STATE OF CALIFORNIA

COMMISSION ON THE 21st CENTURY ECONOMY

STATE OF CALIFORNIA

REVENUE & TAXATION

FUNDAMENTAL TAX ALTERNATIVES

PUBLIC MEETING

Thursday, April 9, 2009
9:07 a.m. – 5:03 p.m.

University of California, Davis
Walter A. Buehler Alumni & Visitors Center
Mrak Hall Drive
Davis, California

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

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

A P P E A R A N C E S

COMMISSION ON THE 21ST CENTURY ECONOMY

Commissioners Present

GERRY PARSKY
Commission Chair
Aurora Capital Group

RUBEN BARRALES
President/CEO
San Diego Regional Chamber of Commerce

MICHAEL BOSKIN
Professor
Stanford University

JOHN COGAN
Professor
Stanford University

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

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

GEORGE HALVORSON
Chairman/CEO
Kaiser Foundation

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

JENNIFER ITO
Research, Training, Policy Director
SCOPE

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

A P P E A R A N C E S

COMMISSION ON THE 21ST CENTURY ECONOMY

Commissioners Present
continued

MONICA LOZANO
Publisher/CEO
La Opinión

REBECCA MORGAN
President
Morgan Family Foundation

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

CURT PRINGLE
Mayor
City of Anaheim

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COTCE Staff Present

MICHAEL C. GENEST
Commission Executive Director
Director of Finance

MARK IBELE
Commission Staff Director
Board of Equalization

ASHLEY SNEE GIOVANNETTONE

LORI HSU

ANTONIO LOCKETT

JESSICA MAR

MICHELLE QUINN
Staff Writer

A P P E A R A N C E S

COTCE Staff Present
continued

PHIL SPILBERG
Chief, Financial Research
Department of Finance

MARGIE RAMIREZ WALKER

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Public Testimony

CHRIS NORBY
Southern California Association of
Governments (SCAG)

PETER BRANDENBURG
Southern California Association of
Governments (SCAG)

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Presenters

STEVEN B. FRATES
Senior Fellow
Rose Institute of State and Local Government
President, The Center for Government Analysis

LENNY GOLDBERG
Executive Director
California Tax Reform Association

WILLIAM HAMM
Managing Director
LECG

ROBERT S. MCINTYRE
Director
Citizens for Tax Justice

RICHARD S. MOON
Tax Counsel IV
Legal Department
California Board of Equalization

A P P E A R A N C E S

Presenters
Continued

ROBERT P. MURPHY
Senior Fellow in Business and Economic Studies
Pacific Research Institute

TERRI A. SEXTON
Professor, Department of Economics
California State University, Sacramento

RICHARD G. SIMS
Chief Economist
National Education Association

LARRY E. STONE
Assessor
County of Santa Clara

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Table of Contents

Table of Contents

Table of Contents

--o0o--

BE IT REMEMBERED that on Thursday, April 9, 2009, commencing at the hour of 9:07 a.m., at the University of California, Davis, Walter A. Buehler Alumni & Visitors Center, Mrak Hall Drive, Davis, California, before me, DANIEL P. FELDHAUS, CSR 6949, RDR, CRR, in the state of California, the following proceedings were held:

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(The meeting commenced with Commissioner Boskin and Commissioner Cogan absent from the meeting room.)

CHAIR PARSKY: I want to welcome everyone to the meeting of the Commission on the 21st Century Economy. We've had public sessions at UCLA, at Berkeley, at UC San Diego. And we are delighted to be here at UC Davis; and we want to thank all of the UC Davis community for welcoming us.

The UC system has been terrific at making facilities available, and a number of the members of the UC family have contacted me and said that they're counting on the work of this commission in being some assistance to them in these difficult times. We'll have to see how our recommendations come out.

Just one announcement that I would make and then we'll turn to our public comments, and then ask commissioners to comment.

At the last meeting, all of the commissioners requested that we seek an extension of the time frame for giving our report, which I did, of the Governor and the legislative leaders. And they all understood exactly why we wanted such an extension. And we've been given until the end of July to make our recommendations. As a result, we're going to have a public meeting in June, in Los Angeles again, on the 16th of June. And we will use the approximately two-month period to do an extensive amount of staff work if we can end today and a few days after today, giving the staff appropriate directions. And then we will come back together and look at some of the work that the staff has done and refine it further.

And then we have tentatively reserved -- I wanted to be sure that all Commission members could attend -- I did get a "yes" from all commissioners in the June meeting.

I was able to get all but one. I'll leave the person that is not quite available in suspense. But in July, I think it's July 17 was the date that everyone said "yes" to, except one. So I have to work with that person to see if we can get everyone there. But I'd like to really see where we are in June before we finalize it. But put a pencil on July 17. And that one would be in

Sacramento.

Okay, let's turn to the public comments, then I'll make a few comments before I turn to any commissioners who would like to speak.

I think we have one speaker, Chris Norby is here. And Chris, as many of you know, is part of the Board of Supervisors for Orange County. And he has asked for a little extra time, and we're happy to provide it to him. As the only public speaker, we have the discretion to extend the comment period.

So, Chris, please go ahead.

MR. NORBY: Thank you, Mr. Chairman.

My name is Chris Norby. I'm a resident of the City of Fullerton. My public experience includes 18 years on the Fullerton City Council, including three years as mayor. And for the last six years, I've been a member of the Orange County Board of Supervisors, representing the cities of Fullerton, Anaheim, La Habra, Placentia, and Buena Park.

As a supervisor and as the county's representative on the Southern California Association of Governments, I'm also serving currently as the vice-chair for SCAG's Fiscalization of Land Use Committee, to look for solutions which would lead to more fair and balanced revenue, and also a defiscalization of land use, to encourage cities to have more balanced land use.

The term "*fiscalization of land use*" means that cities are looking and are zoning specifically only for those uses which will maximize revenue. And because of the extreme reliance on site-based sales tax, cities have exhibited an extreme prejudice in favor of commercial uses because they want the sales tax.

If a Wal-Mart comes to town, the question is, how much are we going to give it? And Wal-Marts have gotten about -- it's estimated about $100 million in public subsidies over the last 20 years in California.

If a housing developer comes to town, well, we put a Mello-Roos on him, he's got to build his own streets, he's got to have an association fee, maybe he'll have to throw in a fire station. So housing gets punished with extra fees and regulation, and commercial is rewarded. But it has led to a highly distorted system by which cities are directly competing with each other for sales-tax producers.

You have extreme examples of cities, like the City of Industry, which has about just a couple hundred people, and yet lots and lots of commercial uses and no housing at all. So then the State tries to compel cities to allow housing through the RENA process, through the 20 percent set-aside that has to be spent on low-income housing through RDAs.

So our goal is to look for approaches, revenue-neutral approaches, which would reallocate tax revenue for local government. And we've come up with three draft proposals which are in front of you right now, which we're continuing to work on.

One is PPC, Prospective Per-Capita Sales Tax. All existing businesses in any cities will remain a site-based sales-tax allocation. But as new businesses move into cities, as new businesses are created, that additional sales-tax revenue would be pooled, either on a county-by-county basis or a statewide basis, and then redistributed on a per-capita basis to cities in that county, or perhaps throughout the entire state. This way, the highest current high-sales-tax cities would guarantee all the sales-tax revenue from the current big boxes and the auto dealers; but over time, sales-tax revenue would even out, and would lessen the need, in fact, eliminate the need or the lure to use public money to subsidize new sales-tax producers, since their sales-tax revenues would be distributed per capita.

So there are a lot of advantages to this. And this approach has been discussed for a number of years. It doesn't do anything, however, to incentivize new housing. It's simply redistributing the sales-tax pie. And a lot of high-sales-tax cities that have been winners in the game and have got the auto dealers and the big boxes are reluctant to do anything that might tweak site of sales tax, even though under this approach they'd be guaranteed the revenue they currently have.

The second approach is "R & B." We call this "R & B," Reduce and Broaden. This has been discussed by a number of people as well, although I don't know if they have our catchy title "R & B."

Reduce and broaden. Statewide sales tax, base sales tax could be reduced from 6¾ percent down to as low as 3 percent. Cut it in half. But expand it to include all services -- health services, legal services -- anything that you might purchase other than just a tangible good.

This would simplify the sales tax. So if you work at an ARCO *am-pm* or an Albertsons, you're not figuring out what is taxable and what is not taxable. There would be no more discrimination between taxable and nontaxable transactions. It would slash the price of consumer goods by about 3 percent immediately, because the base sales tax would be reduced. It would end the pro-retail bias that cities have in land use. And so if a city has a law office, if a city has a hospital, suddenly they are getting sales tax revenue from those services, not just from the auto dealers and the furniture stores. And it would incentivize more balance in land use.

The challenges of this would be it would increase the price of services, and you'd have a lot of people like lawyers and doctors that wouldn't really want to have to do all the sales-tax reporting. And it would be hard to calculate how much you could reduce this and still make it revenue-neutral.

You'd also have to figure out what to do with the other sales taxes: The Prop. 172 sales tax, public safety sales tax, the local sales taxes for Measure M's. Would those be reduced and broaden as well, and how much could you do that by?

But the idea that you have a form of value-added tax to all goods and services that simplify it and reduce it has a lot of appeal.

It still is slicing up the sales-tax pie and not really doing anything to incentivize residential. So the third concept we're looking at, which we've labeled "FRESH," that's Fiscal Reform: Equity, Stability, and Harmony. And we all want equity, stability, and harmony; right? Especially if it spells something like "FRESH."

In this case, the cities would give up completely the 1 percent of gross that they currently get -- all of their sales-tax revenue. That would go to the State General Fund. And in exchange, cities would get the same amount of increased property tax revenue during that base year.

(Commissioner Boskin entered the meeting room.)

MR. NORBY: And based on that increased property-tax revenue, each city's property tax allocation, the percentages that they get, would then rise accordingly and be locked into that higher rate. Cities and counties would be kept whole because they would be getting now property tax instead of sales tax. And subsequent property tax allocation would reflect this new amount.

Now, this could be done on a mandatory basis: The State Legislature simply saying, "Okay, we're getting the sales tax. We'll give you more property tax back," or giving cities the local option: Do you want to be a property-tax city or a sales-tax city? It could be done on an optional basis.

Now, the advantage of this was, it would stabilize local revenue since property taxes are more stable over time.

Now, you might think, well, if sales taxes are less stable, why would the state want sales taxes?

(Commissioner Cogan entered the meeting room.)

MR. NORBY: Well, another thing this does, is it incentivizes housing. It also leads to fewer subsidies for big-box retail, for auto dealers, and things like this.

Currently, the State is losing several hundred million dollars a year, perhaps up to a billion or two a year, in local-government subsidies to the sales-tax producers. And if there was no incentive to do that, all that money would stay in the public domain. It would also reduce the incentives for cities to expand their redevelopment agencies, because if they got more of their property tax back, the redevelopment agencies they're creating are actually taking more of their own property taxes from the general fund and into the RDA.

It would incentivize housing as well, in the sense that if a city had an undeveloped area at the edge of town now, of course, the city wants the big boxes, they want the auto dealer, they want the auto malls by the side of the freeway because of the sales tax.

Under this system, a city would actually prefer housing. Since they're not getting any of the site-of-sales tax back but only the property tax from that new development, property taxes with housing gradually go up faster over time since they change hands more often than commercial property; and in changing hands, they're reassessed. So in this case, we actually are going to incentivize housing and lead to more balance land uses and zoning.

We're looking at all three of these proposals, which would be the best. And we're also looking at a possible combination of these, either mandatorily passed by the Legislature or perhaps voluntarily entered into by cities themselves. But we believe that any three of these, especially the third one, in my view, would lead to a defiscalization of land use, more balanced land-use options, and an end to this fiscal free-for-all, whereby the cities take money from the state to subsidize retail to get the sales tax so the state, lacking money, takes money from the city general fund, and the whole thing just goes round and round.

I have to my right, Peter Brandenburg of SCAG's staff who is working on these proposals, and we're excited about this. It's the first time I've really been excited about being a SCAG member because we're tackling something that the State isn't telling us to do. But we're advising you as representatives of the state, as to how we can improve our fiscal system in this state.

MR. BRANDENBURG: Good morning, Commissioners. Again, my name is Peter Brandenburg. I'm staff to the subcommittee at SCAG that Supervisor Norby is a member of. And I think he summed it up pretty well. Just the idea that we've got several general concepts that we're exploring as possibilities.

As you, I'm sure, understand, there's almost an infinite number of formulas and ways these ideas could be cobbled together. And it's all a balancing act in terms of the policy benefit versus the political and even constitutional feasibility of some of these ideas. But we just want to make sure that the local-government perspective is included in your deliberations and that whatever we come up with is more or less compatible with the proposals that come out of your commission.

Thank you.

CHAIR PARSKY: Thank you very much.

I will just say that in all my experience, I don't think I've ever seen a pro and con presentation in which the con has none apparent at this time. But that's an interesting commentary.

Any questions?

Yes, Bill?

COMMISSIONER HAUCK: On the third option --

MR. NORBY: Yes.

COMMISSIONER HAUCK: -- where are you going to shift property taxes to cover the loss in sales taxes? Have you figured, have you included in that calculation a Prop. 98 impact?

MR. NORBY: Well, my understanding of Prop. 98

is it guarantees the State will backfill to the schools any losses. And if the State now is getting all this locally produced sales tax, they'll have the revenue to make the schools whole. And with that revenue, they can spend it directly on public education.

Currently, what happens is because cities are so sales-tax-dependent, a lot of that sales-tax revenue, they'll use as a formula to then subsidize these retail developments. And so I believe that it can be a revenue-neutral option, where the State has the revenue to make good on their Prop. 98 promises. But it requires work.

COMMISSIONER HAUCK: All of this definitely requires work.

MR. NORBY: Yes.

COMMISSIONER HAUCK: 1 percent of our sales tax is worth about five, five and a half billion a year, in that neighborhood. And it's not growing too rapidly. The Prop. 98 formulas really make schools whole, even when the economy is down.

MR. NORBY: Right.

COMMISSIONER HAUCK: So I guess I would just suggest that when you're talking about shifting property taxes and sales taxes, you need to be sure that you include a Prop. 98 calculation in that process because wherever you go with this, somebody is going to ask you that question.

MR. NORBY: There are perceived winners and losers in anything like this.

COMMISSIONER HAUCK: Right.

CHAIR PARSKY: Yes, Ed?

COMMISSIONER DE LA ROSA: I've got one question. What happens to voter-approved user-specific sales taxes under these plans? Are they left aside, like sort of county's transportation, sales tax, half-cent sales tax?

MR. NORBY: Right. Any locally approved sales taxes would have to remain intact. If a city has voted to raise their own sales tax and they're paying more than other cities do, that would not be put in a pool and done per capita.

On the last proposal, we're only talking to about that 1 percent that automatically goes to cities. The other sales taxes in this last proposal would not be shifted for property taxes; they would remain intact.

CHAIR PARSKY: Yes? Michael.

COMMISSIONER BOSKIN: Thank you for your presentation. My apologies for being late. We got stuck in traffic driving up.

As I read this material, there seems to be probably at least a partly justified concern about winners and losers. But there seems to be a concern that competition is a negative thing.

And I am sure totally unfettered competition at times can cause some issues. Maybe we've seen that on unregulated capital markets and so on, lately. But generally, there is a long tradition in economics and law and so on of competition being a good thing. Mr. Justice Brandeis' "states as laboratories," for example.

So why are we so concerned about competition among local areas for residence and for business?

MR. NORBY: Well, I would submit that competition among private businesses in a private market is a good thing. It leads to better products. It leads to lower prices. But when government entities are using public money to transfer to private interests so they will locate in their city, it becomes destructive because -- when I was on the Fullerton City Council, for example, we got a Costco, we gave them about $2 million in subsidies to locate on a piece of raw land.

About a year later, we got a letter from Costco, then called Price Club, saying, well, we're moving across to Anaheim because Anaheim is going to give us even more. And there was no reason to stop them.

Now, we in Anaheim could have continued to spend more and more public money, which should go to libraries, police officers, it should go to streets. I mean, that's what public money is for. So I would submit that public money really isn't something that ought to enter the private market in terms of subsidizing just to move one business across a city line.

So we had entered into sort of a side agreement with the City of Anaheim, saying, "Look, we're not going to use public money to compete for businesses along this Orangethorpe corridor." And so the Costco didn't move, but we agreed to share with them some sales tax.

And what happens then is it becomes a standard business practice -- and it definitely is among big boxes and many auto dealers -- simply to go to cities and say, "Look, what are you going to give me if I locate in your city?"

And it gets to the point where we had an auto dealership in Fullerton that had been there for years, McCoy & Mills Ford, that said "Look, Buena Park is giving all this gravy to their auto dealerships, to steal them away from La Mirada, who lost them to Cerritos. So we want money just to stay."

Businesses should make money based on competing in the private market; but I don't believe it's really in the benefit of capitalism or good public policy for businesses to make money off of shaking down local governments under the threat that they would move to another city. And it also then puts the housing developers at a disadvantage because he can't promise anything. Since most cities are getting such a low percentage of the property tax, he's not in a position to get these kinds of subsidies because he doesn't offer as much.

So I think by balancing the benefits, directly fiscally to cities from commercial and housing, you'll balance the land uses as well.

Cities will still compete with each other in terms of having effective government, low crime rates. They'll still compete with each other in terms of location. But the direct giving of public money in that competition I don't think really is a part of a free-market system where we value competition.

COMMISSIONER BOSKIN: I've long objected to those kinds of public subsidies on economic and political grounds. But on the other hand, if the duly elected representatives of a community decide that it is in the interest of the community to use public money for those purposes as opposed to other things because they think there will be large benefits from that, to actually raise revenue to have more people located -- it would seem to me that we then have to back up and change the constitutional nature of our contracts among our explicit-implicit contracts among governments to say that they can't do that.

MR. NORBY: Well, that's what we're suggesting here, is a kind of a --

COMMISSIONER BOSKIN: So you go as far as prohibiting this, not just --

MR. NORBY: Well, I wouldn't prohibit -- this doesn't prohibit it, but it deincentivizes it.

COMMISSIONER BOSKIN: So where do you draw the line? Why not at all local revenue? Why not a half a percent? I'm just trying to get the conceptual basis of where you draw the line.

MR. NORBY: That's why we're here, so you can help us draw the line. These are still concepts, these are still drafts. And I would say that duly elected officials oftentimes do give this; but, oftentimes it's out of self-defense.

I had a councilmember say to me, "Look, if we don't give this money to McCoy & Mills Ford, they're going to move to Buena Park because they're offering them more." And so I think if you change the rules, you deincentivize certain things. And you also incentivize housing because a lot of the competition we're talking about is for commercial. But people have to live somewhere as well.

And we want to incentivize that, too. And right now, housing pays the freight: Mello-Roos, association fees. But the commercial developers are the only ones that get the subsidies. So we're trying to balance that.

And we're here to get your ideas as well; aren't we, Peter?

MR. BRANDENBURG: That's right.

CHAIR PARSKY: Becky?

COMMISSIONER MORGAN: Thank you.

I'm rather intrigued by these proposals, actually.

MR. NORBY: Well, that's why we're here, to intrigue you.

COMMISSIONER MORGAN: And I'm someone who --

CHAIR PARSKY: There may be a gap between "*intrigue*" and "*recommendations*."

MR. NORBY: Okay, but it starts with intrigue. If you were bored by them, we'd never get anywhere.

COMMISSIONER MORGAN: In the goal of simplifying government, I always am looking for ways where there's a better relationship than what we have now between sources and uses of revenues. And I think this moves in that direction.

Having been an elected official -- and you know even better than I, probably, being on both sides of the table -- how hard it is to get votes for changing the taxing policy, which is why I think we've been asked as a commission to make recommendations that elected officials may not be bold enough to make.

And considering, as you said, that the property tax is the main source of revenue for the locals, and that the housing tends to be going up faster than the commercial, if the local cities are getting more revenue, then would it then be possible for the State to send less money down to the locals because they're getting -- and I think that analysis could be done.

MR. NORBY: Right.

COMMISSIONER MORGAN: And I would like to see if we can't look at some of that.

And to answer Mr. Boskin's question, this may sound a little crude, but a lot of elected officials are put on city councils by developers and big-box retailers. And so the balance between housing and retail is pretty slim in some housing and retail, it's pretty slim in some parts of the state. And so sometimes government has to step in to equalize it.

CHAIR PARSKY: Richard?

COMMISSIONER POMP: It's a very dramatic cut in the sales tax. And, I take it, if I understood, you get that by taxing everything?

MR. NORBY: Right.

COMMISSIONER POMP: Every turnover?

MR. NORBY: Right.

COMMISSIONER POMP: So this is exactly the opposite of a value-added tax. I noticed you used that term, but these are diametrically opposed concepts. You're really recommending a gross-receipts tax --

MR. NORBY: Okay.

COMMISSIONER POMP: -- which has been criticized for a long time.

Lack of transparency. You don't know what the sales tax is on the final good because it gets buried in the price. You get this pyramiding. You get an incentive for businesses to produce in-house rather than buy in the marketplace. It puts our businesses that compete against foreign businesses, subject to a value-added tax, at a competitive disadvantage. So I find it kind of an odd proposal, especially when we have heard from all previous speakers we should be eliminating the tax on business inputs. So that's one comment.

MR. NORBY: Well, it makes Number 3 maybe that much more attractive.

We're not necessarily recommending these. We're just kind of throwing them out to have something to start with.

COMMISSIONER POMP: The sharing of the sales tax has its counterpart in other states with the property tax. And you may want to look at that.

Minnesota comes to mind. They do similar to what you are suggesting, but they share the property tax from new development. They think it gets them better land-use planning, more rational zoning.

So you may want to take a look at what other states have done, albeit with the property tax, and see if there's lessons to be learned for sharing the sales tax.

And I guess we're going to hear this morning or this afternoon about reforming the property tax to try to address some of your concerns, which is another way to go about it.

You've taken the status quo as fixed with respect to the property tax. And I think we'll hear speakers that will make suggestions that will address some of your concerns.

MR. NORBY: Good.

COMMISSIONER POMP: But thank you very much.

MR. NORBY: Thank you for inviting us.

CHAIR PARSKY: A final question, Curt?

COMMISSIONER PRINGLE: Yes.

Thank you very much.

I want to thank my fellow Commission Members for being so kind to my supervisor. Mr. Norby represents me and 63 percent of the residents of my city. And so these are issues that he has been a champion of for a long time.

And I appreciate you sharing them today, Chris.

MR. NORBY: Thank you, Curt.

COMMISSIONER PRINGLE: I don't necessarily agree with them, but I do agree with some.

MR. NORBY: We'll take "*some*."

COMMISSIONER PRINGLE: And I think the most important ones here is really the continued focus -- and it really hasn't been much of a focus of this commission, and that is, on the local government side, which is reflected in the last segment, and that's the fiscalization of land use.

I understand Mr. Boskin's point, and sometimes it gets -- this issue gets confused on two fronts: People who don't like any type of subsidy that goes to a private entity, and governments are bad when they do that. Well, the state does it regularly in a variety of tax credits and tax programs to support and encourage certain types of activities, and the local governments do it in many, many types of programs, be it what was reflected by Supervisor Norby, but also in every single affordable housing property that is being built in Southern California today, there is some degree of local government participation, and certainly state participation. Therefore, there's going to be, to encourage certain type of activity, some government investment. And I think that challenge gets to the point of saying: Is that government local or otherwise owed this benefit of the sales tax? That they get this auto dealer, therefore, should they stomp their feet and say, "All of that sales tax collected is ours, or don't come into town"?

And some cities look at that in a different way, and say that there's other things, be it revitalizing areas of our community, expanding a tax base for the future, and so forth.

I think the most important issue, though, on this whole fiscalization of land use is more importantly focused on really what local governments do in terms of designating uses of land based upon what their return is. And I really think that is a very, very serious issue because in my opinion, there's no doubt that governments -- local governments who face challenges of finances, like every entity does, looks to find out the place where they make money. And they will make a land-use decision, and that pure power of designating a land-use right, of saying only a commercial development can go here and only this type of commercial development that will drive this very high-end retail sales-tax revenue is what many local governments do, and to the detriment of building housing and to the greater detriment of building higher density housing.

And I really think there's a very legitimate point to be made there. And, therefore, I think that contemplating some shift in use of property tax has a lot of merit.

Part of that merit is that property tax going to a government that oversees property-based services, you are building a greater nexus to the tax. The increase in the value of that land and the services that are providing services to that land, there's a good nexus in that. And I think that's very important.

All of these require votes of the people. All of these challenges, the Legislature could not implement any of these procedures without a vote of the people.

And in the bottom section, the only caveat I would give of the FRESH proposal is when the Legislature and the Governor put before the voters Proposition 1A, which protected local-government funding, there was a carve-out that said that county by county, a county government can agree to swap their share of property tax with a city's share of sales tax. Those dollars could be swapped so more property tax would be retained by the city. Therefore, there is that existing right in the

State Constitution that allows for that. But in a wholesale action, or a mandatory action, that would require a vote of the people, that is not consistent with Prop. 1A.

And the problem with that, as Mr. Norby pointed out, there are so many winners and so many losers. And each will battle this to the death as they have in the Legislature for a long time. Cities that are very dependent upon sales tax are going to continue to fight to keep it and who have invested in it. Those who have not are going to fight the opposite battle.

But I don’t want to discourage, one, of course, my fine supervisor, but also us as a commission to consider what that fiscalization of land use means in that proposal. And I’m very happy that we are able to have it presented.

CHAIR PARSKY: Thank you very much for coming here and your presentation.

MR. NORBY: Thank you. We look forward to working with you on this.

CHAIR PARSKY: We do, too.

Okay, just a few kind of general comments and then any other commissioners that would like to make comments, we would certainly welcome it before we move to our first panel.

At each of the Commission meetings, I try to remind the commissioners of the overall objectives or goals that were set out as the Commission was established. I just want to make sure that the public here understands those broad-based goals, and then maybe a few other comments.

Those goals include helping to -- from the Commission making recommendations that recognize that the 21st century economy of California is different; that the recommendations should take into account how the tax system fits within the new economy.

Second, the recommendation should make a contribution to stabilizing tax revenues or to reducing volatility.

Obviously, the elements of volatility may be impacted by the ballot initiatives that are on the table for the voters to vote on, but I think at least it’s the conclusion of the Legislature and the Governor that it can’t solve all volatility questions. And so addressing volatility as part of one of our goals, I think it still remains.

Third, promoting long-term economic prosperity or economic growth for the state.

Fourth, helping to improve California’s ability to successfully compete with other states or nations for jobs and investments -- a climate that would encourage job creation and investment.

Fifth, whatever the recommendations are, they should reflect principles of sound tax policy, including elements of simplicity, predictability, ease of compliance and administration.

And finally, the recommendation should help ensure that the tax structure that we would be proposing was fair and equitable, addressing issues of progressivity/regressivity.

I think we should keep in mind those six general goals. I also think that it's clear that the leadership in Sacramento is looking to this commission to think boldly. We will have a choice in terms of the kind of recommendations that we want to make. This may be a little too simplistic, but we can nibble around the edges in terms of making some changes, recommending some changes; or we can step back and attempt to be bold. And we'll get into a little discussion of what that might mean as the day progresses and as we give direction.

But the one interesting thing that the dynamic that is unfolding is that the work of this commission, I think, has the attention of the policymakers of the State. And so if we can come up with unanimous recommendations, cutting across all different interests, satisfying these goals, that call for significant reform, I think we have probably a unique opportunity to get the legislative leaders and the Governor to endorse them.

And sometimes when you're in a situation where you're in a form of crisis, it gives you an opportunity to make major change that can be positive. So I just would urge all commissioners to think about those concepts as we go forward.

And as I said, we have a commitment from the legislative leaders that the package of recommendations, they will take up for an up-or-down vote.

Now, we recognize that many of the recommendations would have to be converted into legislation, maybe some of the recommendations may have to go beyond legislation. But I think we are offered a unique opportunity to really get the legislative leaders to address the recommendations as a whole.

And one final comment I would make, that I think, to some extent, the enactment of tax policy suffers when recommendations are looked at singly, one recommendation to make this change or one recommendation to make that change. Because it's quite easy, as we saw this morning, but it's quite easy to criticize an individual change in the tax law as being not fair or as being too regressive or whatever -- however you want to look at it.

But if you have a body of recommendations that would be looked at as a whole, and we pass the prism of these goals through, I think you have a greater opportunity to be able to get support. So I would urge all the commissioners to kind of think about that as we go through.

There will be some ideas that will come forward today that may look dramatic. Don’t be too shocked, but let’s step back and think about it. And the goal here is to come out of today -- and we certainly can give direction individually -- to get the staff to spend the next approximately two months doing -- and maybe with some outside help -- doing some analytical work as to how various options would impact elements of our society, so they can come back and say, “If we did this, here’s what the impact might be revenue-wise, progressive, regressive,” and so forth.

So with that in mind, I’d welcome any other introductory comments from any of the commissioners.

Chris?

COMMISSIONER EDLEY: Gerry, thanks very much for all that.

I just want to say, I agree with absolutely every word and sentiment that you just expressed.

It seems to me that, frankly, we owe it to the people of California to try to be bold. And if we are unable to reach a consensus -- a strong consensus around bold ideas, we can always fall back and just explain that Gerry wasn't capable of pulling us together. But it's clear to me that it would be far better to be ambitious and fall short than to be timid ab initio.

I also think that there's probably a much broader public appetite for boldness than there is among most elected officials, because I think the public has just seen what's been going on these last many years and is kind of fed up with it.

So I think a big part of our challenge -- and I hope we'll do some thinking about this over the next several weeks -- a big part of our challenge once we do have recommendations is to think about the nature of the, quote, unquote, campaign, the public discussion that needs to be triggered, and how we should involve ourselves in that to try to help close this gap between the public's appetite for boldness and what we can expect from officialdom.

CHAIR PARSKY: Becky?

COMMISSIONER MORGAN: Thank you.

Just a couple suggestions, and particularly in light of the fact that you suggest that we direct staff to come up with some of the pros and cons of suggestions we make, and in agreement with Chris on boldness.

We have not heard during these hearings, really, from vice-presidents of tax or of finance in all the hundreds of companies throughout California. Companies are expanding elsewhere, not in California. And they can tell us why. But those aren't the kinds of people that we've been hearing from. And I would like very much to have a couple industries, anyway, represented at our June hearing, to see what the impact of our proposals would be, and charge them with coming up and telling us what they're willing to do as opposed to just what they are opposing. That's number one.

And, number two, someone that I would like to hear from is Noel Perry, who founded Next Ten several years ago. He has been trying to educate the public on the California budget through the Internet. He has done studies, his organization has done studies on the impact of budget. And they've just come out with their innovation index on the fact that you can make money from the new green economy, if you will.

So to me, those are a couple representations that have been missing from our hearings.

Thank you.

CHAIR PARSKY: Thank you.

COMMISSIONER MORGAN: And I support “*bold*.”

CHAIR PARSKY: I’ll ask you at the end of the day if you still feel that way as we put some things out there.

Bill?

COMMISSIONER HAUCK: Well, in the spirit of “*bold*,” you’ve got a memo in front of you this morning from me, urging the Commission to take a positive position on Prop. 1A, a different Prop. 1A, from the one that Mr. Pringle was speaking of. This one is on our May 19 special election ballot.

I feel strongly that with respect to the issue of volatility, which is of concern to this commission, Prop. 1A would go a long way toward helping the State of California with its budget volatility.

I think we’ve gotten ourselves in trouble in the past, certainly in the early 2000s, in terms of the budget, by spending what we’ll call “*revenue spikes*” that result from an unusual circumstance which we know will not recur. And the one particularly I’m thinking of, is the spike that the State experienced in the early 2000s, resulting from the dot-com boom. We had about $12 billion in additional revenue from capital gains, dividends, stock options, that the Legislature and the Governor knew would not recur. Unfortunately, the Legislature in the end decided to spend all of that money on ongoing programs.

And I want to give Governor Davis credit for having proposed a budget at the beginning of the following year that did not propose to do that. He proposed a budget that would not have spent the $12 billion on ongoing programs. Most of it would have been for one-time infrastructure projects, one-time debt reduction, very little of it in ongoing programs. And we supported that proposal.

Unfortunately, about three months later, the Legislature essentially overrode the Governor and decided to put that money into ongoing programs. And in some respects, we're where we are today in California because that occurred, as well as the subsequent energy crisis, which is still costing California really billions of dollars today.

It's my feeling that the proposal on the ballot on May 19 is a reasonable proposal. It's not -- I mean, I think it's reasonable because we've heard criticism of it from the right and the left. There must be something good about it as a result of that. It would let state government grow at a reasonable rate based on a ten-year trend. It would set aside these spikes in revenue in a so-called rainy-day fund or reserve that could only be used for restricted purposes. It would be very difficult to get that money out of the reserve for anything other than the purposes that are described.

And, to me, a lot of the volatility that we’re experiencing is the result of what I’ve just described, as well as a general unwillingness by the Legislature -- not all members, but on a bipartisan basis -- to restrain themselves and to make decisions at a time when they should be making decisions, rather than putting them off because they’re too difficult to make.

So I offer that as a suggestion to the Commission. Do with it as you choose.

CHAIR PARSKY: Yes, Michael?

COMMISSIONER BOSKIN: I just want to endorse aspects of the last three -- three of the last four sets of comments -- actually, all four.

First of all --

CHAIR PARSKY: Therefore, we don’t have to guess which one you don’t endorse? That’s good.

COMMISSIONER BOSKIN: Well, I didn’t mean to exclude the fourth one since I didn’t agree with it. But I’m emphasizing things that three of the four of you made, which was the proper construction.

First of all, I think it would be a shame if we didn’t come up with some bold proposals. I think structurally and corporately, we may or may not be able to get overwhelming agreement around a proposal. But if not, then we ought to have some bold proposals in our report that we couldn't agree on, and say that a group of us believe X would have been a good idea or another group believe Y would have been a good idea. But this is what -- hopefully we won't do that; hopefully we'll agree. But if we can only agree on very small changes, I think it will not have accomplished a lot. So I share your sentiment in that regard.

I think it's pretty obvious what the structure of complying with our list of six things must be. I don't think there's any grave doubt on that, to decrease volatility and to promote growth, we're going to have to figure out ways to lower marginal tax rates or deal with a shift in the composition of taxes or things of that sort, and the state's competitiveness.

We also have an injunction to be concerned about equity. So we're going to have to figure out a way to -- if we do do the former, have a way that we can deal with the latter.

And there are a variety of ways we can do that. But we ought to be getting some runs done by the staff, et cetera, on various combinations of those, and better sooner rather than later that some archetypes given by one or more commissioner be sent in, and we can group them into types, et cetera.

I guess I would also make one last point on -- which I think was very prescient of both you and Chris, pushing what we can say to the public and going beyond our report, to selling it. And that gets back to your point about, if we deal with each individual item, or even each -- or focusing exclusively on one of the six charges to us, we're going to fail because either we won't be able to come up with a recommendation; or when we make a recommendation, people trying to defend this deduction or that specific feature that they're living off of now, we'll focus on that and we'll blow up, and we'll have to make a case of the general good, even though there will be some winners and losers. And we can figure out ways to cushion -- have a glide path for the losers, to have a glide path to have something phased in gradually or something.

But it seems to me, that's the structure. And the sooner we get started with some archetypes, the better, to enable us to be trying to make some decisions in the summer.

CHAIR PARSKY: Well, I think you'll see some of that unfolding this afternoon.

COMMISSIONER BOSKIN: Great.

CHAIR PARSKY: Any other comments about

Bill's -- yes, Ruben -- or Monica?

COMMISSIONER LOZANO: Actually just to reiterate what's already been said, and I agree with four out of the five, not just --

CHAIR PARSKY: I know you well enough to know who is excluded.

COMMISSIONER LOZANO: The sentiment of the group.

And as I think about our recommendations and the guidelines and the criteria by which we need to measure them, when you think about maintaining competitiveness or equity and fairness and progressivity or, you know, long-term growth and competitiveness of the state, it becomes in my mind too easy to then pick apart the proposals. And if we send them in as a package, clearly that's -- but I would prefer for us to really put on the table today -- and I see it's part of the agenda -- some very bold ideas.

And what I've seen us doing over the course of the last few meetings, I think, is valuable but somewhat tinkering around the edges. So I think the sooner that we can get to laying out some big sort of major structural ideas and allow us the time to begin to analyze the impacts, and then weigh them against the other set of proposals that have to be taken in tandem as a singular package, I think the better for the work of this commission.

CHAIR PARSKY: Ruben?

COMMISSIONER BARRALES: I do want to reiterate what Becky had mentioned. I think it's important for us to hear from some of the folks that have built and are running 21st century companies in California. And I think staff has tried to get some folks here earlier.

And we've heard from some of the associations, and that's fine. But I'd like -- especially if we have on the table by June, obviously July, some of these ideas, and get reaction from folks that are better successfully doing that, the challenges that they're facing, and how some of the potential recommendations we might make might affect their decision-making in terms of creating jobs and expanding their companies here in California.

CHAIR PARSKY: Curt?

COMMISSIONER PRINGLE: Yeah, two counts.

First off, I served eight years in the Legislature, so I lived those eight years nibbling around the edges.

Being on this commission --

CHAIR PARSKY: Maybe I shouldn't have used that expression.

COMMISSIONER PRINGLE: No, no, but really, it is exactly the dichotomy that we have. And I appreciate, Mr. Chairman, you presenting it because it is groups like this that are outside of the mainstream operations of government, that can think about the big things and offer big ideas. And if we're not willing to do that, then we shouldn't spend any more time having meetings and hearing from fine folks.

We should think about what those big ideas could be. There's many that are presented, many people here have them. But I do think that the most important thing is looking at that all-inclusive plan.

There's going to be winners and losers of every single presenter. And, actually, to be kind of candid, Ruben, the challenge with exactly what you suggest, I think would be great to hear from different sectors as to how things may have impact. But by and large, any entity that we hear from singularly, will tell us how one proposal or another affects them singularly. And our job probably is bigger than that. Our job is to see the whole state and the future of the state, and maybe whether we can understand where the state is going a little better, or should go, that would be nice to hear.

But to hear how one proposal may, in fact, limit or challenge, or one proposal may encourage and grow one business or one subsection of the state's economy, that brings value, but probably only to the extent that it is contributory to the whole of figuring out what that big idea, that big presentation can be. And that means we need to narrow down what those three or four may be, and then start honing in on what they are and getting the feedback from all as opposed to all who wish to, as opposed to try and then narrow it out and hear from just a couple.

I do think, Mr. Chairman, I like the path in which we're going. I guess the one limitation I have is trying to get those ideas out, having the time to discuss them, and really trying to figure out what consensus, if at all, could be brought, which I think would be very powerful; but also the very largest group of Commission members that could make some of those bolder recommendations. And, hey, I don't plan to run for reelection.

COMMISSIONER HALVORSON: Mr. Chair?

CHAIR PARSKY: Some people may think that's a negative. But it's perfectly okay if you want to run for reelection. This commission will clearly have an end, that's for sure.

Chris, did you want to make a comment?

COMMISSIONER EDLEY: I'm sorry to speak again.

Two things: One, I'm hearing a lot about the marginal tax rates and so forth. And I know that there is a school of thought about the way to create growth that stresses tax cuts and reductions in marginal rates. And that's a very strongly held set of policy views.

On the other hand, I'm just as committed to the proposition that our competitiveness and location decisions are dominated by concerns about the fact that our K-12 public school system is sliding downhill and is now probably in the bottom quartile of school systems nationally. The cost of housing. The deterioration in the infrastructure. These are things that speak to the competitiveness of California and the attractiveness of locating in this state, and that speak to whether or not the next generation is really going to pull California back to the forefront. And I feel that very strongly.

So the challenge for us, I think, is going to be to reconcile those two very -- I'm hoping there's somebody on the Commission who agrees with me with what I just said about schools and infrastructure and the like. The challenge is going to be how to bridge those two deeply held policy stances about the strategy for growth and competitiveness.

COMMISSIONER BOSKIN: Why do you think --

COMMISSIONER EDLEY: The second point I want to make is that what we're doing is so difficult, we could go on forever hearing from more experts and more constituents and more representatives of this perspective or that perspective. And I would strongly suggest that given the limited amount of time that we have left, that after today, we not have any more public -- that we not have any more public speakers or any more invited guests; and that the additional perspectives we would like to get, we try to get in writing rather than through oral presentations. And I say that because of the first point that I made, because the task of bridging our differences on these policy stances is going to require a lot of mud wrestling. And we need to make sure that we have sufficient time to do that in good faith and with care.

CHAIR PARSKY: I just urge that -- keep in mind, not isolating one recommendation at a time. And let's leave aside for the moment whether we should only focus on reducing marginal tax rates or we should only focus on progressivity in our tax system. Let's just hold back a minute so we can see if a group of recommendations can address both the need to encourage economic growth, and at the same time, not overburden one element of our society. So let's just hold off. This is 100 percent predictable, but let's just be patient a little.

Ruben, one more comment.

COMMISSIONER BARRALES: Well, George hasn't spoken yet.

CHAIR PARSKY: I'm sorry, George.

COMMISSIONER HALVORSON: I agree with 12 of the last 17.

CHAIR PARSKY: As long as you agree with Michael Boskin, you'll be okay.

COMMISSIONER HALVORSON: Exactly.

No, the point I'd like to make is the legislative process inherently is annual and inherently looks at a stream of revenue in the context of having to make decisions on the fly. And what we have an opportunity to do here is to stand back from that process, take the broader view, look at the entire revenue stream of the state, and come up with the total recommendation -- we have a luxury of perspective that the Legislature inherently doesn't have because the Legislature is dealing every year with this year's expenses and this year's revenue stream and this year's channels of revenue.

And so I think we should -- I think we would miss a golden opportunity and do the state a disservice if we don't stand back and take a look at and say, "What should the told package look like? What kinds of things can we do?"

And I think we should look at the total package. We should be looking at the total context. And I think we should look at the total context of spend as well in the sense that we should encourage the State to be doing multiyear planning and not doing all the planning in the context of annual revenue cycles. Because if you try to run a large organization and you try to look at everything as one-off annual, you will make all kinds of bad investments over time. You won't get the cash flow you need. The money won't be going to the right places at the right time.

And so I think we need to fix the revenue. But the revenue needs to be linked to a purposeful planning agenda going forward for where the state needs to go. Because we know what the school situation is going to be, we know what the prison is going to be, we know what the bridges are going to need. All of those things should be part of a long-term plan, and none of them should surprise us annually. And the revenue, they shouldn't surprise us annually, and then we should look at the total revenue.

So I would speak in favor of an overarching recommendation that is not constrained by the current situation.

CHAIR PARSKY: Last comment.

Ruben?

COMMISSIONER BARRALES: I'm sorry, I just need to reemphasize, I think we've had some wonderful speakers with great perspective. Many of them are folks who are involved in Sacramento on a daily basis. We've not heard from one speaker who creates a job, one person who has made that decision about education, workforce, location decisions.

And we can get all of that in writing as well, but we could also do this online and blog each other and come up with a recommendation. So I strongly recommend -- I think it is important to hear from people who are creating 21st century jobs in California and making those decisions.

CHAIR PARSKY: Okay, before we turn to our first panel, I just want to come back to Bill's suggestion to the Commission, which was to seek from the Commission an endorsement of Proposition 1A.

Unless the Commission feels otherwise, and I would strongly urge each individual member of this commission to express his own or her own personal view, publicly or otherwise, but my recommendation would be not to put the Commission as a whole into a position of endorsing or not endorsing ballot initiatives.

I mean, one of the reasons that we delayed our recommendation was to see how the voters would respond. And these ballot initiatives are very important and will impact the recommendations we make. But they do go beyond -- in part, beyond the charge, if you will, of this commission. So this in no way represents my own personal view. But unless everyone feels differently, I think I would recommend that we not try to take a commission position.

Does that seem --

COMMISSIONER LOZANO: Agreed.

COMMISSIONER COGAN: Yes.

CHAIR PARSKY: Okay. Thank you.

Let's turn to our first panel now under the overall heading of *"Structural Reform and Economic Growth."* But I think you will begin to see some maybe differences of opinion or approaches that would talk more structurally.

First, we're going to hear from Robert Murphy, and he will talk to us a little bit about a form of reform. And then we'll also hear from Robert McIntyre, and then open it up to some questions.

Please.

MR. MURPHY: Well, thank you very much for this opportunity to present. And, again, I'm from Pacific Research Institute; and we're a free-market think tank. It has offices in San Francisco and Sacramento. And so I'm here talking about a paper that I wrote for PRI, that I was the lead author of, that came out last year, called

"*Ending the Revenue Rollercoaster*," talking about flat-tax reform. So our mandate was to come up with a revenue-neutral flat-tax proposal, and that's what I'm going to go over.

The idea of a flat tax has been around, just for the benefit of the public -- what is a flat tax? The idea is that instead of having different tax brackets, there's just one single rate that applies to anyone, regardless of the level of your income. And then depending on the different proposals, they're all agreeing to the details, but the idea is to get rid of as many loopholes and exemptions and deductions as possible and, you know, to be able to do on the proverbial postcard. That's the goal, that it's a very simple system and everyone pays the same flat rate. And as I say, different proposals -- some people allow a certain standard deduction or particular exemptions. But the idea is to greatly simplify the tax code.

So the point is to be able to suck the same amount of revenue from the taxpayers for the government to spend with as little distortion to the economy as possible. So that's the overriding point of this.

The slides that are going to be in this presentation are largely drawn from the paper. And that's the link for those who are just so dazzled by the presentation that they are having to go read more. That's where it's available online.

So what I end up concluding in this study was that if you got rid of the AMT, the personal, corporate income tax, and the inheritance and gift taxes, that you could replace all of that with a flat rate of 3 percent. And it would be a dual system. So for personal household filers, they would just put their gross income down and pay the 3 percent on that. And literally, it could be the size of a postcard.

For businesses or for households that had a lot of complicated things going on, then they wanted to file as a business, this 3 percent would apply to their net income, all right, so that they would deduct their business expenses. And I can get into the details later on in the presentation.

Okay, so we call it the revenue rollercoaster. And what I want to stress is, to make sure everyone understands -- you're all well aware of the fact that California's revenues go up and down, hence, the term "*revenue rollercoaster*." But it's not simply because, oh, the economy's fortunes change and so, therefore, during boom times, revenue is up and during busts, it goes down, that it is particularly severe in California. So for the period that we studied, it had the fourth most-volatile income-tax revenues. And that's even a bit misleadingly optimistic because the three states that were more volatile, they don't rely that heavily on income taxes. So Alaska and Florida, at least when the study came out, I think this is still true, didn't tax personal income; and Tennessee only taxed dividend income in terms of personal income tax.

So the point is, the three states that had more volatile revenues than California, they don't rely on their income-tax receipts for their funding as much as California does.

Counting the millionaire surcharge, California's top rate of 10.3 percent was the highest in the nation. And that figure is before the recent revision that came out -- you know, the recent compromise.

And what I'm going to argue in a few slides here is that that's not a coincidence. All right, so it's not a coincidence that California just so happens to have one of the most progressive tax codes in the nation and the revenue stream that you guys are experiencing is also the most volatile. Those two things go hand in hand. And I'll talk about why that is in a slide or two.

Okay, these figures are just to emphasize the points I've been making, just to make sure everyone, again, realizes how serious this problem is specific to

California. On the left, it has the difference between the forecasted revenues and then the actual revenues. So those points that are connected by a single line there, those two different points. What those represent are the January and then the May revisions for the Governor's forecast of revenues. And then the solid black line is what actually came in.

So as you can see, during the recession period, like, early nineties and then early 2000s, there was a huge discrepancy between how much revenue the Legislature -- or the Governor thought would be coming in and then how much actually did come in.

As you can see, in the early 2000s, there was a gap of about $10 billion on revenues of $65 billion. That's a huge discrepancy. And so it's no wonder you're going to have these recurring budget crises if you can't even plan on how much revenue you're going to have to spend.

On the right figure of the slide, again, just reiterating the point that this is not something that every state experiences to the same degree, this really is a California-specific problem. You can see how much that –- the wild up and down in the revenue stream for California relative to the U.S. average, in terms of the states.

All right, so, again, when you're asking yourself, why do these crises keep hitting California, it's not just the economy, it's not just, well, when recessions happen, this is a natural outcome. There is something specific to California. And I'm going to argue, of course, that a lot of it has to do with the structure of the tax code here.

Okay, so why do we have this revenue rollercoaster? The intuition is that the progressive tax code exaggerates the boom-bust in receipts. So, again, very intuitively, I think part of what's going on is that when you have a strong economy, people's incomes, in general, are higher, so the tax base is bigger, so you get more revenues that way. But if you have a very progressive tax code where the rates are higher depending on how much money you make, during boom periods, not only are people, in general, making more, so income is higher, but more people are getting bumped up into the higher tax brackets. So you've got a larger base, and then it's being taxed on average at a higher rate. And so that's why you see the huge spike.

And then, of course, the opposite happens when there's a recession in a state like California that has a very progressive tax code, not only are people in general making less income, but it's getting hit at a lower tax rate because they fall into lower brackets, and so that's why you have a huge crash. All right, so that's why I said earlier that I don't think it's a coincidence that California has both one of the most volatile and also the most progressive tax codes.

All right, so among its other virtues, which I'll discuss in a moment, why we're here and why we call it the "*Ending the Revenue Rollercoaster*" in terms of paper, is that a flat tax automatically smoothes out that revenue stream. And obviously, if you understood the first bullet point, the second one follows naturally that if you're taxing all incomes regardless of the level, at the same percentage rate, obviously during boom periods, the Legislature is still going to see a rise in receipts, but it's not going to be exaggerated. It's going to be more proportional to the overall increase in the economy, or the amount of income people are earning. You're not going to have people paying a higher percentage on top of the fact that they're making more money. And so, in a sense, the flat tax relative to the current structure would take money from the good years and shift it to the bad years.

So in addition to proposals like 1A and other things to sort of set aside a rainy-day fund, the idea here is, let's not, as much as possible, leave that up to the willpower of the legislatures. I mean, even in your own personal household, it's hard enough if you have a really good year to not blow that and take your wife out to dinner and buy her some nice jewelry. It's hard enough to set that aside because you know down the road something might come up. It's even harder in terms of the politics that legislators who might not even be in office five years down the road when the really bad recession hits, rather than expecting them to be able to get over the political constraints and have the willpower to set billions of dollars aside during good times, the flat tax, in a sense, does that automatically.

Okay, there's other benefits of a flat tax, like I said, for the purposes of this testimony or this presentation, focusing on the revenue rollercoaster aspect. But, actually, there's a bunch of other benefits.

So for one thing, it closes so-called special-interest loopholes. And I'll have a slide in a moment to show you just how dramatic it is. But that's one aspect that people don't often think about, is that what happens when you have a very progressive tax code? Naturally, certain businesses, they lobby and they get particular exemptions and deductions put in that are sort of couched in terms of the public interest. But really, if you wonder why that specific exemption should get into the tax code, it's because of a particular corporate donor, or what have you, benefits particularly from that.

So we'll see the next slide, I think, that there are some perverse outcomes where even though California does have a very progressive tax code, you might think, "Oh, so all rich people in California really pay a lot in taxes?" There's actually some perverse outcomes because there's such a wide array of various loopholes. And so the flat tax, in a sense, is fairer in that respect, that at least everyone understands it's the same rules applying to everybody, and you just get rid of the loopholes.

And then also it lowers the marginal tax rate. And people have discussed as to why that's important.

So what does it do? The lower marginal rate encourages work and investment, boosts the economy as well as tax receipts. And I'll have some slides in a moment to try to emphasize the point.

But let me here just put it in different words to say it intuitively. Again, the idea here is the type of tax code matters. So the question is not simply what percentage or how much gross revenue do we want to take out of the economy in terms of taxes, and then how much are we leaving to private citizens to spend as they choose; that the size of that pie itself will be affected depending on the structure of the tax code.

So even if you took a typical business and you said, “Okay, with all the deductions and exemptions and things that we have and then the progressive structure of the tax code, what’s the size of the check you would be writing to Sacramento this year?” Instead of that, we could come up and say, “Let’s get rid of all the exemptions and so on, and then lower the rate -- the marginal rate that’s hitting this business, and what number would we come up with so that the check would be the same amount, the revenue -- that the legislator would get.” Given that switch, the new incentives, that business now, because of the lower marginal rate, would have the incentive to earn more income. All right, so it actually would end up generating more income, even though the rate would be lower.

Of course, in practice, the businesses are all going to be different, so you couldn’t do that for every single household or business, that some are going to gain and some are going to lose, naturally. But the point is, in principle, the goal of a revenue-neutral flat-tax approach is that you want to say, let’s calibrate that single rate such that by getting rid of all the exemptions, everybody -- or the average representative household or corporation would pay the same amount if its behavior were identical, so the State’s not losing revenue and it's not a tax increase or a tax cut on anybody. But now because we've changed the incentives, they actually want to go out and earn more income because of the lower marginal rate.

Okay, this third point here that business decisions under a flat tax, getting rid of the loopholes would be based on the bottom line, not the tax code. And here, there's a couple things.

So, of course, with all the exemptions, I mean, it was popular, this "*sloop hole*" loophole, with the yacht tax and the sort of strange, perverse incentives it was giving people -- all these particular loopholes give uneconomic incentives to individuals that makes perfect sense, given the tax code, but that's sort of an arbitrary constraint, that you want people making decisions based on profitability; or if you're a consumer, you want to be spending your money based on in terms of what actually benefits you.

And just to give you a personal anecdote, I incorporated. I'm a consultant and I work for PRI and other groups. And a silly example. Say, I need a new fax machine or I need to buy a new laptop for my business, when I go to the store and I see the price tag, I automatically knock it off by 30 percent or whatever the number is because I know, well, that's a business expense, all right, and that's because of the federal tax code, not the state level.

And the point is -- you know, that's real, that businesses tend to spend more extravagantly on things that are business expenses because they're tax-deductible. And so it makes perfect sense, it's rationale from the individual business's point of view, but it's not good for the overall economy.

So it's not merely that I'm arguing that if you switch to a flatter tax code, it's not merely that the volume of income would increase, but also the way that income was spent in terms of business decisions would be more efficient. That businesses would be less -- you know, they wouldn't spend as much on the nice buildings or catering lunches for their employees or maybe having free parking that they could write off as business expenses. It would make more sense for them to just pay that as salaries to their employees, and then those people could spend it the way they wanted to.

But the way it is right now, the higher that marginal tax rate, the more it makes sense to shift compensation in other perks in ways that can be tax-deductible, even though everybody would be better off if they didn't have that constraint of that high marginal rate.

Okay, and then the last point is that the flat tax would draw workers and businesses back to California. And I'm going to have a slide -- I think two slides after this to emphasize the point. But, again, the idea is, California is competing with other states. And so regardless of the abstract fairness of having a progressive tax code or whatever the issues are -- and certainly I'm focusing on one set of issues here; I understand you've got other presenters talking about other things that you need to keep in mind. But what I would like to stress is regardless of the abstract fairness of it, it's undeniable if California has one of the highest tax codes -- or marginal tax rates, that's going to discourage people from moving into the state. And it might not kick in for a while if you raise taxes; but what's going to happen is, people aren't going to move in as much, and then just a natural exodus from the state, you're going to see over time on that more and more people moving out of state. And, again, I'm going to have a slide in a moment to show that.

And to bring it back -– again, another personal anecdote -- I'm not trying to hurt anyone's feelings or anything -- but I don't live in California, and there's two main reasons. I live in Tennessee, and I quit my job there two years ago, and I interviewed here at PRI, and they wanted me to come out and work in the Sacramento office. And I also interviewed with another think tank. And both jobs I would have loved doing. My wife grew up and spent some of her childhood in California. And, obviously, it's cool to live in California. You know, we would have liked to tell our friends we're leaving Tennessee. I tell people I live in Nashville, and they make jokes about country music. And so it would be much better for us to be able to say we lived in California. And there are two main reasons we didn't.

One is, I had a young son, and his grandparents would have been on the East Coast, so that was a major reason we didn't want to fly out here and move here.

But the other major reason, to be honest, was the tax code here terrified me. You know, on the off chance that I'd become a successful author and make a bunch of money, I didn't want my prime earning years to be here.

And it's not simply that I could say on paper, okay, well, what are -- how high are the taxes here, and then how much more would I have to make in order for it to be worth my while to come out here so, after tax, it's comparable? Because I knew that I couldn't trust that the rates would stay the same. You know, I saw this budget crisis coming; and, in retrospect, I was right that, you know, taxes went up relative to when I was making that decision.

All right, so, again, there's all sorts of other issues you're talking about. But it really is the case that people do make decisions based on the tax code. And, obviously, my household income isn't a drop in the bucket. It doesn't make a difference, but you've got thousands of people like me. Or if you're a business deciding where to locate and you know it's going to be harder for you to attract talent because of the tax code, I mean, that's a real consideration.

Okay, this -- I apologize, it's hard for people in the back to see this, but going back to the point I made about tax fairness. So, yes, probably the primary objection to a flat tax is that, undeniably, it lowers -- you know, there's no way to get around it. If you want to impose an average rate, you're going to have to lower the marginal rate that rich people pay. There's no way around that. But again, I would stress there's a lot of perverse outcomes with the current code.

And here again, it's difficult to see, but I think this is the 2005 tax year, there were 1,597 filers who had adjusted gross incomes of over $200,000, and yet they had no tax liability. All right, so it's a little bit misleading sometimes to think, well, you know, California's got problems but at least they make the rich pay their fair share. Well, not for these 1,597 rich people. And this table just lists some of the exemptions -- the deductions that they were claiming.

So the point is with the flat tax, yes, that marginal rate comes down; but at least if it really is a true flat tax and you get rid of the exemptions and other deductions, you know that people who are paying a lot, they're at least paying proportionately to how much their income is.

All right, so this slide goes to the point I was making about migration patterns. And I have to be honest, when I saw this data, I was surprised. So I, of course, theoretically was primed to agree with this sort of philosophy, but I was surprised by how significant the effect apparently is.

So what this is showing, the bar-chart aspect of it, is the percentage of California's population that either comes in or leaves, that's excluding foreign immigrants. So this is just U.S. citizens. It also excludes births and deaths. So this is just trying to capture California compared to other U.S. states, how many people relocate. And, again, it's a percentage of the population.

So, as you can see, what you would think, without having seen this chart, you would think it wouldn't be that big of a deal when they drop the top marginal rate from 11, down to a little under 9½ percent, that coincided with people coming into this state. And then they jacked the rate back up, and that almost perfectly overlaps with when people were leaving en masse. And then, again, the pattern reverses itself.

Now, let me concede the correlation is not causation. You can make an argument that there's some third factor that, you know, the California economy was bad, and so that's when people were leaving the state, in the middle there. Revenues were falling, and so that's why the Legislature raised the rate because so many people were leaving, and they had to make up the gap. So in fairness, you could make that argument. But nonetheless, like I say, that struck me just how apparently significant just fairly minor changes in terms of a few points that the top income tax rate is.

COMMISSIONER DE LA ROSA: Are those bars affluent Californians or all immigration and outmigration?

MR. MURPHY: No, that's, I think, the graphics person put that on the title, and I didn't catch it. So that's -- we're making the point --

COMMISSIONER DE LA ROSA: This is everybody?

MR. MURPHY: That's everybody, yes.

There is data that I don't have to present to you, that just isolates in terms of upper-income people that is also pretty striking. But I don't have those figures for you. But, yes, this particular chart is everybody.

COMMISSIONER DE LA ROSA: So people pick up and move their lives for a 2 percent change in the tax rate?

What does that mean to a person that makes $100,000 a year?

MR. MURPHY: You're right, after taxes, you wouldn't think it would be that significant.

What I would stress, though, I think part of it is, it's not so much you raise it by a point and a half and then a bunch of people sell their house and say, "Honey, we're leaving. We're going to Phoenix." I think more of what it is, is that fewer people move into this state -- that, you know, they're considering -- if someone's leaving and where am I going to relocate? They're interviewing at various places. They don't go into California. And so people that are leaving for whatever reason, they're taking a job somewhere else or what have you, they're taking care of their sick mother on the East Coast. Those people are still leaving, but then you're getting fewer people coming in. So I think that's part of it.

So you're right, it's not merely that thousands of people are just going to up and leave because of a small change, in that sense. But, again, in economics, a lot of these times, you see stuff like this, the things that you wouldn't think would matter all that much, actually in the aggregate, when you're talking about millions of people, it does add up.

CHAIR PARSKY: Let's hold off, everybody. Hold off. This is meant to give you -- you're going to hear different points of views, and then we're going to come back around. So let's hear them both first.

MR. MURPHY: Yes, let me -- you can grill me when I'm finished here.

So again, this is just speaking to the point -- I'm going to have this and then a slide for the experience in the eighties. The idea -- this is a Laffer-curve effect, that when you lower the top tax rate, actually receipts don't collapse. And, in fact, there's historical examples where they went up.

So to be clear, what we're proposing in the PRI plan is not a tax cut, per se, because it's revenue-neutral by design. But the way it manifests itself is, it is lowering that top rate, and so that's why we thought this was relevant to show when the top rate was lowered in earlier periods, what happened with receipts. So this is Mellon, under Harding and Coolidge, lowering the tax rate. And you can see what happened to receipts, especially near the end of the Roaring Twenties there.

And I would argue, as someone believing in supply-side economics, that it's no coincidence that it was the Roaring Twenties when tax rates were brought way down. In other words, people say, "Well, that's just because in the twenties or in the eighties, yes, the economy was booming, and so no wonder tax receipts went up. It had nothing to do with the tax cuts." But I would argue it's not a coincidence that the two decades when tax rates were really cut, is when we associate with prosperity.

And then you see --

CHAIR PARSKY: No one on this commission remembers the twenties, so don't worry about that.

MR. MURPHY: Right.

A similar thing in the 1980s --

COMMISSIONER EDLEY: I'm sorry, so the implication there is that the -- okay, so the implication there is that the reduction in the tax rate brought on the Great Depression? Is that what you're saying?

CHAIR PARSKY: Chris, Chris, Chris. Let him finish. Let him finish. You're sitting here, and --

Go ahead.

MR. MURPHY: No, we cut the chart off.

I don't even know what you're talking about.

Yes, so the theory behind this is not just throwing up lines here for correlation. The theory, of course, is you lower the top marginal rate. That gives high-income earners the incentive to earn more.

And there's also -- I don't have the specific numbers to show you, but there's also an issue of mobility. So it's not simply -- or let me put it this way, you see statistics about, "Oh, well, sure the top 1 percent earned 30 percent more," or whatever the number is during the eighties, "and so a tax giveaway to the rich." But the composition of who is the top 1 percent changes over the course of time. And so if you cut rates and you get rid of loopholes and things and you get rid of crippling regulations so people who were previously middle class can open a business and become millionaires, the way that's going to show up in the data is, "Oh, the income accruing to the top 1 percent increased even though" -- that's what you want, you want people who were previously of modest means to make it rich, to hit the jackpot in that respect.

So, again, the figures you see about what happens with income distribution, you should all keep in mind that a lot of times, that masks the mobility between classes that increases. It's easier, in other words, for someone of modest means to open a business and become very successful if marginal tax rates are lower because the person gets to keep more. If they go out and work 100-hour weeks and plow all the money back into their business, they get to keep more of it if marginal tax rates are lower.

But, again, the same patterns you see here in the 1980s, the top tax rate receipts went up.

So what happened in the eighties is that the reason the deficit went up so much was not because Ronald Reagan cut taxes and so the government was starved for revenue. It was that Ronald Reagan agreed to increase spending so much that the spending increases outpaced the revenue increases.

Okay, I've only got two more slides left here.

I was asked to briefly comment on the Laffer flat-tax plan as well because, I'm sure as many of you know, he has, over the years, proposed something for California. So let me just go over the differences between the two.

So what he proposes is to replace just about all state and local taxes with a business value-added tax and a personal income tax of about 6 percent. So in the Q&A,

if you want I can get into more specifics, but he would keep mortgage-interest deduction and sin taxes and a few other things, I believe. But the idea is, he wants to completely overhaul it and replace it at the state level with just these two taxes.

The benefits there, the simplicity in terms of economic efficiency as well, that from a textbook economist, economic-theory point of view, it makes more sense to completely overhaul the thing and have one system in place.

Also, the business value-added tax -- so this is what Laffer's plan does -- but the plan I wrote for PRI does not do -- is Laffer would allow complete business expensing. So when a business buys a new machine that tax year, it completely writes that off, so there's no depreciation schedule.

So the benefit of that in terms of economic theory is, that's more of a consumption tax rather than an income tax. And so it distorts the saving consumption decision less, whereas an income tax does distort that decision. It makes it more advantageous to consume rather than to save and invest. Because when you save and invest, that accrues as income in the following tax period. So if you're taxing income, it makes it less attractive.

The cons of the Laffer flat-tax plan relative to the PRI plan, is that because of that allowing full business expensing, you get some counterintuitive results, at least as far as the average citizen might think. And so if you're going to implement this plan, you just have to be aware that there could be cases that some citizens would think would be crazy.

So, for example, you could have a company that is very profitable, they're reporting to their shareholders that they're having a great year. But if they plow all that profit back into the business by buying a new factory or what have you, they might have no tax liability that year because they completely expense all those investments.

On the other hand, you could have a company that's having an awful year and they go bankrupt and they're selling off their assets just to satisfy their creditors, and they could have a huge tax bill because they had previously expensed those things. And so the revenue they get from selling them is going to be counted that year.

So it makes sense in terms of economic theory. And, you know, I could explain to you why that's a good idea. But for a lot of people, that seems crazy that a business that has a very profitable year has no tax liability compared to one that might be suffering losses.

The other main problem, I think, with the Laffer flat-tax plan is that he does -- again, in the interest of simplicity, it makes perfect economic sense -- but he wants to, you know, get rid of all the individual tax codes at the state and local level and replace it in one fell swoop with this business VAT and personal income tax. And so, of course, you get into trouble there with: How do you allocate the revenue coming in from this one flat tax to the various localities? What if one city wants to be more responsible, and they would have cut their own taxes and their own spending -- you know, how do you deal with that if all the money is coming into one pot and the State's divvying it out? So that's more of a practical problem -- not in terms of a pure economic-theory one, but that is an issue.

Okay, this is the last slide here, contrasting with the Laffer plan. This is the plan that I wrote up for PRI.

What does it do? It would replace corporate and personal income tax with the flat rate of 3 percent and eliminates the AMT, estate, inheritance, and gift taxes.

Again, in this pure theoretical form, we got rid of all deductions. So you don't get deductions for mortgage interest or how many kids you have -- anything like that. Just to see if you really push this to the theoretical purity extreme, how low could you get that rate? And we were thinking you could do it with a 3 percent rate.

Obviously, I know there's political constraints, and this isn't going to probably come out of the Commission, but I just want to show you, this is -- you know, in terms of the benefits of a flat tax, that is, you could push it that far.

So the pros are, that would be fewer -- the pros in terms of if the State wants to go the route of a flat tax, the Laffer plan versus this one, the pros here, there would be fewer surprises that you're just reforming the income-tax code. And so you could better assess -- your people, your economists on staff could anticipate what's going to happen with fewer surprises.

There's also fewer complications. Because I know you've got dedicated spending programs that are tied to particular taxes, and you've also got things like unemployment insurance.

And so it's easier to deal with all those other constraints if you do a more modest, just reforming the income tax.

The cons of doing it this way, as opposed to the Laffer approach, is that under our plan, we still --

you know, businesses still have a depreciation schedule. So when a business buys new equipment, for example, it doesn't get to completely expense that and write that off that year. It only, every year, claims as a business expense the depreciation. As you know, there's a lot more in terms of compliance, and you have to worry about fraud and things like that. And then also you're taxing income and not consumption, so there's still that distortion.

The other main objection to doing it this way as opposed to what Laffer wanted to do -- or to flip it around, the benefit of the Laffer plan compared to this one -- is his, because he's going to completely get rid of sales taxes and other very regressive taxes, even though on the income-tax side, you're reducing progressivity, because you're bringing down the top rate, you're increasing it because the Laffer plan, you know, eliminates those very regressive taxes and replaces it just with the one flat rate; whereas the PRI approach, since we're not tinkering with those other regressive things like sales taxes, you're –- on net, this is going to be more regressive if you did this as compared to the Laffer plan.

And I think that's it. Thank you.

CHAIR PARSKY: Thank you very much.

We'll have Robert McIntyre present, and then we'll raise some questions.

I would just bear in mind the last two slides that this presenter gave us, and recognize that the principles or the prism we have to pass any recommendations through would cover not only proposals that would encourage economic growth, that would deal with the issue of predictability or volatility, but also on the issue of regressivity or progressivity.

So let's just bear that in mind as we are looking ahead.

Mr. McIntyre, why don't you go ahead?

MR. McINTYRE: Thank you. I appreciate the opportunity to be here. And I want to announce at the outset, that of the two panelists that you're hearing today, I agree fully with one of them.

CHAIR PARSKY: We appreciate your sense of humor.

MR. McINTYRE: And my candor.

CHAIR PARSKY: We always like to keep these discussions light, so that's good.

COMMISSIONER PRINGLE: And we all agree with "Bob."

CHAIR PARSKY: There, you have it.

MR. McINTYRE: My basic message to you today -- and I have a long, written statement which I'm not going to read the whole thing of, thank God.

CHAIR PARSKY: Please don't.

MR. McINTYRE: And I hope you have a chance to look at it. And it did kill a weekend for me, so you should be punished slightly yourself, I hope.

My basic message is that a fair tax system is the best way to assure both adequate revenues for California and economic prosperity in the state, and that proposals to make the tax system less fair in California will not serve the interest of the vast majority of California residents.

My daughter lives in Oakland. She loves your tax system the way it is because she doesn't make very much money. I suppose when she makes a lot, she'll be asking me to move to the Pacific Research Institute, but I don't expect it.

The first thing I wanted to focus on is where California's tax system is right now. I asked the Institute on Taxation and Economic Policy, which is a group that's sort of related to us but is just a research group, to take a look at the overall California tax system. And it's on page 2 of my testimony, looking at all of your taxes -- income taxes, sales taxes, property taxes, business taxes -- the whole ball of wax. And what they came back with, in looking at it in 2007, is that

California's tax system for all the talk of it being so progressive -- and the income tax is -- but when you put all the taxes together, your tax system is sort of flattish; and when you take account of the federal deductibility for income and property taxes, quite regressive. And the recent changes made it more regressive still.

So when you look at the final results here, the best-off 1 percent of Californians pay less than every other income group in the state. Less than the poor pay by a lot. Less than the middle income pay.

So you shouldn't think you're starting off in a place where there's a lot of room to reduce taxes on the top incomes and retain a fair tax system, because you already have one where the top incomes pay the lowest effective rate.

And anybody who says that they want to make California's tax system less progressive, what they're really talking about is making it more regressive. And they ought to be held to a high burden of proof for why that's a good idea.

The second section in my testimony is something you've heard so often, I'm not going to repeat except in a sentence. Your income tax has kept up with the economy over any reasonably long period of time. The other taxes have either muddled along or fallen far behind the growth in the economy, especially the sales tax.

So the income tax is another advantage besides being the one progressive light in your tax system. It has also, over time, with some volatility, kept up much better with the economy than any other tax.

Now, part three of my testimony is the part that I think –- I hope -- at least, I find most interesting, and I think you might find most interesting, and particularly in the second part of it.

I've heard there's been talk about cutting the capital-gains tax in California to reduce volatility or reducing the top tax rate in California to, I guess, reduce volatility.

What we've done here is to take a look, with using the same model that gave us the figures I talked about a minute ago, as some kinds of alternatives, if you wanted to cut capital gains taxes or cut the top tax rate, because that's the same people. You know, 80 percent of the capital gains go to 1 percent of the Californians. Taxes on the rich and taxes on capital gains are practically synonymous.

So we looked at some -- I'm not saying plausible, but certainly conceivable alternatives within the revenue-neutral mode. Obviously, there could be many more.

And in fact, if you guys come up with some interesting ideas and would like to know how our tax model would score them, we'd be happy to do it. Because one thing we can do, and I don't think even the people in your government -- and they're very advanced in their tax-analysis capabilities compared to most states -- but it's very hard to get all the taxes put in. And we've spent an awful lot of time and money building this tax model over the years, and we think we can give you some with reasonable answers.

But just looking at -- suppose, for instance, you want to get rid of the capital-gains tax. That gets rid of the volatility in the income tax. Throw it away, and let's just solve that problem inside the income tax. You'd have to raise all the tax rates by 37 percent.

Hugely, in other words, including the top regular rate. And when you were done, you would have cut taxes for the top income group by about $40,000 a year, and raised taxes on every other single income group quite substantially. That's the most progressive of the options I looked at.

The second option I looked at was to exempt capital gains and replace it by increasing the sales tax by about 40 percent. You could do that with rates. You could do it with base broadening. The differences are minor. And the answer there is, you would have an even bigger tax cut for the top group, and even bigger tax increases for 95 percent of Californians.

Finally, I took a look at the Murphy plan adjusted, so that it actually does break even, but only just looking at the personal side, and adopted this flat tax to replace the income tax, the personal income tax. And that came out the worst of all. The tax cut for the wealthy was about 50 percent, and the tax increases for the middle class were 300 percent. So not happy solutions to any. And you know this is a tough business.

But I hope that if you do come up with some plans -- not along these lines, I hope -- but that you think may add up to something that would be good for the general public overall, let us know before you decide, and we'd be happy to run through the tax model. And you can believe us or not, but at least you'll know what we'll be saying about it.

Now, I have another long section on capital gains and economic growth. And I'm going to skip to the punch line, which is this: You hear so much about other states who have done something that apparently has helped their economy, or so they thought. Well, look around you. You're surrounded by states that have, in recent years, cut their top tax rates, cut their capital-gains taxes. In one case, adopted a PRI-style flat tax. And they're all in the same boat as California in this economic crisis, where revenues are falling off tremendously, they're running big-budget deficits. This is a problem that is not caused by California having a fair tax system. It's caused by outside economic factors. And all these other states -- Arizona, New Mexico, Utah, Nevada, with no taxes at all except on gambling -- all in the same boat.

Now, finally, what should you do, in my humble opinion? Well, the personal income tax is a terrific tax in California. You should be proud of it. It taxes the poor and the middle class much less than in most states. It taxes the rich more, the people who can afford to pay, the people who benefit the most from your society here in California, in your wonderful state -- which is so wonderful, my daughter refuses to move back to where I live on the East.

Your property tax is a disaster, and you all know it. It's just crazy. If there was ever something that cried out for revenue-neutral reform, it's the property tax. I mean, I'd like to raise some money someday, too. But in the short -- even if you can't, a system where you have two houses next to each other, one assessed at a hundred thousand and one assessed at a million, where businesses don't get reassessed and their share of the tax burden keeps falling. I mean, you all know this; but, boy, you're going to hear from some property-tax people this afternoon, you heard some interesting ideas this morning. Fixing the property tax, I think, should be at the top of your list if you're worried about fairness on a horizontal basis, if nothing else.

The corporate income tax in California hasn't done particularly well in revenues. Of course, you're at the mercy of the federal government to a large degree on that. Congress does something or fails to do something or their administration does something or fails to do something. The failure in large part over the last decade or so has been enforcement. And corporations have been moving profits offshore where neither the federal government nor the State of California can get to them.

You really ought to be pushing Barbara Boxer and Dianne Feinstein and all of your representatives to do something about this. I think there's some hope that it will happen because the Obama Administration is desperate for money and might have to do something positive in this area.

In the meantime, single sales is an allocation formula. It's just a recipe for tax-sheltering and moving income to other states. If there's any chance to stop that before it takes effect, I think you ought to recommend it.

Sales taxes, I don't have much to tell you other than this: Expanding the base is not going to make the tax -- the sale, and lowering the rate will not make the sales-tax system much fairer in terms of distribution. Hardly at all. So if you want to tinker with that, if you want to start taxing health care -- God forbid -- or something, just keep in mind, it's not going to improve the overall regressivity of the sales tax very much.

And as for volatility, in general, everybody knows the answer: Smarter budgeting. Not endorsing your particular version, but that's what needs to be done. I mean, you would not give away a source of revenue that's, on average, 20 percent of your income tax if you could budget better. You know, it's like if your kid goes to school and he's a C student and he gets an A a couple of years and you pull him out. God, I can't stand that anymore. You wouldn't do it. You wouldn't pull your kid out of school just because he got a couple of A's once in a while. You would hope that someday he would do better overall.

Anyway, so that's my message to you and my offer, which is -- and more importantly than an offer --

we care about this deeply. My group spends most of its budget and time on state and local tax policies. And you are the most important state in the union.

We'd be very happy to help you with this, eager to help you. And if you have some good ideas -- or even bad ones -- we'd be happy to evaluate them.

Thank you for the opportunity to be here.

CHAIR PARSKY: Thank you very much. And we will call on you for some analytical help.

MR. McINTYRE: Notice, I only took ten minutes.

CHAIR PARSKY: Okay, let's step back now and we'll ask some questions.

Again, these presentations were here to evoke some questions and ideas.

One thing I would say to start, and that is that, once again, a change in one element of tax, if we are going to take a look at overall reform, will have significant pros and cons on the goals we set out. So let's step back and make sure that we're looking at something comprehensive, but let's start some questions.

Richard?

COMMISSIONER POMP: Mr. Chairman, I just want to endorse the earlier comments about doing something bold. But for me, boldness has to be based on analytical rigor and empirical evidence. That boldness based on anecdotes is negligence, that's not boldness.

So this was a very important panel, I think one of the best we've had. And I compliment the staff for putting it together.

The Laffer curve, about reducing taxes and encouraging work and investment, I heard Mr. Murphy's comments and I'd like to hear Mr. McIntyre's comments on that.

MR. McINTYRE: Well, as you know, President Reagan fell for that particular idea briefly in the early 1980s and had his big tax cuts, and it didn't work out. In fact, a quote in my testimony, when Dave Stockton gave him the bad news, the budget director, Reagan looked at him, and he said, *"You mean, Tip O'Neill was right?"*

Well, it's a theory.

Now, I would say this, in addition: The people who hold the theory that cutting taxes on the wealthy increases revenues also hold the theory that cutting taxes on the wealthy will lead to lower government spending because it cuts revenues. It seems to me, if you hold both of those positions, you probably need to wonder what is a believable thing for you to say. So I don't know what to -- Art Laffer does believe that cutting taxes increases revenues, and Jack Kemp does believe it, and Ronald Reagan believed it recently -- excuse me, not recently -- briefly, when he said that he would pay for his defense buildup with the revenues from the tax cuts. It was about three days after he said that by cutting taxes, he would take away Congress's allowance. So I'm done with that, other than to say it's goofy.

CHAIR PARSKY: I think a theoretical debate over whether or not reducing taxes produces more revenue is an interesting discussion. But I would urge that we look at changes: Not assuming that those changes will produce more revenue, but scoring whatever changes we come up with against a trend line of revenue to try to produce the same level of revenue, but in satisfying the goals that we're talking about.

So I think it's perfectly okay to debate back and forth whether or not the Laffer theory works. But I would urge that we at least think about not getting into that debate, to start, because we might be here for a long time over whether that was right or wrong. But I do think we need to score whatever we are proposing, as you said, Richard, to come up with an analytical case that we can defend.

COMMISSIONER POMP: I am very happy to stipulate that in our deliberations, we should not assume that lowering rates is going to increase revenue. I think that's a perfectly reasonable stipulation, and I will subscribe to that.

So may I continue?

CHAIR PARSKY: Please.

COMMISSIONER POMP: There is, I think we will hear, a proposal at some point to eliminate the sales tax. And so I am curious -- I think, Mr. Murphy, you would be in favor of that. And I'm curious what Mr. McIntyre would think about that.

CHAIR PARSKY: Mr. Murphy, is that a "yes" or a nod or what?

MR. MURPHY: I actually -- I mean, we don't discuss that at all in the proposal. So, I mean, certainly PRI, per se, does not have a position on that.

COMMISSIONER POMP: Then I will let each of you respond to how you would feel about that.

MR. McINTYRE: Well, eliminating the sales tax and turning yourself into Delaware, without the corporation filing fees, has certain attractivenesses, if you could figure out how to replace the revenues. And that's very difficult.

California's sales tax is extremely high. And perhaps finding ways to lower it, maybe by fixing the property tax or maybe by getting the corporate income tax to start yielding the revenues it used to, I think it would be a perfectly fine approach.

Eliminating it is going to be extremely difficult because it's such a big revenue source. And you just have to raise something else so much.

CHAIR PARSKY: Becky?

COMMISSIONER MORGAN: Just a quick question for clarification. Maybe I'm overlooking it, but a simple question on the flat tax.

Are you using gross income, adjusted gross? Or what is your basis for determining the 4 percent?

MR. McINTYRE: The –- oh, him?

CHAIR PARSKY: No, I'm talking to Mr. Murphy on his flat tax.

MR. MURPHY: Yes, the figures here, that was gross. So for the personal side.

So the businesses, it's net, like their standard expenses.

COMMISSIONER MORGAN: I just wanted to clarify that.

CHAIR PARSKY: Curt?

COMMISSIONER PRINGLE: Yes, Mr. McIntyre, if I could ask just a couple questions on the chart, which I do find intriguing in a positive sense of the use of the word "*intrigue*" on page 2.

Could you explain to me what property taxes you see -- since it's such a significant part of the lowest 20 percent of income-earners in the state -- what property tax does that include for them as payment?

MR. McINTYRE: Primarily, the low-incomes, who tend not to be homeowners, of course, it's a portion of the building owners' property tax.

COMMISSIONER PRINGLE: So you are -- in this chart, you're ascribing all incomes to the state, all taxes? You're breaking that down to the individual?

MR. McINTYRE: Right.

COMMISSIONER PRINGLE: And you're showing where that --

MR. MCINTYRE: Exactly.

COMMISSIONER PRINGLE: -- individual receives that?

MR. McINTYRE: It includes the taxes that hit residents of California. Of course, some taxes are exported out of state. They're not on the table.

COMMISSIONER PRINGLE: Therefore, under this chart, for example, if there were a split-roll tax on commercial property, and most of those in that lowest 20 percent, as you had suggested are not homeowners, have you assessed what some of the proposals on a split roll, how that would increase that tax burden on their share of property tax?

MR. McINTYRE: Well, it depends on what you did on other taxes -- excuse me, within the property tax, no, I haven't looked at it particularly. But if you just did that on split roll and residential, period, and you raised the tax rate on the business side for residential, then it would increase the burden on the low incomes, yes.

COMMISSIONER PRINGLE: Therefore, as we hear later today on all of the discussion, be it of in creating a split roll for an increased rate or a reappraisal or reassessment, all of those that would affect commercial property, that would be seen against that population?

MR. McINTYRE: Right, unless you coupled it with an increase in the renter's credit or something like that to deal with it.

COMMISSIONER PRINGLE: Where do you put property tax on nonresidential property? On just commercial property. Are you distributing that among all of the income categories as well?

MR. McINTYRE: Yes. It's on the table, under "*Other Property Taxes*."

COMMISSIONER PRINGLE: So that would be -- so tell me which one that is.

So "*Property Taxes on Families*." And so that would be the "*Other Property Taxes*"?

MR. McINTYRE: Yes.

COMMISSIONER PRINGLE: So the "*Property Taxes on*

Families" mainly mean on residential use, primarily?

MR. McINTYRE: Homes and personal property.

COMMISSIONER PRINGLE: Okay.

MR. McINTYRE: And also a share of the renter's -- of the taxes including rent.

COMMISSIONER PRINGLE: Okay. On this chart, do you -- sales tax, property tax and income tax. So sin taxes are not included on this chart?

MR. McINTYRE: No. They're included under excise taxes, generally.

COMMISSIONER PRINGLE: So it's under the "*Sales and Excise Tax*"?

So all of the State's sin taxes would be captured in either one of those?

MR. McINTYRE: All the primary ones, yes.

COMMISSIONER PRINGLE: Okay, have you looked at things like a state lottery or some recent state contributions from gaming, gaming tribe contributions, such, back to the state? Have you looked at any of those? Is that something --

MR. McINTYRE: I've been unable to conceptualize how to distribute them or whether they ought to be distributed. They're sort of voluntary contributions to the government by people not smart enough to know the odds. And it's just hard to -- it's hard to figure out whether it's a burden or a benefit to be able to play the Lottery. I can't --

COMMISSIONER PRINGLE: Well, but I'll bet you there's some people out there -- mainly a Toyota dealer -- that would say the same thing about buying a Saturn.

MR. McINTYRE: Well, that's true. We don't count the price of a Saturn in our distribution table, either.

COMMISSIONER PRINGLE: But you do on all the sales tax collected on it?

MR. McINTYRE: That we do, yes.

COMMISSIONER PRINGLE: And I guess that's -- I mean, I'm not challenging you in that sense.

MR. McINTYRE: Right. If you come up with a good idea to do the lottery, I'd love to do it, because being a good right-wing Christian, I just don't like it.

CHAIR PARSKY: Those equate; is that what you're saying? That's good.

MR. McINTYRE: The lack of likeness for -- maybe they don't, I don't know. We all were brought up to think our version of Christianity was better than the other.

COMMISSIONER PRINGLE: Well, and God bless you on Maundy Thursday. But beyond that, if we could -- if we could, in fact -- I really do think that this is very valuable, and I like that. And I'm not being --

MR. McINTYRE: No, no, I think those are really good questions, and I'm glad you asked.

COMMISSIONER PRINGLE: But also I'd like to see, if in any other state, you see where gaming proceeds that come to the state, I view them just like taxes. They may be more voluntary taxes but, in fact, I believe that when people go out and buy certain goods that they pay sales tax on, they're making a voluntary action as well. And, therefore, some of that sales-tax activity is voluntary, just like gaming.

So I would like to -- you know, if you ever come up with that, that would be -- if you ever see that, I would like to see if you could share that with us, too.

MR. McINTYRE: I actually -- other people have done some work on it, so I could get that over to you.

COMMISSIONER PRINGLE: Thank you.

CHAIR PARSKY: I just want to pause to make sure I understand, Robert.

I think it's clear your views of the Murphy proposal -- that's clear. But -- let's not call it the "*Laffer proposal*" because that will get into a discussion about the increase in revenue as you lower rates. But an alternative proposal that would not just focus on the income tax, but would include a form of business sales, value-added consumption tax -- net-receipts tax, something along those lines -- and your view of -- and eliminating all other taxes.

MR. McINTYRE: Okay.

CHAIR PARSKY: So what would your reaction to that be?

MR. McINTYRE: Well, it would be negative. I've written about this endless times at the federal level where that's been proposed.

The problem is this: There is no doubt that under any one of these flat-tax proposals, taxes on the wealthiest people will fall. No doubt in the slightest.

COMMISSIONER EDLEY: Income tax?

MR. McINTYRE: Everything. If you add it together, all the taxes they pay now, compared to what they would pay under any of the flat-tax proposals that I have ever seen -- and I've seen most of them -- taxes on the wealthiest people would fall.

So if that's true, and you have a revenue-neutral constraint, then taxes on everybody else would have to go up. And I'm unhappy with that result.

CHAIR PARSKY: Okay, but the going-up or going-down, you're focusing on a given point in time. You're focusing on, you know, at X-year, that --

MR. McINTYRE: Y-year and Z-year, all three.

CHAIR PARSKY: But one more time, just to make sure we understand. If you looked at a trend line for revenue and a trend line for progressivity and focused on California, have you done that analytical work for eliminating all taxes -- all state and local taxes except for the personal income tax, flat, with deductions or no deductions, and a corporate sales tax that might exclude intercorporate purchases? Any equivalent of a form of that. You've looked at that vis-à-vis a trend line. You've got that analytical work done?

MR. McINTYRE: A trend line in terms of revenues?

CHAIR PARSKY: And progressivity.

MR. McINTYRE: Well, I don't need a trend line on progressivity to tell you it would be far more regressive than it is now.

In terms of revenue, you'd have to tell me the rates. But because a progressive income tax grows much better with the economy, often more the economy than a flat-rate tax, the comparison would be that, over time, the flat-rate tax would fall behind the progressive tax.

The sales tax that you've suggested to replace the sales tax would also fall behind, most likely. But it depends. I mean, unless you really think you're going to get food and health care and all the other things that are exempt now, in the base. Because I think that's politically very difficult.

CHAIR PARSKY: We'll do some analytical work, I think, on some of that.

John?

COMMISSIONER COGAN: One quick question, and it relates to this volatility issue on the flat tax. So I see the flat tax is a very helpful, kind of useful instrument for thinking about reform. And, Mr. Murphy, you emphasized that one of the benefits of a flat tax is to reduce volatility.

So the question is, how much volatility would be reduced by a flat tax? I mean, it does seem that a lot of fluctuations of state revenues are a consequence of fluctuations in the economy. And certainly some part of the fluctuations in revenues are a result of the progressivity of the code.

So my question is an empirical one: Did you do any simulations that would show us how much volatility would have been reduced if we had a flat tax through 2000, and one up through the nineties, and then down, and then the current experience?

MR. MURPHY: No. I think Arthur Laffer has done work on that. But, no, for the PRI analysis, we didn't do that.

COMMISSIONER COGAN: Right.

MR. McINTYRE: Let me just say, he did actually have a table on volatility in his testimony, and he listed the five states with the most volatility in their tax systems. And four of them basically did not have any income tax at all.

So my point is this: He has contributed to this debate.

MR. MURPHY: Can I respond to that?

COMMISSIONER COGAN: Yes, please.

MR. MURPHY: Just to clarify that, to make sure everyone understands what's going on. So I was arguing that the top four most volatile states -- and California was Number 4, and the top three -- the top two don't have personal income tax and the third one only taxes dividends. But the ranking of the volatility was on income-tax receipts. So I wasn't saying that -- what is it, Alaska and Florida and Tennessee -- have more volatile tax receipts in general. I'm saying income tax, and they only tax corporate. So they're -- presumably, if they taxed personal income, it would be less volatile because they have a bigger base.

COMMISSIONER BOSKIN: Alaska ought to be removed from the sample because it's almost all -- oil prices determine Alaska.

MR. MURPHY: Right.

COMMISSIONER BOSKIN: So that doesn't inform us of anything.

COMMISSIONER COGAN: Right. Maybe -- for both Roberts -- would it be possible to take your models and run a flat tax, calculating what the change in volatility would have been had we had some sort of flat tax through the nineties and through the recent experience? Because I understand Mr. McIntyre's point about the distributional consequences. And I'm trying to get a handle on, what is the magnitude of the benefit in terms of a reduction in volatility that comes from a flat tax, since that is one of the alleged benefits of the tax?

MR. McINTYRE: That's an interesting assignment. It would be easy to do.

COMMISSIONER COGAN: Would not be?

MR. McINTYRE: Would be. Would be easy to do. Just go back in time and see what would happen with the alternative tax.

COMMISSIONER COGAN: Yes, yes.

MR. McINTYRE: I'll get back to you on that.

COMMISSIONER COGAN: Great.

And, Mr. Murphy, could you do that?

MR. MURPHY: I could.

One thing, we did look at it briefly. We didn't pursue it. Part of the trouble is for particular years, there was this odd result where the proportion approach of the tax base that was going in as revenue would go up during recession years. And that doesn't make sense. So I don't know if it was that the rates were changed.

COMMISSIONER COGAN: Uh-oh. The model doesn't make sense?

MR. MURPHY: Yes, go figure. I don't know. In economics, that usually doesn't happen.

COMMISSIONER COGAN: If you could give it a shot, I'd appreciate it.

Mr. McIntyre, if your group could give it a go, I'd really like to see those.

CHAIR PARSKY: You would, John, ask that other taxes be left in place? This is just the impact on --

COMMISSIONER COGAN: Yes, yes, just the impact of a flat tax on the income-tax side.

CHAIR PARSKY: The income-tax side?

COMMISSIONER COGAN: Yes.

CHAIR PARSKY: Michael?

COMMISSIONER BOSKIN: Yeah, I want to ask a couple questions in the spirit of getting something, as Richard said, that's analytically rigorous and empirically verifiable. And I want to come back to the context of the two of your remarks of a flat tax to hopefully promote some growth. We can argue about how little or much it might do, and concern, Mr. McIntyre, that I think you rightly raised about distributional considerations. And I want to do this in two stages -- actually, three.

I want to first start by saying, remember our remit is to deal with the tax side. Many of us feel that the spending side needs to be dealt with. We don't all agree. But there's a proposal for rainy-day fund. Chris Edley would like a drought-relief fund to match it symmetrically. And symmetry is a good thing to deal with in life. It's a good principle to start from, in a lot of things, I'm sure you would say, including in the law.

But we have to just hold the spending side -- we can't make recommendations to change the spending side, although we can raise issues on the spending side that our proposals would create.

With that being said, I want to deal with the distributional issues in two phases. First, a lot of state spending, growing over time for various reasons, goes to transfer payments: To Medicaid payments, to welfare, to various education types of subsidies, and things of that sort.

Some of those transfer payments go to rich people. On balance, they go to -- they're more heavily concentrated at the bottom.

So isn't it -- wouldn't one's views about the desirability of a more or less progressive tax system for, say, the state of California depend on what the money was being spent on? So if the transfer-payment system was very progressive and you had a proportional tax, the overall tax transfer system would still be somewhat progressive. So don't we need to at least think about that a little bit?

And then the second part of the question is, the overwhelming part of spending and of transfer payments goes on at the federal level. So we certainly need to be concerned about regressivity, progressivity, changes in how different groups -- even well-off groups, if their taxes go up, et cetera. In anything we propose, we need to bear that in mind.

But isn't it the case that most of what goes on in the transfer payment -- in the overall effect on the distributional income is going on at the federal level? And I understand you would like to see probably more progressivity at the federal level, and we may be getting some soon. But just in a conceptual sense, whether you agree or disagree with the current California system of taxes and spending, et cetera, in thinking through fairness, we need to think through what's going on in the transfer-payment side as well and at the federal level as well, just as we need to think through of our growth --

or the effects on our competitiveness and growth, we need to think through any change we do because it might be deductible against the federal income tax, the net effect may be larger or smaller. So don't we have to put it in that context to get an idea of what the net effect on people is?

MR. McINTYRE: That's a very long question. I'll try to remember where it started.

Funding of a progressive transfer system through a regressive tax could ultimately be slightly progressive. However, it would be much less progressive than funding it through a progressive tax.

COMMISSIONER BOSKIN: I don't disagree.

MR. McINTYRE: We agree on that, but I mean it's their lobbyists. And so I didn't know what your point was.

Let me answer your question another way. If you have a transfer system, which you believe is a good idea because the low-incomes need help and so forth --

COMMISSIONER BOSKIN: Sure.

MR. McINTYRE: -- funding it with taxes on the low-incomes would seem to be counterproductive.

COMMISSIONER BOSKIN: Well, let's just make it a narrower question then. If we look at your tables and we included transfer payments and we netted out the transfer payments from the taxes, it would seem that your discussion that we're overall about proportional or maybe slightly -- actually slightly regressive, at the very bottom, would change from that, from adding in the transfer payments at the bottom, or transfer --

MR. McINTYRE: The overall spending and tax system.

COMMISSIONER BOSKIN: Yes, yes.

MR. McINTYRE: That would be a different question to answer. I'm not arguing with that.

COMMISSIONER BOSKIN: I'm just asking if that's correct.

MR. McINTYRE: I don't know how it would come out.

Last evening, I was at another building in this great university where they talked about state subsidies to businesses done through the program over there.

COMMISSIONER BOSKIN: Sure.

MR. McINTYRE: So I don't know if you added up all of the subsidies in California, whether they would come out as progressive or regressive. But it would be an interesting exercise. I just haven't done it.

COMMISSIONER BOSKIN: I'd like to see you do that because --

MR. McINTYRE: I don't have a model for it, however, so I can't. I can't promise you I can deliver that. I'm two for three now.

CHAIR PARSKY: We'll see if we can find some other way to get that.

COMMISSIONER BOSKIN: It would be very valuable to us.

MR. McINTYRE: But why would you want to take it into account, since it's not even your mandate here?

COMMISSIONER BOSKIN: For a very simple reason: If we made a change, for example -- let me just give you a hypothetical -- I'm not saying this would happen or we could even come up with something that would make it happen -- suppose we created a tax system that was more pro-growth, more competitive -- you might agree or disagree -- let's just say hypothetically we could -- that was able to accomplish those things in an administratively simple way, but it very slightly -- just in this extreme, hypothetical example -- was very slightly less progressive, very slightly more regressive than the current system, but it made things far more stable. If this was how it turned out empirically, we don't know. If it managed to provide, over time, any growth dividend, if there are any supply-side effects, we can argue whether there are, and we're able to give a more stable base of funding for things that are really important to low-income people in education and transfer payments, that might be, on balance, a good deal, and actually, on balance, be a benefit to low-income people.

So I'm just trying to say that I think we have to conceptualize what we do in its context, even if we can't change that other context.

And you seem to want to focus just on the taxes. And that's a place to start. All I'm saying, it's not the end of the story.

Mr. Murphy, would you care to comment on either of those, and on the fact that the federal government is what dominates taxes and transfers?

MR. MURPHY: Yes, so it's true -- and I think this is what he was saying -- that if by design, if we're saying, let's just focus on the way we raise revenue and we're not going to assume that that impacts the spending side, then, obviously, you know, making the tax code more regressive in a way that raises the same revenue and you spend the same way -- whatever the overall regressivity is of the tax and spending system, if you just tinker with the tax side.

But I think what you're getting at is, if the whole point of the -- or a large point is to smooth the revenue over time, then what you're going to see is, yes, it's true that a low-income person might see their tax bill go up in static terms. But if it means they're not going to get laid off or they're not going to have to -- if they work at a state job, they're not going to be furloughed as much because we've ended or we've smoothed out the revenue streams, that maybe that person would rather, with certainty, pay a slightly higher tax bill but know the revenues to the state are going to be a lot more stable.

COMMISSIONER BOSKIN: Or we're not going to slash social services every five years.

COMMISSIONER HALVORSON: Mr. Chair?

CHAIR PARSKY: George?

COMMISSIONER HALVORSON: Almost a purely informational question. I'm not a tax expert at any level. And I'm curious, as I look at this page on the Laffer flat-tax plan --

CHAIR PARSKY: We're going to call that "*the alternative*." Because when you use -- "*an alternative*" -- if you use the word "*Laffer*," we get into this discussion immediately over whether or not lowering rates is going to increase revenue. So we're not going to deal with that, but "*an alternative*."

COMMISSIONER HALVORSON: Laffer-like or whatever -- the question I have is, I don't understand the way this works, exactly.

Does this purport to say that if we eliminated sales taxes, property taxes, all state and local taxes -- eliminated all of those taxes, and replaced it with a 6 percent flat tax, that that would generate the same amount of revenue?

And my question about that, is this a pure mathematical assumption or does that say the economy is going to get better in some area, and other things are going to happen in other areas, and there's all kinds of complexities behind it, and the complexities in the end drive to a similar number? Is this more complicated than it looks? Or is it just arithmetic?

MR. MURPHY: It's just arithmetic. So he is making no supply-side assumptions to come up with that. He just calculates the base.

COMMISSIONER HALVORSON: And is the math good? Has anybody actually checked the math?

MR. MURPHY: Just to disclose, I did work for Arthur Laffer. I don't want anyone to find that out later and then think they were hoodwinked. Yes, when I worked for him, I think I did a good job, and we checked these numbers.

So it's stuff like they take the gross domestic product because, in theory, that's the same as business value-added, and they had that number for California, and then say how much revenue do we want to raise, and then just -- yeah, what percentage do you need to apply to it.

So there are --

COMMISSIONER HALVORSON: So it's arithmetic?

MR. MURPHY: Yes, there are simplifying -- because you don't have all the perfect data. But it's not relying on some economic theory. It is in terms of the measurement, what's the rate.

MR. McINTYRE: Given the source, I would take the arithmetic with an extremely large grain of salt. I've looked at these proposals before, and they almost always grossly overstate their base in order to make the rate look artificially small.

CHAIR PARSKY: Well, I think we'll have a chance to ask our staff to refine concepts like that over the next two months.

So save some of those questions to this afternoon's discussion, because I think you'll see that there will be some thoughts that will tie into that.

Chris?

COMMISSIONER EDLEY: Two questions, please.

The first is, it seems to me -- maybe this is a clarification, but as between Robert II, McIntyre, and Michael, I thought the core of the complication is that while the calculation may be simple, if we're trying to net the distributional affects of taxing and spending, the calculation may be relatively simple for transfer payments. There are a lot of other expenditures that convey benefits with economic values, marketplace values, and the price of those is more complicated. So I don't think we really have any disagreement analytically about the points that would be made there.

CHAIR PARSKY: Right.

COMMISSIONER EDLEY: My question really to, again, Bob McIntyre, have you seen or can you envision any way of making property tax more progressive? You know, a zero bracket?

MR. McINTYRE: The way that many, many states deal with making the property tax less regressive is, they offer circuit breakers or similar relief to the lower- and sometimes middle-income people.

Another way to do it, and some states do this, is a homestead exemption, so that the first X-value of your house isn't taxed, and that reduces the regressivity of the tax quite a bit.

Louisiana has a $75,000 homestead exemption, and because of their unique form of government, every house in the state is assessed at $74,999.

That becomes a flat tax. A very low rate.

COMMISSIONER EDLEY: So I guess do either you or -- Mark, do we have the modeling capacity to look at different -- not just the split-roll issue but different sort of rate assumptions with respect to --

MR. IBELE: On the residential property side?

COMMISSIONER EDLEY: Yes. Do you see what I'm going after?

CHAIR PARSKY: Yes.

MR. IBELE: I'm going to have to punt on that one. We'll have to get back to you on that.

I think there are some models out there that we could use as a starting point. It's a little bit -- and on the residential side, the impact will be easier than on the commercial property side because we don't have the same sort of incidence of tax-shifting questions to address. But we could certainly try to look at that.

COMMISSIONER EDLEY: Maybe with the federal deductions. Maybe we could look at somehow -- anyway, to figure out what could be done with respect to -- if we were lowering the -- if we were lowering the top end of the income tax, if anything could be done with the property tax that would offset it.

MR. IBELE: Expanding the homestead exemption or something like that?

COMMISSIONER EDLEY: Right, right.

CHAIR PARSKY: Becky?

COMMISSIONER MORGAN: Let me first say that, obviously, I'm not an economist and don't do a lot of research these days, but I'm interested in the psychological impact of taxation. And I don't want to do it anecdotally. I think Richard makes a good point, that, you know, we need theory and research behind the recommendations that we're going to make.

But is there any way to factor in the fact that a middle-income person might rather pay a flat tax of some amount on a postcard, not have the attorney, not have the accountant, and be happy with that? Or anecdotally, there are many people I'm aware of, and many of them are in the higher-income brackets, that are leaving California and so -- and the workers are leaving California at 3,000 a week. Psychologically, how do we figure a tax policy that doesn't drive these people out of California, so we are not getting the income? So one that Mr. McIntyre talks about -- where is his chart here? -- on page 2, about the higher-income people taking the federal offset are really paying less taxes.

On the other hand, these people in the middle-income group, the 20th and 40th percentiles, might not be so upset if they didn't have to hire the accountant and the attorney to deal with all of this. And I don't know whether anybody's ever done any study on the psychology of taxation, if you will.

MR. McINTYRE: Well, let me make a point that anyone in California who does not want to take deductions on their tax returns so they'd have a two-line return, can do that right now. And it may raise their taxes. But if they prefer it, they're entitled. So you have an optional flat tax, if you like, where people don't have to take any credits, deductions, anything. It's available. So if people decide they prefer taking deductions, apparently they value those more than simplicity.

COMMISSIONER MORGAN: I'm aware of that. I'm still interested in the impact.

MR. McINTYRE: I filled out my daughter's taxes for her yesterday, by the way, and it took five minutes. California taxes. They're very, very easy to do.

COMMISSIONER MORGAN: I'm sorry that she makes so little.

MR. McINTYRE: Excuse me?

COMMISSIONER MORGAN: I'm sorry that she makes so little.

MR. MURPHY: Can I respond?

CHAIR PARSKY: Yeah, go ahead.

MR. MURPHY: There's -- it wouldn't speak to the psychology of it. And certainly just the headaches of people wondering, "Am I missing out on deductions?" or

"Am I going to get audited for the complexity?" And it is true that, unfortunately, no matter what you do in California, you're still going to have the convoluted federal code. So there's that problem.

I couldn't -- when we did this study, I couldn't find anyone who had studied compliance costs for California, per se, at the federal level. It was the Tax Foundation said it was $325 billion in terms of compliance costs. So that's money that corporations primarily were spending to comply with the tax code over and above what they're sending to Washington.

So how much would that be at the state level? We don't know because we couldn't find a study, but it was $325 billion for the country.

CHAIR PARSKY: I'm not sure, Becky, that the focus is necessarily on psychology, but simplicity and the impact of changes on simplicity.

I mean, one of the commentary that is made about the alternative tax, if it was as simple and there were no deductions, it was really a tax on gross income, if your income was exclusively wages, you'd have no tax return to file because the withholding would take care of your obligations.

Now, that's not a reason in and of itself to have that form of taxation, but it will be a factor, if you will, in people's willingness to support certain changes.

Thank you both very much.

Why don't we take a 15-minute break now, and then we'll come back and finish our morning discussion?

Thank you, both, very much for an interesting discussion.

(Recess taken from 11:33 a.m. to 11:59 a.m.)

CHAIR PARSKY: We have one more presenter for the morning session. There's an item on the agenda that says, "*Commissioner Discussion*." We've engaged in some of that discussion already, but we'll certainly leave some time.

But the next subject is "*Taxes, Education, and Development*."

So Richard Sims is going to give us a presentation, and then we'll be open to some questions.

Richard?

MR. SIMS: Thank you very much, Mr. Chairman, Members of the Commission.

First, thank you very much for allowing me to be here today. I greatly appreciate the challenge that you're confronting. I've looked through your marching orders that you've been given, and better you than me.

Best of luck.

I've spent a number of years working for state legislatures as a chief economist in several states and with some national organizations that deal with state and local tax policy and economic development, primarily. And a large part of what I wanted to share with you are some things that I picked up over the years, some principles and policies to consider when you're engaged in your deliberations, and then some fairly current findings out of academia and in some of the research work that we've been doing in-house that you might find hopefully a little enlightening.

I'd like to start out by mentioning something that I generally refer to as the first principle of public finance: Your tax system should be like you did it on purpose.

That's my economic joke for today.

I was just mentioning to someone, I've been in 41 states, doing studies over the last, roughly, 24 months. Most states, before going in, I kind of refresh myself on their tax system, basically on the plane going to wherever I'm going to.

California, I'd need to go coast to coast several times, and I would still miss a lot because you have a complex and ever-changing tax system, which is to the point of economic development, not a plus.

The second principle of public finance -- and these are my principles -- is that your tax system will probably do just what it's designed to do. That's the old Chinese curse: If you don't change directions, you'll probably end up where you're headed.

You have some specifics that you are already aware of in your tax code that are leading you into a direction that you probably don't want to go. There are a lot of good things about your tax code. The complexity is probably the worst thing about it.

Part of the concerns -- and you've heard much of this talked about this morning -- I'm sure you have in your previous meetings -- you have the various elements that go into your overall tax structure. And I encourage you to always keep your eye on the total composition of your tax portfolio as opposed to one tax at a time.

You do a have a fairly diverse portfolio of taxes, which is a good thing.

A common feature of tax portfolios around the states -- meaning, of all the major revenue sources they have -- is you've got basically the income taxes, individual and corporate; you've got the sales taxes, excise taxes, property taxes. Those are your main sources of revenue, revenues that are big enough to actually make a difference on the funding of the State's General Fund and of its overall services.

Of all of the taxes that you have to utilize potentially, there's only one that actually has the potential to grow as fast as or faster than growth in the economy, and that's the individual income tax.

Nationally, the individual income tax among the 45 states that have individual income -- excuse me, 41 states that have individual income taxes grow about 1.8 percent for every 1 percent growth in the economy.

Yours is almost on the money for that. Yours is right at the national average. I think it's 1.7, where the national average is 1.8. So even though you have fairly high rates, spread over a fairly large range, it's right at the national average. You have no other tax that grows as fast as growth in the economy.

When I was doing revenue forecasting for state legislatures, one year to the next, having a tax system that doesn't go as fast as the economy is not a particularly big deal. Extend that out over the next ten years, let's say. A tax that grows as fast as the average state, and California's individual income tax, if it produced a thousand dollars in revenue this year, over the next ten years, in real dollar terms, taking out for inflation, it would grow from producing $1,000 to producing about $3,000. Substantial growth.

The sales tax, by contrast, would grow from producing $1,000 this year to about $1,650 over that same ten-year period.

So two taxes today that would produce exactly the same $1,000 -- the income tax producing $1,000 and the sales tax producing $1,000 -- ten years from now, the income tax would have doubled the amount of revenue it provides to your next generation ten years out, with no other changes. No change in tax policies in between time. If you just put those two taxes in place, go home and do nothing else on taxes, that's what would happen over time.

That's the danger of moving away from the individual income tax, is for whatever we think of it, good or bad, it is a growth-oriented tax, it's an elastic tax and, over time, it's the only tax that's capable of doing that.

If you wanted to tell the legislators and the Governor how to set the system on automatic pilot so that they didn't have to come back every two years, every four years, asking for rate increases, changes in tax structure, you would have to have a system that depended fairly heavily on the income tax, individual income tax.

You wouldn't go all to individual income tax because you would end up with the government growing faster than the economy, and that's not your goal. But you've got to have that in the mix because all of the other taxes that you can use do not have the potential to grow fast the economy. So you've got to have the individual income tax in there, and in there fairly significantly, in your overall mix of taxes in order to have a system that you could tell the legislators and the governor: "You guys do this one time, fix it, and you can go home and spend the next 20 years worrying about more important things: Worrying about how to fix the roads, how to fix the schools, how to fix every other problem in California. Not how to raise the taxes to fund it with."

So that's a point to keep in mind.

California has -- and I'm sure you've heard this mentioned before -- a structural deficit. My organization runs -- we do annually an update on structural deficits, but I chose to use one from a different group just in the name of objectivity. When the National Center for Higher Education Management contracted for a study on states' funding gaps, looking at all state and local revenues -- against the state and local budgetary requirements, they found that over an eight-year period -- and they were using 2003 as their starting point -- and for the eight years after, from 2003, forward, the next eight years, California had a gap of about 2½ percent in its revenue.

That means that either you would have to cut your budget 2½ percent or raise taxes 2½ percent just to maintain the current level of services.

That's not unusual. Most states -- almost all states, with the exception of four -- have structural deficits, so you're in good company. But it's also the case that every state has to come back every few years and raise some sort of taxes.

Typically, the sales tax -- very typically, the cigarette tax. The most popular tax in the nation is the cigarette tax. 41 states have raised the cigarette tax in the last six years, often by very substantial amounts. In general, you could argue that's a good thing because you're taxing something that we'd just as soon people didn't do collectively, but that's a value judgment.

From a funding standpoint, it's not such a good thing because when you tax cigarettes, you're taxing a dying base. Very literally. The number of smokers are going to be less five years from now and ten years from now than they are today, so it's diminishing.

If you're going to tax cigarettes, well and good, go ahead and do that, but don't put the revenues to any valuable use in the state. Don't tie them to something like education funding. Don't tie them to some vital public service that you're going to need in the future.

You might suggest that you tie the cigarette tax increases to funding the legislative pension fund, but not to something as vital as education, roads, and public services.

You noticed earlier, when Bob McIntyre was on, he gave you a similar version of this chart, showing the distribution of your taxes. I use this not to be repetitious, but just to show that, in general, you're a heavy user of sales tax, you've got very hefty property tax -- the property tax is the tax that, like Bob and like others, I would worry about the most. It's the tax that really causes -- your property tax violates every principle of good taxation. A good tax should be transparent, it should be understandable, it should be equitable. Similar taxpayers should be treated similarly. If you were wanting to design a tax that violated every principle of good taxation, you've done it, and done a very good job of it.

That has implications for long-term growth. If you cared not a wit about public finance but were more concerned about job and income growth over the future, that's bothersome because individuals that might potentially move into the state or stay in the state are bothered about tax systems they don't understand. That's something that we've seen in surveys that really has an effect. You need to have a system that people understand, know how to comply with, that it's easy, it's simple, or it's understandable; and that they feel that they're treated like their neighbors are treated. Proposition 13 doesn't allow that.

An additional concern -- this comes out of some recent studies that I've been doing -- I've taken the results from the Institute on Taxation and Economic Policy findings. I was the policy director there for a number of years. And we looked at such things as -- this table shows, if you look at taxpayer income, that first line I noticed it's labeled *"2,500,"* it should be *"25,000."* A small rounding error there.

But if you look at a taxpayer of $25,000 at $43,000, $70,000, $125,000, $300,000, and $2 million, and then I put the taxes they pay at those various income levels, then below that, I calculated what it cost to educate one child in your public school system. Right now, you put $8,900 into educating a child in your system. If you have a family come into the state that earns $70,000, they don't pay enough in state and local taxes to pay the cost of educating their child.

On average, the demographic studies on California say that for each new job created, you bring in a worker who has one school-age child in their household. So you lose money on every job created that pays under $92,000 a year. That's your break-even point. That's what you have to make in California in order to pay as much as it costs to educate your child. No other public expenditure is taken into consideration, just educating your child.

You created a lot of jobs, but not that many that pay over $92,000 a year. That means that for every one that pays less than that, existing taxpayers are subsidizing that new job.

Let me skip over that.

I'll just mention this, but you're all very well aware of it. The biggest concern we have is, collectively -- this is California and every other state -- is for health-care cost. Rising health-care cost put the onus on doing what you're doing, coming up with a good system that's long-term-oriented, that's going to be viable over the next ten years, 20 years, and 30 years, because the systems that most states have right now, that are, quite frankly, very haphazard, that are not designed to be structural, that are not designed strategically, they're not going to be able to respond to changes in the future, ignore the threat of rising health-care cost. And that's going to be the factor that drives state budgets in the future.

You have a rare moment in time, you have a rare opportunity right now with this commission; and we've been given the gift, if you will, of an economy in chaos that says you can probably do something right now that you could not have done two years ago, four years ago, six years ago. The chaos that we have in the general economy says it's time for -- the term I heard this morning -- for some "*bold initiatives*." You've got the opportunity for it, you've got the demand for it. And if you fail to do it at this time -- if California fails to do it, I don't think you'll have another chance in our lifetime, because we'll solidify back onto the path that we were on, and that's going to be traumatic for the future, it's going to be short-changing every generation that comes after you. You've got this one time to fix it. Do it right, get it on the long-term, sustainable, structurally viable, strategic pathway for the future. And that's how you'll maximize the economic growth of the state.

We've done a lot of work looking at what causes growth from a taxation standpoint. And when I was working for state governors and legislators, one of the first questions I always got, even on my first job working as a state legislative analyst, the very first question I got was, how do we cut taxes but not cut funding? Well, every state that I'm aware of -- which is every state except Vermont -- has a balanced-budget requirement in its constitution: If you cut taxes, then you've got to cut something. So there's often been a focus on business taxation I wanted to start with here briefly.

Every year, *Site Selection* magazine, that's kind of the bible of economic-development locators -- when I was working for the Department of Commerce, we'd get this every November and be all excited about it, you'd look to see where your state ranked on economic development, the business climate. And the business climate is primarily your corporate tax structure, as well as unemployment benefit cost, some labor rules and regulations and things that businesses are reported to be concerned about; and this group ranks each of the states each year. I've reproduced here the 25 best business-climate states.

North Carolina is Number 1 in the country. It's been in the top ten for at least the last ten years.

Tennessee, where my friend earlier was from, Number 2 in business climate.

Alabama, Texas, and on down the line -- you can read the numbers.

I took the state's rankings, and I compared them to their growth in per-capita personal income over the last five years. Number-1-ranked North Carolina was 36th in growth in per-capita personal income.

Our friend's Number-2-ranked Tennessee was 39th in growth and per-capita personal income.

If, when he was offered the job of coming to California, if he had been more focused on income rather than his tax level, he would have made a different decision.

You'll notice, California was 19th in growth over the last five years versus Tennessee is 39th in growth.

So you're doing okay in per-capita income growth. You're doing very well, better than most.

Overall, the states that have the best business-climate rankings underperform the national average. The states with the very best business-climate rankings, the top-ten business-climate rankings do well below the average. Three of the top-ten-ranked states are among the ten slowest-growing states in the nation.

So having a good business-climate ranking is, in fact, an indicator of bad economic performance. I don't want to say "*bad economic performance*," I want to say "*slow economic performance*."

We've seen this same pattern -- I've looked over a number of years over that, but you've seen the same pattern that the better you rank in the business-climate rankings, the lower you actually grow over time. One reason, if you look at what businesses spend their money on, the chart on the right -- the little bar that's sort of the size of a compact disc laying on the table -- is what businesses spend on state corporate income taxes as a percent as far as total spending. About a quarter of 1 percent.

The bar on the left shows what they spend for labor compensation. Labor cost is about 50 percent of what business spends their money on.

Well, if you're a businessperson, what are you going to be concerned about: Taxes or the workforce?

Rather than answer my own question -- first, individuals, when asked by Fox News, it reported 7 out of 10 said they were more concerned about what their money was spent on, what their tax dollars were spent on than what the level of taxes were. So they're concerned about how it's spent rather than the level.

For businesses themselves, there was a study that came out in the New England *Federal Reserve* a few years back that surveyed 4,000 businesses that had moved over a -- I believe it was a 12-year period. And they asked what their major considerations were when they made their relocation decisions.

For manufacturing-type firms, labor was

number one, 36 percent of the reason; taxes were 4 percent of the reason.

For office firms -- that's Silicon Valley, that's the high-tech firms, that's the white-collar firms -- labor was 72 percent of the reason they're relocated; taxes were 5 percent.

Important to note what they meant by "*labor*." And I'll just read this.

"In summary, site selection data do not suggest any correlation between low taxes and positive economic growth or between high taxes and slow economic growth. The location requirements are simply too many, the process too complicated, and other factors too important to justify any relationship."

When the survey respondents said labor was their biggest issue, what they meant by "*labor*," they say, "The single most important factor in site selection today is the quality of the available workforce. Companies locate and extend in communities that can demonstrate that the indigenous workforce has the necessary skills required by the company or that they have the training facility to acquire these skills for the company."

So when they say "*labor is our concern*," 72 percent of the reason we relocate, they're saying it's the quality of the workforce.

The same answer when they were asked, "Why do you pick one city over another?" A survey that Brookings Institute did in the year 2000 asked managers why they picked one city over another. The answer came out to be –- and they've ranked it kind of in the real-estate adage, "*location, location, location*" -- but the education, education, education, is exactly three different components.

Education Number 1 was K-2.

Education Number 2 was higher education.

Education Number 3 was community and vo-tech.

They said that the K-12 system is what they looked to first because they take that as an indicator of what produced the existing workforce. That's their first measure of the quality of the workforce in the community, is the K-12 system.

The higher ed. system, they say we interact with higher ed., we hire people from higher ed., we like being close to facilities that we can send our people to for higher-ed. training.

And the community colleges and technical schools, they said, that's where we get our continual upgrading of -- reinstall new information on our workforce, is through our community and technical schools.

There have been surveys by numerous state legislatures, one that came out in August of 2008, by the Kansas Post Audit Committee, which is a conservative post audit group, but very much by the books. They were asked whether or not their business economic development incentives were effective. They concluded that the negative and inconclusive findings were far more numerous than any positive findings, was the way they put it. In other words, they couldn't find any correlation that existed.

They specifically say in their rather extensive study that there was no correlation between any economic development incentives and the increase in per-capita income in any of the counties in Kansas. That to the extent that there was any increase in total employment, that it was the smallest factor that they could find, and that most of the growth in employment they found could have been explained completely by movement from one county to another within the state. So, overall, the state did not benefit.

The last point I'll mention on Kansas that jumped out at me was, they said, *"Of a sample of 115 counties and individuals that received economic development assistance in 1998, only a third were still in business ten years later."*

That's similar to what we hear nationally. When

I’ve talked to states and individuals around the country, about two-thirds of the firms that receive assistance simply aren’t around in ten years’ time. So if you’re going to give firm assistance, you need to get your money back very quickly, because they’re going to depart.

Colorado did a similar study through their Legislative Council Staff with similar findings.

The U.S. Economic Development Administration did a study -- and this was in 2002, under the Bush Administration -- that looked under the new economy, looking at the high-tech economy and the growth top firms that California leads the world in, and they were looking to see what causes these firms to grow, what kind of policies work. Their leading line in their study findings I thought was worth quoting.

“In the new economy, knowledge, rather than natural resources, is the raw material of business.”

I’m old enough to remember when California was leading off with Silicon Valley. I accompanied a legislative team from the National Council of State Legislatures out here to look at Silicon Valley, because every state at the time had decided they were going to have the next Silicon Valley. That was 20+ years ago.

I checked last week, and in 2008, 40 percent of the venture capital money in America still went to Silicon

Valley. So nobody stole Silicon Valley away from you. You were doing something right over all this time, and continue to do so. And it ties back into your education system, the quality of the workforce. That's what's not replicable anywhere else.

There was an intriguing study by the World Bank. If you're an economist and don't have a life, you find these things intriguing. This study that came out last summer looked at the seven fastest-growing nations in the world for the previous 46 years. It looked from 1960, up to 2006 -- the last year they have data for.

They found in their conclusions, there was a robust relationship between public spending and GDP per-capita growth. That's World Bank economist-speak for, the nations that grew the fastest, tended to spend the most.

When you go into their analysis, it wasn't just that they spent money willy-nilly, they happened to spend money on things that matter to growth and to business, education being two-thirds of the reason that they grew, with the other one-third being a combination of transportation and communications. But that's what they said explained the growth of the fastest-growing nations in the world over that time period.

The World Bank -- excuse me, the OECD -- that was the World Bank study on that one. This is from the OECD, the Organization For Economic Development and Cooperation -- looks at the rate of return on investment in education. This is the fiscal rate of return, what taxpayers get when their tax dollars go into education. They found in their most recent study that looked at this, that the public return on investment in education is 13.3 percent. This compares to a long-term rate of return on stocks of 6.3 percent.

The 6.3, I'll point out, was the 50 years before last year. So it doesn't have the market crash built in there. But the long-term average return -- and that number is pretty consistent whether you look back 50 years, whether you go back 100 years or whether you go back, roughly, 200 years -- it stays around the 6 to 6½ percent range.

The public's return on education -- and, again, this is the fiscal rate of return. So it's purely money that goes directly back into the states' and federal treasuries, in terms of taxes paid because people have had more spent on them in education, earn more, therefore, pay more in taxes -- than they net out the cost of educating them. So that figure is a net gain to a taxpayer, even if the taxpayer is the curmudgeon on the corner who hates kids, has no children in school, who thinks teachers are overpaid and lazy. Still, when that person's tax dollars go into the education system, they get back a rate that's about double what they would get on common stocks.

At that rate of return, they get their money back in about five years. And so for the rest of their life or the generation that's being educated with their tax dollars life, it's free money to them of about 13 percent a year.

How is California doing with regard to education? This chart just came out two weeks ago from *Education Week*. They use a slightly updated figure for spending than what I had on my earlier chart. They've got you up at -- excuse me, slightly lower -- at $7,571 per-pupil spending which, by their ranking, has you down around 47th in the nation.

COMMISSIONER HAUCK: Let's just make it clear, that number is what state spending is. It's not per-pupil spending in total in California.

MR. SIMS: This one, I'll give a pass on because I'm not sure because I took that number straight out of their number.

The previous one I used was combined, state and local, so it was total minus federal spending.

COMMISSIONER HAUCK: Okay.

MR. SIMS: I netted out the federal part of it and looked only at state and local own-source revenues.

COMMISSIONER HAUCK: Do you know what this one is?

MR. SIMS: This one, as I said, I'll give a pass on the exact sum on that. But it's at least consistent across the states where it shows the national average at $9,900 a pupil, with California at $7,500 which, by their rankings, put you at 47th.

Your graduation rate -- and another of those issues, I don't know exactly what "*graduation rate*" means, how long do you go before somebody's considered to be a "*non-completer*" -- but, again, without regard to exactly how it was measured, in comparing the other states, at least was done consistently, you came out to 34th on the *Education Week* survey. And they also measured student proficiency, which you came through at 41st on.

The concern that I would focus on, if I were a California policymaker, would be my comparison. Because I'm concerned competitively: How do we compete with other states?

Well, this chart's going to be kind of hard for you to read because I only had that in a picture format and couldn't break it down very well. But you're at the bottom, so you can see that last little bar; you're the bottom state in the second bar from the bottom.

The good news is, you're ahead of Louisiana, Alabama, New Mexico, Tennessee, Mississippi, and Nevada.

From a competitive standpoint, that would bother me. That would say we're producing a stock of workers that are going to be better than these six states but not as good as about 45 states.

That's a concern when you think back on the previous findings that business says their number-one concern is the quality of the workforce. You're not competitive on what you're doing today.

California actually overperforms what you would expect right now in its economy. Greatly overperforms. And a large part of that, I have to believe, is because of the system that you had 20 years ago.

When I was growing up, California was the world gold standard for its education system. From the beginning to end, you had a world-class education system. People came here for it. You produced a large stock of high-quality workers, many of whom are still in the workforce that benefitted from that.

By the time your workforce has cycled through, where the people being educated at the bottom of the 50 states become the predominant workforce, your competitive position is going to have deteriorated substantially, I fear.

I put some information on the cost of drop-outs and things. We'll save that for another time.

With that, let me just take any questions you might have.

CHAIR PARSKY: Thank you very much. Our Speaker speaks very highly of you.

I want to make sure I understand the thrust of what you are saying.

Are you saying that we should not change our tax system, and certainly not change the reliance on the personal income tax? Is that at the heart of your suggestion?

MR. SIMS: No. I would be very in favor of changing a lot of things about your tax system. Starting at the bottom, with the property tax, definitely. Building up from there.

But on the new vision for the tax system, where I would hope you will lead towards, is a system that is diversified in the sense that it has a large component of your tax system, at least as large as now, coming from the individual income tax because of that unique feature it has of it being the growth tax.

The other taxes you can change around some, you can make them work better, there are some things you can use that would make your system a little more competitive with other states, but most of that becomes a wash.

What you're concerned about, primarily, is your total ability to raise revenue. And --

COMMISSIONER EDLEY: Over time, you mean?

MR. SIMS: Over time. That's the big concern I'd be focused on, is making sure that the system you come out with, overall, at least has what they call the elasticity of one, so it grows at least with growth in the economy. So you're passing on to the next generation at least as good as you have.

Now, that's presupposing that your competition stays constant; that the other states don't improve their public systems of funding education and the other things that matter; and more importantly, particularly California, that the global competition doesn't become any stronger.

Well, you can give light to that by picking up the paper on any given day and see what the other nations are doing as far as ramping up their funding for education, in particular, improving their workforce. We're falling well behind on most of the countries now.

CHAIR PARSKY: Richard?

COMMISSIONER POMP: What is your response to the argument "High taxes means high wages, high wages means less business, location or even outward migration"?

MR. SIMS: In a pure statistical sense, when I've looked at that, I can't get correlation that says that high taxes attract or repel business or wages. It is a fact that it seems like the higher-taxing states tend to have higher wages. But I'd be very reluctant to ascribe a correlation to that.

California has high taxes, in part -- and it's debatable on how high your taxes are -- it depends on who you are within California. But part of the reason for your relatively high overall taxes and overall cost in the state is simply your success over the years.

If you had been an unsuccessful state, your taxes would be very low, your wages be would be low, your housing costs would be low, and everything else would be low. Your taxes go up because your costs go up because everybody wants to be here.

Remember, the other famous Tennessean at one time started out -– he was kind of a poor mountaineer, did well in the petroleum business, that moved out. And I think after he asked his friends, they all said, "*Jed, you ought to be in California*." So Mr. Clampett loaded up and moved the family out here.

Well, that's been the trend for our lifetime. People want to come to California because it's an attractive place to be. And it hasn't been because of taxes, it hasn't been because -- your taxes hadn't been enough to repel that kind of growth. You've got enough general quality of life here.

Your previous investments -- I mentioned your waterways for your agriculture, your school systems, particularly your higher ed. systems attract people constantly, and will for years.

So on the wages, to the extent that I can get a correlation out of it, I see a correlation in that the higher-tax states tend to have slightly higher wages, and tend to attract slightly better jobs; but I'd be afraid to try to make, again, any real causal argument out of that.

CHAIR PARSKY: Becky?

COMMISSIONER MORGAN: Could you help us with, first, the realization that Vermont is a much smaller state than California? I happen to be interested because that's where I spent my youth. But if they're spending the most on education per pupil and they still have the best surplus as a percentage of revenue, what are they doing right?

MR. SIMS: Their surplus comes about because the way -- when you look over time, they're a declining state.

COMMISSIONER MORGAN: True.

MR. SIMS: They have fewer and fewer children to educate each year. Their revenue system, if they don't lower their taxes, will produce more and more revenue per pupil each year.

COMMISSIONER MORGAN: So there's not too much we can learn from that?

MR. SIMS: You've got to set them aside as an anomaly.

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

And we'll take about 30 minutes as a break for lunch now.

MR. SIMS: Thank you very much.

(Lunch recess from 12:40 p.m. to 1:30 p.m.)

CHAIR PARSKY: As further evidence that this Commission does not want to just discuss easy issues, we're going to spend a little time talking about property tax.

And the first presentation will be on property-tax options and some of the administrative and legal issues.

Now, let's not get too bogged down as lawyers here, but we want to --

COMMISSIONER COGAN: You say, with lawyers or as lawyers?

CHAIR PARSKY: As lawyers.

But, yes, most of the economists would shudder at the thought of being linked with lawyers. So let's be careful.

So which one of the two of you are going to start?

Lawrence, why, don't you go ahead and start. And we'll have two presentations and then ask some questions.

MR. STONE: My name is Larry Stone, and I'm here today in my capacity as the Assessor of Santa Clara County, which has the fourth-largest assessment roll in the state, at over $300 billion. That may go down a little bit this year, but…

So I've served as Assessor for 14 years, including a term as president of the California Assessors' Association. Before I became a full-time assessor, I was a councilmember and mayor in the City of Sunnyvale. And during my professional career, I've been in the real-estate investment and development business and started my career many, many years ago on Wall Street, and later co-founded a Bay Area real-estate investment and development company.

So I want to thank you for the opportunity today to speak to the Commission.

And judging by your meetings and the depth of the discussion and the caliber of the presentations that I've heard today, as well as that you've had previously, you all have taken this assignment very seriously. And I'm eager to contribute to your proceedings.

So let me start by agreeing with the Governor's general premise, and that is, the California tax system is broken. And moreover, I hope that you will propose sweeping reforms to help restore California's promise.

Property tax remains one of the most -- probably the most stable forms of revenue. It annually generates about $45 billion in tax revenue in California. In Santa Clara County, property taxes generate over $3 billion in revenue. And in my county, and I think it's generally true throughout the state, that revenue is allocated as follows:

45 percent of all property-tax revenue generated in Santa Clara County goes to public education, essentially to the state to fund public education.

About 14 percent of the revenue goes to cities in the county.

18 percent to the county itself, to fund county programs.

10 percent to redevelopment agencies.

7 percent to community colleges.

6 percent to special districts, like the water

district and the fire district and so forth.

The last major reform of the property-tax system, of course, as we all know, was Proposition 13. It was highly controversial, as it is today, in some cases. And ever since, it has been the center of the state and national debates about the measure’s intent and its fairness.

One of the major disputes that was raised immediately after Proposition 13 passed was the issue of equity between the taxation of residential properties and commercial and industrial properties.

The recently proposed solution that’s been talked about off and on for over ten years or so has been the split roll. The split roll generally means taxing commercial and industrial properties differently than residential property.

More recently, it’s also been used to describe the legislation attempting to redefine the change in ownership as it applies to the transfer of ownership interest in legal entities. In other words, stock transfers, ownership shares in a corporation or a partnership.

And either way, the split roll attempts really to identify non-voting taxpayers -- that’s business -- and assess them differently than residential property.

Foreshadowing the controversy being discussed today over the split roll, the original task force that wrote the law implementing Proposition 13 could not reach a consensus on the split roll. They ended up kicking the ball down to the Legislature, urging them to study the idea for a constitutional amendment to periodically appraise commercial and industrial properties at market value.

Today, I'm here to address primarily the issue of the implementation of the split roll because that's what I do as an assessor. And I do so wearing exclusively my assessor's hat, as an impartial administrator charged with implementing the law regardless of my personal views.

In other words, I'm not here as a citizen concerned about maximizing the revenue for the schools or local services. I certainly will not discuss the fairness of Proposition 13 because it is not fair. Nevertheless, I oppose the split roll for the simple reason that it would be impossible for assessors to implement.

I have served in local elective office for over 30 years. And I'm not insensitive at all to the fiscal crisis that the State faces. But as the administrator of the property-tax system in Santa Clara County, I am certain that the split roll is not the solution, nor can it be implemented cost-effectively. That opinion is shared by the California Assessors' Association in a published white paper.

The problem is, while it will generate much-needed revenue to deal with the State's fiscal crisis, the revenue generated, in my opinion, would be far less than projected, and most likely between $1 billion and $3 billion a year. The split roll fundamentally does not address the inequities that exist in the current system, in which the owners of identical properties can pay a property tax differential as much as ten times or more.

More importantly, the revenue would not be immediate. Instead, it would come over several years. In addition, a split roll would create an expensive and administrative nightmare for assessors.

To assess at market value every commercial and industrial property annually or periodically would require a significant increase in my appraisal staff. It would create, at least in the first five years, nearly an impossible situation to manage, as the assessment of commercial and industrial properties are the most complex and time-consuming to complete. Without a doubt, the filing of assessment appeals would skyrocket and become a very real burden to assessors.

As would be expected, commercial and industrial properties require the most experienced professionals to assess. Typically, these individuals must have a minimum of five years of experience assessing complex properties. Unfortunately, this pool of talent has diminished, as fewer and fewer individuals have entered the appraisal field since the S & L debacle in the early 1990s. A split roll would not only exacerbate this problem, as senior appraisers would abandon the public sector for much more lucrative opportunities in the private sector, representing appellants.

The LAO has conservatively estimated the annual cost to assessors in the low tens of millions of dollars. That estimate is likely to be very low, in my opinion. In Santa Clara County, we estimate that the appraisal and support staff that we would need to implement a split roll would increase by 20 percent.

In Los Angeles County, using statistics from 2004, the L.A. County assessor estimated a split roll would demand an additional 300 appraisers and supervisors to handle the new reassessments and subsequent assessment appeals. And in addition to the costs of employees and facilities, he estimates that would be about $30 million a year. These costs would be permanent and would increase, obviously with inflation, over time.

In contrast, the assessed values of

nonresidential properties would fluctuate both up and down in response to market conditions as we are now experiencing in the current meltdown of property values.

Administration of the property-tax system has been seriously challenged to provide adequate service since the passage of SB 188 in 1991, which exempted schools from paying their fair share of property-tax administration. Without proper funding, the split roll will only exacerbate the current statewide problem.

Currently, due to budget cuts, my staff is 2 percent smaller today than it was 14 years ago when I took office, in spite of the increases in workload and an assessment roll, which has risen from $115 billion to $300 billion a year.

To attract experienced appraisers, significant increases in compensation would be required. Conservatively, I estimate my budget would have to increase by at least $3 million annually. To offset the increase, the split roll, therefore, would have to generate over $2 billion to $2.5 billion dollars in additional assessed value for the county just to break even, because Santa Clara County, as I mentioned earlier, only receives 18 percent of the total property-tax revenue.

It has been suggested that the solution to the assessors' concern regarding the increased workload under a split roll, that assessors would no longer have to do individual appraisals of these properties. Instead, it's been suggested that assessors can merely use a computer-assisted market analysis, a software program known as CAMA, to do the work for us. The assumption is based upon the faulty premise that most low-assessed values are attributed to very low and very old assessments on land values, beneath commercial and industrial properties. The theory assumes that the assessors would easily use a CAMA program to begin those land assessments to market value annually rather than doing individual appraisals.

The problem with this idea is, you know, that bringing just the land to market value annually, without assessing the value of the entire property, including buildings, which are currently increased by more than no more than 2 percent per year according to Proposition 13, would result in the overassessment of most commercial and industrial properties.

Assessors are required to determine, upon sale or new construction, the value of land and buildings. Over time, land appreciates while buildings depreciate, but the combined assessed value usually remains far below the market value, until there's a change of ownership or new construction.

While this would not apply in a split roll, the problem, I think, is best illustrated with a home. In the 1960s, a home in Palo Alto may have sold for around $50,000. By 2008, the assessed value may have risen to $150,000, at the 2 percent rate a year. 75 percent allocated to the land -- excuse me, $75,000 allocated to the land, and $75,000 allocated for the building.

In Palo Alto today, that would be a classic "*scraper*." A new owner might acquire the property for, say, $1 million and scrape the home to build a new house. In effect, they're buying just the land for a million dollars, as the house was, for all intents and purposes, functionally obsolete and no longer of much value. In fact, the land may have even been reduced in the sale to account for the cost of demolishing the old house. Yet the day before that sale, the building was assessed at $75,000.

In the example, we would bring the land to market value at $1 million, and then we would add the $75,000 to arrive at a total assessed value of $1.075 million, even though we know the total value is $1 million, because that was the sales price for the land to begin with.

In Santa Clara County, we had a more drastic example with IBM. IBM acquired land for their main production facilities in the mid-1950s. Many of the improvements were built in the fifties and sixties, and were near the end of their useful life. Had this methodology been utilized, the potential for overassessment, for the 2003 assessment role, would exceed the -- the overassessment would exceed $335 million.

With wide swings in property values, particularly in my county, the split roll will not generate a consistent amount of new property-tax revenue. Imagine if there's been a split roll in place preceding the current market downturn. Instead of reassessing a handful of recently bought and sold commercial properties, we would be reducing the assessed value on thousands of properties with billions of dollars in swings and assessed values because the markets declined that much.

The stability of the property-tax system -- and it's not fair, as I said, but the major benefit with the current system is its predictability. And, instead, I think a split roll, at least in some cases, would replace that with a much more volatile system, more akin to the income-tax system.

There are practical implementation problems as well. And here's what they are: Even if you ramp up over several years, where do you start? How do you choose which properties will experience, I guess, the joy of being the first to be reassessed annually at market value?

If the property selection is totally random, how does the hotel, gas station, shopping center, office-building owner compete with the same type of property down the street where reassessment to market value comes possibly four years later?

If the split roll is phased in by property type, is it fair to the shopping-center owners to pay taxes based upon the current market value of their property, when the hotel owners don't?

If it's done by geographic area, how fair is it for commercial property owners in Gilroy, which is in the south part of my county, to be assessed at market value, when in Palo Alto, in the north part of the county, the owners are not?

No matter how it's implemented, assessment appeals would skyrocket, as I mentioned, with a split roll. The cost to defend and the uncertainty it would create would be the downfall, I believe, of the split-roll proposal.

And as a political sweetener, proponents of the split roll have dangled the prospect of exempting small- and medium-sized businesses from paying property taxes on the assessed value of business personal property. And that would include machinery, equipment, and computers. From a tax-administration viewpoint, this is an awful suggestion. It is not only the wrong way to devise tax policy, but assessors would have to continue expending the same amount of staff and budget resources, only then to turn around and exempt the potential revenue that we just valued.

Fortunately, there are other options to reform the system. None of them are perfect. All of them, like Proposition 13, create winners and losers. And each is very controversial.

The first set of proposals falls into the variations of the split roll. These proposals all change the property-tax system for the nonresidential property owner. And the two main variations are as follows:

Establish a different tax rate for commercial and industrial properties; or

Increase the annual inflation factor for commercial and industrial properties to reflect the actual rate of inflation, or some variation thereof.

If you assume the cost of government services goes up at least at the rate of inflation and you have a 2 percent cap on the inflation rate increasing property, that's why you're bound to where we are today, where the assessed value of most properties in my county is half of what the market value is, even after the downturn that we’ve seen in the last few months.

Currently, the annual inflation rate in assessed value is limited, as I said, to no more than 2 percent. So instead of 2 percent, you could raise the limit to 3 percent or 4 percent, or tie it directly to the California CPI.

Another proposal would establish a different tax rate based upon the value of the property. Sort of tax-the-wealthy philosophy, I guess.

And yet another proposal seeks to substantially increase the homeowner’s exemption at the same time you establish a split roll. That’s really designed to encourage the voters to support a split roll.

Another approach to the split roll is something I refer to as the backdoor approach. For years, the advocates of the split roll have argued that ownership in a business can change hands many times, without triggering a reassessment of that property. Proponents believe that this requires only a legislative action.

And partially, they’re correct.

What triggers a reassessment can be very complicated. Unfortunately, there is no single rule or single path that guarantees exclusion from non-assessability.

Most assessors have an entire unit of assessment professionals dedicated to examining each transfer to determine whether or not it is a reassessable event. Millions of dollars can ride, as I'm sure you know, on the decision of whether or not to reassess a commercial or industrial building.

The most talked about exclusion concerns limited partnerships. For example, in 2002, E&J Gallo bought the Louis Martini winery in St. Helena, over 1,500 acres. The sellers were approximately 20 shareholders of the family corporation that had owned the property as a corporation since 1933. The buyers were approximately 20 members of the Gallo family who purchased the shares of the sellers in a single transaction. However, because the corporation was subject to the change of control under the Revenue and Taxation rules, not the cumulative change in control rules, and because none of the buying family members acquired a majority interest in the corporation, there was no reappraisal of any of the interest.

While I agree this exclusion is a real problem, I seriously doubt it is pervasive. In fact, I know of no major situation like this in my county.

In reality, when a legal entity such as a corporation buys another legal entity, it is 100 percent reassessed.

I realize that there's been some confusion around this point, but I can assure you that assessors uniformly are reassessing changes in ownership when the majority of the controlling interest has been reported or discovered.

And let me provide a couple of examples, including one that I believe has been discussed previously before this Commission. In 2002, Hewlett-Packard acquired Compaq/Tandem. In Santa Clara County, that acquisition resulted in the transfer of 12 parcels. All were 100 percent assessed, increasing the assessment roll from $140 million to $165 million.

In another recent transfer was Blackstone's acquisition of Equity Office. In this one, 35 properties in Santa Clara County were transferred, increasing the assessment roll by a quarter of a billion dollars.

In a more current transfer that has been in the headlines recently, was Chase/JP Morgan's purchase of WaMu. Our office identified 14 commercial buildings and hundreds of foreclosed-upon residences owned by WaMu that will be reassessed later this year to reflect the change in ownership. In this instance, the discovery of this transfer was through the media.

Even changes in the control of corporations or legal entities where title to property remains in the same corporate name and nothing has been recorded, assessors have tools to discover these changes in control and reassess the property.

The major one being the Legal Entity Ownership Program, or what we refer to in my profession as LEOP, which started less than five years after Proposition 13, in January of 1983, as a result of Assembly Bill 152. LEOP requires the State Board of Equalization to participate in discovering changes in the control of corporations, partnerships and legal entities. Basically, when a corporation files its state income tax, the corporation is required to report any change in the control of that corporation. The Franchise Tax Board notifies the State Board of Equalization, who then notifies the assessor, who investigates whether a reassessable event has occurred or not.

If the legal entity does not respond to the BOE request, a 10 percent penalty is levied on the taxes on all the real estate owned by such entity, whether or not a change in ownership or control actually occurred.

If the transfer of the property is not reported or recorded and the assessor discovers it later, the assessor can roll-correct, going back eight years, unless there is fraud. And if there is fraud, the assessor can go back to the actual date of the change in ownership that occurred.

In 2008, the Santa Clara County Assessor's office discovered 27,475 changes in ownership, all triggering new assessments. Of the total reassessment transfers, only two-tenths of 1 percent are the result of changes by legal entities.

So while the legislative proposals to provide the assessor with more tools to discover changes in ownership or close legitimate loopholes may and in some cases are a good idea, the inevitable result, a split roll, creates far more problems than it solves.

And if I have a minute, I want to tell you about a current problem that most of you, maybe none of you -- maybe with the exception of Becky -- know about, and that is, it's referred to as "*embedded software*."

In 1972, the State Legislature passed a law which exempted software -- 1972, remember that date -- from assessment and, therefore, taxation.

In 1972, there wasn't much software around. It was probably the next step after IBM cards.

And for those years, non-operational -- in other words, individual software, the stuff you might go down to Fry's and buy -- has been non-assessable and nontaxable. But embedded software -- in other words, software that's embedded in practically everything today, including, in some cases people, has been assessable as a part of the assessment entity.

There's been no problem with that since 1972, by industry or by assessors.

Well, a company called Cardinal Health in Orange County, their health-care company, and they make a machine, I guess, that dispenses drugs -- appealed that decision to the -- the assessor's decision -- to the local Assessment Appeals Board. They were unsuccessful. They then appealed to the trial court, and they were unsuccessful there. And then they appealed it to the appeals court. And the appeals court agreed with them.

And when you read the law that was written in 1972, when people didn't know too much about embedded or non-embedded software, the appeals court probably made the right decision.

Well, they remanded it back to the Assessment Appeals Board.

I can tell you, and I think industry folks here would agree, that it's virtually impossible to value embedded software.

Somebody told me there's 33 chips in every automobile you buy. I mean, if you didn't have the chips, it wouldn't run; so it's a piece of metal, I guess, that would have some cost to it.

So much of what we do today -- my wife just bought a new mixer, and it has a chip in it. What portion of the value of that mixer or that automobile should be exempted because its embedded software? I don't know.

But the conservative estimate that we make -- and it's kind of over the top of our head -- is about $1.3 billion to $1.4 billion in lost revenue on an annual basis. And businesses file their business personal property statements on an annual basis right now. And we don't know –- "*we*," meaning the assessors -- don't know statewide what the impact of this is going to be because industry may decide to do some kind of an estimate and to reduce the assessed value as they file their business personal property statements this year, which would have an immediate effect on property-tax revenue.

And with that, I'll stop.

I hope that you'll make those kind of sweeping changes, and I hope you'll address or recommend the addressing of proper funding for the property-tax administration system in this state, because it is not properly funded now.

Thank you.

CHAIR PARSKY: Thank you very much.

I should have alerted the commissioners that because of some scheduling changes, we were going to talk conceptually about the property tax before we got into a discussion about the difficulty of administration. But we reversed the order. That's not meant to color anyone's view of it from a policy standpoint.

Richard, why don't you complete this element of our discussion?

MR. MOON: Good afternoon. My name is Richard Moon. I'm a property-tax attorney with the Board of Equalization.

And I'm going to be talking about the split property tax roll briefly, summarizing some of the legal and administrative considerations.

I guess as an attorney, the first thing I need to do is give a caveat, and that is to say that my presentation here does not in any way indicate that the Board -- that our board, as individuals or as a board, or our staff, endorses a split property tax roll or doesn't endorse a split property tax roll.

I've broken my presentation --

CHAIR PARSKY: That's usually the way a lawyer operates, so that's good.

MR. MOON: I've broken my presentation into essentially two parts. The first part will be to give some background on Prop. 13, and some of the things that it did.

And then the second part, we'll be talking about specific methods that have been around, and specific ways that have been discussed in the past to actually split the property tax roll.

The first part of it I'll go through relatively quickly.

Prop. 13, when it was enacted, essentially did a number of things. It rolled back the property values to the 1975 lien date; and then it restricted annual increases to up to 2 percent per year. And then it also prohibited reassessment of a new base-year value until there was a change in ownership or until there was completion of new construction. And then it also limited the property-tax rate to 1 percent, and it required a two-thirds vote of the Legislature to raise taxes.

Some of the effects of Prop. 13 -- and I guess these also as well could be argued about -- was to stabilize neighborhoods, to promote property tax, certainly in stability and predictability. But it also had the result of having similarly situated taxpayers being able to pay vastly different amounts of property tax based solely on their date of purchase.

And then, again, this could be argued about, but the percentage burden that residential properties bore versus commercial property would increase as well.

This slide essentially shows the stability of Prop. 13. And there's a lot of dots and a lot of lines. But the important line here is the solid, black line that's a relatively slight incline. And that shows the stability of property taxes under Prop. 13, as opposed to the red dots and the lines that are going up and down, which could be the potential of property-tax assessments, if property tax were valued at fair market value.

We have some statistics that show the percentage of assessed value of homeowner-exemption properties versus total assessed value of properties over time. And it's important to note that what these percentages show are the assessed value percentages of properties that are receiving the homeowner's exemption. So this is not residential property, per se, which might have different results.

And as you look at these numbers, what we see is that the share of the assessed value from owner-occupied homes has increased from 33.6 percent to 38.3 percent. And that percentage has gone up and down.

When we're talking about the split roll, generally -- and the way that I'm using the term "*split roll*" is that it's a means of taxing certain types of property, certain types of real property according to different standards of value or a different rate. Technically speaking, I suppose, a split rate would not be a split roll. But that is one of the proposals that has been floated out there.

Currently, there actually is a split roll between county-assessed or locally assessed properties and state-assessed properties. So for state-assessed properties, which would include public utilities and railroads, they are assessed at fair market value every year. And locally assessed properties would have the benefit of Proposition 13, so that they would not be reassessed every year.

There have been a number of past legislative proposals. And as you peruse this list, I think what you'll see, that most of these proposals has involved what Mr. Stone referred to as the "backdoor," which is changing the "*change in ownership*" definition for property that's owned by legal entities.

And there have also been a number of past initiative attempts. And those also would -- one, in particular, would have changed the rate that was applied to commercial property versus residential property.

Several years ago, there was a California Commission on Tax Policy that I'm sure everybody's aware of. And their recommendation at the time was to periodically reassess nonresidential property to market value without changing the existing rate, and, of course, with taking the business climate of California into account.

There are three sort of general methods that I want to talk about, when we talk about splitting the roll.

The first is defining “*change in ownership*” differently, so that it applies to residential and nonresidential properties differently. And there are variations of this, of course. One would be to make it only apply to residential property, so that only residential property is afforded Proposition 13 protection.

The second is what we talked about, redefining “*change in ownership*” for legal entities.

And then the third would be to have a split rate, or a split inflation factor.

The first method would be to define “*change in ownership*” differently for residential/nonresidential property. And effectively, the goal of this apparently would be to cause an annual or a periodic reassessment to fair market value of nonresidential property.

The difficulty, of course, comes in, how you define “*residential*” and how you define “*nonresidential*.”

Would you include apartment buildings? Hotels, for example, that sell individual units? Motels that have long-term rents or leases available?

And then also there are issues with how you define it for purposes of vacant land, and then mixed-use property as well.

So there was one proposal that would have defined *"residential property"* as, "Any real property other than constructed single-family or multifamily unit intended primarily as a permanent residence."

And, of course, as you think about that, I mean, there's -- there are a number of issues that could be discussed as well.

Another way, perhaps, to do it would be to limit it to just properties that are receiving the homeowner's exemption. Again, there can be a lot of arguments over how the definitions might work.

The second method would be to redefine the *"change in ownership"* for legal entities. And there are also different flavors of this or different variations that have been floated in the past as well. One would be to have 50 percent transfer of ownership as a change in ownership, without the necessity of control.

Another one would be to periodically reassess real property -- real business property held by a legal entity. And there may or may not be a rebuttable presumption that every three years or four years or five years, that enough shares changed hands, that there would be a change in ownership of all the property.

At the risk of getting a little bit too technical, I did want to go through how the "*change in ownership*" definitions for legal entities work, because I think it's important to understand what proponents of a split roll in this matter consider a loophole in the law.

For individuals, a change in ownership of real property happens anytime that real property or a portion of that real property is transferred. So in other words, if I own real property and I sell 10 percent of that real property to somebody else, 10 percent of that property is going to get reassessed.

For legal entities, it's different, because the purchase or transfer of entities in a legal entity, whether it's a partnership, LLC, C corporation, any type of legal entity, it does not constitute a transfer of the real property owned by that legal entity except for in two instances.

The first instance is when there's a change in control. And that means that one person or other entity has to wind up with more than 50 percent of the shares, so that they have control over that legal entity.

The second instance involves what's called "*original co-owners*." And when 50 percent of the original co-owner interests in a legal entity are transferred, there would trigger a reassessment of essentially 100 percent of the property that's owned by the entity.

The next several slides I have basically illustrate this, and hopefully it's a little bit more clear.

So on the left-hand side here, an individual who transfers property will be reassessed in the percentage that he transfers.

On the right-hand side, in that example, Individual A owns real property but owns it through a corporation. And when he transfers Corporation X shares to B, there's no change in ownership unless he transfers more than 50 percent to one person.

And the way that this happens, to avoid change in ownership is illustrated here. If A owns 100 percent of Corp X, he can transfer 50 percent of Corp X to B and 50 percent of Corp X to C, and there would be no change in ownership because not one individual or one person wound up with more than 50 percent.

So A has effectively gotten rid of the property through transferring 100 percent of the shares that he owned in Corporation X. And there's no change in ownership of the property.

And then the third picture on this slide would show after, if B decides to transfer 25 percent of his 50 percent shares to D and E, and C transfers 25 percent each to F and G, again, there's been 100 percent transfer of those shares with no change in ownership of the real property.

So you could go from A's 100 percent ownership, to D, E, F, and G, each owning 25 percent of the property, and there would be no change in ownership there. And this could be done repeatedly, theoretically into perpetuity, and there would never be a change in ownership unless somebody wound up with more than 50 percent of Corp X.

COMMISSIONER HAUCK: Is it typical of property transferring to corporations?

MR. MOON: Well, at the risk of giving negligent anecdotal evidence, it is done. It is done. Oftentimes, we don't hear about it because it's the transfers that somebody does wrong and winds up in court, so we hear about those. The ones that are done correctly, we would conceivably never know.

COMMISSIONER POMP: Richard, there's no family attribution rules?

MR. MOON: No, there's not.

COMMISSIONER POMP: Is that right?

MR. MOON: There is not.

CHAIR PARSKY: Proceed ahead, Richard.

MR. MOON: Sure.

This final slide with a lot of pictures with the bubbles is an example of original co-ownership. And essentially, I guess the important thing in this slide is that the original co-owner’s status of shares applies only when what’s called the “*proportional ownership interest exclusion*” has been used. And that means here, if A and B own real property outrightly and then they transfer their ownership of that real property in the same proportion to a legal entity, all of a sudden their shares become tainted, and they’re known as “*original co-owner shares*.”

Once they have that taint, if they transfer more than 50 percent of those original co-owner shares, now there’s a change in ownership of the property that’s held by the corporation, and there doesn’t need to be control in one person or one entity.

So unless there are tainted shares, unless there are original co-owner shares, there always has to be control of that legal entity in order for there to be a reassessment.

As I said, proponents of a split roll in this manner would call this a loophole. I think opponents would contend that the 1979 task force that looked at this contemplated that this would happen and chose this method of reassessing property owned by legal entities as sort of the worst of -- sort of the best of not-so-very-good choices. And so that's what we're left with.

There's also an issue of perhaps one of the -- well, one of the flavors or different variations of this, was the possibility of treating publicly traded corporations differently. Because I think there was a feeling that perhaps they were getting away with something, and this would allow reassessment of big companies with a lot of property, more often.

And, again, one of the difficulties of that would be how to track the entity's share. So, for example, if one of the changes, if a change was to say that control was not necessary and you could have a change in ownership with 50 percent -- more than 50 percent of shares changing hands, especially when you're talking about huge publicly traded corporations with millions of shares, how do you track those shares and how they change hands? I think, administratively, it could be quite difficult.

Finally, the split rate or split consumer price index or split inflation factor method would be, again, variations of this. But one method would be to keep 1 percent for residential property -- again, there may be definitional issues; and then have a higher rate for commercial or business properties. And this would require a constitutional amendment, because the 1 percent is fixed into Prop. 13.

The last slide I'm not going to talk about because Assessor Stone went through many of these, and I believe the other speakers will touch on these as well.

Thank you.

CHAIR PARSKY: Thank you both very much.

I think in the interest of time, I just want to limit the number of questions that we raise for this panel. We have one more, and then I really want to make sure that the staff has an opportunity to kind of put out some thoughts here.

Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

A couple things.

Mr. Stone, let me begin with an apology. It was my statement, both at a previous Commission meeting -- I believe it was in Berkeley -- and also at the Silicon Valley Leadership meeting that Commissioner Barrales and I were invited to make a presentation at, where I used the example, in error, regarding not Compaq/Tandem being purchased by Hewlett-Packard, but when Compaq purchased Tandem. And that was my error, and your staff corrected me at the Silicon Valley Leadership Group. I wanted to apologize to you for using that example in error.

Let me ask a couple of questions, if I could.

Mr. Stone, relatively early in your testimony, you said that there might be something between one and three billion dollars per year in revenue available. And I wasn't certain what you meant by that, available or not being captured currently. Is that statewide? And I wasn't sure of the context in which you were using those numbers.

MR. STONE: It's a rough estimate, to be sure. But I think the estimate is that the proponents of a split roll that I've heard -- and it's varied as five, six, seven billion in revenue -- when we take a look at it based upon we thought it would be one to three billion, which is a wide range to be sure.

COMMISSIONER KEELEY: Fair enough.

Let me ask you this: Let's eliminate -- my discussion here with the two of you is going to be solely on the issue of change of ownership, and no other flavor of split roll at all. It is only about the issue of when there are, in nonresidential-property situations, there is what Mr. Moon has described in several ways, changes of ownership.

Mr. Stone, first of all, do you have any estimate or does the California Association of Assessors have any estimation about what might be lost currently by the current law not recognizing changes of ownership in the way described by Mr. Moon? Did the one to three billion dollars -- is that your number, or some other number, or do you have a number?

MR. STONE: Well, it's kind of like, you don't know what you don't know. I am sure that there are individual transactions that occur, like Richard mentioned, that escape -- we just don't believe they're that pervasive and that they're that significant. Because the number of ones that we do reassess through the Legal Entity Ownership Program is a very small part, both in number and in assessed value that we pick up.

I'm certain there are things that happen like this.

COMMISSIONER KEELEY: Yes.

MR. STONE: So it's hard for me to make an estimate as to what we're losing, because we don't know. If we knew, we would do it, reassess it.

COMMISSIONER KEELEY: No, if you knew it, the current law, the way you had described it, wouldn't let you capture it, anyway.

MR. STONE: In those individual cases.

COMMISSIONER KEELEY: Is that right, Mr. Moon?

MR. MOON: That's correct.

COMMISSIONER KEELEY: Okay, so let me ask you this question then: When the Howard Jarvis Taxpayers Association testified to the Commission at UCLA, we asked them the question about whether or not the authors of Prop. 13, or anyone else, has ever established that there are two classes of property taxpayers: Residential property taxpayers and everybody else who owns property.

Do you think that that's the case, that there are more than one class or one category of taxpayers?

MR. MOON: Well, the task force did mention --

COMMISSIONER KEELEY: No, no, let me go back to my question.

MR. MOON: Okay.

COMMISSIONER KEELEY: Do you think that Proposition 13 establishes more than one category of property taxpayer?

MR. MOON: Well, I'm not sure either way.

COMMISSIONER KEELEY: You're not sure?

MR. MOON: I would say that it appears that Prop. 13 would contemplate one class.

COMMISSIONER KEELEY: Thank you. Okay, thank you very much.

So let's go then to your slide about property-tax examples, and it's the one that has -- it's the first pretty one.

MR. MOON: Okay.

COMMISSIONER KEELEY: Not that the others aren't wonderful, but this one is especially pretty.

So on that, if I understand it the way you've described it in here --

COMMISSIONER PRINGLE: It all depends on your definition.

COMMISSIONER KEELEY: The property, in fact, changes ownership but is not recognized as a change of ownership for purposes of reassessment; is that correct?

MR. MOON: If it changes ownership, it would be reassessed.

So in these examples -- for example --

COMMISSIONER KEELEY: This example here -- so if we could get that up, by any chance, that would be great.

MR. MOON: Page number –- I think it's the first.

I'm sorry, these are not numbered. But in the example with the individual on the left and the legal entity on the right, in that example, on the right-hand side, there would be no change in ownership unless B wound up with more than 50 percent of Corp X.

COMMISSIONER KEELEY: Okay, so let me ask this question: Where in Proposition 13 does it say that's the case?

MR. MOON: It says that in the statute. It does not say that --

COMMISSIONER KEELEY: It doesn’t say that in the Constitution; does it?

MR. MOON: No.

COMMISSIONER KEELEY: So what is done by statute can be changed by statute?

MR. MOON: Yes.

COMMISSIONER KEELEY: Okay. So if this Commission or the Legislature -- well, if the Legislature and the Governor decided to recognize this differently, or see this differently, a statutory change could accomplish that?

MR. MOON: Yes, I believe statutorily “*change in ownership*” definitions could be changed.

COMMISSIONER KEELEY: So let’s go to your next one. Property-tax transfers, and now we have -- we’re getting a little bit more complicated as we go through this -- and there still is not a change of ownership under statute; is that correct?

MR. MOON: That’s correct.

COMMISSIONER KEELEY: Okay, and we’ve already established that that exists nowhere in Proposition 13, that Owner A up here, who is -- by the time you get down to ownership D, E, F, and G, A is long gone?

MR. MOON: That's right.

COMMISSIONER KEELEY: And so there have been at least two changes of ownership by the time you get to D, E, F, and G? That constitutes -- now, there have been three sets of owners?

MR. MOON: Yes.

COMMISSIONER KEELEY: And there's no change in -- Mr. Stone is not permitted by law to go out and reassess; is that correct?

MR. MOON: That's correct, that's correct.

COMMISSIONER KEELEY: Okay. And, again, we've established that there's no place in Prop. 13 that says there's two classes of property taxpayers?

MR. MOON: No.

COMMISSIONER KEELEY: Okay. Let me just say that what interests me about this, is a couple of things: One is, I don't believe that Prop. 13 contemplated anything except one class of property taxpayers; and when the ownership changes, the assessor can go out and assess, reassess. In fact, it's required by Constitution to go do that.

The fact that it is complex doesn't mean that it's okay, as far as I'm concerned. And I think that one of the -- Mr. Stone raises a lot of good issues about --

and I'm the elected Treasurer of the County of Santa Cruz. It also says "*Tax Collector*," but I never mention that, and I'm right across from your counterpart, Mr. Hazelton, who is the assessor. So I have a deep respect for the work of the assessor's office and the underfunding that has happened, especially in the last couple years, when the Property Tax Assistance Program for your office was cut very severely. And that's in nobody's interest, as far as I'm concerned, to strangle your resource and ability to go out and capture every reassessment and sale and so on. Fair enough. I think that's a solvable problem. And I think the administrative issues here are solvable problems.

What I'm concerned about is that the argument that says, "Because it's complex, we shouldn't try to fix it."

First of all, we have no idea what the size of this problem is in actual fact because we're trying to disprove a negative, as Mr. Stone indicated when he said that, essentially, to me in response to a question.

But what interests me here is to try to make sure that if the least-affluent homeowner is subject to this, then the most powerful corporation ought to be subject to this. And the fact that they can use a series of transactional tools that are unavailable to the least-affluent homeowner, and the fact that they can engage in complexities, ought not to exempt them from the reassessment.

And my guess is, there may be a rather simple solution to this, which will probably make it wrong. But one possibility would be -- because if I understand the argument here, just on this issue of change of ownership, we are all expected, under all the laws of the State of California, that ignorance of the law is no excuse. And so you have to comply with the law, and those who don't can be subject to criminal penalties.

And my sense is that what we ought to do, we, as a commission, that we ought to take a serious look at this and not be scared away from it because it may be difficult for either the assessors or the Franchise Tax Board or the Board of Eq. or anybody else to figure this out.

Instead, the burden ought to be on the taxpayer, as it is in all other instances. Taxpayers have the burden to disclose. Taxpayers have the burden to pay a tax. And if they don't, they're subject to criminal penalties. And I would think that would help solve a multitude of problems relative to ease of administration on this.

Thank you, Mr. Chairman.

CHAIR PARSKY: Any other comments?

COMMISSIONER PRINGLE: I'll just ask one.

CHAIR PARSKY: Curt?

COMMISSIONER PRINGLE: I'll make mine really quickly before an intelligent comment is made at the other end of the table -- I said, I'll make mine quick before the intelligent comment is made at the other end of the table. I was trying to be positive towards you, Richard.

He can't hear at that end of the table.

Anyway, we'll move on.

On page --

CHAIR PARSKY: There's no page.

COMMISSIONER PRINGLE: The first example of the property tax -- the property transfer example, in my simple head, help me out here. I see that one person owns interest in a corporation or a corporate entity.

MR. MOON: Yes.

COMMISSIONER PRINGLE: Who owns the property?

MR. MOON: The property is owned by the corporation.

COMMISSIONER PRINGLE: Okay, so are you saying that you think it's valuable to modify the laws of corporation in California, so we redefine what a corporation is, and remove the veil of corporate ownership so that that individual, therefore -- when that individual sells his shares of the corporation, that whatever the corporation, in terms of its liabilities or tax liabilities or, for that matter, transfer of property, that should be reflected to the individuals?

MR. MOON: No, that's not what I'm saying.

The proposals that have been out there in past legislative attempts would have changed the definition of "*change in ownership*" in the Revenue and Taxation Code and not the Corporations Code.

COMMISSIONER PRINGLE: So tell me how that -- so a corporate entity, defined in law, which is a legal entity in California, is different than an individual; correct?

MR. MOON: That's correct.

COMMISSIONER PRINGLE: So if a corporate entity owns it, and an individual owns 100 percent of those corporate shares, and then that individual sells 50 percent to one, 50 percent to -- well, I don't want to say one -- I'll say to B and to C as represented in Diagram 2 on your third pretty sheet -- that, in fact, somehow, even though the same corporate entity still owns it, that you're contemplating that there should be a lifting back of the ownership of that corporation, therefore, a reassessment of the property based upon that?

MR. MOON: Yes, that's what some of the legislative proposals had sought to do.

COMMISSIONER PRINGLE: No, no, I understand. This is not -- let me see, this is not the BOE's board-approved proposal or the staff's approved proposal ––

MR. MOON: Right.

COMMISSIONER PRINGLE: -- or yours, or any legal entity of the State of California; but it is before us at this moment in time.

So I just don't quite understand that.

So let me see, if IBM, a public corporation, as you've referenced here as one of your little -- in the second challenge you had, probably, the minor challenge, "*Should we treat public corporations differently*," if somehow in one wonderful month 51 percent of the shares of IBM stock is sold and transferred through a blizzard of small investors, does that then, under that theory, if, in fact, we're looking at this principle, do all IBM properties in the state of California get reassessed?

MR. MOON: Under that theory, they would.

COMMISSIONER PRINGLE: Okay, so there may be people that can figure out how to make all that simple? I can't, because, first off, I would like to understand how the corporate entity becomes changed based upon the ownership of that corporate entity. Maybe we should say corporations can't own property, and we could get beyond that, I guess.

Or, two, how it’s not just the simple selling 100 percent of A’s stock to B and C at 50 percent. I mean, I think that that could be sold off in much smaller shares and, therefore, very, very difficult to continually modify, keep track of, and reassess based upon some monthly recalibration of 50 percent ownership of the company; right?

MR. MOON: Yes, I mean, definitely tracking the shares that change hands would be a challenge.

COMMISSIONER PRINGLE: Okay, thank you.

MR. STONE: An impossibility

CHAIR PARSKY: Richard, quickly, so we can move on.

COMMISSIONER POMP: I’m always brief, Mr. Chairman, you know that.

CHAIR PARSKY: That’s why I called on you.

COMMISSIONER POMP: Yes. You know, there’s a continuum of tax-avoidance strategies in this business. And I’ve spent many an evening being regaled by stories of tax lawyers about how they can transfer property without being reassessed.

A couple of just very quick points.

The Internal Revenue Code has to deal with change of ownership in many different contexts. They have attribution rules, Section 318, Section 267. New York once had a real-estate transfer tax. They had to deal with the same problem. There's a lot of answers out there.

And I assume, just adoption of attribution rules would go a long way to stop some of the tax-minimization strategies. I don't know if you agree with that. You've seen the continuum here.

MR. MOON: Yes, I think they would certainly get rid of the ones where, for example, families transfer second homes, vacation homes.

COMMISSIONER POMP: Yes. And that's the ones you worry about. I'm not worried about a couple of shares in IBM trading hands.

MR. MOON: Right.

COMMISSIONER POMP: This is the real planned strategy.

And I'd like to know from Mr. Stone, what is the level of disparity in the commercial property sector in your county? And over time, the property tax has shifted to residential. And is that just because of the relative development? Or maybe you could just explain a little bit about that.

MR. STONE: I hear -- and I don't know what it is for Santa Clara County -- but I hear varied numbers.

I've heard at the time Proposition 13 passed, that the property-tax burden was shared 50 percent by residential property owners and 50 percent by commercial/industrial owners. So I've heard that change from maybe a spread of five points, to a spread of 25 points. And possibly some of the educators here can have a better feel for that. I imagine it varies widely, depending upon the county as well and the percentage of commercial/industrial property that you have, like we have in Silicon Valley versus Alpine County.

I don't know the answer to that question. I probably should know. But, I mean, I've asked the question and I've asked many times, and I get all kinds of different answers.

COMMISSIONER POMP: And other jurisdictions routinely assess commercial property, so the problems you were identifying are really more a function of the fact that you haven't done it and didn't have to do it since, what, 30 years ago?

MR. STONE: Yes, the disparity in assessed values versus market values has become so great that, you know, if you'd have passed a split roll a couple years after Proposition 13, it wouldn't have been a problem. But today, the staffing, the skill-sets that we have on our offices, the level of workload and the quality and the type of workload and the difference in property values between an old assessment and a relatively new one is very great.

So many people think that commercial/industrial properties have been around a long time and they haven't been reassessed and, therefore, they have to go back to the pre-Proposition 13 value. That isn't true. It is for lots of properties, but a lot of companies -- oil companies have bought oil companies, and we've reassessed 150 gas stations throughout the county and those kinds of things. And it's hard to zero in to know what the differential is.

COMMISSIONER POMP: Thank you, Mr. Chair.

CHAIR PARSKY: Thank you, both, very much. I appreciate it.

And if there are any other questions, I'm sure a number of commissioners will raise them with you. But thank you.

Okay, if we could move to our next panel as quickly as possible. We have four -- three.

COMMISSIONER MORGAN: Mr. Chairman, a moment of commissioner privilege, please.

In 1985 --

CHAIR PARSKY: You can have whatever privilege you like.

COMMISSIONER MORGAN: Thank you.

-- one of our presenters today, Mr. Hamm, came to me and proposed the reserve for economic uncertainties. That piece of legislation passed. And California had a reserve for several years, which most people seem to have forgotten. And now we call it a rainy-day fund, which I think is a little less elegant but maybe more appealing to the public. So I'm anxious to hear what he has to say because he had a great idea in 1985, and I'll bet he has a lot more.

CHAIR PARSKY: Okay, we'll start with Lenny Goldberg, and we'll just move along.

So why don't you start us off here, on "*Property Tax - Economic Issues*."

MR. GOLDBERG: And I will get somewhat into some of the discussion that's occurred already.

I really am --

CHAIR PARSKY: And, again, I'd like all of the group to go before we ask any questions. And let's try to summarize it as efficiently as possible, given our time constraints.

MR. GOLDBERG: I really appreciate the opportunity. This is my second bite at the apple.

CHAIR PARSKY: Yes, we're aware of that.

MR. GOLDBERG: So I'm totally appreciative. In fact, I'm very happy that you've decided to take on the property-tax issues. I couldn't be happier. I seem to be wedged between opponents of that, but that's fine. And I have to say, I learned a lot about this from my board chair of the California Tax Reform Association, who is a commercial property owner and has dealt in commercial property for many, many years in Los Angeles; is also an attorney, and knows the ins and outs of many of the change-of-ownership issues, as well, and taught me a lot about it, as well as some of the economics.

So on the economics, we -- and I'll try not to be repetitive, but that's a lot of what I focused on last time. We stand good economics on its head. I don't believe -- and the very distinguished Michael Boskin can correct me if I'm wrong, but I --

CHAIR PARSKY: He will.

MR. GOLDBERG: He will?

Tax: A general rule of public finance is to try to keep the tax off of new investment and the best taxes on economic rents. That is, economic rents are those that occur not as a result of your own activity or your investment, but as a result of someone else. So the tax, therefore, does not change your decision-making behavior at all.

In our current property-tax system, we tax --

if you're investing -- the land is taxed at full market value, the buildings are taxed at full market value, you generally, because of our development climate and because you're being asked to pay for infrastructure that might be paid by somebody else, you're hit with fees, exactions, mitigations, and easements, as we've heard from many, many developers.

You then pay full property tax at the 1 percent rate on the value of all the equipment you have placed in service. And I learned this from Rick Pomp many years ago in terms of the tax on new investment, we pay a sales tax on new depreciable manufacturing equipment.

So we essentially tax new investment five different ways; and then for those of you who are single-sales-factor proponents, they would add to that a sixth, although we seem to have eliminated that.

With regard to the investment decision, the investment decision creates value in the community. It creates value for your neighboring properties, it creates value for your locality, it creates value for other private owners of property. Those are economic rents. Those are entirely untaxed unless somehow a change of ownership occurs.

We all, as homeowners and as commercial property owners, accrue economic rents that are entirely untaxed.

Now, Steve Sheffrin, if he were not in Indonesia, he would be here instead of me but I wouldn't have gotten a second bite at the apple. But he calls this in the paper presented to this commission, very close -- a land tax of this sort, very close to the economist's ideal of non-distorting taxes with very little impact on the cost of capital.

So I think that this is probably unanimously shared by economists, that we should be taxing land rents and going way back, and Mr. Hamm's paper refers to Henry George -- we should be taxing land rents and not new investment.

We do exactly the opposite with our property tax. We may do it with other taxes as well. But specifically with our property taxes and specifically as we add fees, exactions, and mitigations onto the new development decision. So the discussion in terms of the economics of split roll is to essentially reverse that.

Now, let me add a little bit -- I'm going to skip from -- I presented you some testimony, I'll skip around a little bit.

One of the issues that comes up is infrastructure finance. Infrastructure is an investment by the public sector in the land.

Now, let's say you put a new freeway in an interchange, the landowner gets the benefit of that. The landowner pays no new tax on that unless there is a change of ownership. So what we've done -- that's in the most obvious example, but we are constantly using infrastructure to invest in the carrying capacity of the land, whether it's transportation or water or sewer, that's how we talk about infrastructure. It's this public investment in land value which generates land values and is not returned to the public sector because you can hold on to that land and never pay an increased tax.

Now, in the late 1980s, the Bay Area Council, leaders of the business community, said, "Well, you know, we should" -- and if you remember in the 1980s, rusty hinges on the Golden Gate, the infrastructure crisis was starting to be discovered post-Prop. 13. Much of the infrastructure investments are local government who are the recipients of the property tax, the cities and counties' curbs and roads and sewers. The Bay Area Council suggested, well, if we could capture that money for infrastructure, we would be amenable to the reassessment of commercial property. And the reason for that is obvious: You have a virtuous cycle of infrastructure investment, when you invest in the carrying capacity of the land, only you get no return or no revenue back from that. So it’s not just the economic rents that accrue to the private owners of property that are completely untaxed -- which, in most economics, is the right way to tax, not the wrong way. It doesn’t affect the decision-making of the recipient of that rent. But it also short-circuits public finance insofar as that you want to locate highly job-generating, higher-carrying capacity, higher-intensity land use. You have to invest in infrastructure to do that.

Back to the fees, exactions, and mitigations for a second. One of the things that developers are always being asked to do is not just pay for the marginal impact on the infrastructure that their new development puts in, but to fix up all the infrastructure that everybody else has to put in those fees because there’s no other way that the land values that you generate by your new investment gets captured. So it turns good economics on its head.

You know, I know you want us to be quick here, but let me get to --

CHAIR PARSKY: I do. I want to move it right along.

MR. GOLDBERG: Let me talk about the homeowner issue. The homeowners also get economic rents; but the difference with commercial property -- that is to say, people invest in my neighborhood, I get the benefit of that, but I do not capitalize that into income. And the advantage of reassessment of commercial property, and generally one of the methods of assessment, is capitalized earnings assessment. That is, we know what the stream of future earnings are going to be, that determines the value of the property.

In a recession, you go down, the capitalized value of that stream of earnings temporarily looks less, you lower the value of the property. As the economy is booming, that same stream of future earnings goes up.

Not true for the homeowner.

So conceptually, if you wanted -- now, I know you want to be bold. If you wanted to take on the homeowner, what you would probably do is actually very simply lower the capital-gains break, the $500,000 to $250,000 on time of sale of a home, through legislation, and call that a recapture of some of the capital gain in the form of property tax back to the homeowner.

And I've done some calculations on that. And it's sort of an interesting way of saying, let us take economic rent seriously, but let's only capture them as they are capitalized into income.

The economic benefits here become a land market -- another part of the economy here is that I'm holding on, and I can give anecdotes, they don't really matter, but in Inner East Oakland, it used to be in the 1970s a fairly drug-infested slum, now is the new Chinatown-Vietnamese area of Oakland.

There are a bunch of junkyards and car lots in Inner East Oakland that have been held by the same family since the 1950s. There are various new capital, Vietnamese businesses that want to come in and invest and buy that property on East Fourteenth Street, cannot do it because there is no holding costs, no cost to holding that land off the market permanently.

And so a land market, we try to talk about highest and best use, we try to talk about infill, we try to talk about sprawl. But if you can hold land off the market forever, essentially because there is no tax consequences to doing so, even as in Inner East Oakland, that area has risen very rapidly in value, you could continue to hold it off. And then what happens to the investor? The investor has to pay substantial -- in order to get ahold of that land, they have to put more money into land, which is less money into productivity and productive equipment. So the result becomes sinking values into land.

Steve Sheffrin and I have both categorized this current system as Ricardian, in the sense that the values end up accruing to the holders of land rather than in

Ricardo's system, the productive capitalists who are making the investments. You have competitors being treated unequally.

So this is the economics of the current system, the economics of the split roll. The cost --

CHAIR PARSKY: Lenny, I don't mean to interrupt. But if you go on for any longer, we're never going to be able to get through. So why don't you come to a close and then --

MR. GOLDBERG: Okay, and may I say, as the chief proponent, I'm getting attacked from both sides, and I haven't even laid out --

CHAIR PARSKY: No, no.

MR. GOLDBERG: -- laid out the proposal and the discussion of the proposal. But that's fine, I assume I'll have my time.

Nonresidential properties should be periodically assessed at market value. This becomes a question with Larry Stone. There are any number of ways of doing that. And I'll defer on that discussion.

The change-of-ownership solutions, the law is a lemon. Can you make lemonade from it? You probably can. It would certainly get people to the table, and I'd be happy to elaborate on that. I've done a lot of thinking about Judge Quentin Kopp had the bill in the nineteen-nineties estimated at raising $2 billion.

Let me talk about the numbers then --

CHAIR PARSKY: No, I'm going to interrupt you.

Why don't you submit the rest in writing? Because we won't be able to get to what is really the heart of this commission.

MR. GOLDBERG: Okay, just one last comment.

CHAIR PARSKY: Okay.

MR. GOLDBERG: We think the numbers are in the range of 6 to 8 billion dollars to cities, counties, and schools, although that would back out the state.

CHAIR PARSKY: Terri?

MS. SEXTON: Thank you, first of all, for inviting me. And I guess -- I don't know how to get --

COMMISSIONER BARRALES: The presentation?

MS. SEXTON: Do you want us to switch the order?

CHAIR PARSKY: I'm sorry, why don't we go in -- do you have it on here in this order?

MR. IBELE: I think it's in this order.

CHAIR PARSKY: Oh, Bill, I'm sorry. Go right ahead.

MR. HAMM: Good afternoon Mr. Chairman and Members of the Commission. And thank you very much for allowing me to participate in your hearing today.

My name is Bill Hamm, and I am with the firm called LECG. It’s an international consulting firm with offices throughout the United States and on several other continents.

I am the global head of the economics practices for the firm. And before that, I worked with some of you in my capacity as Legislative Analyst for the State of California.

When I was invited by Mark to appear before you, he asked me to discuss the study that Dr. José Alberro -- who is with me today, the distinguished-looking gentleman in the second row -- and I submitted or prepared last August.

My good friend, Mr. Goldberg, said that I was an opponent of split roll. And, actually, that’s not the case. I take no position on whether split roll is good or bad. I’m here strictly to talk about the economic impact. And I recognize there are other considerations that you and the Governor and the Legislature have to take into account. I think this is an important one, but it’s not the whole story.

I do want to acknowledge for the record that our study was sponsored by two organizations that have taken a position on the split roll and are opposed to it. And this didn’t have any impact on the work that Dr. Alberro and I did, but you should know where the money came from.

I'll try to cut down here.

CHAIR PARSKY: No, I rushed Lenny a little bit because this is his second bite at the apple. This is your first bite at the apple, so that's all right. Go ahead.

MR. HAMM: But I'm very sensitive to the fact that you've got a lot to hear this afternoon, and I don't want to take too much time.

Let's talk about the economics of the property tax. And in doing our analysis, we relied on four, what I believe, are bedrock principles of economics:

That land is fixed and capital is mobile.

That business behavior is shaped by expectations.

That investment decisions are based on expected after-tax returns.

That a change in taxes will lead to changes in behavior, first, because a change in taxes will affect the expected after-tax returns; and secondly, because a change in taxes will affect a business's cash flow and, thus, its ability to undertake new investment, or even to maintain its operations.

Now, from these four principles, we can confidently, I believe, set forth certain principles about how businesses will respond to an increase in taxes.

Obviously, their first port of call would be to pass that increase along to somebody else. The somebody else is being either the renters who occupy the dwellings they own, the workers that work in their factories or offices, or the consumers who buy their products.

This is not always possible. And when it's not possible to pass along the cost of an increase in taxes, the next strategy will be to reduce their exposure to the increase in taxes.

Obviously, if you increase the payroll tax, business will try to economize on its use of labor. If you increase taxes on plant and equipment, it will try and economize on that.

The third strategy is to shift operations to a different taxing jurisdiction, where the rates are more favorable. This doesn't mean picking up a plant and moving it to Nevada, but it might mean expanding in Nevada rather than expanding in California.

A fourth strategy is where you have a noncompetitive market, and you have firms earning what economists call "*supra-competitive profits*." The reaction of a business will be if the first three strategies don't work, it will be simply to absorb the increase in taxes. But there are going to be cases where there aren't supra-competitive profits, the higher taxes can't be passed along. And at the end of the day, the firm has to cover its cost, including the cost of capital. And if it can't do that, it will close its doors.

Before I share with you our forward-looking assessment of what the economic impacts would be of adopting a split roll, let me just address an argument that is frequently made in support of adopting a split roll. This is the claim that Proposition 13 has shifted the property tax burden in California away from business and towards homeowners.

Dr. Alberro and I have tested this hypothesis. We did so by calculating the ratio of assessed value to market value for two classes of properties: Owner-occupied, residential properties, where the owner claims a homeowner exemption, and commercial/industrial properties.

We used data from the U.S. Census Bureau and the Board of Equalization. And what we found is that there is no evidence, at least to date, that Proposition 13 has shifted the property tax burden from business to homeowners in the way I've described.

We calculated -- this is a difficult slide to read, I apologize for that; but we calculated what we've called the *"disparity ratio,"* the disparity between assessed value and market value. And the disparity ratio for homeowners’ property is 53.2 percent. In other words, for every dollar of market value, there is 53 cents in there for assessed value.

The corresponding figure for commercial and industrial property is nearly 60 percent. So, actually, commercial and industrial property, as a class, is taxed at a value that is closer to market value than is the case for residential property.

The gap -- and this refers to the most recent data available, which is 2006 -- that gap in 2006 was probably a good deal wider than the 7 percent shown in the slide before you.

And the reason is that we were forced by data availability to calculate market value of homeowners’ exemption property using the median home price. But in effect, the value used for commercial and industrial property is the mean. Had we used the mean, had that data been available to us, the denominator would have been bigger almost certainly and, thus, the disparity ratio would have been wider.

Now, we’re no longer in 2006. If any of you have noticed, the real-estate market is a very different one today than it was back in 2006. And when we get the 2009 data, we’ll get different results. I don’t know how different. The disparity-ratio difference may be greater, it may be narrower. But at this point, it is our conclusion that there is no empirical, reliable evidence to suggest that that shift has occurred as a result of the provisions of Proposition 13 that determine assessed value.

Let's look forward now and look at how would adoption of a split roll affect the California economy.

I think the starting point here ought to be, how do property taxes affect businesses in what they do: Making investments, employing people, selling their products? As Mr. Goldberg said, and I agree with him, taxes on unimproved land generally do not change expected after-tax returns from new investment. And if you tax unimproved land, you are not going to distort investment incentives in the same way you would otherwise.

And I've got a picture of Henry George, who all students of economics -- certainly those who were in graduate programs -- will remember is the father of the single tax. His recommendation for raising revenues, for public entities, was to limit all taxes to simply those on unimproved land.

However, it's important to understand that although taxes on unimproved land don't change expected after-tax returns, they do affect the ability to invest. And those taxes also are shiftable. Even though you can't pick the land up and move it to Nevada, it is still possible to shift the tax on land to another party. And this is exactly what happens to renters -- to business renters, for example, who are on a triple-net lease. When the taxes go up, be they on land or on structures or equipment, those taxes are automatically shifted.

The reason why the investment incentives are affected by a tax on improvements to land, is that capital is mobile. In fact, in today's economy, it is highly mobile. It can go anywhere. And as a consequence, the mobility of capital is something that decision-makers always have to take into account. Failure to do so can lead to disastrous results.

Now, there are literally hundreds of studies that have been published in referee journals seeking to determine something called the "*tax elasticity of economic activity*." In English, what that means is if you raise taxes by 1 percent on business, what happens to the level of economic activity? It's probably not going to go up. Does it stay the same? Does it go down? And if so, by how much?

Two sets of authors have attempted to compile all of those results using a technique called "*meta-regression analysis*," and determine what the consensus tax elasticity of economic activity is. And they come up with surprisingly consistent results.

Tim Bartik, who is a senior economist at the Upjohn Institute, has determined that a 1 percent increase in taxes will lead to a .25 percent reduction in economic activity.

Joe Phillips and Ernest Goss, in an article published in the *Southern Economic Journal*, found that the tax elasticity of economic activity was .32 percent, so very close to what Tim Bartik found.

Now, we've made a very rough estimate of what adoption of a split roll -– but I should tell you how we're interpreting this -- simply bringing the assessed value of commercial and industrial property to market value -- what that would do to the overall tax burden. And we think it's somewhere in the neighborhood of 2 to 2¼ percent. That would be the increase in the overall tax burden for those affected by the split roll.

In using the metrics that Bartik and Phillips and Goss came up with, this would translate -- again, if economic activity is measured by jobs, this would translate into a loss of about 100,000 jobs. Adopt a split roll, take commercial and industrial property to market. When the adjustments were completed, there would be 100,000 fewer jobs, other things equal.

Now, a more targeted method of answering the question, "What is the economic impact of adopting a split roll?," is to use a dynamic input-output type model that is geared to the California economy. And there is such a model available. It's called the Dynamic -- I have to always look at the formal name because I use the acronym. It's the Dynamic Revenue Analysis Model. And it was jointly developed by the University of California at Berkeley and the California Department of Finance, expressly for the purpose of measuring the behavioral changes to a change in tax rates.

We had to make a number of assumptions in utilizing the DRAM for this purpose. We assumed that the increase in the effective tax rate of taking commercial and industrial property to market would be about 67 percent. That's an increase in property-tax burden, not an increase in the overall tax burden. So you can't multiply that by 43,000 jobs and get the impact.

We assumed no change in property-tax rates. We assumed that 45 percent of the assessed value represents land. And then we made several assumptions about the portion of capital that can't migrate out of state. And we've laid out our assumptions in a technical appendix to our paper.

With these assumptions, the model yields an estimate of the job loss from adopting split roll. It comes to about 152,000 lost jobs. In addition, there would be a modest reduction in the average wage rate in California of about four-tenths of a percent. About 48 -- is that right -- 48,000, almost 49,000 California families would be expected to leave the state as a result of the adjustment process.

Now, the job losses from the DRAM are about 50 percent larger than those that one gets by applying the meta-regression analysis data to the California economy. But the conclusion is the same, and that is, the price for obtaining the additional revenues that a split roll would produce would be a significant loss of jobs. It's not a criticism. It's just merely a statement.

I think in this particular case, the distributional impact is very important to keep in mind. It is likely -- in fact, it's virtually certain that the impact would be much more severe for small businesses. And the reason for that is that small businesses tend to be in more competitive markets, they operate closer to the economic margin, their cash-flow position generally does not allow them to absorb the kind of shocks that all businesses experience. I know that my business is experiencing a shock now. And as a consequence, a reduction in cash flow caused by an increase in taxes is likely to be a much heavier burden for small businesses.

And within the universe of small businesses, there is another group that would be even more severely affected, and that is minority-owned businesses. And Steve is going to talk about this, and so I will skip over that.

Just in conclusion, let me mention a couple of other economic consequences that are discussed in the paper. To the extent rental property, residential rental property is moved to the business rolls, there would be higher rents on apartment dwellers, the additional taxes in some cases would be passed along.

We've already talked about small businesses. We've talked about lower wages.

There would be an increase in consumer prices, where the competitive conditions in the marketplace allow the business to pass along the property taxes.

And there would be a decline in the value of financial assets held by California's two big public retirement funds. Both of these funds own a lot of California real estate. Much of it -- some of it residential, but most of it, nonresidential.

And to the extent property tax rates are increased on this property, the net present value of the income that those properties can generate will go down, as will their value.

The situation is not all negative. If -- a big *"if"* -- the increased property taxes are used to improve the business environment in California, some of these adverse taxes might be mitigated. This is something that's very difficult to model, and we were not able to model it, but it's something that you need to keep in mind, the Legislature needs to keep in mind; but we don't think it should be taken on the basis of faith.

The last point I want to make has to do with psychology. Now, most of you know, universities and colleges, there's a separate economics department and a psychology department. But certainly economists believe that a lot of their science or art, whichever you please, has to do with psychology. And if you have any doubt about this proposition, most of the woes of the world economies today are due to the fact that there are psychological perceptions about value that differ very substantially from intrinsic values.

But, in any event, the last point I want to make, having to do with psychology, is that to the extent business property is split off from homeowners for purposes of taxation, businesses are going to look upon it as though they're stepping out from under an umbrella. They benefit very significantly from being joined at the hip with homeowners because homeowners are very influential.

And the question that I can’t answer for you is, how does this psychology translate into additional behavior? My guess is that investors are going to be much more likely to feel vulnerable to further increases in property-tax rates or taxes beyond those brought about by a split roll. If they do, the employment estimates that I have given you, the estimated job losses, are likely to be significantly greater.

And with that, let me conclude. Thank you very much for your attention.

CHAIR PARSKY: Excellent. Thank you very much.

We’ll keep going and then come back for some questions.

MR. FRATES: Mr. Chairman, Members of the Commission, thank you very much for allowing me to speak today. My name is Steve Frates. I’m a senior fellow at the Rose Institute of State and Local Government, and I’m also president of a proprietary economic analysis firm called the Center for Government Analysis. We do public policy analysis.

You should know that our study was under the auspices of the Small Business Action Committee. And as my colleague, Dr. Hamm, pointed out, the primary focus of our research was both the size, scope, and characteristics of the business community in California, to give you some sense of what the impact might be.

So with that, turning to I think the first one -- there we are.

The vast majority of businesses in California are privately owned firms, not corporations. Over 90 percent, almost 98 percent are privately owned firms. Sometimes the perception is that it’s large corporations you’re playing around with when you look at a business tax or any form of a split roll. But you’re really talking about privately owned firms.

And what are the characteristics of those firms? On average, the annual receipts for the privately owned firms, as you may suspect, is much, much lower than they are for publicly owned firms.

Number of employees, again, much lower. If you take a look there, the publicly owned firms have about 95 employees on average.

By the way, these data are primarily from the 2002 U.S. Bureau of Census data. Some a little bit updated, but we didn’t have the full 2007 suite.

Private firms, much smaller.

If you look at minority-owned firms in California -- remember, we’re talking about privately owned firms -- there are over 2.8 million privately owned firms in California, almost exactly a third of those, or 957, are minority-owned firms. So it's a very significant portion.

If you take another cut at that, on average, the annual receipts for minority-owned firms are about 40 percent of the annual receipts for nonminority-owned. And these are privately owned firms.

So the minority-owned firms are a large number of the firms in California, private firms in California. Their size, their receipts, and their employees are much lower.

Here, we take a look at same data set sliced a different way. Men-owned firms versus women-owned firms. And in this case, once again, women-owned firms are close to a third of the number of those privately owned firms in California. So, taken -- we did not run cross-tabs on them, but taken together, women- and minority-owned firms are statistically very significant. Over 30 percent of the privately owned firms in California are owned by a woman.

On average, the receipts, annual receipts for woman-owned firms are much lower than they are for men-owned firms. You can see the data there, it's markedly lower. Again, in this particular case, it's 2002 data set.

So these are smaller firms: Minority-owned firms are smaller, women-owned firms are smaller. Most of the firms, the vast majority of the firms in California are privately owned firms. They're small outfits. So when you talk about a split roll, you're talking about, in toto, small firms in California.

Payroll for employee -- or employees per firm, excuse me. You can see there that the men-owned firms, only three employees; the women-owned firms, it's basically the proprietor and one other person is the average. They're very, very small outfits.

And as Dr. Hamm indicated, they all tend to be thinly capitalized, and not much in the way of financial resources.

A payroll for employee, woman-owned versus men-owned, you're not getting guys who are making a lot of money in these firms. These are people that are getting paid in small outfits, for everything from flower shops to things like that, where it's only one person -- or the proprietor running it and another person, maybe an employee. And they're not making a whole lot of money.

If we go on to the next one, Latino-owned firms, you can see of all the minority firms in California, of those 957 firms, 44 percent are Hispanic- or Latino-owned. So very substantial, a significant portion of these privately owned firms in California and the minority-owned privately owned firms in California are Latino.

If you look at the next one there, on your printed copy -- I apologize -- I made the PowerPoint myself, and I made an error. I neglected to put the word "*lower*" after "*substantially*" and before "*average*." But fortunately, Margie Walker and the staff here saved me and corrected it this morning.

So on average, the annual receipts for Latino-owned firms are substantially lower than the average receipts for all minority-owned firms.

So keep in mind, minority-owned firms, in toto, have lower income per firm than all privately owned firms; and Latino-owned, minority-owned firms have lower income per firm even yet. So the impact would be pretty substantial on these folks.

Conclusions: Split-roll property taxes, as Dr. Hamm pointed out, would negatively impact businesses that rent places of business. We mentioned in passing the triple-net rent provisions are the norm. That's for most industrial and retail properties. Triple net is the norm.

What does "*triple net*" mean? It's a fancy way of saying that the tenant pays property taxes, not the landlord. So property improvements, all those kinds of things, utilities and property taxes are borne by the tenant. And that's a very key point, because most of those privately owned firms and particularly the minority-owned firms and the woman-owned small private firms are renting their properties. So they get hit right off the bat.

A slightly different situation for office properties, although that's changing now. But for small retail operations, small manufacturing assembly and those kinds of things, they'll definitely get clobbered.

Businesses that own their own place of business, of course, if they are fortunate enough to do that, would face the direct property-tax cost.

As you can see from the size of most of those Latino- and minority-owned and woman-owned firms, that a lot of these outfits that they do own their own property, they're not very big outfits at all. They're not renting a whole lot of stuff to folks in the way of property.

The vast majority of businesses in California are smaller, privately owned firms. These privately owned firms employ more Californians than publicly owned firms. A very significant point, that they're a major economic driver here in California. And if you come up with a tax regime that has an impact on them, you're going to come up with a tax regime that has an impact on the employment profile of the people California.

And particularly if you harken back to earlier data set that talked about how much these people are paid, these aren't people with master's degrees from Stanford. These are people who are maybe high-school graduates, who are somewhat on the periphery of the financial situation. They're more vulnerable.

Women- and minority-owned firms in California are, on average, smaller and have lower receipts than other firms, as the data show.

Latino-owned firms on average are smaller and have lower receipts than minority-owned firms overall. And that's an important thing to keep in mind. We're not just talking about Latino firms compared to all privately owned firms in California, but to minority-owned firms.

The split-roll property-tax regime would have a negative impact on minority-owned, woman-owned, and Latino-owned businesses in California, which on average are not as large and financially robust as other businesses.

Thank you very much.

I'll answer any questions you may have.

CHAIR PARSKY: Thank you very much for that presentation.

Terri, why don't you complete this panel, and then we'll ask some questions.

MS. SEXTON: Well, thank you again for inviting me. Now that we're in order, I feel --

COMMISSIONER BARRALES: You get a bite at the apple now, Terri.

MS. SEXTON: I'm afraid to take a bite at the apple.

CHAIR PARSKY: Only Lenny gets two bites, that's okay.

MS. SEXTON: The apple might be poison, though; right?

Well, just as a way of introduction, I teach economics across the causeway at Sac State, but I also am the associate director of the Center for State and Local Taxation here at UC Davis, and have worked with our director, Steve Sheffrin, for years and years -- 20 years, probably, at least, on issues related to the property tax. And we've conducted several studies looking at the impacts of Proposition 13 in California.

So a lot of my comments will be sort of summarizing some of those results. And in addition to -- this isn't showing up very well; is it? But I guess it's the lighting.

In addition to commenting on some of our research -- some of the previous comments that have been made, so this just kind of is a brief outline. And I'll try and go as fast as I can so that we can move on, knowing that you can ask questions afterwards.

The first point I want to make is that California -- that this is not a unique issue. Most states have some form of a split roll, or what we might call a "*classified property tax system*," in which different classes, or use-classes of property are treated differently. And basically, it just involves imposing a different effective tax rate on different classes of property.

And I went through some of the recent data compiled by the Lincoln Institute, and they have, by the way, a very nice Web site where they're gathering all of this information on different states; and it's very up-to-date. It's sort of the old -- some of the things that used to be available but haven't been for years.

In any event, there are 11 states that actually assess at a different ratio, residential property at a lower rate than nonresidential property. So that's an assessment ratio difference.

There are another 12 states that assess the property the same but actually tax residential property at a lower rate.

Then there are four states that do both, both assess and tax residential property at a lower rate.

So there at least 27 states that are treating -- giving some preferential treatment to residential property. And how they define "*residential*," there's variation in that across states as well.

Then if we look at other states that have assessment limits, like California's Proposition 13, obviously, ours is the lowest, at 2 percent limit on assessment growth. But there are 19 other states, plus the District of Columbia, that have some form of assessment ratio in place. And of those, 12 of those states exclude business property, or commercial/industrial property, entirely from the limit. And seven states, in fact, only allow the limit to apply to homestead owner-occupied property.

So, again, it's not a unique thing that we're considering here.

This next table summarizes some of the results from the three studies that we've done. And I recognize that this is somewhat dated. The last extensive look we took was in 2002, at Los Angeles County. Our first study in 1991 was a statewide study. We included, in some respects, all counties, gathering very detailed data from nine counties.

Steve and I then took another look in 1996, after the recession, at the decline in property values to see what had happened to the relationship.

And then finally, in 2002, we looked just at Los Angeles County, and that was sponsored by the Senate Office of Research. They wanted us to take a look at that.

What we did basically in all three of these studies was gather data on properties that had recently sold, comparing their sale price to what their previous assessed value had been, to see what the disparity was between assessments and market values. We broke the properties down according to their base year, recognizing the properties that hadn't sold since 1975 would have the greatest disparities.

And what you see reported in this table are disparity ratios for the 1975 base-year property. So these are the ones with the greatest disparities.

Interestingly enough, in 1991, among the commercial/industrial properties, there were still 36 percent of the properties that hadn't been modified -- in other words, just had the single base year -- were still 1975 base-year properties and 44 percent of those that were modified had at least one of their base years being 1975. So there hadn't been a complete change in ownership there.

Those percentages obviously have declined over the years. And to a certain extent, that's influenced these revenue ratios that are reported in the last two rows of this table.

Going back up to the top couple of rows, we see that the disparities -- and this, again, is a measure of the market value divided by the assessed value for these properties -- was quite high.

COMMISSIONER BOSKIN: You mean the reverse, right, assessed value divided by market value? The numbers are less than one.

MS. SEXTON: The revenue ratios are assessed value over market value. The disparity ratios in the top two rows are the reverse. They're the market value divided by assessed value.

COMMISSIONER BOSKIN: Okay.

MS. SEXTON: Our revenue ratios that we report at the bottom are similar to what the Board of Equalization disparity ratio currently reported. I think the 2006-07 was 60 percent. So those are directly comparable.

We came at it from a different approach, a little more detailed data, where we actually categorized everything according to base year and computed separate disparity ratios for each base year of property, and then aggregated them over that. So it's a fairly detailed analysis of these disparity ratios.

But one of the things you'll see is that the revenue ratios or the disparity ratios clearly have changed over time, and they fluctuate with the real-estate markets or property markets or the economy in general.

I think using -- if we look at the Board of Equalization figure of 60 percent disparity ratio, I think that was for 2006-07, was the figure that they came up with, that would translate into if we moved all the commercial/industrial property to market value, about a 78 percent increase, or somewhere in the neighborhood of $9 billion.

If we look at a disparity ratio, for example, of closer to what was realistic in 1996 for the non-modified properties, we're talking about maybe only a 22 percent increase in revenue.

So in terms of how much money is going to come out of this if this reform is adopted, it depends on several factors. So we have to be careful.

This next figure that I included in this presentation is just -- I guess it's a graphic of the data that Lenny showed you earlier. But if we want to look at the homeowner tax burden, I think that this does show that there has been some increase.

This is, again, the proportion of assessed value that is made up of the homeowner-exempt properties. And irrespective of the disparity ratios, this is showing that homeowners are paying a larger percentage of the total property-tax revenue allocated than they were pre-Prop. 13.

And there are several explanations for that, of course -- well, two primary. One is that there's been more new construction of residential single-family homes, or that there's been higher turnover, or both. It's probably a combination, clearly.

If we were to talk about moving to a split roll, this type of reform, even irrespective of additional revenue -- in other words, we could put this in a revenue-neutral context and talk about lowering the tax rate on commercial/industrial property while raising the assessment to market value, there would be some advantages from an economic efficiency standpoint to doing that. And this is identifying some of those.

These are some of these sort of unintended effects of Prop. 13, that, while there are not very detailed studies that have measured these, again, it's trying to measure something that hasn't happened in a lot of cases, and so it's very difficult.

But one of the things that we did show in some of our work was that Proposition 13 has involved a disincentive to move on the part of homeowners. Well, the same sort of disincentive, or mobility effect applies to businesses. There's a penalty associated with moving if it involves investment and new improvements, purchases of new property and so forth.

So to the extent that, in a similar way that households delay moving to avoid this penalty, there is a presumption that businesses as well would.

Clearly, firms that move frequently have a disincentive to be owners and a greater incentive to rent property.

And new businesses are put at a disadvantage, or businesses where there is a change in ownership, they are put at a disadvantage relative to established competitors.

And I think this is an argument also that probably you've heard from Lenny, that taxing new investments at full market value is something that we're currently doing, while we're failing to tax the increases in value to long-time owners. And so there is this disparity, and it does cause behavioral changes, and it does have an impact in terms of excess burden or welfare laws of our tax system.

In terms of the incidence of a split-roll property tax, what would happen. I think that Dr. Hamm was suggesting a lot of these things. I think the thing that's important to recognize, if we actually break down the tax base and where the largest disparities occur, much of the increase in assessed value and consequently the increased tax revenue would come from increasing the assessment of these really undervalued parcels of land. The land is the component most undervalued.

And to that extent, again, these taxes would fall primarily on land, a fixed input, an immobile input; and it would have very little sort of excess burden or efficiency costs associated with them. It is sort of the Henry George *"tax land"* argument.

So if we're looking for revenue and we're comparing -- I mean, this is the job that you have to do. You have to compare -- not just look at the effects of going to a split roll, but compare that to what are the costs there compared to raising the sales tax or raising the income tax? And from an economic standpoint, I would argue that the excess burden, the costs imposed in terms of loss in welfare will be lower with this type of reform.

Much has been discussed regarding the business climate, and won't this negatively impact the business climate in California if we impose additional tax burdens on businesses? And I'm not going to argue. I think everyone would agree that increased taxes on businesses will have a negative impact. There will about be some impact on employment.

Again, what we would want to do is if we're going to collect more taxes, we need to compare whether or not the impact on employment is going to be greater through a split roll or through an increase in the sales tax or an increase in an income tax.

I've noted three studies here that have, in fact, pointed to other taxes as having a greater negative impact.

The Mark, McGuire, and Papko 2000 study showed that personal property taxes and sales taxes have the largest negative impact on employment growth.

In terms of personal property taxes, personal property, if you look at the Board of Equalization numbers, is pretty close to market value now. So there's not much of an increased burden associated with that.

Harden and Hoyt pointed to the corporate income tax as the biggest problem in terms of negative impact on the economy.

And Gupta and Hofmann said it's lower income taxes in general that firms look at in terms of influencing their location decision.

So we have to look not just at whether or not state taxes, increased state taxes are going to affect employment, but let's look at which taxes. Again, we have to make choices in terms of where that revenue is coming from.

So no one will argue that California's business tax climate is bad relative to other states in terms of the rankings. This is the 2009 Tax Foundation's rankings puts California at the rank of 48. But when we break that down by taxes, it is the individual income tax, the sales tax, and the corporate tax that are really pulling California down. It's not the property tax. California ranks 15th with respect to the property tax.

Ernst & Young provide another sort of measure of business tax burdens in terms of comparisons across states. And they look at the ratio of business taxes to expenditures to that help business. Again, this is sort of the Thibeaux argument that people will look at not just the cost associated with locating in a particular state in terms of the tax costs, but what benefits do they get from it? And California's business taxes as a percentage of expenditures that benefit business, the tax costs of those expenditures is lower than the national average. It's 1.67 in California versus 1.83.

Business taxes are a lower percentage of gross state product in California than is true for the average across the U.S.

And the business share of the tax growth that's occurred since 2002 is lower in California than across the other states. So, again, just some counterfactual information regarding, I think, the business tax climate in California.

Another argument that we've heard a lot about, I think, in all of this discussion of where to look for revenue is the impact that it has on the volatility of -- looking at the volatility of California's revenue stream.

This first slide looks at the three major tax bases. Again, I apologize, it's hard to read.

The top one, of course, is the property tax base assessed value; the yellow one is the personal income; and the last one is taxable sales. And, of course, you know, if you were going to look for a steady growth, obviously assessed value looks better or the property tax looks better. A better view in terms of volatility looks at the annual growth rates in these tax bases. And I think here, you see, you know, pretty clearly that there is much more stable -- the property tax base is much more stable than either taxable sales or personal income.

Of course, we have to recognize that if we start moving part of that property tax base to market value, that's going to become less stable. It will certainly have an impact. But it's certainly -- you know, looking at this, it doesn't really suggest that maybe the income tax or the sales tax is the tax to increase if we're interested in volatility.

CHAIR PARSKY: Thank you very much.

Five minutes, max, of questions -- or less.

Richard?

COMMISSIONER POMP: I'd like to ask Dr. Hamm, what did you assume about the use of the increased taxes from the split roll?

MR. HAMM: We assumed that they would be used to reduce the deficit -- the structural deficit.

COMMISSIONER POMP: I see. But not put into infrastructure, education, or anything like that?

MR. HAMM: To reduce the structural deficit.

COMMISSIONER POMP: So on that assumption, the conclusion was virtually foregone? You got absolutely no benefits from the increased tax? It couldn't be anything else but a loss?

MR. HAMM: Well, obviously different assumptions would have produced different results. If we had assumed that the funds would have been used to increase expenditures, for example, it would have produced different results. I think the assumption we made was the right one under the circumstances, given the state of the budget today. But I certainly agree with you.

COMMISSIONER POMP: You're familiar with Robert

Lynch's work on this, who draws exactly the opposite conclusion from yours? But he assumes the money goes into infrastructure and education.

Professor Sexton --

MR. HAMM: I'm not sure that's inconsistent with mine. I said that different assumptions will get you different results.

COMMISSIONER POMP: Yes, and I told you the assumptions he made, and he draws exactly the opposite conclusion.

So, Professor Sexton, your conclusion was Proposition 13 shifts or has shifted the tax from business to homeowners?

MS. SEXTON: My conclusion is that since we passed Proposition 13, the burden on homeowners has increased.

COMMISSIONER POMP: I don't know that that's different from what I said, but --

MS. SEXTON: Well, I don't know that it is, necessarily, either; but I've been taken to task on that. I have not seen the data, but I've been told that there are comparable data out there that show that the burden on business has also increased since Proposition 13.

I haven't seen -- I would want to see commercial/industrial values as a proportion of assessed value over that same time period; but I haven't been able to get my hands on that data to --

COMMISSIONER POMP: And I notice one thing you -- the split roll would affect people, I think you said, at the upper end of the income distribution?

MS. SEXTON: Well, in terms of the incidence, the fact that most of the increased taxes are going to come from raising up those land values, those undervalued land –- commercial/industrial land parcels and the land component of existing parcels -- I should be clear there -- that that burden on land can't be avoided.

How can you avoid that? You know, if these businesses try to sell, to move to Nevada or some other state, they're going to immediately bear the burden of that tax in the form of lower land values. And that can't be passed. Land is an immobile factor.

And the ownership of that land, I would hazard to guess, is probably distributed across the income distribution and falling at the higher end.

COMMISSIONER POMP: Thank you.

MS. SEXTON: So I think land ownership in general and that type of land in particular.

CHAIR PARSKY: Chris?

COMMISSIONER EDLEY: Just one question.

Do any of you have any data -- or I'll even take intuition -- about whether, with respect to minority businesses and women-owned businesses, the disparity between assessed and market value is the same as for other businesses?

(No response)

COMMISSIONER EDLEY: What about intuition?

MR. HAMM: I do not, Dean Edley. I don't have –- I don't think that data exists, because we did look to try to break down the disparity ratio into subgroups, and I don't think we were able to come up with that data.

MR. GOLDBERG: The only thing I would say there, because I don't have the data, is that the largest disparity that exists are for land that has been held since 1980, or 1975, or in the early eighties, that's where you get the huge disparities; and the largest disparities in the data that we've looked at is on land and not buildings.

Buildings have been modified significantly and reassessed. So what you're really looking at are the owners of land with regard to the greatest disparities.

COMMISSIONER EDLEY: Of course, the chances are that in 1986, the farther back you go, the smaller the proportion of entrepreneurs and businessmen who would be minorities.

MR. FRATES: Commissioner, there's one factor that might be germane there, and that is, most of the those women- and minority-owned firms are renters.

COMMISSIONER EDLEY: Renters?

MR. FRATES: So the fact that as they -- and there's much higher turnover in those firms. You can see in driving by any strip small, you see that all the time. So I would hazard a guess -- and this is only a guess -- that because of the triple-net provisions, that the impact was more acute and more immediate over time on those women and minority firms. But that is only a guess.

CHAIR PARSKY: One last question, Michael?

COMMISSIONER BOSKIN: Yes, I want to posit something I think we -- just take as an assumption -- if you disagree with it, you can amend your answer. But if we assume that we're going to hold government spending constant and its composition constant for a moment, and the experiment is the one Terri has suggested, that we shift the composition of taxes away from income or sales taxes and rely more and more heavily on property taxes, I for one think that, to the extent that tax is on land, it's immobile, that may not be -- I may agree with you that that may be less inefficient than the other taxes. But we also have a lot of analysis that tells us -- and this is why I'm holding the spending and its composition constant, because I think it's also true of good schools -- that the property taxes will be capitalized into land values.

So if we do this, what happens to land values, and how does your estimate of how much revenue you're going to raise and everybody else change? I assume you haven't done a full dynamic analysis where the value of the land has now gone down because we've raised property taxes. If you've done that, I'd like to see it. But I assume you haven't.

MS. SEXTON: No.

COMMISSIONER BOSKIN: So I guess we should say that the amount of revenue you're estimating is kind of the upper bound, assuming there's no effect on land values?

And so I'll let her answer that, and I'd like each of you to respond to that.

MS. SEXTON: Right. All of our estimates have been simply based on the disparity ratios, assuming that those -- taken that the current assessed value is given and not changing.

But you're right, to the extent that capitalization occurs, that does reduce the revenue that would be forthcoming.

MR. FRATES: Commissioner, there are two other things there that I think we need a little clarification on. One is that we've been talking about property taxes in aggregate across the state. There's a huge variation amongst the various subagencies: with 480 cities, fifty-some-odd counties, three or four thousand special districts, a thousand K-12 districts. And there's tremendous variation in the revenue streams amongst those various agencies, as well as tremendous difference between their reliance on property tax. There are cities that virtually don't rely on it all. And the mix, as we pointed out earlier, that you saw earlier, I believe was for statewide. And, again, there's huge variability there.

So I think you bring up a very salient point, that trying to get your arms precisely around the impact of a change in the property tax would be, I would say, a very, very challenging --

COMMISSIONER BOSKIN: Yes, I totally agree that when we deal with the disaggregation, it adds orders of magnitude to the complexity. But even if every district was the same, and the question I pose, land values would fall, market values would fall, and we'd collect less revenue than the static estimate would show.

MR. FRATES: I think what I would say in that regard is that to the extent that land values have fallen or market values have fallen, it would depend on how the individual -- the land -- the jurisdiction and where that land was located, assessed the property and taxed it, that that might, at the margin, have some difference. That's the only thing I would suggest.

COMMISSIONER BOSKIN: Well, I agree if there were disparities, disaggregation would be important to get a full analysis.

MR. HAMM: Dr. Boskin, I agree with you certainly on the economics. And I think as a practical matter, there are three methods of assessing commercial property. And the one that is overwhelmingly used is the income approach. And so to the extent you reduce the after-tax income, which is what gives the property value, you're going to reduce the market value. And this will translate into lower assessed values, either because the assessor does his job or because the taxpayer goes to appeal the assessment. But I think both the economics and the assessment practices get you to the same place.

MR. FRATES: Right.

COMMISSIONER BOSKIN: Lenny?

MR. GOLDBERG: Yes, I agree, I think it's a beneficial impact. I do think it does affect the revenue analysis over time. Basically, what you have is the ability to hold land off the market right now at virtually no cost. As a result, you would be bringing -- when you create that cost, there would be more land -– parking lots being held in downtown LA that could be held off forever. People would start to have to put land on the market. That would lower, generally, your land costs, the amount of capital sunk in land. It would have an impact on the analysis. It would also have very positive impact on investment and productivity.

COMMISSIONER BOSKIN: Yes, so my basic point -- I agree with virtually everything all of you have said. My basic point, though, just to reiterate, is that were this commission to go down the route of suggesting relying more on the property tax changing to a split roll -- doing any of these various things to get closer to market value, there are a lot of different ways you could do it, you know, in the extreme of push abolishing Prop. 13 or something like that. I don’t happen to support that. But if the Commission went in that direction, we should just take this initial estimate of how much revenue and think we’d be able to reduce the other taxes by that amount, because we wouldn’t raise that much revenue because land prices would fall.

I think you would all agree to that; correct?

MS. SEXTON: Yes.

COMMISSIONER BOSKIN: Okay, thank you very much.

CHAIR PARSKY: One last question, very briefly, from Curt Pringle.

COMMISSIONER PRINGLE: If I could just make it real brief.

Professor Sexton, the one chart that talks about the shift of property-tax burden to homeowners, I think I might just be missing something. I can see that maybe what you're saying is a percentage of the total amount of property debts collected, there is a higher percentage collected from residential properties now; is that what this chart says?

MS. SEXTON: Yes, homeowners are paying a larger proportion than they were before.

COMMISSIONER PRINGLE: Homeowners are paying a larger proportion?

Do you have, in fact -- you said you didn't have the assessed valuation comparison of commercial/industrial property --

MS. SEXTON: No.

COMMISSIONER PRINGLE: -- versus homes?

MS. SEXTON: No. I'd love to have that.

COMMISSIONER PRINGLE: Do you have the number of homes that were built in the last 30 years versus the amount of commercial/industrial property that was built in the last 30 years?

I would assume a new home would, in many cases, be assessed or bought -- turned over, certainly not bought; right?

Well, maybe not in the last six months. But, I mean, that your chart ends in 2006, so we're all safe. But, in fact, this chart, just as a raw comparison between the dollar amounts, not a shift of the burden, because there could be a lot more homeowners -- there's a lot higher home appraisal, appraisals in residential properties could have gone up at a faster rate than commercial properties and industrial rates. I mean, there's a lot of that discussion that may be factored in to come to that conclusion that there's been a shift of the burden of property tax; right?

MS. SEXTON: No, that's right. And that's why I was very careful in the way I said that, that the burden on homeowners has increased. I didn't say that it has shifted from a particular source.

Now, I did look at -- I was able, from the Board of Equalization Web site, to get a couple years. They have the 2006-2007 assessed value, market-value estimates in there. And I was able to get an earlier year and show that over that -- it was about a two- or three-year span that the commercial/industrial share had fallen from 31 percent to 30 percent.

Well, it shows that it's a smaller share than the homeowners' share. But that still isn't enough to say that the burden has shifted. So you need to have the same history for commercial/industrial to say that, over that same period of time, there's been the steady decline in the proportion of the tax that that property has paid, so…

COMMISSIONER PRINGLE: But I could come up with a similar answer to this chart by saying there is a faster increase in the valuation of residential or home property versus commercial property?

MS. SEXTON: Well, and the only way it gets reflected is if there's new turnover or new construction, so…

COMMISSIONER PRINGLE: Okay, thank you.

CHAIR PARSKY: Thank you all very much. We appreciate it.

Now, we'll move to the staff discussion, which will begin a discussion of goals, principles, and options.

To some extent, the staff and I had the benefit of knowing some of these presentations. So we're going to at least start some thinking, and then request the staff to do certain kind of analyses. And I apologize for eliminating the break this afternoon, however, we don't have dinner so I thought it would be useful to keep going.

CHAIR PARSKY: Okay, Mark, go ahead.

MR. IBELE: Thank you, Mr. Chair, Commissioners.

I wanted to spend a little time at the beginning. We had sort of a discussion of Commission goals, which the Chair has already gone over. So in the interest of time, I won't do a repetition of that. But I did want to spend just a few minutes going over some of the principles that it's a good idea to remind ourselves. And I'm going to try to go straight down the middle here in terms of perspective; and if I deviate too much to the left or to the right, hopefully those will cancel each other out.

CHAIR PARSKY: We don't talk left and right here, so it's okay.

MR. IBELE: So one of the principles that we've talked about quite a bit, the economic efficiency, we want to have a tax system that minimizes market interference and decision-making, except to the extent that there is a corrective tax or market failures or certain distributoral goals. And this goes to a theme that the Commission has visited often in its short life, the desirability of broad bases and low tax rates.

On the broad-base side, this can eliminate different treatment of assets and income from different activities, which might bias decision-making and discourage efficient outcomes. A simple example, in a sales-tax-only regime, if we were to only levy sales tax on tangible personal property, we'd be basically subsidizing the services sector.

In terms of low rates, it raises the return to working, saving, and investment and reduces incentives to avoid or evade taxation.

And then finally, in terms of low rates, it also reduces the degree of the excess burden, which is basically a way of saying the difference between the revenue that the government receives from a tax and the cost to the taxpayer.

Economic growth. This, in many ways --

COMMISSIONER MORGAN: Can I ask you, this is not in our binder?

CHAIR PARSKY: The principles are in your binder. Mark's just giving you an elaboration of each principle. But if you look in your binder, it's there.

MR. IBELE: I'm speaking. I can give you a copy of this later.

But in terms of economic growth, this, in many ways, flows from the idea of broad bases and low rates. Without putting too fine a point on it, it probably --

CHAIR PARSKY: Phil will get it.

MR. IBELE: I'm still going through these principles and objectives.

CHAIR PARSKY: Right. But they're elaborated a little bit in the next slide.

MR. IBELE: There we go. Thank you.

Without putting too fine a point on it, it probably doesn't mean giving incentive or preferential treatment to particular industries or activities unless they're specifically identified, such as some would argue with a research-and-development tax credit. But it goes beyond that. It means ensuring that alternatives don't so far go in the direction of base-broadening, that we end up with a tax base which is actually broader than the economy, such as with a gross-receipts tax that ends up in a tax-pyramiding or tax-cascading scheme.

By the same token, it would suggest introducing consistency in the tax system which doesn't tax business inputs, intermediate or capital. The use of the products which can then themselves be taxed, and you end up in a double-taxation system.

And as my colleague will talk about in just a minute, at least on a temporary basis, it probably gives a preference to destination taxes as opposed to origin taxes, which can increase the cost of production.

Administrative feasibility, we haven't spent a lot of time on this, but I think it's important because it's really the intersection of tax policy and the taxpayer.

We could devise a system of Ramsey taxes that are very sophisticated, but we'd get bogged down in trying to come up with the compensated demand curves that would allow us to put that into place.

So at the very least, the Commission should consider reforms that don't make the process of tax compliance any worse, but give appropriate consideration to the feasibility, the simplicity, the clarity of the tax system that allows taxpayers to easily comply.

Revenue stability and sufficiency. We've talked about this in terms of the volatility aspect. Obviously, there's a trade-off here that we've talked about quite a bit. The volatility -- a trade-off with the growth and the revenue base.

The propositions or initiatives that are on the ballot will certainly -- 1A would go some ways towards addressing the volatility issue. To a certain extent, it can be addressed through the budgeting process. To a certain extent, the Commission may want to trade off that growth and address it through the tax system as well.

And finally the last one, which is certainly not least, perhaps the most difficult, we can suggest or provide information on the data and measurements for the effects of different taxes. Obviously, the Commission itself needs to decide how to balance a regime that is based on benefits received as opposed to ability to pay.

The benefit principle might suggest that people with -- that the taxes are equivalent, or people with higher incomes may pay more because they attach a higher monetary value; but it would except the entitlement to earnings.

The “*ability to pay*” principle would call for a pattern of taxation that minimizes the aggregate loss, and then serves the goal of welfare maximization. Often, these are combined. For example, you could recognize the entitlement to earnings as a principle but except distributional corrections in extreme cases at the lower end of the income, which is, frankly, where a lot of states end up.

I think looking at some of the information that was given to us this morning, California was one of the few states that has at least a proportional system. Most states tend to be fairly regressive. Distribution is not traditionally an activity that states have gone into because of the difficulty with mobility.

And the last point I want to make about distribution is the element of -- it’s a moving target. It has changed. And as we went into last time, it’s changed in California for two major reasons. We changed from a tax which is largely regressive, the sales tax, and shifted over to a tax which is largely progressive, the income tax, and income itself has shifted towards the I-end. So without doing anything in particular, our system has become more progressive.

CHAIR PARSKY: Everyone will have the opportunity to have these basic principles and some of the elaboration of them in draft form that everyone will take a look at. But I at least wanted to start the process of thinking about some basic principles.

Go ahead. Why don't you complete your presentation and we'll have some questions?

MR. IBELE: Okay, that's what I was going to say in terms of principles. It depends upon how you want to proceed.

We have an alternative that we discussed last time. It's not quite to where we want to get to, but it's what we have now. And then we have some additional materials on different types of reform that the Commission may want to consider.

CHAIR PARSKY: Why don't you go ahead through it, and then we'll pause as we go along here?

MR. IBELE: *"Eliminate, Flatten and Exempt."* This sounds like a diet, but it's not. It's a tax alternative. This came out of our last session. And it's basically a proposal to -- it's revenue-neutral over a trend line. It eliminates the 5 percent state sales tax.

CHAIR PARSKY: I should say that any of the alternatives that we will ask the staff to model, we'll ask them to accomplish, at least, or show us how it accomplishes revenue-neutral over a trend line. So that's not just allocated to this particular alternative.

But go ahead.

MR. IBELE: So in the process, one of the policies that I mentioned earlier about exempting business inputs, that would partially be accomplished through this because it would eliminate the state sales tax. The local sales tax would still be in place. This would result in a revenue that would be raised by the personal income tax. It would be a flat rate of 8 percent on all income. There would be no credits or deductions, with the exception of a $500-per-return exemption. It would raise an additional $28 billion -- this is on the personal-income tax side -- an additional $28 billion, which is basically enough to buy out the sales tax.

With the flat rate, you'd be reducing volatility very slightly. The reason for that is because you'd still have -- you'd still be taxing the capital gains itself, which itself is volatile. So simply lowering the rate to the 8 percent would only result in a slight decrease in the volatility.

And it would obviously have -- because of the way we structured this, it would have a distributional impact on taxpayers.

In looking at this chart I'd ask you to concentrate not on the effective rates, which I have to say I'm not happy with at the low end, not because I think it's inaccurate, but it's just difficult. At the low end, you get into situations where people with a negative income, you end up with a higher rate than the statutory rate. So it looks a little bit odd at the lower end. And then the effective rate then declines because the concept of income we're using here is total income. So you'd have retirement contributions, health insurance, things of that nature. And then the spike at the end is because of the 1 percent on high-income individuals.

So now that I've asked you not to concentrate on the effect of tax rates, we can move on.

The other reason why there's a spike at the beginning there, at the lower end of the income spectrum, is we're eliminating the sales tax. But a lot of purchasers on that side of the spectrum, their purchases are already not taxed. Their food, it's prescription medicine. So it doesn't have a huge, huge impact there.

One of the things in talking amongst ourselves and with different members of the Commission, is putting in a larger exemption -- that is, an exemption exempting the first $20,000 or $30,000, which would do a lot to get at the distributional impact at the lower end. And this sort of goes to my comments earlier, which is, you could except an entitlement to earnings approach, and then you'd encompass within that a much more distributional, or redistributional approach at the lower end of the income spectrum there.

The next slide is just the average tax change per tax return for each of the income categories. And, obviously, the absolute changes are quite substantial at the higher end.

That is the sort of tax combo that we put together at this point.

One of the things that -- and this goes in a slightly different direction -- one of the proposals that we were asked to take a look at is a much more fundamental approach, and it goes back to our discussion earlier this morning, which is looking at an overall flat tax, similar to the tax that Dr. Murphy described, which would cover -- but it would be broader than that. It would cover state revenues and local revenues. It would encompass the personal income tax, the sales tax, the corporation tax, the gas excise tax, the sales tax on the local side, and the property tax. And for 2006-07, those taxes were just shy of $160 billion. They'd be somewhat more shy of that this year. But we'll just base that on 2006.

CHAIR PARSKY: And the trend-line analysis would be lower, presumably?

MR. IBELE: That's right, that's right. And for the purpose of putting together these exercises, we're pretty much stuck with the 2006 ––

CHAIR PARSKY: That's fine.

MR. IBELE: -- because that's where we have the most recent data from FTB and on the sales-tax side. But we would have to address that in coming out with a model that put that into a longer-term context.

So what we have in this regard is, you know, far from a simulation. In fact, it's quite conceptual in nature. And I'm going to turn it over to Phil, and he is going to discuss this particular approach.

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

What we're going to be presenting is a very broad base for personal income tax. And we're going to start off with personal income and then adjust personal income. So we start out with personal income, we're going to add in capital gains because that's not included in the National Income and Product Accounts for personal income.

And then we're going to subtract out imputed rents for owner-occupied homes and transfer payments, which may not be taxed. And that base turns out to be about 30 percent higher that adjusted gross income.

And the next slide is sort of difficult to read, but it basically shows how it would appear on a tax return. And though it's much broader than adjusted gross income, it would be somewhat difficult to administer that broad a tax. What's included in there, in addition -- and basically, I start off with federal adjusted gross income, and then make adjustments to that. So in that, you'd have to add employer contribution to retirement plans, employee contributions to 401(k), 457, basically defined contribution plans; then earnings of those retirement plans, annuities, and also life-insurance policies; employer-provided health care, and other employer nontaxable fringe benefits. All of these are included in personal income, but they are not included in adjusted gross income.

The administration problem in this, is that there's very little reporting of that income. So to actually shift the California tax base to that broad a base would be difficult to administer.

Also included in there would be employer-provided -- half of self-employment tax and tax-exempt interest on federal and California obligations. Again, though those are available, we're prevented by federal law from taxing interest on federal obligations, so that will be problematical.

From this tax base I've seen deductions, again, based that broad that included charitable contribution and mortgage interest. So that would give you taxable income. You can multiply it by a tax rate for a tax liability. That would provide you the lowest tax rate; but, again, it's difficult to administer.

CHAIR PARSKY: If you eliminated all those pluses, you'd have to apply a higher rate?

MR. SPILBERG: Yes.

CHAIR PARSKY: But it would eliminate all your concerns about administration?

MR. SPILBERG: Yes, sir.

CHAIR PARSKY: So I think one of the things the Commission might want to see is what that might amount to by way of rate, if you were going to change things along those lines, and not be burdened with that administrative difficulty.

MR. SPILBERG: Yes, we can certainly do that.

CHAIR PARSKY: Go ahead, Chris.

COMMISSIONER EDLEY: Well, I'm just trying to -- not all of them are difficult to administer, I mean, in the sense that they're --

CHAIR PARSKY: Well, I should have added, some difficult to administer and some, as a matter of policy, you may not want to include.

MR. SPILBERG: We can go beyond adjusted gross income if the Commission would like us to do some analysis of that. But these items are -- well, the only one that's readily -- well, the only one that's readily available that we can pick up data on, is half of the self-employment tax. That data item is available. This is basically an adjustment made against adjusted gross income for small businesses that basically are required to pay into Social Security.

COMMISSIONER EDLEY: But federal filers will have lines on their 1040 for the top three things?

MR. SPILBERG: No, no, they will not. Those are just not included in adjusted gross income.

It's employer contribution to define benefit retirement plans.

COMMISSIONER EDLEY: Oh, see what you're saying. I understand what you're saying.

MR. SPILBERG: That's not available.

COMMISSIONER EDLEY: Right, right.

CHAIR PARSKY: Well, I think for analytical –- Michael?

COMMISSIONER BOSKIN: Yes, I would just like to follow up on the Chairman's comments.

I think we need to look at a bit more of an array of these things as we look down this.

CHAIR PARSKY: Right.

COMMISSIONER BOSKIN: And so I try to lay out how to do that. Because some of these are altering the income tax, others are altering the income tax -- or raising the income tax in order to substitute for other taxes. So I made a list -- I think it probably encompasses a lot of what we're thinking about, others may want to add to it. Let me just read it and I'll give to you in a moment.

So one is, what would the current income tax look like if we eliminated all these deductions and exemptions in a proportional rate reduction? So that tells us something just about base-broadening of the income tax, up to AGI, not above AGI. So how much rate reduction we'll get.

Now, that's a lot of sensitive stuff, like charity and mortgage interest.

Second is the one you did, except, you know, a flat-rate income tax. However, you did it to buy up a lot of other things. How about if we change the income tax as our primary tax, what would the rate look like? We had some analysis of that in earlier presentations.

Then a flat-rate income tax above an exempt level, which I would strongly support, $20,000 or whatever it happens to be, for a family, so you wouldn't be having a flat-rate tax on low-income, very low-income people.

Then, it seems to me, you could do all of those while keeping the two most sensitive deductions, charity and mortgage interest.

Then you could do each of the analyses to abolish the sales tax, as you're kind of suggesting, or to reduce the sales tax by, say, half or something of that sort, maybe going all the way to abolishing it then causes the rates to get so high that it would be not worth the candle. And then, it seems to me, we need to do one other piece of this, which is -- this is kind of, how do you deal with the bottom end. There's also the issue of the top end. And a lot of people would complain about that larger reduction at the top, shared by the rest of the population, and perhaps not without reason.

So maybe we ought to think about what it would look like if there were two rates. You know, zero below, say, $20,000 -- whatever the number is, we could play around with that. But then there was a lower rate -- say, 4 percent, just off the top -- you'd have to do the math so the revenue breaks out -- up to whatever -- 80 or 100 or 120 or something like that, and then 6 or 7 percent above that. What would that look like?

MR. SPILBERG: Sure.

COMMISSIONER BOSKIN: That, I think, would at least begin to give us -- if we did those steps, it would begin to give us an idea -- it would separate out a little bit about what was trying to load the income tax versus reform the income tax. Okay, and I think that would be very helpful.

CHAIR PARSKY: And then I think we're also going to talk a little bit about the --

COMMISSIONER BOSKIN: Gross receipts.

CHAIR PARSKY: -- while eliminating the sales tax, take a look at a net-receipts tax or something like that as a balance.

COMMISSIONER BOSKIN: Yes. That, I think, is a good thing to do. We're about to get a statement about that.

CHAIR PARSKY: Right.

COMMISSIONER BOSKIN: In some sense, it's separable and could be added or subtracted.

CHAIR PARSKY: That's true.

COMMISSIONER BOSKIN: I think you still have to do the analysis to separate --

CHAIR PARSKY: And it might impact the rate that you would apply.

COMMISSIONER BOSKIN: Yes. But my point is, we have to do this kind of analysis to separate out the loading up of the income tax versus the reform of the income tax.

COMMISSIONER EDLEY: I'd like to –– in the same vein, it seems to me also, I don't know whether it would be better from a distributional standpoint to buy out some or all of the sales taxes as compared to a zero bracket on property tax, give them a bigger homestead, so that -- that question of the -- given that food, et cetera, are already excluded from the sales tax.

Do you see where I'm going?

MR. IBELE: Yes. So you want to look at the property tax as well as the sales tax and the $20,000 or whatever.

COMMISSIONER BOSKIN: You could get an idea by taking what I'm suggesting, and then, in addition, do an alternative where, instead of a reduction in the sales tax by half, you increase the homestead exemption for the same amount of revenue, and then you compare the two.

COMMISSIONER EDLEY: Exactly, and what the comparative distributional impact of those would be.

COMMISSIONER DE LA ROSA: Can I ask, I've got perhaps a dumb question is, but I'll ask it, anyway.

Isn’t it --

COMMISSIONER EDLEY: So you’re asking Bill’s question?

COMMISSIONER DE LA ROSA: Don’t we need to start with some kind of indication of where we think we’re going here? Like, I’m looking at this sheet here, and I’m thinking, well, what’s the benefit of this approach? This one called *“California Flat Rate on National Income*,” et cetera, et cetera. There’s a couple of things that jump out at me. For instance, you have earnings on retirement plans and annuities; but what happens in a year when -- like, 2008, when many people are sitting on top of losses in their house. Do you get to roll those forward and deduct them against -- they don’t show up on the deductions line. Is there a method to give relief to people that suffered losses in those kinds of years? Or are we just talking conceptually or –-

CHAIR PARSKY: Well, I think what has kind of come out of a recitation of this, is that the staff maybe ought to step back and have a variety of alternatives, but not deal with a gross income number that is adjusted for these items, and start without having these -- your adjusted gross income definition add back these items.

So it would -- I think they started with this because in looking at a flat-tax proposal, you might think that these items would have to be added back.

And I think what Phil was saying was, this would become both difficult administratively and may not be good policy. So the comment back was, “Well, build in a number of alternatives, but don’t try to include all of those items in as you start with your definition.” That’s --

COMMISSIONER MORGAN: Mr. Chairman, I don’t mean to be disrespectful but I’m not understanding why the staff is going ahead with this kind of work when this commission, at least on my hearing, has indicated a desire to go in one direction or another. I mean, there’s not a feeling in my sense that this group wants to go towards the flat tax or not.

We talk about buying out the sales tax. I haven’t heard any discussion in this group about a desire of the commissioners to buy out the sales tax.

It seems like the staff is doing work, maybe at their initiation or your initiation, but not at the direction of the Commission.

CHAIR PARSKY: No. Let’s eliminate the words “*flat tax*” entirely from the vocabulary, because I think it evokes something that we -- what the staff wanted to do -- it hasn’t done any work other than what you see on this paper, which isn’t very much work. But we have two months for them to do analytical work. So what they're looking for from us is some direction as to what kind of analysis they ought to do.

And I think Michael was making one suggestion that would say he'd like to see some alternatives staffed out that would include shifting the allocation of tax -- personal income tax, sales tax, and so forth -- with some alternatives.

You, as a commissioner, should feel free to ask the staff to do incremental work in another direction.

No, the staff hasn't gone off in any direction.

COMMISSIONER MORGAN: Is that acceptable to the Chair, that individual commissioners direct them?

CHAIR PARSKY: Absolutely.

COMMISSIONER MORGAN: Because it doesn't do --

CHAIR PARSKY: Well, that's why we're here.

COMMISSIONER MORGAN: It doesn't do any good for one commissioner to ask the staff to do work when 12 other commissioners might disagree with that direction.

CHAIR PARSKY: No, no. The purpose of this discussion is for you to make suggestions. That's why we're here.

COMMISSIONER BOSKIN: Becky?

CHAIR PARSKY: And we've had one --

COMMISSIONER BOSKIN: We've had a couple dozen presentations over the last few months, and most of them were directed at various aspects of this.

The reason I suggest this isn't that I have made up my mind about any of this or that somebody else may disagree; it's that I think we all need this kind of information to evaluate any of these things.

CHAIR PARSKY: Exactly.

COMMISSIONER BOSKIN: So I think, by all means, add other suggestions. But the idea is to give us some comparative data; so when we're talking about moving X to Y and A to B or not, we have some idea of what we're talking about.

COMMISSIONER MORGAN: Alternatives are great. I would just like to know where they're coming from.

CHAIR PARSKY: Becky, I'm more than happy to tell you exactly where they're coming from. Right around this table.

Nobody -- the staff hasn't done any work, but they have two months to do work.

COMMISSIONER PRINGLE: Oh, yes, they have.

CHAIR PARSKY: Sorry, sorry.

COMMISSIONER MORGAN: Did you know that?

CHAIR PARSKY: Staff hasn't done the necessary analytical work, so that we could step back and decide what to do.

MR. SPILBERG: This has not been work. This has been fun.

CHAIR PARSKY: Phil.

COMMISSIONER LOZANO: It seems to me, Gerry, that -- unfortunately, I missed the last meeting, but the one prior to that, we ended on a note where we very clearly said we need to start looking at options and be able to react to distinct alternatives, this being one of them.

CHAIR PARSKY: Sure.

COMMISSIONER LOZANO: And I think what I'm hearing the Chair requesting of us at this point is what other options should we look at that are, in fact, kind of those big ideas -- the bold, transformational ideas.

CHAIR PARSKY: Exactly.

COMMISSIONER LOZANO: And, you know, so I actually think this is very interesting. And what I would echo is if, in fact, we're going to go towards this, we layer in that tiering, so that we can see what the difference is for individuals, maybe exempting those below the 20, 25 -- you know, whatever middle income, how we want to define that. I would suggest, you know, 100, 120, maybe, which you could come back to us and then seeing a higher rate, at the higher level.

So I think this is precisely what we've been asking for, which is give us something that we can react to that is bigger, bigger ideas.

CHAIR PARSKY: And I think we wanted to use most of the first meetings to at least give the commissioners, at least some of whom said to me they didn't have a lot of extensive expertise or background in the tax system itself, to get the background. We don't want to exclude any presentations. But we're at a point now, in order to get some recommendations on the table so that staff needs to be given direction on what analytical work should be done.

So, Becky, we welcome it.

COMMISSIONER MORGAN: I think I got triggered when we were talking about buying out the sales tax.

CHAIR PARSKY: Well, we don't want to trigger anything. Don't worry.

But before we turn, you wanted a little bit of clarification on what Michael was suggesting, so let's – then we'll come around.

MR. IBELE: My question was, it had to do with actually whether we were going to use AGI as a basis to some other -- and we answered that.

COMMISSIONER BOSKIN: I think we should do the bulk of the runs that I think would be helpful for people -- other people have lots of others they would add -- leaving the above AGI stuff out.

COMMISSIONER POMP: I couldn't hear you, Michael.

COMMISSIONER BOSKIN: You're calling that below AGI. Go to your AGI tax form. The way most people would put it is going from personal income to AGI, and leave a lot of stuff out, which is your first few lines out there.

COMMISSIONER BOSKIN: Leave that alone for right now; but the analysis of adding some of that back in and what we can get for it, is something we probably need to know something about. But rather than take this, which would be radically controversial, and do every run that way before we could get some basic stuff done, I think, would be -- it would not be a logical and most efficient way to proceed.

MR. IBELE: And that's the direction where we're headed.

CHAIR PARSKY: Richard?

COMMISSIONER POMP: I would suggest the following -- and I think you're absolutely right, Mr. Chair, to avoid the use of the "*flat tax*." With a spreadsheet, we could play with rates.

CHAIR PARSKY: Exactly.

COMMISSIONER POMP: And there's no reason to sort of sully the discussion now with the baggage the flat tax has.

I would suggest, let’s do gross income, which is before AGI; and then let’s work with what’s easily knowable right now. I mean, there’s certain things that one can add back that exist and is knowable.

For example, the employee contributions is a knowable number, whether it exists on the return or not, it is a knowable number. And that could be added back.

The earnings of your actual plan -- that’s a little bit more difficult to deal with. And so I don’t know that I would worry about that.

The nontaxable fringe benefits, that’s a difficult number, too. That involves an awful lot of stuff that even the employer doesn’t keep track of because it is nontaxable under section 132. And so I don’t know how you would deal with that.

You have a plus sign before “tax-exempt interest on federal obligations.”

What does that mean, Phil, the plus?

MR. SPILBERG: Well, that’s just the difference between personal income and AGI.

COMMISSIONER POMP: I see. So you don’t mean actually tax that?

MR. SPILBERG: Well, I don’t think we can.

COMMISSIONER POMP: Yes, okay, I didn’t know what the plus meant.

The California obligations, you will tax or not tax?

MR. SPILBERG: Well, that, again, I'm not proposing this as a tax base, I'm just --

COMMISSIONER POMP: No, but we're simulating. Well, we're going to simulate, I understand. It's not enormous.

MR. SPILBERG: Yes. That's a policy question for the Commission. I mean, it is possible for California to tax interest on its own obligations.

COMMISSIONER POMP: And other states, too?

MR. SPILBERG: Yes. We already do tax interest on other states' obligations. We don't tax our own.

COMMISSIONER POMP: I'd like to -- if you're going to do runs, I'd like to see it with that in there, a tax on California obligations.

And then so I would like to see gross income, and then you could do AGI. And I would like to see AGI without deductions or charitable contributions and mortgage interest.

MR. IBELE: That's already on the list, Richard.

MR. SPILBERG: So basically, try something very broad and calculate the rate on that and then just do a second run, which maybe a --

COMMISSIONER POMP: Sure, with a spreadsheet, we could easily say “add that,” “delete that.” But if we don’t have it in the first run, we’re not going to be able to add or delete easily.

COMMISSIONER BOSKIN: I was going to say something that’s perfectly consistent and I think is a little simpler, because doing it the way Richard said means you have to do two of everything. One with a few things added back in and one with AGI, so I would just suggest doing the bulk -- the base ones with AGI and doing some illustrative ones rather than doubling the number with a broader income measure. Is that acceptable?

COMMISSIONER POMP: Well, the devil’s in the details. I’d want more rather than less. I don’t know how much harder it is once you get going to really have it all in one place, at one time.

MR. SPILBERG: It’s basically -- the question is, how much detail we would need to present. Because doing it on an aggregate basis, just figuring out a flat tax rate or figuring out what is the base, the taxable income base, that’s easy to do. But, for example, adding in the 401(k) plans, 457, we do not have that at this point as part of our distribution -- our microsimulation models. So this is something that we would have to bring in. It’s possible to bring in. But as you can imagine, it’s not trivial. It requires quite a bit of data work.

COMMISSIONER POMP: All right. Well, I don't want to bog you down for a month here in trying to do that.

COMMISSIONER DE LA ROSA: Mr. Chair?

CHAIR PARSKY: Edward?

COMMISSIONER DE LA ROSA: I had a slightly different take. So I'm terrified, Richard, when you and Michael were talking because I personally feel as though I'm not prepared to sort of dive into whether we should use AGI or -- but I'd like to offer something for us to think about, and that may be -- I think it's a great idea that the staff comes together around a few scenarios because we'd have some metrics then by which we can measure some approaches. But I sort of thought that maybe each of us -- all this board here could maybe work on a list of statements to guide your work. And then you go away and you do this stuff, and then we come back with some options around those statements.

There's, I don't know, 12 people -- 13 people -- 14 people, I guess -- 15 people around this table here. So it's 15 statements, at the least. But for example -- I'm not saying this is a good statement or a bad statement, but I wrote down some sample statements that would maybe give us some idea how this approach might work. We could come to Ed De La Rosa, and he would say, "Well, the State should receive the benefits of a volatile revenue stream. It worries me that they drop some years, but it's great when they're hot, when revenues are higher."

That's tied to another statement that says, "Volatility is not the problem; rather, the problem is the mismatch between fluctuations in revenues and non-fluctuating expenditures."

Statement Number 2 could be something like, "A broader-based lower sales tax is desirable."

Statement Number 3 could be, deductions should be limited to 1, 2, 3 -- pick your "3" out of here.

And so on. So that, you know, by the time we get to the end of the board, you then have a flavor of what we're all thinking is important, and then you could go back and maybe take a look at these three base cases and sort of build them around these ideas. And maybe that's one way to provide some guidance. Maybe it's not; and I really don't want to usurp the prerogative of the chairman. You asked for some recommendations.

CHAIR PARSKY: No prerogative at all. And it will be important to submit broad base statements of policy, principles, goals, no question about that. But I think that if you could take away some of the education coming out of these meetings, we have certain basic taxes in California that we, I think as a commission, need to address: Do we want to alter, change, add to, make recommendations around?

They're not 50 different taxes, there are some basic taxes. And I think that getting out some broad runs, so we can see the impact of shifting some of the burdens, trying to satisfy all of the goals, will give us something to get our teeth into.

I have no problem at all, and we should circulate statements of principle. And the staff is developing them in draft form that every commissioner should supplement. But I think we will lose the benefit -- or I should say, we won't meet our time frame unless we let the staff really do analytical work that has a sound foundation on the impact of altering the personal income tax, the sales tax, maybe other forms -- maybe a property tax, maybe the gasoline tax -- there are certain basic taxes that are applied; and we need to be able to see if there's a way to address the principles by altering those taxes.

Curt?

COMMISSIONER PRINGLE: I don't have much to add, I guess, after all of that. I do like going down the path of, you know, I think, Richard's comments are very intriguing, because I wouldn't mind having some discussion about what you add in on an adjusted-gross-income level. But at this point in time, what I think we're trying to get is just figure out where that line would be on a rate that would balance out with the rate and sales tax with a few of these different things coming and going, as Michael had suggested, to come to -- we don't need to come to a complete decision as to what those total income adjustments may be at this point in time. We're just trying to get that broad-based discussion going as to, do you have a higher homeowner exemption versus how many points can you reduce in a sales tax based upon this overall universal income tax rate?

So in my mind, I think it's so important just to get something to look at in a comparative sense and say, "This is the direction we need to be going," and then we can adjust incomes later, talk about deductions later, talk about what level of -- you know, I like an exemption of the first $20,000, $30,000 of income that goes across the board, for everybody and, therefore, it affects all the way across that way.

But that level of detail we can talk about later; we just have to get to the broad-based discussion of which overall taxes go up and down and how it affects one another, and what that total number is going to be.

So I think this is a good exercise. I would hope we can get as much as we could, though, in terms of those numbers and runs before our next meeting, by e-mail or something else, so we have them, so we then can offer additional ideas, so we're not kind of put on hold for two months while you run the numbers and then we --

CHAIR PARSKY: *"You,"* meaning them (*pointing*)?

COMMISSIONER PRINGLE: Yes, have the staff maybe get the value of the input of the Commission members during this two months, the hard work that the staff is going to be engaged in.

CHAIR PARSKY: Fred?

COMMISSIONER KEELEY: Thank you, Mr. Chairman.

Mr. Chairman, a couple things, first of all, in our packet, at the end of the packet, there's an enormous amount of information that the staff has provided us based on previous inquiries at previous commission meetings. And I want to thank the staff for that. It's actually quite helpful and I think quite detailed. Thank you so much for that.

COMMISSIONER EDLEY: You got a lot done while you weren't working.

CHAIR PARSKY: I truly stand corrected. I did not mean to say they weren't working. I meant to build on Mark's comment that he hadn't done the analytical work here.

MR. IBELE: We have to figure out some way to while away the hours.

CHAIR PARSKY: Sorry, Fred, go ahead.

COMMISSIONER KEELEY: Quite all right, Mr. Chairman.

Mr. Chairman, I'm wondering, by way of following up on Mr. Pringle's suggestion, if the following might be helpful, it would be certainly be helpful to me. We have discussed, on numerous occasions, the idea -- it's been suggested to us on numerous occasions that we consider not taxing business inputs, either -- relative to the sales tax. And if we were to even consider extending the sales tax to certain services, that we would use two filters.

You've provided us in the attachments with three different alternatives relative to extending sales tax to services.

I'm wondering if what we can do is, you could either direct us in the packet today or you could in the future, model for us a sales tax –- the existing sales tax, extended to services that meet two filters:

Number 1, they are not business inputs.

Number 2, that they are not primarily consumed by low- or moderate-income individuals.

That's the first request.

The second one --

CHAIR PARSKY: Now, that will be an interesting exercise. We want to make sure they can do what you're asking.

Say that last part again, Fred.

COMMISSIONER KEELEY: That if we were to consider extending sales tax to services, that we provide two filters in terms of exemptions:

It would not extend sales tax to services that constitute business inputs.

Number 2, we would not extend sales tax to services that are primarily consumed by low- or moderate-income individuals.

That's my first question.

MR. SPILBERG: Could you give an example of a couple of those services?

COMMISSIONER KEELEY: Well, excuse me, Mr. Chairman, if I might.

CHAIR PARSKY: Go ahead.

COMMISSINER KEELEY: Mr. Spilberg, you provided us with three lists in the back here. If you'd like me to, I'd be glad to answer the gentleman's questions and we can engage in a lengthy discussion about that. But if you want me to, I'd be glad to.

So if members would like to look at the attachment provided by staff --

MR. IBELE: This was in our follow-up memo from the last meeting; wasn't it?

COMMISSIONER KEELEY: This is in today's packet. This is today's packet.

CHAIR PARSKY: Let me just say, would staff -- I'm just asking to make sure the staff knows, it's perfectly appropriate to ask for a model to be created along the lines suggested by Fred, as long as you understand what it is you're going to be excluding.

MR. IBELE: I think we have to firm up the definitions.

COMMISSIONER KEELEY: Well, Mr. Chairman, if I could try to firm up a definition then.

CHAIR PARSKY: Okay.

COMMISSIONER KEELEY: The business community has repeatedly come before this commission and said that one of the barriers to a business-friendly California would be if we would stop taxing on sales tax business inputs, under the current sales-tax regime. I'd like to know what that looked like.

Secondly, if we were to extend sales tax to services, we would not want, again, to look at those services. We would want to screen out those services which constitute business inputs.

Maybe you should ask the business community what they mean by "*business inputs*." I didn't come up with that phrase, but they've used it repeatedly before the Commission, and then the Commission has adopted it as language, as jargon -- not "jargon," I'm sorry -- as language that we use.

So I don't know what that is, maybe you know what that is, what these business inputs are that they think are barriers to California being business-friendly. So if you could tell us what those are, that's great. And then what would it look like if we eliminated sales tax currently as it applies to business inputs. On a going-forward basis, if we were to consider extending sales tax to services, which of those 160 services, defined by the National Association of State Budget Officers, which have been presented to us and which you've provided us three charts on it, which of those would you consider business inputs.

Secondly -- or third, which of those services that you have included in the list would you believe, your best judgment -- I don't have a best judgment on this -- what's your best judgment as to those services which are primarily consumed by low- and moderate-income individuals? And we would exempt those.

We've discussed this matter before. Those are the two filters that may make some sense.

MR. SPILBERG: And so just for clarification again, with respect to business inputs, you're looking at the kind of services that are primarily used by businesses?

COMMISSIONER KEELEY: Correct.

MR. IBELE: "*Primarily*," meaning?

COMMISSIONER KEELEY: If you go to Attachments A and B -- if you go to Tab 8, then you've got attachment -- you've got alternatives. Attachments A, B, and C. And so I would be interested if you think that –- and D, for that matter -- you have done some of that work already.

MR. IBELE: Yes, we have a breakout.

COMMISSIONER KEELEY: So I think that the next thing we would need in that regard, would be some -- if you have any idea how to quantify that. Because my guess is, we'll go through an exercise in the next couple of meetings where once we have -- we're going to balance a couple of issues. One is, the type of tax and what we want to do with it; and then, obviously, the impact on the fisc of doing that. So we need to quantify those as well. And I know that's hard work, but…

MR. IBELE: It's not hard, it's a lot of data manipulation. We do have a breakout by business purchases, intermediate purchases, and household purchases.

COMMISSIONER KEELEY: So now it would have been a quantification issue. Try to add some estimate as to revenue gained or lost.

Mr. Chairman, the second item would be relative to the carbon tax that we have discussed. We have discussed it in a limited form, that it would be a tax levied at the refinery level on gas -- excuse me, gasoline, diesel, and jet fuel at approximately $20 per ton equivalent of CO_2 emissions. And that would be a helpful -- if you would model that. Others have modeled that and estimated that that would be about $5 billion a year in income to the General Fund. So if you would model that, that would be a helpful thing.

Mr. Chairman, the third item would be, we have discussed at some length today the property tax. I am interested in one narrow statutory -- potential narrow statutory revision, and that would be to look at the -- revisit the bill by Senator Kopp. Others have introduced bills on this topic as well, unsuccessfully. But the issue of what constitutes a sale under Prop. 13 of nonresidential property. And we discussed that with Mr. Stone and with Mr. Moon today. So I would like to look at that issue and have some sense of quantifying that.

And lastly, Mr. Chairman, if we could have a look at if we were to want to deal with an issue that's come up repeatedly, which is the issue that some folks believe that California is, again, business-unfriendly because we treat capital gains as earned income. What if we treated capital gains not as earned income and, instead, treated it in some other way at a lower rate? Show us some rates that would allow us to treat capital gains differently, and then quantify that.

The reason I say all of this, Mr. Chairman, is because I think those exercises are going to help us in your desire to get to a consensus about what the trade-offs are if we're managing towards something the Governor didn't say we had to do in his Executive Order. But if we're managing towards revenue-neutrality, we'll need to understand what these trade-offs look like on a quantifiable basis as well.

Thank you, Mr. Chairman.

CHAIR PARSKY: Is that clear for you fellows?

You don't have to repeat it, just say -- please don't repeat it. Just say "yes" or "no."

MR. IBELE: They're certainly doable.

CHAIR PARSKY: Okay.

COMMISSIONER BOSKIN: I think the important thing in each of these cases, if someone asks you to do something, you get as much information from them as you can to make your job manageable, to understand what you can and can't do. And then, if and when it's presented to the Commission, it's very carefully explained about what was done.

CHAIR PARSKY: So I think with each of the suggestions, you can follow up with a conversation after the meeting, make sure it's clear, and make sure that you are clear that the information can be done in a sound, analytical way.

COMMISSIONER EDLEY: And if we ask you to do something that turns out to be too burdensome or crazy, Gerry will fix it.

CHAIR PARSKY: Come back and tell me. Yes, please, do that.

COMMISSIONER HALVORSON: Mr. Chair, I think we need to be cautious about the unintended consequences that could result if we start taxing a few of the benefits that are currently not taxable. And I think we need to be very careful, particularly as we look at the health-care numbers, because possibly the single-most regressive thing we could do would be to extend -- consider the $12,000 that's the average premium for a family in California as income to somebody who doesn't get that, and then force them to pay a tax on that amount of money. And for a low-income person, that's a very significant amount of money.

So $12,000 out of a $30,000 paycheck is huge; and out of a million-dollar paycheck, it’s a lot lighter. So in terms of defining regressive taxes, taxing health-care benefits might be the most extreme example. So I think we need to be very cautious about that, and I think we need to do the calculations very carefully.

CHAIR PARSKY: Jennifer?

COMMISSIONER ITO: I just want for us to be able to take advantage of the speaker who offered up their analytical model as well around the distributional impact. And I think it’s taking to light this morning’s conversation about looking at a package. It would be useful to look at some scenarios where we can look at some mix-and-match of reforms of the personal income tax with the property tax and the sales tax.

And I know that there’s a huge amount of different combinations that we could look at. But I would like to see some beginnings of what an overall package could look like, but including through the lens of what the distribution would look like, so that we are taking into account the potential regressive nature that some of these proposals could have.

CHAIR PARSKY: There’s no question that whatever package we put together, we will have to be able to articulate what impact it has on distribution. So that analysis needs to happen.

Richard?

COMMISSIONER POMP: Mr. Chairman, I would like to add back, as a source of revenue, the elimination of some of the big-ticket tax expenditures. Now, my definition, I think, has been a little different from what others have suggested. But these are the provisions that are proposed on economic incentive grounds that aren't part of the normative structure of the tax, and are advanced purely because of their economic impacts.

From what I heard last time, there's absolutely no kind of rigorous examination or cost-benefit analysis of these provisions. So I have to remain agnostic on this. And I would like to see what we could do by using that money to help lower rates. And I could work with you on what I would consider to be the most egregious examples.

MR. IBELE: That would be helpful if you would specify which ones.

COMMISSIONER POMP: Right.

COMMISSIONER BOSKIN: And concerning the usual definition of taxes expenditures, the list they had up there.

CHAIR PARSKY: Is what, Michael?

COMMISSIONER BOSKIN: The big-ticket items and the tax-expenditure budget, which may not be exactly what you have in mind, you may have some other incentives -- the health-care exclusion, the IRA contributions, the pension contributions. Those are by far the largest items.

COMMISSIONER POMP: Yes. And those we'll pick up already when we go to gross income.

COMMISSIONER BOSKIN: Do you have some very specific targeted things like that?

COMMISSIONER POMP: I'm thinking the corporate income tax.

COMMISSIONER BOSKIN: On the corporate side?

COMMISSIONER POMP: But Michael is right, as we use gross income as one of our models, that will eliminate a lot of the personal income-tax expenditures.

CHAIR PARSKY: Yes, Mark?

MR. IBELE: If I can speak out of turn for a minute. But I guess --

CHAIR PARSKY: You're in turn. Don't worry.

MR. IBELE: All right. It would be helpful for staff if we could work out some sort of mechanism so we can go back to you or individual commissioners, saying, you know, this is what we're -- we want to make sure that the exercises that we do are the most effective use of our time, and so we get to a point where there's some packages.

We may run into difficulties with doing individual models; and we want to be able to -- should we communicate directly with you or --

CHAIR PARSKY: Yes, and I'll make sure that --

MR. IBELE: Because we don't want to come -- two months seems like a long time. But we're already behind. So we want to make sure that we don't go spend two weeks going down the wrong track and then find out that we've got to backtrack.

COMMISSIONER BOSKIN: We should have the rule that anybody, including me, who's about to give them something -- that gives them something, spend the time so that all this definitional work can get done, or they shouldn't load something on them.

CHAIR PARSKY: I would agree.

Chris, did you want to say something?

Go ahead.

COMMISSIONER EDLEY: I need a little guidance, if I may.

I would –- Ed's comments a few minutes ago, in which he was offering an additional -- which I interpreted as offering an additional principle, having to do with the difficulty of the mismatch problem between revenues and expenditures, one approach to -- so we've been focusing in our comments a lot on tax simplification and, to some extent, reducing volatility.

We haven't actually talked that much about the 21st century and what distinctive qualities about the 21st century -- what the import of those are for tax structure.

But we also haven't talked much about the way in which -- on the expenditure side -- the contribution to volatility that results not from the volatility alone of revenues, but the problem of mismatch when we hit a recession and expenditures go up.

So to address that part, I think at the level of principle, some kind of an explanation of the value of bringing revenues and expenditures into alignment, I think, would be useful. And towards that end, I'd like an opportunity to have some conversations with staff to actually work out a proposal for a drought-relief fund to complement the rainy-day fund that's represented in Prop. 1A. Because the two of them together, I think, could make a very substantial contribution to matching the revenues with the expenditures.

But I guess I'd just like a chance to try to formulate something that would be reliable enough in terms of retiring drought-fund debt, that it would give some comfort to people who are afraid of borrowing and spending.

COMMISSIONER HALVORSON: What's the difference between a rainy-day fund and a drought fund?

COMMISSIONER EDLEY: Well, the rainy-day fund is that in good times, you save up so that you can empty the piggy bank when the drought comes along, when the rainy-day comes; right?

COMMISSIONER HALVORSON: Yes.

COMMISSIONER EDLEY: And the opposite is that when the bad times come, you do short-term borrowing, and with some kind of locked-in commitment that it's retired within four or five years.

I mean, the advantage of the latter approach -- which, of course, is what businesses frequently do -- is that you know exactly how much you have to go borrow because you're experiencing the revenue drops. Whereas if you're saving in advance, the difficulty, of course, is that you -- do you see the --

COMMISSIONER HALVORSON: Yes.

COMMISSIONER EDLEY: So I think it's probably optimal to actually have a combination of the two, you save as best you can, but then you can complement it with borrowing as necessary.

So, anyway, I think that --

CHAIR PARSKY: Well, I think we should start with the question, is there a way to make a recommendation on the changes in the revenue stream that might complement the rainy-day fund? And how does that deal with the overall question of volatility? And it may not solve it. It may not. There's nothing wrong with, as a matter of principle or suggestions, that policymakers be alerted to the fact that apart from the revenue stream, there may be some other things that they want to consider doing -- borrowing in a downturn. But I just would urge all commissioners to keep their eye on the charge of the Commission.

COMMISSIONER EDLEY: Right, nice try.

Let me reframe my proposition.

If we are looking for revenue stability, revenue is composed of tax revenue, but other forms of revenue as well, including revenue from the proceeds of bond sales.

CHAIR PARSKY: True.

COMMISSIONER EDLEY: Okay, true, right.

Secondly, the kind of proposal that I envision would require introducing a tax-revenue component that would be dedicated to repaying the debt. And in that sense, it does go to the issue of what's the structure of the tax code, all right. Because the idea is if you're going to borrow -- right, if you're going to borrow to get through a recession, you want to have an ability in your tax system to commit tax revenues to pay off that debt before the next business cycle.

COMMISSIONER HAUCK: That's what --

COMMISSIONER EDLEY: That's what a business does.

COMMISSIONER HAUCK: No, that's what the State of California does. The $15 billion in bonds that were issued under Prop. 57, there was a piece of the sales tax dedicated to the retirement of that debt.

I think wherever -- wherever the State has borrowed in that respect, it has had a revenue stream to secure it, except for the borrowing that is cash-flow-related borrowing that's required to be repaid within the current fiscal year.

And in addition, whatever negotiated terms that created the borrowing internally, that's largely where the State has done its borrowing to do the kind of thing that you've described.

So those systems and processes really already are in place.

CHAIR PARSKY: Well, I think you should -- there's nothing inappropriate about thinking about what you said at all. However, I really don't want -- and to continue to think about it. But I really don't want to take our eye off the ball that has been served up to us. And it's not that we couldn't interpret the revenue stream to include borrowing. That is an interesting extension of what I might normally think of as revenue. However -- and we have time. But I think the main focus for the staff right now is to make sure that they have a digestible series of alternatives that they can analyze and come back and at least tell the group, "Making these changes," which could be mixed or matched, "will have the following impact on revenue stream," apart from borrowing, but a revenue stream, "and the following impact on the distribution."

And if they can tell us that, we can step back and we can say, "Well, this kind of recommendation would make sense. There still may be a hole."

They may come back and they may say, "If you adopt this, it won't solve the volatility question," in which case you would say, we ought to be ready to borrow when we can't fill that hole, even with this --

COMMISSIONER EDLEY: I'll subside with the proviso that you and I can arm-wrestle.

CHAIR PARSKY: No question, for sure.

COMMISSIONER MORGAN: But I would like to support something Chris said. This is for the 21st century. And I would hope that the preamble that goes out with this report describes this commission's -- with the help of our staff and others -- what the 21st century is likely to look like. What are we aiming toward with what we're recommending? Because we've talked a lot about different taxes, we've heard dozens of people; but what are we aiming for?

And one of the things that I'd like staff to feed back on, is just today we heard from Mr. Sims that the income tax, is the tax that will grow the most. We heard from Ms. Sexton that the property tax could grow the most.

Where are we on that? Who do we believe?

CHAIR PARSKY: Well, I do think it's very much within the charge of this commission to pass whatever recommendations through the filter of what's the 21st century California economy to be. What do we anticipate it to be? Because we have a tax system that has evolved, but it's still antiquated in the way in which the California economy has changed. So that is an appropriate part of the analysis, it seems to me.

Jennifer?

COMMISSIONER ITO: Just a question, not necessarily a recommendation because I know that we have a short time span. But for one that is not a tax expert, I really appreciate the kind of educational component in all the different presentations. And I'm personally looking forward to the next couple -- the next extended amount of time to kind of go through all this information.

But just a question, we've spent a lot of time on the personal income tax today. I appreciate the conversation around the property tax. And I was wondering if we were planning on any more information or more detailed discussion around the corporate tax system?

CHAIR PARSKY: Well, there's certainly a lot of information that -- there's some information that's been provided; there's more that can be provided. And maybe we ought to think a little bit about a piece that would lay that background, because we do have that.

COMMISSIONER ITO: Okay, okay.

COMMISSIONER POMP: Let me --

CHAIR PARSKY: John?

COMMISSIONER COGAN: It's really a process question, Gerry. I'm trying to think of a way to ease the burden a little bit on the staff and not run afoul of the Sunshine Laws.

Is there a way that a couple of members could work together to put together, you know, one part of a possible plan without violating the Sunshine Laws?

CHAIR PARSKY: Yes.

COMMISSIONER COGAN: How many people can get together without doing so?

COMMISSIONER EDLEY: It depends on how smart they are.

MR. GENEST: Six. It can't be a majority, and it can't be a simple majority.

CHAIR PARSKY: I just want to double check that.

I can only speak from the context of the Board of Regents where it was three, but we will check.

COMMISSIONER COGAN: Yes, I think it would be a good idea. Because Richard's idea of looking at some of these credits, exemptions, tax expenditures on the corporate side is something that I'd be very interested in. And, you know, if we're both coming at Mark and the staff differently, then they're just going to get overburdened quite quickly. So maybe there's a way of coordinating.

CHAIR PARSKY: Let me check on the numbers, and then maybe -- look, I don't want anyone to feel, on the Commission, that they are left out of any deliberation or that their input isn't welcomed or that any part of the Commission is smarter than any other part of the Commission. But I do think the point is well-taken, that the staff has got to get some direction.

I think step one should be, we've heard some suggestions from Michael in terms of alternative analysis that he thinks he'd like to see; we've heard Fred make some specific requests. I think those requests should be provided in writing to the staff so that the staff can look at it. And there could be some give and take between the staff and each of you, in which I will try to monitor.

Anyone else, any individual members that have -- and, Richard, you may want to augment what you've heard here, it's perfectly okay -- in terms of analytical work you'd like the staff to do.

I do think that we didn't get a chance to talk about it, but I do think more work on what has been outlined as a net-receipts tax at the corporate level that might replace –- it doesn't have to, but might replace the sales tax, and be looked at in combination with an adjustment in the personal income tax. It might be combined with some changes in the property tax or carbon tax or something else. But I do think that that ought to be worked on so that we can have that before us as well.

Does that seem okay?

And we'll come back in terms of how we might get a few together to kind of orchestrate some back-and-forth well before the next meeting.

Richard?

COMMISSIONER POMP: I think Becky asked, I think, a very good question. We've heard absolutely contradictory information as we've gone through these proceedings. Some of it, I think, was very partisan. Some of it actually reflected the uncertain state of the economic literature and our understanding of economics and taxation.

And I think the answer to Becky's question is, we really don't know an awful lot. And, therefore, you hedge, just the way you would in investing your own money. And that is, you spread out your risk. You keep rates as low as you can, you keep the base as broad as you can, and low rates bury a lot of sins. And so I think that is the answer. And I hope that will be part of what we'll be looking at. Broad base, low rates.

CHAIR PARSKY: I think there are a couple people down at this end of the table that would like those words to be quoted so that it can serve as kind of a base going forward.

COMMISSIONER POMP: As long as I get to define what I meant, that's fine.

CHAIR PARSKY: Any other comments?

MR. SPILBERG: Mr. Chairman?

CHAIR PARSKY: Yes.

MR. SPILBERG: One procedural question that we need to handle. And that is that to this point, our empirical analysis that we have presented have been illustrative. They haven't really been sort of like estimates that one would use for a bill analysis or for even sort of like -- sort of like a long-run type of analysis. And that is something that I think we need to go beyond. I don't think we would want to continue just using our analysis based upon the 2006 tax year.

CHAIR PARSKY: No.

MR. SPILBERG: And this is an issue that needs to be discussed somewhat. And we could either have a conversation with you, Mr. Chairman, or handle it in some other fashion.

CHAIR PARSKY: No, no. I'm happy to follow it up. I do think -- you're 100 percent right, and it was -- and that's what I meant when I indicated incorrectly that no work has been done. That analysis has not been done.

MR. IBELE: That's correct, yes.

CHAIR PARSKY: And I didn't want to suggest -- because, frankly, we didn't give you very much direction on the analysis that should be done. That needs to happen. And we had contemplated, when we formed the Commission, that we might want to secure some outside help in conducting that analysis from an independent firm. And I think you have been in touch with EY or one of the firms.

MR. IBELE: Yes, yes. We have a possible firm that could provide that information.

CHAIR PARSKY: We will want that there, so that elements of, quote, "*partisanship*" or elements of, you know, a singular point of view can be kind of taken out and we can have some real analysis done. We will do that, and I will follow up with that.

With that, thank you all very much. Sorry we ran over about an hour. But thank you for your patience.

(The meeting concluded at 5:03 p.m.)

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REPORTER'S CERTIFICATE

I hereby certify:

That the foregoing proceedings were duly reported by me at the time and place herein specified; and

That the proceedings were reported by me, a duly certified shorthand reporter and a disinterested person, and was thereafter transcribed into typewriting; and

That the foregoing transcript is a record of the statements of all parties made at the time of the proceeding.

IN WITNESS WHEREOF, I have hereunto set my hand on the 13th day of April 2009.

DANIEL P. FELDHAUS
California CSR #6949
Registered Diplomate Reporter
Certified Realtime Reporter