From: Fred Keeley
Sent: Tuesday, July 28, 2009 1:17 PM
To: COTCE Commissioners
Cc: COTCE Staff

Subject: RE: Tax Packages

Gerry,

I have attached the exact proposal that the commission was given before our last meeting, without any changes. Please see Items 8 and 9.

Regarding the workshops, I have an idea to share that may resolve this.

Again, thank you.

Fred

(See attached Blue Proposal below. Previously posted on COTCE website)

Blue Proposal

Note: This proposal, as submitted, uses the Governor's Executive Order S-03-09 as the rationale and goal of each and every item contained herein. Additionally, each and every item is further based on testimony and written material submitted to the Commission during public meetings and deliberations of the Commission.

1/ Rainy Day Fund. Amend California Constitution to require that all General Fund Revenues that exceed Department of Finance projections by 5% within the Fiscal Year, be placed in an account (Rainy Day Fund) that is restricted as to expenditure or appropriation by the Governor and the Legislature, to state General Obligation Debt reduction, or to remain in the account to be available for expenditure or appropriation for General Fund-supported purposes when the General Fund Revenues underperform Department of Finance projections by 1% or more.

Rationale: The Rainy Day Fund responds to nearly every one of the objectives set forth in Governor's Executive Order S-03-09[1]. First and foremost, the Rainy Day Fund will force the state to commit more seriously to a basic business practice -a budget reserve- thus providing a greater degree of fiscal responsibility and bringing the state's tax and budget system into the 21st century. Of the two main approaches outlined in the LAO Report[2], revising the revenue system or relying on budgeting strategies to manage volatility, a blend of both methods is proposed herein to manage the state's General Fund revenue

[1] Link to the Governor's Executive Order S-03-09: http://www.gov.ca.gov/executive-order/11836/
[2] LAO, *Revenue Volatility in California*, 2005, COTCE website.

volatility. To rely solely on revising the revenue system would mean a flattening of the income tax which represents a significant trade-off in terms of progressivity.

The Rainy Day Fund's main function will be to help stabilize state revenues and reduce volatility, thus insulating the state budget from vicissitudes of the economic cycle. A more stable state budget will improve the state's creditworthiness and thus, promote the long-term economic prosperity of the state and its citizens, and, as a result, improve California's ability to successfully compete with other states and nations for jobs and investments. As mentioned, establishing a Rainy Day Fund is not only a basic business principle, but also reflects principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration.

2/ Amend State Personal Income Tax to Provide for New Allocation of Capital Gains Revenue. Capital Gains Tax Revenue will be apportioned as follows: (i) One-third of the moving five-year average Capital Gains receipts will supplement the General Fund; (ii) One-third will pay for debt reduction, pension liability prepayment or other one-time expenditures; and (iii) The remaining one-third will be allocated to the Rainy Day Fund.

Rationale: The proposed reform addresses several of the objectives set forth in the Governor's Executive Order S-03-09. Specifically, by reserving equal portions of the capital gains each year for the General Fund, debt reduction and reserves (Rainy Day Fund), this proposed reform will stabilize the revenues flowing to the General Fund, by providing the discipline to allocate surplus capital gains revenues during strong revenue years to reducing the state's debt and building up the state's reserves; and, during weak revenue years, drawing down reserves, thereby reducing volatility of General Fund revenues. In turn, by providing a mechanism for debt reduction and healthier reserves, the proposed reform will help to improve the state's creditworthiness and thereby promote the state's long-term economic prosperity and enable the state to compete more successfully for jobs and investment.

3/ Business Net Receipts Tax will be Studied Further in a Process to Include Public Hearings and Informational Filings.

Rationale: The Business Net Receipts Tax is a VAT-style tax with a high potential in terms of helping to create a 21st Century tax structure. The potential merits of a VAT-style tax are many: including reducing taxes on mobile capital; providing a more stable source of business tax revenue than corporate income tax; taxing all forms of doing business, not just corporations, thus broadening the base and allowing for lower tax rates; and providing an alternative and perhaps superior, way to tax services and cross-border sales.[3] However, Bob Cline of E & Y, Richard Pomp and Michael McIntyre[4], all experts

[3] E & Y presentation, June 16, 2009 COTCE meeting, COTCE website.
[4] Pomp, Richard, and McIntyre, Michael, *A Policy Analysis of Michigan's Mislabeled Gross Receipts Tax,* COTCE website.

on the business net receipts tax and variations thereof, all agree on the significant challenges associated with transitioning to such a tax.

Therefore, without further study, the Commission would seem to be unable currently to say with any certainty that the objectives as set forth in the Governor's Executive Order would be attained by implementing a net business receipts tax, either in conjunction with the elimination of the state sales and use tax and corporate tax or in conjunction with a reduction in the rates of those taxes.

4/ The State Sales and Use Tax Rate Will be Reduced by X%[5]**, and the State Sales and Use Tax base Will be Expanded to Some Services, Exempting "Business Inputs"**. Many details as to implementation will need to be worked out both with respect to which services to include and which business inputs to exempt. Regarding the exemption of business inputs, one possibility is to follow the approach used for the manufacturer's sales/use tax exemption (1993-2003), but to broaden the exemption to cover all business purchases. To prevent abuse, there may need to be exceptions for items that could be converted to personal use.

Rationale: The proposed sales and use tax reforms will put California at the forefront of pro-business sales tax reform, thus responding to many of the objectives set forth in the Governor's Executive Order S-03-09. Specifically, this reform directly responds to the challenge to establish a 21st century tax structure that fits with the state's 21st century economy, by promoting the state's long-term economic prosperity and enabling the state to compete more successfully for jobs and investment. According to Charles McClure, taxing business purchases reduces California's competitiveness, employment, and income, and reducing taxation would increase them.[6]

In addition, a combination of SUT base expansion and rate reduction is an ideal, pro-business and progressive, tax reform. The slow growth of the sales and use tax base is largely due to the increased consumption of services which are not included in the base, putting goods consumption at an unfair disadvantage relative to closely equivalent services. This is a widely recognized problem with the sales and use tax in California, where just 21 of 168 service sectors are currently taxed. According to the 2007 Federal Tax Administrators' survey, only nine states tax fewer services than California. Including additional services in the sales and use tax base will also make the sales and use tax more fair and equitable, since services which are currently untaxed are mainly consumed by higher income households.

5/ Amend California Constitution to Reassess Annually the Market Value of Non-Residential Commercial Real Estate Property for Property Tax Purposes. The type of split role reform proposed herein involves a change in how the tax base for commercial property is calculated annually. Specifically, the proposed split role reform

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[5] X% is a placeholder for the amount of rate reduction which can be achieved, while still preserving at a minimum the current level of sales tax revenue.

[6] McClure, Charles, *How to Improve California's Tax System: The Good (But Infeasible), the Bad, and the Ugly*, Testimony at February 12, 2009 COTCE meeting, COTCE website.

would leave residential property as-is under Proposition 13, but would require non-residential commercial properties' valuations to be reassessed periodically to reflect their market value for tax purposes and continue to be taxed at a rate of 1%.

Rationale: According to the Federal Tax Administrators, "taxes should not only be fair and equitable towards individuals and businesses similarly situated…[and] businesses engaged in similar commercial activities should be subject to the same level of taxation." While Prop 13 provided many benefits, since its passage in 1978, there has been wide recognition of the unfairness and inequities and other issues embedded in Prop 13. Addressing some of these issues will help to establish a 21st century tax structure that encourages new investment and job creation. In addition, the proposed reform of Prop 13 will increase property tax revenue, which is widely recognized as a stable source of tax revenue, thus helping to stabilize state revenues and reduce volatility.[7]

By evening the playing field between new and existing commercial property investors, the proposed reform will reflect principles of sound tax policy including competitiveness, efficiency, predictability, and stability. In a very direct way, the proposed reform will ensure that the tax structure is fair and equitable for all commercial property investors, whether they are new investors considering an investment in California or an existing investor. By making California more attractive to new investors, the proposed tax reform will improve California's ability to successfully compete with other states and nations for jobs and investments and thus, will promote the long-term economic prosperity of the state and its citizens. The downside is that the proposed tax reform will be more complicated to administer than the current system, but the economic benefits dwarf the additional costs associated with the proposed reform.

The proposed tax reform will support the goals of SB375, *Redesigning Communities to Reduce Greenhouse Gases*, as well as AB32, *Global Warming Solutions Act*. Reassessing commercial properties and land more frequently to reflect their true economic value will increase the cost of warehousing valuable land and will create pressures for highest and best use, a necessary condition for dense and efficient land use. The increase in property tax revenue that would result from treating all commercial property equally would lessen the reliance of local governments on sales tax revenue and, thus, alleviate the 'fiscalization' of land use that has been one of the inadvertent and negative consequences of Prop 13.

6/ Allow Local Governments (Cities and Counties) to Increase Existing Local Sales Tax by Up to 1.50% (or any .25% fraction thereof) by Majority Vote of Electorate.

Rationale: The proposed tax reform aims to restore some of the fiscal autonomy that local governments have lost, particularly since the passage of Prop 13 in 1978, thus ensuring a more fair and equitable tax structure that enables local governments to provide necessary services. Allowing local governments to access additional financial resources to provide

[7] Sheffrin, Steve, *Economic Aspects of A Split Roll Property Tax*, February 5, 2009 article, COTCE website.

necessary services will help to improve California's ability to successfully compete with other states and nations for jobs and investments. While the proposed reform does not address the main cause of the chronic tension in the state-local fiscal relationship (i.e. a lack of a separate, dedicated source of tax revenues for local government), it does acknowledge the impact, i.e. the smooth and efficient delivery of local services, and aims to restore some fiscal autonomy and, thus, rebuild local officials' sense of accountability.

7/ The Bank and Corporation Tax Rate will be Reduced by 2% and the Bank and Corporation Tax Base will be Expanded By Making the Single Sales Factor Apportionment Mandatory and Eliminating the NOL Carryforward and Tax Credit Sharing Provisions.

Rationale: The proposed reform responds to the challenge to establish a 21st century tax structure that is fair and equitable. While an ideal tax system would eliminate a corporate tax, an interim step in that direction is to reduce the corporate tax rate, while improving the predictability, stability and fairness of the existing corporate tax structure. The three corporate income tax reforms proposed greatly reduce the predictability and stability of the corporate income tax. In addition, the reduction in corporate tax revenue that is forecasted from the changes to the corporate tax laws in September 2008 and February 2009 are estimated to be $2.0 billion per year, and potentially as much as $2.5 billion, an amount equal to nearly one-quarter of the income tax dollars currently paid by California corporations.[8]. The benefits arising from these corporate tax reduction measures are poorly distributed. In particular, the benefits from single sales factor apportionment and credit sharing would largely go to a very few, very large 'incumbent' corporations. A superior way to achieve the goals of the Commission, i.e. to promote the long-term economic prosperity of the state and its citizens; and to improve California's ability to successfully compete with other states and nations for new jobs and investments, is to lower the corporate tax burden for all businesses, new and existing, large and small. The proposed tax reform also reflects principles of sound tax policy including simplicity, efficiency, predictability, stability and ease of compliance and administration.

8/ Adopt a Pollution Tax on Carbon-based Fuels. The proposed pollution tax on fuels will be structured so that it moves inversely with the price of crude oil, effectively putting a rough floor under the price of gasoline.[9] This tax could be structured so as to

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[8] California Budget Project, *To Have and Have Not*, June 2009, COTCE website.

[9] For instance, a tax that is only in effect when the price of crude oil is below $72 per barrel, and is equal to 2.5 cents per gallon for every dollar that oil is below $72, would roughly stabilize California gasoline prices at about $2.75 per gallon so long as the price of oil is below $72. It would have no impact on gas prices if oil was above $72 per barrel. (An equivalent approach that takes effect only for gas prices below $62 per barrel would stabilize gas prices at about $2.50 per gallon.) The amount of revenue that the tax would bring in would depend on the oil price trigger level.

Any volatility of oil prices could be hedged with a tax on oil extraction (a severance tax) that is progressive in the price of oil. For instance, an oil severance tax could be zero so long as the price of oil is below $50 per barrel, but if the price rises above $50 per barrel the severance tax would take an increasing share of the incremental dollar of revenue. Revenue from such a severance tax would increase with the price of oil and would offset the loss in revenue from the gas tax. If oil prices fell, revenue from the severance tax would fall, but revenue from the gas tax would rise. Parameters of the taxes could be set so as to significantly combine a sliding gas tax with a severance tax, yielding a steady stream of revenues with little volatility. The intention also is that the tax is borne by California residents so as to promote more efficient use of energy (i.e. driving, home heating, etc.). Exemption certificates will be considered in the event that it is determined that the proposed tax will impact manufacturers and possibly lead to job loss (although this raises issues with respect to the scope of the exemption).

Rationale: Pollution taxes are widely accepted as an ideal type of tax in that they discourage 'bad' behavior (in this case, the consumption of fuel by high fuel-consuming vehicles and congestion). As such, a fuel tax would be the hallmark of a 21st century tax structure. Given the state's above-average reliance on passenger vehicles and its leadership in the clean energy and transportation industries, a fuel tax will support the state's 21st century economy. A fuel tax will also support Governor's Executive Order S-03-05 and AB32, *Global Warming Solutions Act*.

As proposed, the fuel tax will help to stabilize state revenues and reduce volatility by providing a steady source of revenue. By supporting the clean energy and transportation industry, which many investors view as the next growth industry, this proposed tax reform will advance California's role as a leader in the clean energy sector and promote the long-term economic prosperity of the state and its citizens.. As proposed, the fuel tax reflects principles of sound tax policy including simplicity, efficiency, predictability, stability and ease of compliance and administration.

9/ Add to the Income Tax a Universal Tax Credit of $100 to $300 as a "universal rebate" of the carbon tax revenues, the exact amount depending on the amount of revenues expected to be generated by the carbon tax and the degree of offset of the carbon tax desired. Every state resident would receive the exact same refundable credit or "prebate" (to use the language of "Fair Tax" advocates).

Rationale: The proposed tax reform has several advantages. First, rebating the carbon tax revenues shows that such a tax is not about raising revenue for government, but changing the collective habits of the state's citizens. Second, the universality of the prebate suggests a certain "we're all in this together" attitude that is consistent with the principles underlying the tax. Third, a universal rebate/credit gets high marks on simplification grounds (and leaves ReadyReturn untouched). Some might suggest that a rebate should be means-tested—and that's certainly do-able, but any phasing out by income would reduce some of these advantages. The universal credit provides progressivity, since the credit of $100 to $300 is a significant amount to lower income households, but much less so to wealthy households. It turns out to be more efficient in many ways than a means-tested credit.

10/ Tax Expenditures:

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reduce the volatility of the total stream of revenues from the two taxes. In addition, once the taxes were in place, remaining volatility of the total revenue stream could be hedged through financial transactions on the oil futures markets.

i) Display all Tax Expenditures in Governor's Annual Budget;
ii) Require all Tax Expenditures (existing and future) to have a sunset date, in no case longer than five years;
iii) Require all Tax Expenditures to have estimated cost in the Budget Year; and, estimated/actuals for Fiscal Year displayed in Governor's Proposed Budget (including available demographic information);
iv) Require all Tax Expenditures, existing and future, to have legislative intent language, including, but not limited to, outcome purpose of Tax Expenditure, sunset date (not longer than five years).
v) Require in the statutory implementation of these reforms that all tax expenditures contain a performance-based metric.

Rationale: Transparency of government tax expenditures, while not called for explicitly in the Governor's Executive Order, is a principle of sound tax policy, as mentioned in 2(e) in EO S-03-09. Transparency of government tax expenditures will also ensure that the state tax structure remains fair and equitable.

11/ Create an Independent, Pre-Payment Tax Dispute Forum. The only prepayment resolution tax forum for income taxes and sales and use taxes is the very entity that administers those taxes, thus creating the appearance of impropriety.

Rationale: Creating an independent, prepayment tax dispute resolution forum will help bring California's tax administration into the 21st century and into conformance with the federal model.[10]

[10] Rubin, Robert, Testimony at March 10, 2009 COTCE meeting, COTCE website.