# California Commission on Tax Policy in the New Economy

Los Angeles
April 14, 2003

Proceedings

## APRIL 14, 2003: LOS ANGELES

√Perspectives
Sunne Wright Mc Peak - California Economic Strategy Panel
Ex-Officio Member of the Commission

√The FY2004 California Budget Proposal
Arthur Laffer, Ph.D. - President, Laffer Associates

Testimony
Antonio Villaraigosa - Former Speaker, California State Assembly

Blue Ribbon Panel
David Abel - ABL, Incorporated
Nick Bollman - President, California Center for Regional Leadership
Fred Silva - Senior Advisor, Public Policy Institute of California

Testimony
Bob Hertzberg - Former Speaker, California State Assembly
Dan Carrig - Legislative Representative, League of California Cities
Jean Korinke
Art Pulaski – Executive Secretary – Treasurer, California Federation of Labor

√Testimony
Rusty Hammer - President / CEO, Los Angeles Area Chamber of Commerce

**MEETING OF THE**

**CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY**

**www.caneweconomy.ca.gov**

Los Angeles City Council Chambers
200 North Spring Street, Room 340
Los Angeles, CA 90012

April 14, 2003
AGENDA

| | |
|---|---|
| 10:00 AM | Chairman Bill Rosendahl<br>Meeting called to order<br>Announcements<br>Roll Call and Introductions |
| 10:15 AM | Sunne Wright McPeak, California Economic Strategy Panel<br>Ex-Officio Member |
| 10:45 AM | Dr. Arthur Laffer, Economist |
| 11:15 AM | Break for Lunch |
| 11:30 AM | Working Lunch<br>Tom Bradley Room (27th floor)<br>Staff Discussions on Workplan for 2003 |
| 1:00 PM | Antonio Villaraigosa, Former Speaker, California State Assembly |
| 1:15 PM | David Abel, Nick Bollman, Fred Silva<br>Blue Ribbon Panel |
| 2:00 PM | Bob Hertzberg, Former Speaker, California State Assembly |
| 2:30 PM | Dan Carrig/Jean Korinke, League of California Cities |
| 3:00 PM | Rusty Hammer, President / CEO<br>Los Angeles Area Chamber of Commerce |
| 3:30 PM | Art Pulaski, California Federation of Labor |

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(continued)

| | |
|---|---|
| 4:00 PM | Commission Business<br>Agenda for April 21st<br>Discussions / Deliberations |
| TBD | At the Discretion of Chairman Rosendahl<br>Public Commentary<br>Adjournment |

Agendas for public bodies supported by the California Technology, Trade and Commerce Agency, are available at http://commerce.ca.gov. For additional information regarding this notice, please contact Marshall Graves, California Technology, Trade and Commerce Agency, 1102 Q Street, Suite 6000, Sacramento, CA, 95814, (916) 445-7654, mgraves@commerce.ca.gov

Laffer Associates  (Excerpt from Budget Proposal)

**The FY2004 California Budget Proposal**

On January 1, California expanded its bicycle helmet law, requiring those under age 18 to wear a helmet while riding a skateboard or scooter. It might be advisable for all Californians to wear protective headgear.  California now faces a $34.6 billion budget deficit, representing 44% of the current year general fund budget of $79 billion and $1,000 for each of the state's 35 million men, women and children.

In 1991, former Gov. Pete Wilson faced a $14 billion budget deficit, which then represented 35% of the general fund budget. The $6.4 billion static tax increases signed into law by Wilson that year—the largest state tax increase in U.S. history—combined with the nearly $1 billion static tax increases in California the previous year to send California into a multi-year tailspin and resulted in soaring unemployment, plummeting home values and an exodus of people from the Golden State.

Today, Gov. Davis faces a fiscal dilemma of similar proportion. Despite the fact that California is projected to run out of operating cash no later than July or August, and with full knowledge that action must be taken quickly to prevent further fiscal deterioration—proposed spending cut deadlines have already come and gone—Davis and the legislature have accomplished very little toward the passage of a budget by the June 15 constitutional "deadline."  California has routinely exceeded this deadline in recent years, and it appears very likely to do so once again with the legality of the "automatic" $4.4 billion vehicle license fee (VLF) increase grid locking the legislature.

Davis' proposal contains $8.3 billion in tax increases, and indirectly another $4.4 billion if Davis and the Democratic-controlled legislature have their way with the VLF increase, bringing the total tax increase to a staggering $12.7 billion.  It appears that California didn't learned its lesson a decade ago under Gov. Wilson, and the current budget proposal recommends that California make the exact same mistake today that it made back in 1991.  While there is truly never a good time to raise taxes, raising taxes during an economic downturn is the worst possible time.  Tax increases never raise the amount of money expected, and they only serve to worsen economic downturns.

Unfortunately, the best solution to California's fiscal problems is the one least likely to be implemented:  California's tax structure is in desperate need of an overhaul in the form of a modified flat tax, simple in theory yet equitable and powerful enough in practice to provide the immediate boon to growth so desperately needed.

**Tax Increases: The Wrong Solution**

Davis' proposed $8.3 billion tax increase would result in two new personal income tax brackets at 10% and 11% for high-income taxpayers, a one percentage point hike in the sales tax rate (the top state and local rate would increase from 8.75% to 9.75%) and a more than doubling of the cigarette excise tax to $1.97 per pack.  In addition, it appears likely that the vehicle license fee will be tripled, adding another $4.4 billion per year on top of the $8.3 billion.  All of these proposed tax increases would fall on California residents and businesses already facing some of the highest tax rates in the nation. There are many problems with tax increases during periods of financial crisis:

i.) By raising taxes during depressed economic conditions, employers and employees face additional impediments just to keep from moving backwards. It makes no sense to raise taxes on the last three people working. People don't work to pay taxes, nor do businesses locate their plant facilities as a matter of social conscience. People work to earn what they can after tax—after all taxes. During tough times after-tax earnings are depressed naturally, which is why unemployment rates are so high. Piling on more taxes only exacerbates the problem.

Businesses locate their plant facilities to make after-tax returns for their owners. During depressed times, businesses often are desperate to reduce costs because of a shortfall in revenues. Increased taxes in one location can be the final straw leading to businesses relocating to more tax-friendly locations or to make the ultimate decision to close down operations.

ii.) If raising taxes actually does improve a state's fiscal circumstances, it does so by worsening the fiscal circumstances of those it governs. No phrase is more important for government to adhere to than *primum non nocere* (first of all do no harm). Balancing the government’s budget by unbalancing its citizens’ budgets is contrary to any moral justification of government I’ve ever heard of.

iii.) Raising tax revenues is far from cost free. Obviously, when tax rates on an activity are raised the volume of that activity shrinks, leading to a revenue offset. There are also substantial collection costs to both the government and the taxpayer from raising taxes. These additional costs result in less money being collected than is paid. To the extent taxpayers seek to avoid, evade or otherwise shelter and hide their taxable income, the amount of additional revenues is also greatly reduced and can, in fact, end up costing the government money directly as a consequence of raising taxes. Capital flight and human flight, along with companies going out of business, are classic responses to increased taxation at the state and local level. In many of these cases the state and local governments actually lose revenues when they raise taxes.

iv.) Raising tax rates during depressed times virtually always deludes politicians into believing that more revenues will materialize than actually do. Static revenue estimates always assume that no one's behavior will change, and therefore a 10% tax increase will increase tax revenues by 10%. In fact, this is never true. The dynamic effects of slower growth, reduced profitability, higher unemployment (and its associated costs), and tax evasion and avoidance, just to name a few, combine to ensure that actual revenues fall far short of forecasted revenues. California’s recent history is filled with examples of the flaws of static revenue analysis.

v.) As a result of overestimating revenues, politicians believe their fiscal circumstances are less severe than they actually are, causing delayed spending cuts, deeper declines in the economy and extended periods of crisis. It's a classic case of the correct response being too little too late.

The simple point is, during good times the need for public spending shifts from necessity to luxury, from emergency to indulgence, from central to marginal. During good times less people are unemployed, poor or in desperate straights, and yet government spending skyrockets right along with tax receipts. During good times pension funds tend to be over funded, resulting in reduced contributions made by employees/employers and more generous retirement benefits. But true as it can be, it is the bad times, such as those that California faces today, that expose flaws. Bad times expose fiscal flaws, spending flaws, pension fund flaws and yes, flaws in the tax codes.

***TESTIMONY BEFORE THE***

***CALIFORNIA COMMISSION ON***

***TAX POLICY IN THE NEW ECONOMY***

***Rusty Hammer, President & CEO***

***Los Angeles Area Chamber of Commerce***

***April 14, 2003***

**Mr. Chairman and members of the commission:**

I am rusty hammer, the president and chief executive officer of the Los Angeles area chamber of commerce. I want to thank you for inviting me today to participate in these important hearings.

California is facing one of the greatest crises in recent memory. You may be thinking that i am referring to the state's budget situation. Certainly a $35 billion budget shortfall is a crisis, and the governor and state legislature must immediately develop a plan that will resolve this budget situation.

However, an even greater issue – and one that they alone cannot resolve – is the crisis facing business in our state.

Business throughout California is facing its harshest times in many years. The collapse of the technology sector has increased unemployment, halted capital investment, and had other significant impacts in Silicon Valley, the bay area, and other areas that depend on technology business.

The entire state is in the grip of a major downturn in the tourism sector – due to post 9/11 issues, terrorism, and the war in Iraq. This has driven airline load factors and hotel occupancy levels to historical lows. Convention bookings are scarce – and when they occur, are for participant levels below where they should be.

Other sectors suffer as well, including those that support these two that have been most significantly impacted.

What's more, the corporate scandals have all but dried up investor capital for new startups.

These are vertical industries that are in a crisis – but there is a horizontal crisis as well – and that is the crisis impacting small businesses in California. It almost does not matter what sector you are in, or whether your customers are local or global – if you are a small business you are finding it difficult to survive in today's economy.

I know that the purpose of this commission is to recommend changes in tax policy. And i will talk about some specific issues in that regard. However i want to bring a different perspective to this discussion, and that is the perspective of the state's business climate.

What we call taxes are just one component of the state's business climate, and unless we approach improving the business climate on a holistic basis, we will not solve much of anything. We must recognize that regulations and hidden taxes on business are just as insidious and tax related as taxes themselves – and in many cases go even farther toward making California a difficult place to do business than taxes themselves.

I say this because business can best exist in an atmosphere of certainty. If, for example, a company knows that it has 10 years to depreciate a capital asset it can make a decision to purchase such an asset based on the tax rules it knows about. If it knows that its tax rate will be x, and that it needs to pay certain taxes and fees, it can price these levies into the cost of its product.

However, when actions – or inactions of the legislature increase the costs to do business, such actions create uncertainty, increase costs, and make California a difficult place for business.

Let's take just a few examples:

Workers compensation is the one area that is on the minds of business like no other issue. Over the past 3-5 years it is not uncommon for companies – large and small – with good records and bad ones on worker safety – to witness premium increases of 100% or more per year! And there is nothing a business can do about it. If, for example, a business finds its health care costs increasing at a rapid rate it can develop cost sharing programs with employees, reduce benefit levels, or even cancel coverage altogether. They can do what good business people do – manage their way through adversity. This is not possible with workers compensation. You must have workers comp – so if your costs rise all you can do is reduce costs in other areas – and that means cutting workers, reducing capital expenditures, and not investing in the future. None of this is good for our economy.

I can talk for my entire time today about this issue and want to go on to others – but make no mistake about it – the dramatic increases in workers compensation in California are doing more than any tax to drive companies out of business – to keep businesses from locating here – and to drive business out of California. This is not just impacting business, but local government as well. Estimates are that workers compensation costs local government in la county $1 billion per year. Reform will reduce these costs and put more police on the streets, teachers in the classroom and nurses in hospital. I strongly recommend that your commission recommend an immediate special session of the

California legislature to deal with this issue and that such special session be called to adopt a comprehensive set of reforms in workers compensation not later than 60 days from now. Unfortunately, even that may be too late for many businesses.

California's labor laws are another set of examples of hidden taxes on business that harm our economy. The repeal of the 40-hour work week, living wage laws that require wages above the state's minimum wage, and many other examples are all items that put us at a competitive disadvantage with most other parts of the country.

And, on this year's agenda are even more bills that could further regulate and increase the costs to do business in this state. For example, sb 2 that would mandate that all California employers either "pay or play" in health care. The fact of the matter is that requiring many small businesses to pay the cost of health care will drive them out of business. Enactment of this legislation will cost billions to our economy in lost jobs and lost taxes from those who will be forced to close their doors over these new mandated costs.

The problem with these issues is that they are all good ideas. Who can argue that everyone should not have health care? Who can argue that $6.75 per hour is not enough to feed a family? It is hard to argue – and I certainly won't do it. But the argument is not in the end – it is in the means to the end.

We have created a society in which it seems that the only way to realize societal goals is to tax and regulate – rather than to incentivize. Instead, we need to build incentives into our tax code that will promote our ability to meet our societal goals. For example:

It is good public policy to promote family leave. Yet the mandates of last year's SB 1661 are tough on business – especially small business. Instead of mandating family leave, why not use the carrot? Why not give employers who choose to provide family leave required under the bill a tax credit that is greater than their out of pocket cost – perhaps declining over several years, but one nevertheless that would give them an incentive to provide the benefit rather than a penalty through regulation? That way, those who choose to provide the benefit will have better employee relations – will compete more effectively for people – and in the end the market place will take care of and reward those companies with better and happier people.

In much the same way, we could stimulate businesses to provide health care through a declining tax credit system that gives them an incentive to provide the benefit – rather than taxing them.

For example, congressman Dick Gephardt has introduced legislation to provide businesses with a tax credit to pay for most health care costs for their employees. This may not be a perfect bill, but at least Gephardt gets it—we're going to get more employees insured in the long-term by working with business than by taxing and mandating business to the extent where they leave California—for good.

There are those who would say that these credits reduce revenue.  But if they encourage business to provide health care and fewer people are thus uninsured, that will have a positive impact on the budget.  And, if credits help companies stay in business in California that will be accretive to our economy as well.

Now I'd like to cover a few issues here in California that are directly related to any semblance of an economic recovery.

According to a recent study by Ross Duvol at the Milken institute, our state's tax burden is 23 percent higher than the national average. Despite this significant disparity, California is the only western state to increase our tax burden by three percent at a time when our neighbors reduced their tax burdens. No wonder states like Nevada and Arizona have attracted many of California's businesses—and employers--to move east.

The manufacturing sector is a key employer of California's middle class. Workers in manufacturing "are paid, on average, $25,000 more per year than a service sector employee," according to the California manufacturers and technology association. "in addition, the economic multiplier effect of each manufacturing job is 2.5, the highest of any type of job. Thus, when California loses one manufacturing job, two and a half jobs in other sectors of the economy also disappear."

Some of you may have read George Skelton's commentary in today's *Los Angeles times* in which he laments the decline of California's middle class, both culturally and economically. The la area chamber has numerous members who have relocated their manufacturing jobs to other states, not just because the tax rates are more inviting to business, but the quality of life and affordability of raising a family is more inviting as well. Our state's fiscal and regulatory policies are making it exceedingly difficult for middle class families to buy a home, raise their kids, send them to college and perhaps start a new business. Not only are we losing our employers due to higher than average tax policies, but also we're losing our educated workforce as well.

To that end, the la area chamber announced its early support AB 122, a bill to extend the manufacturers investment credit (mic). AB 122 extends the date on which the mic will cease to be operative to January 1, 2006, or January 1 of the earliest year thereafter, if total employment, as defined, in California does not exceed by 100,000 jobs the total employment in California on January 1, 1994. While the la area chamber supports this bill, the logic behind the sunset clause is backwards. Why should the mic cease to be operative if we lose manufacturing jobs?

Here in Los Angeles, we're leading the country in small business start ups, in part because the city is waiving business taxes for the first two years. In Sacramento, assemblyman Marco Firebaugh is carrying AB 678, which waives bank and corporation taxes for start up businesses for the first three years of the business' existence or until the business grosses more than $500,000. We support AB 678 even though we believe the revenue levels are too low.  Opponents are arguing that AB 678 will cost the state tax revenue if AB 678 is approved, but i would argue that AB 678 would cost the state tax revenue if it *weren't* approved. Policies that help business start ups to "weather the storm" and emerge as large tax payers and create more jobs so that the state gains more taxpayers. I would also like to point out that a large portion of these small business start-ups are woman or minority owned.

Those are only two bills that will help California get back on the road of economic recovery, but let me discuss some bills that will make things worse.

Many of our members are concerned about SB 17, the "split roll tax" that seeks establisher higher property taxes on business than on residences. By periodically reassessing business property taxes, these taxes will cost billions of dollars to business – and therefore to consumers – raising prices and costing jobs. The timing of SB 17 could not be worse as its tough enough for business owners to afford workers' comp insurance and retaining as many jobs as possible. Furthermore, the relatively low commercial property tax rate in California is one of the few things we have going right for us!

The vehicle license fee issue is now moot because of the trigger mechanism that allowed it to be restored to pre-1998 levels in times of severe tax revenue shortfalls. Vlf supporters argued that for those who drive new Cadillac escalades, it was a small fee in comparison to the sticker price of such a car. That may be true, but think if you're a business owner and you have a fleet of commercial trucks—that becomes a lot of money. Some of our members are paying millions of dollars more just to cover the vlf increase.

Fees such as the vlf may not legally be defined as taxes, but they really are. Lawmakers need to understand that the public considers fees to be taxes that are eventually passed along to consumers. In this environment we must make sure we don't tax business through new fees that circumvent the tax setting process.

Policy makers need to consider the full economic impact of taxes, fees and other costs that are not always recognized as harmful to business. As some of you who are in business know, it's one thing to be taxed when you are aware of the upcoming cost on your business. But it's another when a new policy is enacted that results in you having to reassess your budget—and eventually your ability to make payroll.

I will wrap up my remarks with reference to a bill that the la area chamber of commerce is sponsoring—AB 873. Assembly members Keith Richman and Sharon runner are carrying this bill for inclusion of an "economic impact assessment" before state agencies enact new rules and regulations.

We recognize that some rules are necessary to protect public health or improve water quality. But the business community also wants to be reassured that state policymakers have fully considered the economic consequences of such rules.

- How does this proposal compare to other states'?
- How might this rule impact employment in a certain job sector?

- Will other states use this rule to recruit California's businesses to relocate and save money elsewhere?

AB 873 simply gives policy makers additional information so that they will be aware of the full picture before they intentionally enact rules that further erode our business climate. This bill will be heard on April 29 in the assembly business & professions committee, and I look forward to testifying in support.

In conclusion, I thank you for providing me the opportunity to scratch the surface of what is impacting California's economic recovery. Clearly, the business community needs to do a better job of delivering our message that lawmakers need to look at alternatives to tax increases to reach their goals. At the same time lawmakers need to look at the big picture and realize that it's hard to run a business in California, especially when you look at neighboring states, many of which do not have sales taxes or income taxes.

I wish you success in your task of addressing how to change our thinking on tax policy as we move into a new era and new economy. I hope that you too will look at the big picture and consider that other states are using California as an example of how not to attract businesses into a state.

Thank you.

**February 1996**

# CALIFORNIA CONSTITUTION REVISION and ECONOMIC COMPETITIVENESS FOR THE BAY AREA

## Introduction

Government operations and regulations are clearly factors for the Bay Area and California in the cost of doing business and competing globally.  There is a compelling need for change and reform in order to remain competitive.  The Bay Council strongly supports revision of the California Constitution as fundamentally important to the long-term economic prosperity of the region and the state.

The Bay Area Council is a business-sponsored, CEO-led, public policy organization established in 1945 to promote economic prosperity and quality of life in the nine-county Bay Area region.  The Bay Area Council and the Association of Bay Area Governments jointly sponsor the Bay Area Economic Forum which convened leaders from business, government, labor, academia and the community to develop this policy statement regarding revision of the California Constitution.

The current work of the California Constitution Revision Commission provides an opportunity to review the premises of government in California and reformulate a Constitutional framework that fosters and supports an effective and efficient system of governance as an important component of economic competitiveness.  This paper sets forth the policy position of the Bay Area Council on Constitution revision from the perspective of reforms needed to enhance economic competitiveness.  It should be noted that while the Constitution and government operations are significant factors in economic competitiveness, they are not the only forces.  Further, many innovations are being initiated by public officials to improve government operations and significant progress is being made to enhance the economic climate of the Bay Area and California.

## Overview

In considering the relationship of government operations and regulations to regional competitiveness, it is essential not only to identify mechanisms for improving the efficiency and productivity of existing operations, but also to re-examine and re-think the fundamental roles and functions of government.  The overall cost of government in comparison to its effectiveness is too great a burden:  there is a need for massive reform.

It will not be sufficient, however, only to find ways to "reinvent government" by doing the same things faster and cheaper.  While streamlining existing procedures and applying technology to improve efficiency and productivity of current operations can make significant contributions to the cost-effectiveness of specific functions, the problem is much deeper.  The challenge is far more fundamental.

Government in its present structure along with its model of centralized decision-making is unable to keep up with the pace of global competition and is inadequate to support a knowledge-based economy. This reality demands substantial reorganization and shift in philosophy. For example, although new information technologies facilitate direct, decentralized communications and commerce, government is organized on a much different and almost contradictory premise. Government today presumes effectiveness in centralized power without an ability to capture the efficiency and energy of direct citizen action. While we strive to meet the challenges of the 21st Century, our government structures are rooted in the 19th Century.

A new paradigm is needed which parallels the pattern of commerce in a knowledge-based economy. The new paradigm must embrace decentralized decision-making, moving responsibilities not only closer to the people at the level of local government, but also fostering greater involvement of individuals themselves. It must encourage and support cooperation, collaboration, public-private partnering and volunteerism in order to achieve efficiency, effectiveness and economies.

**We must "re-discover governance" in a democracy--the power of individuals and communities to become more involved in solving their own problems and determining their own destinies. And, we must organize government to complement and encourage economic competitiveness. A new paradigm is needed for governance in the 21st Century. The foundation for a new framework must be set forth in the California Constitution.**

**Recommendations**

The Bay Area Council strongly supports revision of the Constitution and applauds the work to date of the California Constitution Revision Commission (Commission). This policy paper responds to the preliminary recommendations of the Commission regarding the goals and specific proposals for Constitution revision. The Bay Area Council endorses the four goals (listed below) identified by the Commission. They are pertinent and germane to enhancing economic competitiveness:

- Improving accountability and responsiveness of state and local governments.
- Eliminating barriers to efficiency.
- Increasing flexibility.
- Enhancing fiscal integrity.

The thrust of these goals should be incorporated into the Constitution. This will articulate official policy for the State of California and establish a legal presumption that: (a) government shall be accountable, efficient, flexible and fiscally sound; and (b) all elected officials and officers of the State shall be compelled to act in accordance with these principles.

The first goal--Improving accountability and responsiveness of state and local governments--is strongly supported by the Bay Area Council. It is a fundamental principle for promoting competitiveness. It should be underscored because it emphasizes a "bottom-line" focus on outcomes and results.

A "culture of accountability" and an “ethic of customer service” must be infused throughout all of government so that taxpayers can better evaluate performance by their representatives. In fact, increased accountability will help taxpayers view government operations not just as expenditures, but rather as "investments" from which they can expect certain "dividends" that benefit them. A public spotlight on outcomes and performance may also foster a greater willingness by taxpayers to "invest" more for particular purposes based on expected results.

The specific recommendations of the Commission should be augmented to more aggressively achieve the goals. For example, the Constitution could:

- To improve accountability, require the state and all political subdivisions to prepare budgets which delineate measurable goals and objectives.

- To eliminate barriers and promote efficiency, require each county along with all political subdivisions within that county to periodically hold joint hearings (e.g., once every ten years) to determine the fewest number of separate taxing authorities and political subdivisions needed to efficiently and effectively achieve the performance outcomes specified in the collective budgets. Such a plan could be required to be submitted to the voters for approval to increase individual responsibility and accountability. This approach to efficiency is complementary to the concept of a "Community Charter" and ensures that the citizenry has an opportunity to regularly review and engage in the design and structure of government.

The above examples are cited to illustrate the potential for greater fundamental reform if the goals are more vigorously pursued and integrated throughout the Constitution. There should be discipline exercised, however, to include in the Constitution only provisions essential to establish a new framework and promote the overall goals. In contrast to the current document, a new Constitution should be concise and free of extraneous sections or provisions that more appropriately should be enacted through legislation.

The Bay Area Council generally supports in concept the specific revision recommendations of the Commission. Some are more critical to improving economic competitiveness than others. The following comments are organized according to the most important concepts.

- ACCOUNTABILITY AND FOCUS ON OUTCOMES
  The recommendation for a State Strategic Plan with measurable performance outcomes is strongly endorsed. It should incorporate regional economic strategic plans. Current Constitution provisions for units of government to adopt budgets should be augmented to require measurable goals, objectives and outcomes.

- REALIGNMENT OF STATE-LOCAL RELATIONSHIP
  Reorganization of the Legislature is intriguing, but it is not as critical to economic competitiveness for a knowledge-based economy as an excellent education system or fiscal stability and integrity for local government. The revisions proposed by the Commission emphasize reforms at the state level. More focus on education and greater clarification of the relationship between local government and the state is needed to frame a new paradigm of governance.

- EMPHASIS ON EDUCATION
  The Commission recommendations lay a foundation for additional emphasis on education. The Constitution should specifically embrace the goal of excellence in education, ensure fiscal stability and integrity for schools and higher education, and require measurable goals and objectives for the education system. Counties and cities should be required to articulate budget performance outcomes consistent with supporting and achieving the education goals and objectives.

- FISCAL RESTRUCTURING
  The Constitution should realign local government revenues and responsibilities, guarantee local government revenues, and prohibit state government "raids" or reallocations in order to achieve fiscal integrity and stability that fosters a new governance paradigm. Local government revenues collected and distributed by the state should be managed independent of the state's general fund; distribution of funds should not be dependent upon the adoption of a state budget. Constitutional provisions against unfunded mandates must be significantly strengthened.

- LOCAL FLEXIBILITY AND COMMUNITY GOVERNANCE
  The "Community Charter" concept should be more clearly defined and developed in order to foster a governance paradigm with increased responsiveness and flexibility. Communities must have the tools to take greater responsibility for solving their own problems and governing themselves.

**Conclusion**

Constitution revision in California can be a positive force for enhancing economic competitiveness. The Bay Area Council strongly supports revision of the Constitution and encourages the Commission to aggressively advocate fundamental change in governance demanded by global competition in the 21st Century.

TO: Commission on Tax Policy in the New Economy

FROM: Sunne Wright McPeak, Ex-Officio Commission Member
California Economic Strategy Panel

DATE: April 14, 2003

SUBJECT: Perspectives from the California Economic Strategy Panel

On behalf of the California Economic Strategy Panel, thank you for inviting input on the important issues being deliberated by the Commission on Tax Policy in the New Economy. It is significant and timely that the Commission seeks information on the economic implications of tax policy. All too often economic impact is not considered when tax policies are debated, or considered only as an afterthought, usually framed in terms of short-term consequences (such as who will pay more or less taxes as a result of the policy reform). The Commission is to be commended for studying and considering the long-term economic strategy implications of tax policy option.

***It is the role and responsibility of the California Economic Strategy Panel to bring the "voice of the economy" to state policy deliberations, and to support the thoughtful integration of economic impact into critical policy choices.*** Too often, other issues drive state policy in the absence of this analysis. Today, there must be a focus on how creating a strong economy will impact all public policies, whether it be policies about education, the environment, transportation, telecommunications, water infrastructure, public safety, or taxes. Thus, the Panel applauds your decision to factor this into your deliberations.

The California Economic Strategy Panel recently released its second report, titled: *Creating a Shared California Economic Strategy: A Call to Action*. That report is attached to this memorandum and forms the basis of this presentation. A simple analytic procedure for the Commission when considering a single tax policy reform or a package of reforms is to evaluate whether or not the reforms aligns with the principles and strategies of a successful economy. If the answer is either neutral or positive, then there is a solid economic argument for adoption, although clearly other factors of adequacy, fairness, ease of collection and political viability, among others, should be applied. If the answer is negative, then from the perspective of economic strategy, the burden of proof for going forward, based on these other factors, should increase. Therefore, tax policy options should be addressed using both standard tax principles and pro-economy principles.

This presentation addresses two principal questions:

***What are the characteristics of the 21st Century California Economy?***
***What are the implications of this 21st Century Economy for tax policy?***

The *Economic Strategy Call to Action* identifies the four foundational elements of a long-term successful economy:

1. Understand the industry and workforce characteristics of regional economies, with a special focus on leading industries for which California has comparative advantage in the global economy.

2. Apply this information to education and workforce investment strategies that will enable California's workers to participate in the successful economy, with career progression opportunities so that all workers can earn a decent living to support their families.

3. Plan and invest in essential infrastructure (housing, water systems, transportation, open space and so forth) to ensure that communities are attractive places to site businesses and for workers to live.

4. Assure vital and effective economic leadership through policy-governance bodies (such as the Economic Strategy Panel and the Commission on Tax Policy in the New Economy) and strategic public-private partnerships.

As important as are short-term "business climate" concerns that drive up the costs of doing business in California, these may be more than offset by quality factors that attract employers and workers who provide the talent necessary for an innovative economy, and who can live wherever the quality of life suits them. The long-term issue for employers is whether or not there is an appropriate "return on investment" for the taxes being paid to support and promote public benefit.

The following responds to the two primary questions posed above.

**1. What are the Characteristics of the 21st Century California Economy?**

Four major issues should be considered when thinking about the 21st Century Economy. (The appendix to the memo elaborates on each of these issues.)

<u>This is not the first time that California's economy has changed significantly.</u>

The California economy is constantly changing. It has been one of the most innovative economies since Gold was first discovered in 1849 and the industry structure of the state has been transformed over many decades. In many ways, each transformation in the economic structure of the state has created a "New Economy"—referred herein as the 21$^{st}$ Century Economy.

<u>What has really changed is the "way things are done" in the economy today, not just the products and services made and sold.</u>

The Economic Strategy Panel found that the transformed, evolved 21st Century Economy has several key characteristics:

— *Fast* to market with mass customization.
— *Flexible* production with new ways of organizing work.
— *Global* orientation with local supply chains.
— *Skilled workers*, who have become the key competitive advantage.

<u>Firms and regions must compete on innovation (not low cost) across a wide range of industries (not just "high tech" manufacturing).</u>

California's' 21st Century Economy is a composite of diverse regional economies which must compete on the basis of innovation across a range of industries including agriculture, manufacturing, and services, not just a narrow band of so-called "high tech" industries such as semiconductors, computers or software.

<u>The definition of a competitive business climate in a 21st Century Economy has changed</u>.

Rather than focusing only on low taxes and regulations, the essential requirements today are for tax and regulatory policies that encourage the private and public investments essential for the skills and infrastructure to compete.

The Economic Strategy Panel recognized that the cost of doing business is a major factor in the location, retention and expansion of business in California and recommended the assessment of business climate concerns, particularity in regards to the impact on the competitiveness of California.

**2. What are the Implications of the 21st Century Economy for tax policy?**

As the California economy continues to change, so must California's tax policies and structures. The Commission on Tax Policy in the New Economy was established initially to examine one aspect of this change—the issue of internet taxation—but its mandate has changed by request of the Governor to include a broader review of California's overall tax structure and recommendations for fundamental tax reforms

The timing is right for this assessment. Not only has the Internet dot.com "bubble" of the 1990s broken, reducing state revenues, but the state faces a major budget deficit which requires creative thinking about both revenue and expenditure reforms if the magnitude of the challenge is to met without major negative long term impacts on the California economy.

The 21st Century Economy warrants consideration of appropriate tax principles rooted in three basic premises:
<u>California's current tax structure is inadequate for moving the state forward in the 21st Century.</u>

While addressing immediate revenue shortfalls, one or two short-term tax changes will not "solve" the long-term problems from an "economic" perspective. The real issue involves fundamental reform of the tax structure.
<u>California has become an innovative economy across all of its industries not just high tech.</u>

Accordingly, California needs a tax structure that rewards innovation and investment in both the private and public sectors.

<u>California suffers from a "boom/bust" revenue cycle that is disruptive of state and local investments in skills and infrastructure essential for a strong economy.</u>

While, the "surge" nature of an innovative economy creates this problem, the overall tax structure could help moderate this problem if the tax base is broadened and made less dependent on single tax sources that are tied to the "boom/bust" economy cycle (e.g. broaden the sales tax base, changing the schedule of income tax rates, realign state and local tax sources)

The following are list of "standard tax principles" and "pro-economy tax principles" to consider in evaluating tax reform alternatives. *

***Standard Principles***

*Equity:*
Ability to pay: Is the tax fair for different income groups?
Benefits received: Is the tax related to benefits received?

*Stability*: Is the revenue stable or sensitive to economic cycles?

*Administration*: Is the administration of the tax cost effective?

*Compliance:* Is compliance simple and inexpensive?

***Pro-Economy Principles***

*Efficiency*: Does the tax system distort economic decision-making?

*Growth*: Does revenue grow in proportion to the economy over time?

*Diversity*: Is the tax base broad, so tax rates can be low?
*Neutrality*: Does the tax system foster a 'level playing field"?

*Pro-investment*: Does the tax system encourage private and public investment in plant, equipment, people, and/or technology that will promote innovation and a rising standard of living for all?

Finally, tax policy options must align with the four foundational elements of a successful economy:

- Do the policies advance industries that are important for California's economic competitiveness?

- Do the policies advance the ability to support education and workforce investment strategies necessary for a long-term, competitive workforce?

- Do the policies advance the ability to support infrastructure planning and investment, and on-going infrastructure operations and maintenance?

- Do the policies advance the perception that California is able to provide sustained and stable economic leadership, involving business, labor, community and local government sectors?

In summary, these suggestions are intended to help inform the deliberations of the Commission with the "voice of the economy." Please know that the Economic Strategy Panel stands ready to assist you in your deliberations in the short-term and over the next several months. The Panel would be pleased to review proposed recommendations and provide specific input on potential impact on long-term economic strategy. Further, given that tax policy reform is so important for California's long-term economic success, we also hope that you are given whatever time and support is necessary to ensure that your mission is fulfilled with all the thought and care that these very complex issues deserve.

Enclosure: Creating a Shared California Economic Strategy: A Call to Action December 2002.

**APPENDIX**

(*These principles are adapted in part from a study by SRI International for the Florida Chamber Foundation in 1990 which was submitted to the Commission by its principle author, Doug Henton, President of Collaborative Economics, at the February meeting. Mr. Henton has been a technical advisor to the California Economic Panel since 1994 and is a consultant for the California Economic Regions Project which is providing "real time" economic information to the Panel and California Workforce Investment Board as well as regional groups for strategy.)

<u>This is not the first time that California's economy has changed significantly.</u> California's economy has been transformed by gold (1850s), agriculture (1860s), railroads (1880s), oil (1900s), Hollywood (1920s), defense (1940s), micro-electronics (1960s), and personal computers (1980s). Each economic "surge" changed the industrial structure of the state, created new jobs and changed the pattern of development. The most recent Internet surge (1990s) was not different, although the impact was large in terms of employment gains and the financial speculation. Each of these eras could have been called a "New Economy". At the same time, the more "old economies" did not go away; they often created a base upon which for the new to build.

<u>What has really changed is the "way things are done" in the economy today, not just the products and services made and sold.</u>

Based on industry cluster studies and regional forums around the state, the Economic Strategy Panel documented in the first report that California has become an "economy of regions" driven by different export-oriented industries ranging from wood products in the North, food processing in the Central Valley, biomedical in San Diego, entertainment in Los Angeles, information technologies in the Bay Area, to diversified technology manufacturing in the Sacramento region. The Panel found that the changed economy was about key characteristics

— *Fast* to market with mass customization
— *Flexible* production with new ways of organizing work
— *Global* orientation with local supply chains
— *Skilled workers* have become the key requirement for competitive firms and, hence, education, workforce development and good quality of place are now essential for attracting and retaining these skilled workers at all occupational levels for different kinds of industries.

The Panel found that firms often collaborate to compete within industry clusters among geographic concentrations of inter-related firms, usually on a global basis. The infrastructure needs of these firms have shifted from low cost land, labor and tax incentives to high quality skills and quality of place to attract and hold talent.

Firms and regions must compete on innovation, not low cost across a wide range of industries, not just "high tech".

California’s' 21st Century Economy is about competing on the basis innovation across a range of industries, including agriculture, manufacturing, and services, not just a narrow band of so-called "high tech" industries such as semiconductors, computers or software. Firms have to be constantly innovating in product development and process improvements or they will fail to prosper. There are only innovative and non-innovative firms, and the non-innovative firms will not succeed long in the global economy today.

This means that firms and the regions where they operate, whether its is value added food processing in the Central Valley, advanced logistics or entertainment in Southern California, biomedical or software in San Diego, Orange County or Silicon Valley all need skills workers, suppliers, quality physical infrastructure and a competitive business climate.

The definition of a competitive business climate in a 21s Century Economy has changed.

Rather than focusing only on low taxes and regulations, the requirements today are for tax and regulatory policies that encourage the private and public investments essential for the skills and infrastructure to compete. Taxes and regulatory policies should not slow down speed to market or create distortions in the marketplace. However, the overall tax structure has become as important, if not more important, than tax rates as a determinant of a competitive business climate that supports quality infrastructure, including skills

The Economic Strategy Panel 2002 *Call to Action* finds that " economic development incorporates a wide variety of government functions and policies, such as education and workforce development, housing, transportation, energy, environmental protection and tax policy. A lack of a unified economic development strategy has resulted in duplication, gaps and state and local government working at cross-purposes." It recommends that economic strategy and workforce development should be better connected based on real time information and joint planning, that infrastructure investment needs focus on the "triple bottom line" of economic impact, environmental sustainability and equitable development. It also recognizes that the cost of doing business is a major factor in the location, retention and expansion of business in California and recommends the assessment of business climate concerns, particularity in regards to the impact on the competitiveness of California.

COMMISSION ON TAX POLICY IN THE NEW ECONOMY
**Bay Area Council**
**Sunne Wright McPeak**
**April 14, 2003**

## Overview

The Bay Area Council is a business-sponsored, CEO-led, public policy organization founded in 1945 to promote economic prosperity and quality of life in the nine-county Bay Area region. The Bay Area Council has participated on several state policy bodies and has consistently recommended major reform and reorganization to promote greater economic prosperity and quality of life in California. State fiscal and tax policy is pivotal to issues of economic competitiveness and prosperity. Thus, the Bay Area Council considers the work of the Commission on Tax Policy in the New Economy to be vital for California's future. The following comments augment the presentation from the California Economic Strategy Panel and draw upon the adopted position of the Bay Area Council regarding California Constitution Revision and Economic Competitiveness. The Bay Area Council also participated in the development of and supports the recommendations from the Speaker's Commission on State and Local Government Financing and the Speaker's Commission on Regionalism.

Fiscal and tax policy should consider both sides of the revenue dynamic: (1) the reasonableness of the tax source (see the Standard and Pro-Economy Principles in the presentation from the California Economic Strategy Panel); and (2) the appropriateness of its dedicated use. (a) accountability for use of revenues; (b) alignment of revenues and responsibilities; and (c) return on investment.

In making recommendations for revision of the California Constitution, the Bay Area Council observed that the present structure of government with a model of centralized decision-making at the state level is unable to keep up with the global competition among regions and is inadequate to support a knowledge-based economy. A new paradigm is needed which parallels the pattern of commerce in a knowledge-based economy and which embraces decentralized decision-making, moving responsibilities not only closer to the people at the level of local government, but also fostering greater involvement of individuals themselves. Further, given the importance of regions as the relevant units of economic competition in a global marketplace, local governments must be required, incented and rewarded for regional collaboration to achieve regional economic prosperity.

## Reasonableness of Revenue

From perspective of employers and business community, fees are too high and bureaucracy and time delays are too costly. The base of burden is too narrow in many cases, disproportionately impacting employers (housing, infrastructure, energy).

- See Standard and Pro-Economy Principles from the California Economic Strategy Panel.

- Split roll can be a slippery slope that will only exacerbate the situation. There may be an opportunity to establish an innovative approach and program consistent with the principles of reasonable revenue source and appropriate deployment.

**Appropriateness of Deployment and Dedication**

— Accountability for use of revenues.
— Alignment of revenues and responsibilities.
— Return on investment.

Generally, from the public and private investment perspective, especially from the perspectives of employers and the business community, today there is insufficient return on investment for the taxes and fees being paid, detracting from the economic competitiveness of the California business climate.

- Foster "culture of accountability" in the budgeting process. (See recommendations from the Bay Area Council regarding revision of the California Constitution and the recommendations from the Speaker's Commission on State and Local Government Financing.)

- Stabilize funding for local government and provide tools for raising future revenue (with appropriate and reasonable vote threshold):

— Establish adequate, reliable, and predictable revenues sources dedicated to local government outside of the State General Fund to provide services according to outcome performance standards.
— Increase percentage of property tax that is allocated to counties and cities for exercise of property-related land use decisions (alignment of revenues and responsibilities). Preserve the "layer-cake" or "three-legged stool" construct of revenue streams (property tax, including VLF which is an in-lieu property tax, sales tax, state subventions contributed to by income tax + TOT and fees).
— Enact requirements, incentives and rewards for regional collaboration and achievement of regional goals.

- Consider how to foster and encourage public-private partnerships, including harnessing the energy and innovation of individual citizens, organizations and employers. This can be done through a combination of program structure in statute and tax credits to encourage and reward behavior.

COMMISSION ON TAX POLICY IN THE NEW ECONOMY
CALIFORNIA ECONOMIC STRATEGY PANEL
Sunne Wright McPeak
**April 14, 2003**
**- Outline of Comments -**

California Economic Strategy Panel applauds the work of the Commission on Tax Policy in the New Economy and welcomes the opportunity to work together. It is the role and responsibility of the California Economic Strategy Panel to bring the "voice of the economy" to state policy deliberations and to support the thoughtful integration of economic impact into critical policy choices. The California Economic Strategy Panel recently released *Creating a Shared California Economic Strategy: A Call to Action*. This presentation highlights the major elements of that report and addresses two principal questions:

***What are the characteristics of the 21st Century California Economy?***
***What are the implications of this 21st Century Economy for tax policy?***

The *Economic Strategy Call to Action* identifies the four foundational elements of a long-term successful economy:

5. Understand the industry and workforce characteristics of regional economies, with a special focus on leading industries for which California has comparative advantage in the global economy.

6. Apply this information to education and workforce investment strategies that will enable California's workers to participate in the successful economy, with career progression opportunities so that all workers can earn a decent living to support their families.

7. Plan and invest in essential infrastructure (housing, water systems, transportation, open space and so forth) to ensure that communities are attractive places to site businesses and for workers to live.

8. Assure vital and effective economic leadership through policy-governance bodies (such as the Economic Strategy Panel and the Commission on Tax Policy in the New Economy) and strategic public-private partnerships.

As important as are short-term "business climate" concerns that drive up the costs of doing business in California, these may be more than offset by quality factors that attract employers and workers who provide the talent necessary for an innovative economy, and who can live wherever the quality of life suits them. The long-term issue for employers is whether or not there is an appropriate "return on investment" for the taxes being paid to support and promote public benefit.

**1. What are the Characteristics of the 21st Century California Economy?**
Four major issues should be considered:

<u>This is not the first time that California's economy has changed significantly.</u>

<u>What has really changed is the "way things are done" in the economy today, not just the products and services made and sold.</u> 21st Century Economy key characteristics:
— *Fast* to market with mass customization.
— *Flexible* production with new ways of organizing work.
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<u>Firms and regions must compete on innovation (not low cost) across a wide range of industries (not just "high tech" manufacturing).</u>

<u>The definition of a competitive business climate in a 21st Century Economy has changed</u>.

**2. What are the Implications of the 21st Century Economy for tax policy?**

<u>The current tax structure is inadequate for moving the state forward in the 21st Century.</u>

<u>California has become an innovative economy across all industries not just high tech.</u>

<u>California suffers from a "boom/bust" revenue cycle that is disruptive of state and local investments in skills and infrastructure essential for a strong economy.</u> While the "surge" nature of an innovative economy creates this problem, overall tax structure can moderate this problem if the tax base is broadened and made less dependent on single sources.

***Standard Principles***
<u>*Equity:*</u>
Ability to pay: Is the tax fair for different income groups?
Benefits received: Is the tax related to benefits received?
<u>*Stability*</u>: Is the revenue stable or sensitive to economic cycles?
<u>*Administration*</u>: Is the administration of the tax cost effective?
<u>*Compliance:*</u> Is compliance simple and inexpensive?

***Pro-Economy Principles***
<u>*Efficiency*</u>: Does the tax system distort economic decision-making?
<u>*Growth*</u>: Does revenue grow in proportion to the economy over time?
<u>*Diversity*</u>: Is the tax base broad, so tax rates can be low?
<u>*Neutrality*</u>: Does the tax system foster a 'level playing field"?
<u>*Pro-investment*</u>: Does the tax system encourage private and public investment in plant, equipment, people, and/or technology that will promote innovation and a rising standard of living for all?

Finally, tax policy options must align with the four foundational elements of a successful economy:

**Outline for staff discussion with on process for the California Commission on Tax Policy in the New Economy April 14, 2003, Working Lunch**

The following questions are designed to prepare the Commission for its all-day discussion at its April 21 meeting in Sacramento. The discussion on April 14 will be brief, but Commission feedback will allow staff to help prepare the Commission agenda for April 21. Staff believes that the results of the April 21 meeting, then, will provide the framework for any interim report the Commission wishes to prepare, and will also outline the work plan for the Commission for the remainder of the year.

1. What can the Commission do to add value to the public's and policymakers' debate on tax policy in California?

2. Is the Commission fulfilling its statutory directives?

3. What will be the Commission's end product?
    - When is the Commission's job complete?
    - What are the benchmarks for progress?
    - What is the product to be developed by mid-May?
    - How are the Commission's efforts to be impacted by funding and staffing? What does this mean for how and who is responsible for the final product/report?

4. What is each individual commissioner's personal priority for the Commission? What does each commissioner personally require from the Commission's end product to feel as if the Commission has been a success?

5. What type of process does the Commission envision or require to get to a successful final product?