MR. COGAN: Reducing lawyers' fees then is a good outcome; right?

MR. POMP: Lawyers' fees, unless I am providing personal consumption, like a divorce, if I'm doing business, that's business input and shouldn't be taxed.

CHAIR PARSKY: Chris?

MR. EDLEY: I have symmetrical questions, and that is, are there models to which either of you would point of effective rainy day fund, slash, lockbox schemes? And then on the other side, of those states that do permit borrowing for operating expenses, are there models which you would point to for fiscally responsible rainy day lines of credit? That is to say, where they do, in fact, retire the debt on the upside?

MR. PATTISON: Well, I'll answer by saying there are. And I'd be afraid to go into a lot of detail right now, because what I'd rather do is make sure I -- double-check and make sure my memory's correct about a lot of them. But there are models, I think, to look at.

I mean, I'm obviously most familiar with the Virginia rainy day fund simply because I was there. And I think they are a great model. It's a constitutional provision. And the effect basically is, if there's a surplus over a certain amount, it goes into the rainy day fund.

Now, it's capped, and perhaps now that we know we need more money than we ever thought we did during downturns, perhaps the cap should be raised and you take a higher percentage of that huge surplus when they occur.

But I think that's a good model, because it really does ameliorate the pain of the budget-cut period simply because you've got this big amount sitting out, and what it does, too, is, it -- when there is a huge surplus, when revenue is just going crazy, and there were times in Virginia when I was there during the late '90s, there was 11 and 10 percent growth rates each year, which was unbelievable, it kind of takes some of that off the top so you're not just spending that in ongoing programs.

As far as debt, I would have to say my initial reaction is that I -- if you talked to the well financially managed state, I think to a person every director or CFO there would say you just never in a state borrow for operating funds.

Now, I think some states perhaps do a fairly good job at the cash flow issue. I think a good example is -- I think it's Tennessee and Alabama which have mechanisms to go to other pools of funds within state government, so they never go out on the market for short-term cash flow.

MR. EDLEY: Internal borrowing.

MR. PATTISON: It's all internal. And so there's that aspect, too, which might be a good model.

MR. EADS: One short-term solution for California's revenue problem would be for Governor Schwarzenegger to become very good friends with Governor Palin.

I was at an FTA revenue conference last fall, and states were going around the table talking about collections are down and all of this is down, and they got to Alaska and the Alaska guy said, "We have a rainy day fund of $80 billion."

It's good to have oil. I mean . . .

MR. BARRALES: Mr. Chairman?

CHAIR PARSKY: Yes.

MR. BARRALES: I should know this, having been a temporary Virginian, but when did they -- when do they access that rainy day fund? I mean, what is considered -- I mean, one person's rainy day might be another person's . . .

MR. PATTISON: That's the other nice thing, frankly, about it is the constitutional provision. And you have to -- I forget the exact numbers, but you have to have an actual revenue decline and a decline in the amount of revenue actually coming in based on forecast. And I think it has to be over 1 percent. But there's a certain percentage where it doesn't kick in.

MR. BARRALES: Right.

MR. PATTISON: So it has to be a fairly dramatic decline in revenue before the rainy day kicks in.

Oh, the other thing that I think is interesting is, you have to make an affirmative decision to tap it. In other words, you can tap it if the threshold is reached, but you don't have to.

And actually, it's interesting, there are quite a few states -- and I think this is a good thing -- who do not turn to the rainy day fund immediately even when they can. There are states like Missouri and Virginia which have delayed tapping rainy day funds.

And it's interesting, too, as we lobbied for state funds for the stimulus, through the stimulus, staffers on Capitol Hill have told us their concern that a lot of states haven't tapped their rainy day fund.

And we successfully argued that if someone was laid off, you wouldn't expect them to drain their savings account immediately. So our argument was, don't penalize us for being good fiscal managers. And so that seems to have carried the day, at least this time.

MR. BARRALES: One other question. It relates to both of you, your experience, and I guess it varies, but I think at some point California was considered a model in a number of activities, but today, given your perspective, what are some of the well financially managed states, in your experience? Which are some of those states?

MR. EADS: You go first.

MR. PATTISON: I would say there are two factors that I would look at for that. And I think the most important factor, frankly, is the bond rating. And there's been a lot of argument over those over the years and I think some of it justified. But that being said, I think those analysts at the bond-rating agencies, I would look at AAA-AAA states.

Now, from a policy perspective, you may not agree with the policy perspective and the policy choices, because I think that's really critical. There are states that have made decisions not to provide the social services and safety net that California does.

MR. EDLEY: AAA bond rating and DDD schools. I mean . . .

MR. PATTISON: Right. Right. No, and I think that's a very legitimate point. And I think that's what you look at. But when you're looking at financial management, I think that is a factor. And I think it's an important one. But I also think you do need to look at -- bring in some of those more -- I guess I'll call them intangible factors and things like that. You have to look at states that seem to have provided some balance in terms of everything from revenue structure, spending, but also good quality schools, things like that. And I think, whether it's a Utah or a Minnesota or some of those states, it's worth looking at.

I also think, my view, if you're looking at other states is to look at -- I don't know what other term to use, but medium states. And what I mean by that is a Massachusetts, a North Carolina, states that are not tiny.

As Jim pointed out, I think a New Mexico, a

North Dakota, an Alaska aren't necessarily good states to look at. They're not analogous enough to you.

But I think states with a very diverse economy and spend a fair amount on services and have a fairly diverse revenue structure, again, like a North Carolina or, frankly, a Virginia would be a good example, perhaps a Minnesota, certainly Massachusetts. I think those are the states -- if you're going to look at other states, those are the states I'd really analyze and try to compare and contrast with California.

MR. EADS: All of the states are my members and I want to keep all of them as members, so I'm not -- it really -- it ultimately comes down to what's been alluded to, and that is, it depends on what kind of programs you want and what kind of programs your citizens and your businesses are prepared to pay for.

You have a -- you have as robust an array of services in California as anybody has, so your revenue needs are substantial. You have a huge population. You're a big state. You do a lot of things. So your revenue needs are substantial.

But I agree with Scott. I think I would look at -- I would look at Illinois. I would look at, you know, Massachusetts. I would look at North Carolina. I would look at some of these other states. And they're not nearly as big as you, but they -- you know, in many ways they try to do as good as they can for their citizenry and they have a fairly wide array of taxes.

CHAIR PARSKY: Last question.

Fred.

MR. KEELEY: Thank you.

Mr. Pattison, thank you for your testimony.

And Jim, thank you for yours as well.

Mr. Pattison, also, thank you for the work that you've assisted California Forward with with regard to looking at budget reform issues. Very much appreciate that for California Forward.

Let me ask you a quick question on the issue of borrowing. There's borrowing and then there's borrowing. And one of the things that California has done once and appears to be on the verge of doing a second time is essentially securitizing a stream of revenue in the future, whether it's the lottery or the tobacco tax settlement or whatever it might be, for the purpose of dealing with ongoing expenses. Do you know of any other state that does that or has done that?

MR. PATTISON: Actually, a fair amount of states have done that. It's fairly common. For example, the tobacco settlement funds, and there are many more than I can remember off the top of my head, but I know Rhode Island and Wisconsin, to name a few, have done that. So it's certainly not an unusual occurrence, but it's -- it has occurred.

MR. KEELEY: The reason I raise it, I think that's distinguishable from the kind of borrowing that folks would think of in your earlier testimony. I mean, for example, the tobacco tax case, that was a matter of shifting the risk of a tobacco tax settlement that was going to come in over 30 years. You don't even know if those companies are going to be here in 30 years. There was no requirement under the law that they set the money aside. You don't know if they're going to go offshore, going to move to some other country. Who knows what's going to happen? So there was some public policy justification for doing that.

Now, whether you pull forward the -- some portion of the revenue on the lottery, that debate is going on in Sacramento right now.

Thank you very much for your testimony.

MR. PATTISON: Sure. And let me add a couple -- just a couple points on that. One is that when I talk to financial folks across the country, what they often say -- or I should say public finance folks -- as far as securitization, that it's not whether you do it, it's what you do with the money.

But the second thing, too -- and I think this is an important point to just throw out to you all as a Commission -- and that is kind of the long term. And I mentioned that at the beginning of my presentation. I think the big part of this is long term, because it's easy to get lost in the weeds about, gosh, we've got a cash flow problem, so we -- should we borrow for that?

In my judgment it's not necessarily bad or good how that's being approached, because it's an issue that's been caused by an accumulation over years and years in terms of financial practices that have led you as a state to be where you are.

So I think as a Commission one of the huge benefits you can provide is really trying to kind of step back -- and I can sense that in the discussion that you're there -- but really step back and think long term and provide that big-picture, long-term perspective, that, unfortunately, the way our political systems in all the states are set up doesn't provide that kind of legislative and executive type of action.

CHAIR PARSKY: I think that's a very good comment to close our session around, because I do think it is -- was one of the basic underlying reasons that the Commission was set up, to step back and look at long-term reforms that could be recommended.

Let me just make a couple of suggestions in terms of the staff and how we get prepared for the next session.

First, I think that it would be helpful to broaden a little bit the tax discussion to include a little broader perspective on the economy. By doing that I mean perhaps including presentations from some groups that were not here, business groups, for instance, maybe nonprofit entities, civic organizations, broaden a little bit so that we have a discussion about impact of tax reform as it affects them. And in that regard, any suggestions -- I know that we're going to have a presentation from California Forward, which I think will be very helpful, but any suggestions any of the Commissioners have about specific presenters that would broaden a little bit of our discussion, please provide them to Mark.

Second, I think that our next meeting ought to focus a little more heavily on what I would refer to as overarching issues. I think that -- and some specific suggestions on how we might address them.

There were some options that were laid out in a couple of the presentations. I think we should bring those forward and have the staff outline those in a little bit more detail. And things such as sales tax on services, what that might mean as an overarching issue, rainy day fund and how a rainy day fund might fit into tax reform.

It's pretty clear that the suggestions today were that the expenditure side and a rainy day fund doesn't answer all of the questions or the issues of volatility. What that might mean I think needs to be explored.

I think that perhaps a discussion of special treatment relating to capital gains as a broader issue we might want to hear a little bit more about.

I think some of the other taxes -- I know Fred has emphasized a carbon tax -- broaden it perhaps to a discussion of the tax on energy generally, how a carbon tax would fit in, how it fits into the 21st Century California economy. I think that could be quite useful, those kinds of things.

If the Commissioners could think about the presentation in that context, e-mail or send a note to the staff about other issues I might not have identified that fit in there, we'll try to bring them forward in the next session.

MR. KEELEY: Mr. Chairman?

CHAIR PARSKY: Yes.

MR. KEELEY: Mr. Chairman, thank you very much for that. And I certainly concur with that. I'll run through my list very quickly with you.

I think that there is an issue here about -- also about the state-local government relationship which the Mayor I suspect might be interested in a discussion about that, which is to say where the revenues are raised versus where the responsibilities for delivering governmental services happen to be. I think that would be a helpful discussion for us to have.

The -- in that regard, I think the relative stability of the property tax fits into that conversation, but it is also a very good example of where authorities don't exist but a tax gets collected and it has -- locals have nothing to say about the -- its rate or base or value or any of the other issues. I think that would be worthy of integrating in the way you had outlined that.

I appreciate you raising the issue of carbon tax. So done. Check that off the list. That will be here next time. Appreciate it.

I do think that it's worth our while looking at this question of tax expenditures and the construct of the law on how those exist and how they continue to exist and whether we would have recommendations on those.

And lastly, Mr. Chairman, if you would be kind enough, if we could take a look at the possibility, in conjunction with the -- with the carbon tax, take a look at this notion of a permanent dedicated funding source for the stewardship responsibilities of the state, and I would be glad to communicate with staff in more detail on that.

Thank you, Mr. Chairman.

MR. PRINGLE: Mr. Chairman, if I could just add one thing maybe, Mr. Chairman, you could think about with staff. I have my own impression of what the 21st Century economy is, but I'd like to know if there is some common ground of contemplating what it is today in California and what it might be in the future, and, you know, maybe seeing in a historical context, you know, the dominance of which industries and which places and how that interacts with, you know, where those future trends are.

Nobody's going to be able to predict it completely and accurately, but it would be interesting, particularly with our charge, to see what some people would even contemplate would be a part of California's future as it pertains to jobs and industries and its base economy.

MR. EDLEY: And I'd like to go on record as taking serious exception to the disparaging remarks that the professor from Stanford, who was here earlier, made about Cleveland. I had a wife from Cleveland. But more importantly, I think -- I think it's important for us to try to be united, not divided.

MR. POMP: You "had," in the past tense? What's the problem? You obviously agree.

MS. LOZANO: There was a division.

CHAIR PARSKY: We're going to bring back that uniter-divider concept before we're finished, I guarantee you. Okay. Last comment.

MR. DE LA ROSA: Mr. Chairman, I liked what Mayor Pringle said. And interestingly, there must be public policy institutes, the Milken Institute, somebody must have done a lot of thinking already about the 21st Century economy. Perhaps having a presentation from a representative of one of those organizations would be helpful in that regard.

MR. HALVORSON: Could we specifically get the implications of the Internet to the tax situation? That's one -- something, if we could even get 15 minutes on what impact is it having both on commerce and the opportunity for taxation? Because I think there's a whole bunch of implications we need to understand.

CHAIR PARSKY: Well, I think it may tie in nicely with a discussion of at least what California's 21st Century economy and --

MR. HALVORSON: Well, California's rolling into an Internet-based economy in many respects. Businesses are heavily there. Retail sales are massively flowing through the Internet. And if sales taxes go away because everything's being done on the Internet, I mean, it's not only the implications of how we restructure the way we do work, but also how we bypass. So if we could get a little bit of expertise on that, it would be helpful.

CHAIR PARSKY: We'll try.

MR. EDLEY: Gerry, you're thinking documents rather than witnesses?

CHAIR PARSKY: Yes. Obviously, we have some time constraints, so we're going to try to combine document submissions with presentations.

Thank you all very much. Seven minutes. A little bit late. But thank you all very much for being here. That was a very good day.

(Time noted: 4:07 p.m.)

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REPORTER'S CERTIFICATE

I, CAROLE W. BROWNE, a Certified Shorthand Reporter in and for the State of California, duly commissioned and a disinterested person, certify:

That the foregoing transcript was taken before me at the time and place herein set forth;

That the statements of all parties made at the time of the proceeding were recorded stenographically by me to the best of my ability and were thereafter transcribed into typewriting;

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 26th day of January 2009.

CAROLE W. BROWNE
California CSR #7351
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