Review of the Report of the Commission on the 21st Century Economy

Introduction

At the May 2008 Delegate Assembly meeting CSBA Delegates approved a position statement on revenue principles that states, in part, "…the principles of Adequacy, Equity and Simplicity will provide the primary (though not exclusive basis for a CSBA 'revenue template') to guide in determining its organizational position (if any) on specific revenue proposals brought forth in the Legislature or other venues."

The purpose of this report is to provide an analysis by CSBA's Governmental Relations office on the California Tax Commission's recommendations, which would require either a statuary change or a constitutional change.

Background

Governor Arnold Schwarzenegger created the Commission on the 21st Century Economy (California Tax Commission) by executive order on October 30, 2008. The purpose of the Commission was to produce recommendations to change laws to achieve the following goals:

- Establish a 21st century tax structure that fits with the state's 21st century economy
- Stabilize state revenues and reduce volatility
- Promote the long-term economic prosperity of the state and its citizens
- Improve California's ability to successfully compete with other states and nations for jobs and investments
- Reflect principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration
- Ensure that the tax structure is fair and equitable

While not required by the executive order, the Commission also sought to make recommendations that were revenue neutral. In other words, they would not—by themselves—increase or decrease state revenue from current levels.

The Commission consists of 14 members, seven appointed by the Governor, three by the Speaker of the Assembly, three by the President pro Tem of the Senate, and one appointed jointly by the Speaker and President pro Tem.

After multiple delays, the Commission released its recommendations on September 29, 2009. Nine members signed the final report. One of the non-signers was William Hauck, who was appointed by the Governor. The other four were legislative appointees—George Halverson, Jennifer Ito, Fred Keeley and Richard Pomp.

Review of the Report

The report makes six recommendations, five of which require statutory changes and one of which requires a constitutional change. They are:

- Reduce the number of personal income tax brackets from six to two, with top rates of 2.75 percent for taxable income up to $28,000 (single) and $56,000 (joint), and 6.5 percent for taxable income above those amounts. The standard deduction would be $22,500 for single filers and $45,000 for joint filers. Itemized deductions would be limited to mortgage interest, property taxes and charitable contributions.
- Eliminate the corporation tax and minimum franchise tax. The top corporation rate is 8.84 percent, although the Commission notes that only 55 percent of corporations doing business in California pay any tax at all. The current minimum franchise tax is $800.
- Eliminate the state general purpose sales tax (this would not affect local sales taxes). The current state rate is 8.25 percent, but will revert to 7.25 percent when the temporary increase expires in 2011. The Proposition 42 gas tax would still be assessed.
- Establish a business net receipts tax (BNRT) of up to four percent. The BNRT is defined as gross receipts less gross purchases. Wages, salaries and fringe benefits would be excluded from gross purchases
- Create an independent tax dispute forum for resolving tax disputes with the state
- Increase the target for the state's rainy day reserve fund from 5 percent to 12.5 percent and restrict the ability to use reserve assets (this would require a constitutional change)

The Governor has declared his support for the recommendations, saying if they came to him in the form of a bill, he would "sign it immediately." In releasing the recommendations, the Administration also provided supportive statements from Senator Dianne Feinstein, Co-chair of California Forward (and former Speaker of the Assembly) Bob Hertzberg, former Governor Gray Davis, former mayor of San Francisco and Speaker of the Assembly Willie Brown, and former President pro Tem of the Senate Don Perata.

On the other hand, opposition to the recommendations has been expressed by business and labor groups alike, who have expressed concern about the shift in who pays taxes, the heavy reliance on an unproven new tax (the BNRT), and the potential negative effect on California's economic development.

Major Shift in Who Pays Taxes

The proposed change in the state personal income tax (PIT) would result in a major shift in who pays the tax as well as a substantial reduction in the percent of total state revenue received from this source. Commission documents project revenue from the PIT would be $15.1 billion lower in 2014 than under current law. More than one-fourth (25 percent) of this reduction ($4.1 billion) would accrue to the 0.2 percent of taxpayers with adjusted gross incomes (AGI) of $1 million or more. The average reduction for millionaires would be $108,925, while the average reduction for taxpayers with an AGI of $50,000 to $75,000 would be $190.

In general, lower income taxpayers would account for a larger share of total revenues from the PIT. This results from (1) reducing the top rate and (2) flattening the overall structure to include

two, instead of six rate categories. The rationale is to reduce the current volatility of revenue from the PIT, which results from a heavy reliance on the highest earners.

The Commission notes that the share the total PIT paid by the top 1 percent of taxpayers increased from 33 percent in 1993 to 48 percent in 2006. *However, the top rate actually declined from 11 percent to 9.3 percent during that time.* What changed was the percentage of AGI received by the top 1 percent, which grew from 14 percent to 25 percent over the same time span. Using data from California's Franchise Tax Board, the California Budget Project has shown that, from 1993 to 2007, the average AGI of the top 1 percent grew 117.3 percent. This compares with 7.7 percent for the bottom 20 percent, 8.7 percent for the next 20 percent, 9.1 percent for the third 20 percent, 11.3 percent for the fourth 20 percent, and 51.0 percent for the top 20 percent. Income disparity has widened considerably in California over the past 15 years. This increased disparity has been the cause of the growing share of PIT taxes paid by high-AGI taxpayers, despite a reduction in the tax rate.

Net Business Receipts Tax (NBRT)

Revenue from the NBRT would replace revenue from the state sales tax and corporation tax (which would both be eliminated) as well as make up for reduced revenue from the PIT. The Commission proposes to eliminate the corporation tax, because "it is expensive to administer, susceptible to manipulation, cyclical in nature, and can result in double taxation of income." While acknowledging that the sales tax has been "a steady performer for the state," and is "the least volatile of the state's general purpose taxes," the Commission nonetheless found it "defective" because it:

1. Has a high rate structure
2. Is applied to a narrow base
3. Taxes business inputs

All of these concerns could be addressed by modifying the sales tax itself, but the Commission chose instead to replace it with the NBRT.

The Commission asserts a NBRT rate of 4 percent would achieve "revenue neutrality," and recommends that the rate not exceed that level. However, the Commission's own consultant estimates that a rate as high as 6 percent would not fully offset the revenue lost though reduction of the PIT and elimination of corporation and sales taxes. A rate of 4 percent is likely to result in a $20 billion annual drop in revenue.

Some have raised concerns about the exemption of personnel costs from the gross purchases that would be deducted from gross receipts to yield the net receipts on which the tax would be based. This would have a heavier impact on labor-intensive businesses. In addition, the cost of outsourcing labor would be a deductible gross purchase. That could provide an incentive for business to outsource labor—perhaps to other states or countries—instead of hiring their own employees. And employees could also be affected; the Commission's consultant estimates that 19 percent of the tax would be passed down to employees in the form of lower wages.

Others have raised concerns about the untested nature of the NBRT. Only one other state—Michigan—has such a tax, and its tax is low (1 percent) and is integrated with a corporation tax. It is not a major source of revenue for Michigan as it would be for California under the Commission's recommendation.

Another criticism is that the NBRT is a hidden tax that would ultimately be passed on to consumers in the form of higher prices. The Commission's consultant estimates that 71 percent of the tax would be passed on in this manner.

One major unknown is how the new tax would apply to out-of-state firms that do business in California. The Commission believes, for example, that a call center in another state that provides services to California companies or consumers would be subject to the tax, even if it has no physical presence or employees in California. That interpretation is likely to be challenged in court, should the recommendations be adopted.

Property Tax

The Commission report includes a brief history of the property tax in California, including a table showing that the ratio of property taxes to personal income has halved since 1975, dropping from 5 percent to 2.5 percent. Property taxes also have a major impact on state revenues through Proposition 98 and the school funding formula. However, the Commission, without explanation, makes no recommendations regarding the property tax.

Revenue Neutrality

Although not part of its charge from the Governor, the Commission made revenue neutrality one of its objectives. The Commission asserts that this standard is met by its recommendation, although this assertion is not supported by an analysis by the Commission's consultant.

Revenue neutrality would mean that revenue would be locked in at current levels. An analysis by the California Budget Project shows that tax cuts enacted since 1993-94 cost the General Fund $11.7 billion in 2008-09. This reduced level of revenue would provide the base for future revenue with revenue neutrality. For schools, revenue neutrality would reduce, if not eliminate, the chances of restoring the $12 billion Proposition 98 maintenance factor. School funding likely would remain at its current, reduced level.

Another consequence of the proposed changes would be to slow down the growth of state revenue from current and historic trends because revenue from the NBRT would likely grow at a slower rate. This could lead to larger budget shortfalls and reduced funding for state programs—such as schools—in the future.

Impact of the Tax System on the State's Business Competitiveness

A major theme running throughout the Commission's report is that "California's taxes are out of step with the goal of economic growth and efficiency and are an impediment to the state's ability to compete with other states for jobs and investment." No evidence is provided to support this

statement other than an observation that California has relatively high marginal tax rates for personal and corporate income taxes (although California is about average in terms of total state and local taxes paid per $1,000 of personal income).

The conventional wisdom is that high marginal rates equal a bad business climate—a view widely and uncritically accepted. However, when cross referencing a state's relative tax standing with its actual economic performance, a different story unfolds.

California currently ranks 48th on the Tax Foundation's "State Business Tax Climate Index." Only New York and New Jersey rank lower. California has placed near the bottom of this index for years. Yet, based on growth of gross state product (GSP), California continually outperforms most other states year after year. (GSP is the broadest measure of a state's economic condition.)

Specifically, according to the U. S. Bureau of Economic Statistics, California's GSP per capita grew 31 percent between 1997 and 2008, compared to a national average growth of 20 percent. Only five states outperformed California during this time, including two (Massachusetts and Vermont) that rank among the worst business states according to the Tax Foundation. If it were true that California's tax structure is "an impediment to the state's ability to compete with other states for jobs and investment," this could not happen.

Meanwhile, some of the states that have the *best business tax climate* according to the Tax Foundation are among the *worst performers* in terms of GSP growth. In fact, Alaska, which ranks third best on the index, is the only state to actually experience a *decline* in GSP per capita since 1997, having dropped nearly 5 percent. Of the ten states that the Tax Foundation identifies as having the best business tax climate, only two—Oregon and South Dakota—outperformed California in the growth of GSP per capita. Texas, which due to relatively low taxes and "business friendly" regulations, has been identified by *The Economist* magazine and others as a new economic powerhouse, yet, it had a growth rate slightly below the national average.

Conclusion: the evidence does not support the conventional wisdom that relatively high marginal tax rates results in an uncompetitive business climate.

This is important to note, because falling victim to the fallacies of conventional wisdom leads the Commission to ignore one of its own stated principles of taxation regarding revenue generation. Specifically, the Commission states that the principal reason for taxation is to raise revenue for publicly provided goods and services and that desirable features of such a system "include the *adequacy of the [revenue] stream*, the reliability of the revenues, and the stability of tax payments over time" (emphasis added). By insisting on a revenue neutral approach, ignoring the billions of dollars of lost revenue resulting from the last 15 years of enacted tax cuts, and arbitrarily placing a priority on tax reductions in a misguided pursuit of greater business competitiveness, the Commission's recommendations, if adopted, would foreclose serious discussion and analysis of the adequacy of California's tax structure. This would have serious consequences for California's ability to adequately fund its public schools.

Conformance with CSBA's Position Statement on Revenue Principles

The Commission's recommendation to replace corporation and sales taxes and part of PIT revenues with revenue from a new NBRT does not meet the test of adequacy. The Commission's assertion that its recommendations are revenue neutral is at odds with its own consultant's projection that the new revenue will fall well short of the amount needed to replace the lost revenue. In addition, the Commission implicitly assumes that current revenues (which have declined in recent years) are sufficient to meet the state's needs and makes no attempt to quantify or evaluate those needs. Finally, by replacing the current tax structure with one that will produce lower revenue increases over time, the Committee's recommendations could result in a growing gap between needs and resources over time.

The NBRT also fails to treat all businesses equitably. Businesses that are labor intensive or that require higher-priced labor would pay higher taxes because wages and benefits are not subtracted from gross receipts to compute the tax base in contrast to the current corporation tax, under which wages and benefits are deductible from gross income.

On one level, the recommendations meet the principle of simplicity, because it would be an easy tax to compute. On another level, however, there is uncertainty over who would be subject to the tax, especially with respect to interstate commerce. This confusion would almost certainly hamper enforcement and likely delay collection until legal issues are resolved.

Next Steps

The Assembly Committee on Revenue and Taxation will hold an informational hearing on the Commission's recommendation today (Thursday, October 8, 2009). Gerald Parsky, the Commission's Chair, and Legislative Analyst Mac Taylor are among those scheduled to testify. No Senate hearings have been scheduled yet. Given the widespread opposition to the Committee's recommendation, which comes from both ends of the political spectrum, it is doubtful they will be adopted by the Legislature without major modifications, if at all. Meanwhile, CSBA is working with others in the education community to plan a coordinated strategy, should one be needed.

Attachments

Commission Members
CSBA Position Statement on Revenue Principles

Commission Members

- **Governor's Appointments**

    - ***Gerald Parsky***, Chairman, Aurora Capital Group
    - ***Ruben Barrales***, President and Chief Executive Officer, San Diego Regional Chamber of Commerce
    - ***Michael Boskin*,** Senior Fellow, Hoover Institution and T. M. Friedman Professor of Economics, Stanford University
    - ***John Cogan***, Senior Fellow, Hoover Institution and Professor of Public Policy, Stanford University
    - ***William Hauck,*** President and Chief Executive, California Business Roundtable
    - ***Rebecca Morgan***, President, Morgan Family Foundation (and former state senator)
    - ***Curt Pringle***, Mayor, City of Anaheim (and former Speaker of the Assembly)

- **Legislature's Appointments**

    - ***Edward De La Rosa***, Founder and President, De La Rosa & Company
    - ***Christopher Edley, Jr.,*** Dean and Professor of Law, Boalt Hall School of Law, Univeristy of California, Berkeley
    - ***George Halverson***, Chairman and Chief Executive Officer, Kaiser Foundation Health Plan and Kaiser Foundation Hospitals
    - ***Jennifer Ito***, Director of Research, Strategic Concepts in Organizing and Policy Education (SCOPE)
    - ***Fred Keeley***, Treasurer of Santa Cruz County, Professor of Political Science, California State University, San Jose (and former member of the State Assembly)
    - ***Monica Lozano***, Publisher and Chief Executive Officer, La Opinión.
    - ***Richard Pomp***, Alva P. Loiselle Professor of Law, University of Connecticut

CSBA Position Statement on Revenue Principles

In response to the Governor's 2008-09 budget proposal as introduced in January and revised in May, the California School Boards Association has taken a position to oppose a cuts only budget and support a budget that is balanced with a combination of cuts and revenue increases. The Board of Directors of CSBA recognizes that if we are to insist that the Legislature raise revenues as part of the budget solution, then CSBA must be prepared to support or oppose proposals that the Legislature may take under consideration.

To that end, the Delegate Assembly considered revenue principles that could guide the decision to support or oppose specific tax proposals. The principles are **not** to be used as a basis for CSBA sponsored legislation, and CSBA will **not** initiate tax legislation. Rather, they will provide a basis for guiding the organization's response to and to help shape legislation and ballot measures proposed by others.

In addition, the revenue principles do not supersede CSBA's Policy Platform. To the contrary, the Policy Platform will continue to be the primary basis for determining support for or opposition to specific legislation, and tax proposals that violate the Policy Platform will be opposed, even if they comply with adopted revenue principles.

The principles considered were: vertical equity, horizontal equity, adequacy, simplicity, exportability, and neutrality. "Adequacy" is defined as relating to the ability of a tax to provide a stable, reliable revenue stream over time that keeps pace with the costs of programs and services it supports. This is distinct from the concept of adequacy as it relates specifically to school funding and the question of whether resources available to schools are sufficient to achieve desired outcomes.

In addition to the principles, delegates also considered the option of remaining silent on revenue issues, meaning that CSBA would take no position for or against specific tax proposals.

During the course of conversation, thoughtful reasons were presented in support of each of the principles and in support of the option to remain silent. However, after taking a vote and analyzing the notes from the discussion sessions, the following principles received an overwhelming level of support: adequacy, vertical/horizontal equity, and simplicity. This analysis reflected a clear line of demarcation between these principles and the other options that were considered.

Analysis of the comments with respect to vertical and horizontal equity reflected broad support for the common concepts underlying those two principles. For that reason, the votes for those two principles were combined, to create an accurate reflection of the Delegate Assembly's position.

Therefore, the principles of

- Adequacy
- Equity
- Simplicity

will provide the primary (though not exclusive) basis for a CSBA "revenue template" to guide in determining its organizational position (if any) on specific revenue proposals brought forth in the Legislature or other venues.

Approved May 2008