California Commission on Tax Policy in the New Economy

Beverly Hills
July 18, 2003

Proceedings

JULY 18, 2003: BEVERLY HILLS

Scoring The Current California Tax System
Annette Nellen, CPA, and Esq. - Joint Venture: Silicon Valley Network

A Flat Tax Proposal For California
A Flat Rate Tax for California State and Local Governments
Second Flat Tax Testimony of Dr. Arthur B. Laffer
The Only Answer: A California Flat Tax
Arthur Laffer, Ph.D. - Laffer Associates

A Flat Tax Proposal For California
Phil Spilberg, Ph.D. - Director, Economic and Statistical Research Bureau, California Franchise Tax Board

Comments on a Value Added Tax
Benjaimin F. Miller, Counsel, Multistate Tax Affairs, California Franchise Tax Board

An Overview of the Michigan Single Business Tax
Should Michigan Reform Its Current Business Tax System?
Douglas C. Drake, Associate Director, Wayne State University State Policy Center, Lansing, Michigan

Selected Data Tables from: The Michigan Single Business Tax, 1998-99. A report by the Michigan Department of Treasury, Office of Revenue and Tax Analysis, July 2002.
http://www.michigan.gov/treasury

MEETING OF THE

CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

www.caneweconomy.ca.gov

Beverly Hills City Council Chambers
455 N. Rexford Drive
Beverly Hills, CA 90210
July 18, 2003
AGENDA

Note: This meeting is being simultaneously webcast. To view the proceedings online please go to: www.beverlyhills.org and follow the webcast link.

9:30 AM	Chairman Bill Rosendahl Meeting called to order Announcements Roll Call and Introductions
9:40 AM	Annette Nellen, CPA, Esq. Joint Venture: Silicon Valley Network Scoring the current California tax system
11:00 AM	Break
11:15 AM	Annette Nellen Continued
12:15 PM	Break for Lunch
1:00 PM	Dr. Arthur Laffer Laffer Associates A flat tax proposal for California
1:30 PM	Dr. Phil Spilberg, Director, Economic and Statistical Research Bureau California Franchise Tax Board A California perspective on a flat tax system

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

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(continued)

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2:00 PM Dr. Arthur Laffer/Dr. Phil Spilberg
Dialogue with Commissioners

2:20 PM Break

2:30 PM Doug Drake
Wayne State University, State Policy Center
Michigan's Single Business Tax (SBT)

3:00 PM Ben Miller, Esq., Senior Counsel, Multistate Tax Affairs
California Franchise Tax Board
A California Perspective on Value Added Tax (VAT)

3:30 PM Doug Drake/Ben Miller
Dialogue with Commissioners

3:50 PM At the discretion of Chairman Rosendahl
Public commentary

Adjournment

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From: Annette Nellen [anellen@email.sjsu.edu]
Sent: Monday, July 07, 2003 6:43 AM
To: Graves, Marshall
Subject: Re: July 18th

Marshall,

See my reply below:

Graves, Marshall wrote:

>Annette,
>
>I'll be doing the coordinating with you for July 18th.
>
>A couple of things:
>
>o Scoring the present tax system
>
> - have you had any contact with Glen Rossman? VERY LITTLE OTHER THAN OUR PRIOR WORK SCORING PRIMARILY THE PERSONAL AND CORPORATE INCOME TAX SYSTEMS
> - have you a general scheme on how you will help the Commissioners do the scoring? I CAN GO THROUGH A DISCUSSION OF THE SCORING I HAVE PREVIOUSLY GIVEN TO THE COMM'N ON THE SALES TAX (IN THE JOINT VENTURE BOOKLET) AND THE PERSONAL AND CORPORATE INCOME TAXES (HANDED OUT IN APRIL). I COULD THEN GO THROUGH THE PROPERTY TAX GETTING MORE OF THEIR INPUT THAN PERHAPS I'LL GET OR NEED ON THE OTHERS. DO YOU KNOW IF THE COMMISSION ALSO WANTS ME TO GO THROUGH A SCORING OF VARIOUS TELECOM TAXES?
> - Glen requested 4 hours, but we think the job can get done in 3. What do you think? I'LL USE THE AMOUNT PROVIDED. I THINK 3 IS FINE.
> - if you need more than 3 hours we will probably move the start time to 9:00 AM unless your travel plans preclude that.
>
>o Help with other agenda items:
>
> - Dr. Laffer and Doug Drake (Michigan) will do the flat tax proposal and VAT in the afternoon - would you be able to offer some counterpoint presenters to ensure a vigorous debate on both sides of the issues? I DON'T KNOW OF AN ECONOMIST OFFHAND WHO OPPOSES THE FLAT TAX. POSSIBLE SPEAKERS WHO WOULD LIKELY RAISE SOME POINTS OF WHY IT WOULD NOT BE GOOD - BUT WOULD PROBABLY FOCUS ON A GROUP OF TAXPAYERS RATHER THAN PROVIDE AN OVERALL LOOK:
>

- JEAN ROSS WITH THE CA BUDGET PROJECT

- SOMEONE FROM A REAL ESTATE ORG (THEY GENERALLY OPPOSE ELIMINATION OF DEDUCTIONS FOR MTG INTEREST AND PROPERTY TAXES)

A GOOGLE SEARCH CAME UP WITH ANOTHER OPPOSER: - M. Jeff Hamond, of the Progressive Policy Institute

> - the email copied to you from me, 6/27/03 @ 11:12 AM, suggests some possible speakers on the con side of VAT. What are your thoughts on that?
>
PERHAPS THE ABOVE INDIVIDUALS WOULD ALSO BE ABLE TO SPEAK AGAINST A VAT

> - do you have any suggestions to counter the flat tax proposal by Dr. Laffer? I may be able to get a few suggestions from Bob Affleck at EDD.
>
IF DESIRED, I CAN OFFER SOME COMMON CONCERNS RAISED ABOUT A FLAT TAX. MUCH OF MY WORK HAS BEEN LOOKING AT A FEDERAL FLAT TAX OR OTHER FORM OF VAT. SOME OF THE ISSUES RAISED ALSO EXIST WITH A STATE VAT

>I know you are in meetings all day today. I'd like to discuss this with you Monday, at your convenience. My schedule is flexible. If you are available, >please suggest a time when I can call you.
>
YOU CAN REACH ME AT HOME - 408-269-4724 BETWEEN 10:30 AND 11 IF THAT
WORKS FOR YOU. OTHERWISE, I CAN ARRANGE A TIME THIS AFTERNOON ON MY ELL PHONE - LET ME KNOW.

Thanks,
Annette Nellen

>
>Thank you for your generous offer of assistance.
>
>Marshall

Annette Nellen, CPA, Esq.

CALIFORNIA COMMISSION ON TAX POLICY

IN THE NEW ECONOMY

Comments on a Value Added Tax

Benjamin F. Miller
Counsel, Multistate Tax Affairs
California Franchise Tax Board

Beverly Hills

July 18, 2003

At its meeting of July 18, 2003, the Commission received a presentation regarding the Michigan Single Business Tax, which is an example of a Value Added Tax (VAT) in use in the United States. The Commission extended to me an invitation to provide commentary on that presentation. This written report is intended to supplement my oral comments made at the Commission meeting.

It should be noted that Michigan is the only state among the United States that has enacted a VAT. The Michigan tax is characterized by economists as an origin-based VAT, as compared to the European model, which is a destination-based VAT. The difference between a destination-based VAT, as compared to an origin-based VAT, is that in a destination-based VAT, the incidence of the tax is on the consumer similar to a sales tax, and, in an origin-based tax, the incidence falls on the firm rather than the customer. The firm obviously will be in a position to pass the tax along to the customer, but it will not be as obvious as in the case of a destination-based tax because it will probably not be disclosed as part of the purchase price. If it did, it would appear to make it more difficult to justify to the purchaser.

It should also be noted that Michigan is in the process of a long-term phase-out of the Single Business Tax. The reasons for this phase-out should be considered in evaluating whether California should consider imposing a VAT based upon the Michigan Single Business Tax or a European model.

EUROPEAN STYLE VALUE ADDED TAXES (VATS)

The VAT is a commonly used tax in Europe and Latin America. In the European model, the VAT calculation is relatively simple. The taxpayer calculates the tax on all of its sales and is able to claim a credit for the VAT that has been assessed on all of the inputs it has purchased. The amount of credit is easily determined from the purchase invoices. The European VAT is assessed on a national basis and operates on a cross-boundary basis. The VAT is assessed based upon the location of the seller, and it is separately stated on an invoice so the purchaser can claim the credit. The credit is allowed regardless of the jurisdiction where the seller of the input is located. For this system to work, there is a requirement that cross-border transactions be on an arm's-length basis. Because there are national boundaries involved, because the rates are generally equivalent within Europe, because the purchaser receives a credit for the VAT assessed on its purchase, and because of the expectation that third-party transactions will normally be at arm's length, there is a reasonable expectation that the transfer pricing problems are manageable.

VAT CONSIDERATIONS WITHIN THE UNITED STATES

Between the States of the United States of America, there is a much greater opportunity to take advantage of transfer pricing. First, the transactions are even more likely than in the European model to be between related parties. Second, the States do not have the resources to police transfer pricing. (Recognition of these two facts is what has led the States to rely upon the unitary business principle, and in California, combined reporting, with respect to the corporate income tax.) Third, there is no national tax agency assessing a VAT to police and audit the tax. It appears that in recognition of these facts, Michigan has adopted a different type of VAT than the one used in Europe.

MICHIGAN SINGLE BUSINESS TAX (SBT)

The Michigan SBT is an apportioned, additive VAT. The base is essentially equal to income plus compensation plus depreciation. The base is then apportioned based upon the three-factor formula that is common to state corporate income taxes. The decision to use an additive method and apportionment is responsive to the Fourteenth Amendment Due Process concerns that limit state tax initiatives with respect to multijurisidictional businesses. Most commentators have agreed, in the context of the United States, apportionment is a requirement in order to avoid the concerns that might arise if it were necessary to review transfer pricing.

Use of the apportionment formula is designed to limit the tax base to that portion of the tax that can be properly attributed to Michigan. It should be noted that the Michigan SBT survived a constitutional challenge, *Trinova Corp. v. Michigan Dept of Treasury* (1991) 498 U.S. 358, based upon the fact that both the base and the apportionment formula reflected elements of property and payroll. It was argued that since both Michigan-specific property and payroll could be, and were, for purposes of the apportionment formula separately determined, it violated due process to include payroll and property everywhere in the apportioned base. The United States Supreme Court rejected the argument on the basis that the fact the base was calculated in an additive manner did not mean that the tax was effectively assessed on each of the components of the base; it was, in fact, assessed on the overall base. This challenge occurred during years when Michigan was using an equally-weighted, three-factor formula. Michigan, along with many other states, has departed from the equally-weighted, three-factor formula to a formula that now weights the sales factor at 90 percent. This change in the weighting of the formula might give rise to a different conclusion if a new court challenge was mounted.

In addition, since only Michigan is now using a VAT-type tax, there is little likelihood that a substantial number of other states will adopt it, meaning that there will not be the homogeneity that exists in the European market. Adoption of a VAT-type tax by another state is likely to raise claims for the establishing of a credit mechanism to take into account the VAT asserted by any other state.

The Michigan SBT is nominally applied to all businesses regardless of the form in which they are carried out. In practice through the use of exemptions, most small businesses are exempted from the tax. The exemption is based upon size, however, not organization characteristics.

ATTRACTIVE ATTRIBUTES OF A VAT

Two of the claimed major attributes for a VAT-type tax are its stability and its neutrality, particularly when compared to the corporate income tax. There should be careful study and analysis before these claims are accepted.

Stability

A superficial comparison of the California corporate tax revenues with Michigan's suggests that the California corporate collections has been as stable as Michigan's. However, a much more detailed analysis is required to take into account changes in rates, the partial allowance and suspension of operating loss carry-forwards, and the addition of various tax credits.

The current California Corporate tax is measured by income, and thus is based upon an ability-to-pay concept. It is argued that this makes the base volatile. The stability attributed to the SBT is based upon the fact that it is not solely dependent upon the ability to pay reflected in a pure income base. The Michigan SBT has, as one of its components, income, and therefore is, to a certain extent, based upon ability to pay, but the income component is a relatively small portion of the base, with payroll being the largest single component. The largest single element of the Michigan SBT is payroll, and it is not just payroll in Michigan, but payroll everywhere. In California for the year 2000, net income would represent about 13.7 percent of an SBT base, depreciation about 14.8 percent, and payroll over 71 percent of an SBT base. Clearly, as long as there is economic activity, an SBT will generate revenue regardless of how productive that activity is. Even a partial abandonment of the ability-to-pay justification of a tax would represent a major philosophical shift in tax assessment.

Neutrality

Claims of tax neutrality, at least in terms of locational decisions, for the Michigan SBT also need to be examined in detail. First, the largest component of the base is typically payroll. Based upon the most recent year's statistics, a California tax modeled on the SBT would have about 71% of the base attributable to payroll. Michigan's experience is similar, and its law contains a cap that appears to limit the payroll portion to about sixty-five percent of the base. It should be kept in mind that this is the total payroll of the reporting group, not state specific payroll. To the extent the base includes all payroll and property, it can be said to be neutral from a locational perspective, but there will be political or legal pressures to make it state specific, that is, to measure it by only California payroll and property and apply the apportionment formula only to the income component of the base. In that event, the "locational neutrality" will no longer exist.

Second, the Michigan SBT has had a number of credits directed to encourage various types of activity in Michigan. California has also had a similar experience with respect to its corporate taxes. The addition of these credits tends to reduce the neutrality of the tax. There is no reason to think that California would be able to resist efforts to either add

credits with respect to the tax or transfer the current credits from corporate taxes to a California SBT. In addition, depending on the nature of the credits, there can be serious constitutional concerns with respect to credits given against an apportioned base.

Third, neutrality to a certain degree is dependent upon adoption of a similar system by the other states, and if the system is adopted, to having virtually identical rates applied. There is currently a great disparity in corporate tax rates between the states, and it should be expected that such a disparity would continue to exist even if all the states went to a VAT system. For example, using the year 2000 as a base, California would have to impose a SBT at a rate about twenty percent higher than the Michigan SBT to duplicate the revenue it currently receives from corporate taxes. In part, Michigan justified its "single business tax" on the basis that it replaced a number of taxes to which Michigan corporations were subjected. In California, corporations are not subject to the other taxes replaced by the Michigan SBT, and therefore it would only replace the Corporation Tax.

Finally, claims of tax neutrality are difficult to reconcile with changes in the apportionment formula to more heavily weight the sales factor. The consequence of increasing the weight of the sales factor in the apportionment formula is to assess a greater portion of the tax on those corporations that manufacture out of state and sell in state than those which manufacture in state to sell out of state. One of the claims of VAT proponents is that there is a matching of taxes to those who make claims on government services. Increasing the reflection of sales in the apportionment process moves away from this matching to the extent it is believed that government services are used mainly by those with facilities or employees in the state.

Base Broadening and Low Rate

Another attribute of the SBT is that it applies to all types of business activity. The same can be said with respect to a corporate tax based upon income. If, however, the comparison is made to the sales tax (to which a VAT is in many respects similar), the base is much broader in that it encompasses services as well as tangible products. Because the base is much broader, the tax can be assessed at a much lower rate and produce the same amount of revenue. The low rate is an attribute that makes a VAT politically attractive.

OTHER CALIFORNIA ISSUES

1. California uses combined reporting, either worldwide or elective water's-edge. Michigan does not. Use of combined reporting results in an increased base because a taxpayer would not be able to restrict its base through the use of corporate entities. Adoption of the Michigan model without combined reporting would provided significant incentives for corporate tax planning by reducing the payroll that is assigned to the corporate entity that is taxable in the state.

2. The concept of business/nonbusiness income does not appear to be addressed under the Michigan SBT. Because this is a question that arises due to the United States Constitutional limitations on the states' ability to tax, it will have to be addressed in California.

3. There are a number of transitional issues that might arise, but Michigan's experience is likely to be useful in resolving these, and there is no reason to think that they would be insurmountable.

4. Because the SBT applies to all business activities without regard to the form in which they are conducted, issues would arise as to how it would be integrated with the Personal Income Tax.

July 18, 2003

In attendance:
Commissioners: Bill Rosendahl, Sean Burton, Marilyn Brewer, Bill Dombrowski, Scott Peters, William Weintraub
Ex-officios: Marcy Jo Mandel, Steve Kamp, Bob Affleck
Staff: Marshall Graves, Eric Weisenthal, Doug Brown, Amy Hair

Bill Rosendahl welcomed the group to the meeting.

Annette Nellen:
Spoke regarding scoring the current California Tax System, SALES TAX. *Burton:* requested specific info on how California's tax rate compares with other states. *Rosendahl:* asked regarding who pays to collect sales tax. Retailers are penalized if they do not collect sales tax? *Rosendahl:* asked regarding services that are taxed. Are there certain services which are taxed more? Minnesota ones that are very simple, everyday services. Each one has different issues for itself. People use different services and what if someone with a higher income uses many services that are not taxable. Are they paying enough in taxes? Some states are expanding their list of taxable services. The complication is where should the exemption be? There are also definition issues. What qualifies as entertainment, etc.? *Brewer:* wouldn't it serve California if there was enforcement of the laws already on the books instead of adding more taxes? It is a record keeping burden for people. You would have to keep of taxes on books bought on Amazon.com and tax you already were charged at Borders. They would just have to keep track. We do include booklets now with taxes to keep track of taxes but most people do read them or use them. It's a tough question and compliance rate is really low. *Burton:* What is the value of the tax if people do not comply? If you got rid of the use tax and kept the sales tax, you would effect how business operate because they can change to places by Amazon.com and don't collect sales tax. *Mandel:* there is legislation to deal with the differences and statue of limitations so that people who are paying their taxes are not late on paying their sales tax. *Dombrowski:* online sales, what has been happening with the sales? *Mandel:* Federal law requires sellers to report who their selling to and the BOE has an enforcement tool and has sent out notices of tax to those who have bought things on line, such as cigarettes. *Kamp:* the best enforcement is the Federal Jenkins Act. *Mandel:* mentioned that Glen Rossman would like us to score the taxes that are in use today. *Nellen:* For Appropriate Government Revenue, gave a + for the state and a – for the system. PROPERTY TAX: *Rosendahl:* What would be your suggestion of how this should be dealt with in a strictly fairness view? *Dombrowski:* Not aware of any significant portion of the business community that any of them want policies to be different. *Rosendahl:* It would drive business out of the state as well. *Dombrowski:* How can you predict that you are going to have profitable business in this state. Peters: State government needs to recognize that we do not have enough money to have so many agencies. We need to look at cutting back on government entities and saving money?

Dr. Laffer:

Flat tax: Very low tax on a very broad area. Remove all sin taxes from the tax collection because they have a different purpose other than bringing revenue. All interest income should be taxable and all interest expenditures should be deductible. All charitable donations should be tax deductible. Rent for a primary residence should be tax deductible. Eliminate all state income, gas tax, payroll tax, capital gains, property tax & sales tax. Should be made a constitutional amendment. We need a steady stable source of revenue. *Peters:* Why would you have an expensing provision? Because you deduct purchases from all other taxing companies. Would you need to include population growth in the flat tax? No, because the income flat tax would follow population growth. *Weintraub:* Deductibility, does it matter if they are purchasing from out of state? We would tax it and the purchases that come from other states. What is the rational for allowing or not allowing deductibility on medical expenses? Medical expenses are benefits to the person. Deductibility of rent, do owners get deductibles if they paid for the house in cash w/o interest? You would pay for your home from pretax dollars. What is the major problem to transition? The special interest groups that are in existence because of taxes.

Laffer & Spilberg Debate:
Marilyn Brewer: (to Dr. Laffer) If it's such a hot idea why haven't we done it yet? We have been evolving in tax thinking for a long time. In the past we would have thought wouldn't work. Now we know more. How can we get this implemented? Have it put on the ballot! *Kamp:* Personal exemption are not in there and if you leave them out the flat tax rate will creep its way up. *Laffer:* With deductions you will have the tax system you have today. I'm trying to do this revenue neutral. Trying to keep the taxes from having peaks and valleys. *Burton:* Are poor people going to have to pay more. Yes, because they will have an income. Is there evidence that this has happened. 1993 tax cuts with Clinton, 1997 capital gains cuts. Pete Wilson vs. Jerry Brown's governorships. *Dr. Spilberg:* there is very little evidence that if you lower the tax rate, people will work more hours. There is no large differential of the unemployment rates in the state's who are doing this. Lower tax and saying that people will make more income and unemployment will increase. Is a leap of faith! *Brewer:* People will end up with more disposable income because they will not be paying taxes on anything else! *Dr. Spilberg:* We need to do more research on this. *Dr. Laffer:* We need to do something now to change the current state that California is in.

Drake & Miller Debate:
Miller: There are going to be winners and losers and as far as reforms go you need have people think there are more winners than losers. *Drake:* In Michigan the Governor but a plan out there and there were lots of public meetings to try and figure out if it work. Maybe you can get people to buy into the over all benefits even if everyone isn't a winner.

Meeting Adjourned 3:45 p.m.

California Commission on Tax Policy in the New Economy

Beverly Hills City Council Chambers

July 18, 2003

Chairman's Notes

Announcements:

- Welcome to 13th meeting of Tax Commission, 7th this year

- Webcasting this meeting

    - Go to www.beverlyhills.org
    - Click on link to Webcasting

- Options for Revising the California Tax System: released June 15, 2003

- Redesigned website

    - User friendly
    - Desire feedback

- Schedule of Events (attached)

    - Also on website
    - Outreach to stakeholders and constituency groups

Today's agenda (attached);

- Annette Nellen (Joint Venture: Silicon Valley Network)

- Dr. Arthur Laffer

- Dr. Phil Spilberg

- Doug Drake – from Michigan

- Ben Miller

Slide 1

A California Perspective on a Flat Tax System

Phil Spilberg
Director, Economic and Statistical Research Bureau
California Franchise Tax Board

Slide 2

In my discussion I will argue that Dr. Laffer's flat tax proposal:

- ✓ Would need to overcome certain conceptual and perception problems.
- ✓ Would need substantially higher tax rates.
- ✓ May prove difficult to administer.
- ✓ Would create many winners and losers.
- ✓ Would impose substantial transition costs.
- ✓ Would further reduce the link between taxpayers and consumers of public goods.
- ✓ I will close with a few general remarks.

Slide 3

The tax system proposed by Dr. Laffer consists of an income tax and a consumption tax. In a fully closed system – if California would not allow anything or anybody in or out – the consumption tax would raise the same revenue as a sales tax on final products.

But in economic terms, consumption is income less savings. And the first thing that this tax system would need to overcome is the perception that income is being taxed twice.

Slide 4

Example 1: Doctor who under current law files as a sole proprietorship:

Income	$100,000
Expenses	$ 40,000
Net	$ 60,000

Under current law income is passed through to PIT return

Under proposal:

$60,000 is subject to tax under PIT and again under VAT

Slide 5

PIT Tax Rate Would Likely Need to be Higher

- Prorated amount is $58 billion
- 5.97% tax rate:
  - Does not reflect the rental cost deduction, and assumes:
    - No standard deduction
    - No exemptions
    - Taxation of fringe benefits, such as health insurance
    - Taxation of pension contributions and income, such as 401k plans and defined benefit plans
    - Taxation of US Treasury Bonds and Notes

Slide 6

Personal Income		1099.4
Plus Capital Gains		118.0
Less Charitable Contributions		-19.4
Less Mortgage Interest Payments		-54.3
Less Transfer Payments		-123.7
Less Imputed Income		-48.5
Equals PIT Tax Base	$	971.5
Alternative Approach:		
CA Adjusted Gross Income	$	829.5
Plus Capital Gains		0
Less Charitable Contributions		-19.4
Less Mortgage Interest Payments		-54.3
Less Transfer Payments		0
Less Imputed Income		0
Equals Tax Base for PIT		755.8
Difference		
Dollars		-215.7
Percent		-29%

Slide 7

Value added Taxes

- Origin Base
- Destination Base

Slide 8

Doctor who under current law files as a sole proprietorship:

Income	$ 100,000
Expenses	
Wages	$ (80,000)
Other	$ (40,000)
Net	$ (20,000)

Under proposal:

$(20,000) is passed through to PIT

$60,000 is subject to tax under VAT

Slide 9

No state has adopted a destination base VA tax.

In concept it is simple:

You start with the value of goods and services sold in CA and subtract out the value of inputs acquired in other states.

But it turns out that it is very difficult and highly contentious to calculate the value of inputs because many are acquired from commonly owned corporations.

Slide 10

Value Added Tax Rate Would Likely Need to be Higher

Value Added Includes:

- ✓ Government
- ✓ Charitable Organizations
- ✓ Owner Occupied Housing

Slide 11

How Much Higher?

- ✓ Prorated revenue amount is $61 billion;
- ✓ To raise $61 billion, the tax rate for Armey's flat tax for tax year 2000 would have needed to be about 13%;
- ✓ The tax rate for Dr Laffer's flat-tax would be somewhat lower

Slide 12

Winners & Losers

Incidence (where does the tax stick)

- ✓ Likely Losers:
  - ✓ Businesses,
  - ✓ Low Income Taxpayers
- ✓ Likely Winners:
  - ✓ Property Owners
  - ✓ High Income Taxpayers

Slide 13

Transition is Hell

- ✓ New technical and administrative systems would need to be developed for the new tax system;
- ✓ During the transition period both the old and the new tax systems would need to be administered, which will drive up costs;
- ✓ Revenues could substantially deviate from estimates;
- ✓ There would be economic disruptions, which are costly in and of themselves.

Slide 14

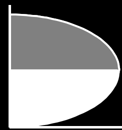
Loss of Local Control

- ✓ Except for user fees, local governments would loose their own revenue sources;
- ✓ A logical extension of Dr Laffers tax system is a federal flat tax with revenue sharing to states;
- ✓ Economic theory suggests that there is a loss in efficiency when the link between the taxpayer and and the public goods he receives is loosened;

Slide 15

Closing Remarks

- ✓ I agree with Dr Laffer that our tax base should be broadened and tax rates reduced;
- ✓ I would not, however, throw out the baby with the bathwater;
- ✓ I would look at each tax to see how that could be done:
  - ✓ User fees
  - ✓ Property tax
  - ✓ Sales tax
  - ✓ Income taxes



LAFFER
ASSOCIATES

10-yr T-Note: 3.88% | DJIA: 8,306.35 | NASDAQ: 1,434.54 | S&P 500: 898.81 | S&P 500 Undervalued:

For too long we have allowed California's tax codes to wreak havoc on our state's finances. During good times revenues have poured in and they've been spent, often on frivolities. Then come the bad times and revenue shortfalls which lead to cuts in essential services, enormously inefficient disruptions in long-term projects, and tax increases that only exacerbate the crises. These crises, which last upwards of four or five years and are exceptionally deep in California, are the direct result of California having the single worst tax system in the U.S. The time has come to consider a flat rate tax on personal income and business value added in California.

My favorite chart on California, which illustrates the state's fiscal malaise to a tee, relates general fund revenue actually collected to the revenue forecasts made by the governor and the department of finance each year (Figure 1). The revenue forecasts plotted here are the six-month (current year) and 18-month (budget year) forecasts taken from each year's January "Governor's Budget Summary" proposal. In addition, I have also plotted these same forecasts once they are revised in the governor's annual May "budget revise."

It's shocking how far off the forecasts can be from what actually occurs. With revenue estimates this far off the mark and off in the same direction for so long, it is no wonder that California's legislature and governor can't govern rationally. Unfortunately, they're only human like the rest of us.

It is this volatility more than anything else that is the root cause of our current fiscal crisis. I expect to see a continuation of this pattern in the "May Revise" to be presented on May 14 when Gov. Davis' January general fund revenue forecasts of $73.1 billion for FY2003 and $69.2 billion for FY2004 are updated to meet the harsh economic realities of today's California's economy.

California's Tax Structure

> *California is, in our view, on the brink of a serious slowdown. The consequences will be falling real estate prices, rising unemployment, a round of failures of financial institutions and a serious budget crisis for state and local governments. The time is now to rethink the entire structure of state and local taxes. The long-term prosperity of California hangs in the balance.*

The passage above is taken from a paper I wrote back in 1990 called "A Proposal For a California Complete Flat Tax."[1] My dire outlook for California at the time, reflected in this passage, couldn't have been more prescient in terms of the negative economic effects the state would suffer over the following five or so years.[2] Yet the opportunity to reform California's tax system came and went unheeded, and the state has once again reached fiscal crisis.

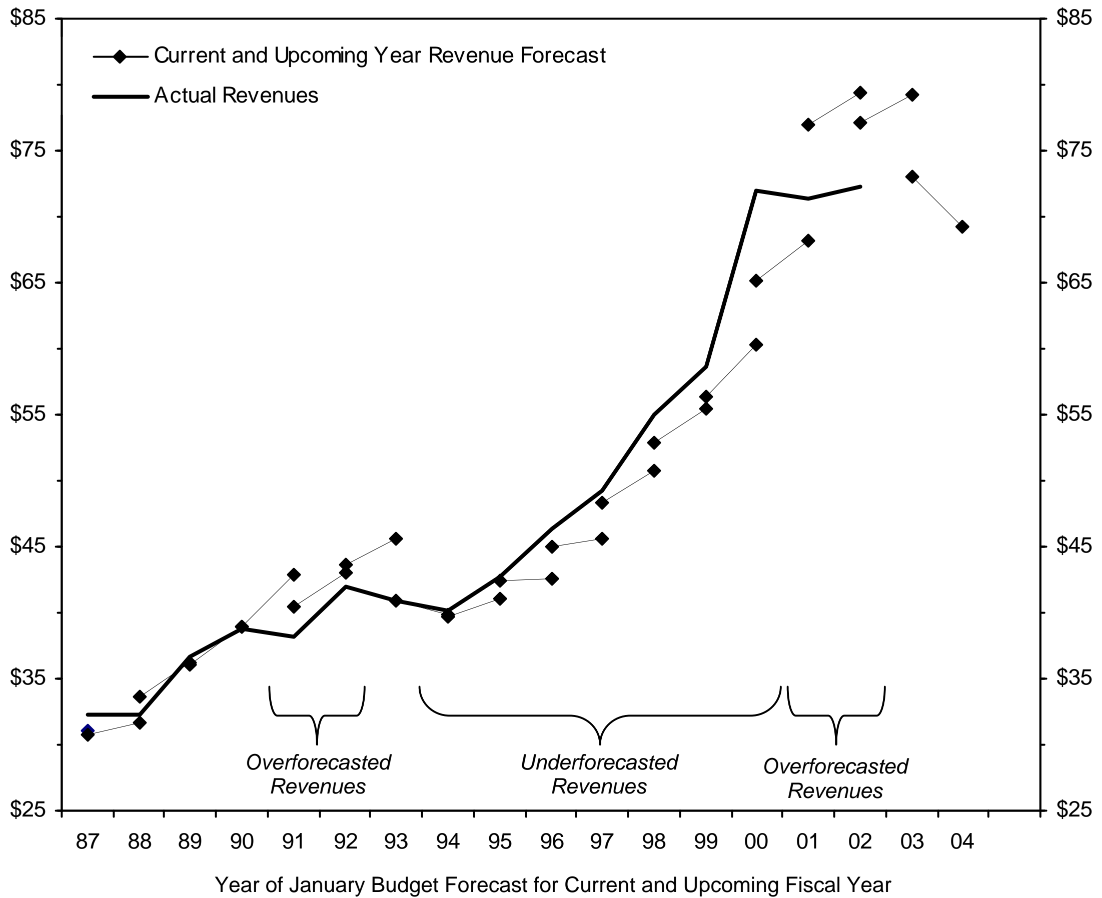
Today, California's tax structure is characterized by top marginal tax rates among the highest in the nation in most every tax category, and these rates are applied to a small tax base. The state relies heavily on the volatile revenue stream from its highly progressive personal income tax—in FY2001 income taxes collected solely from exercised stock options and realized capital gains accounted for 24% of all state general fund revenues. Overall, California state and local governments rely on the personal income tax for 33% of their total tax revenue, while this figure is 23% for the other 49 states combined (Table 1).

California fails miserably in reaching the ideal of having the lowest possible tax rates on the largest possible tax base. Gov. Davis' recent budget proposal is highlighted by the creation of two new marginal personal income tax brackets topping out at 11% (which would be the highest in the nation), a one percentage point increase in the state sales tax rate and a more than doubling of the cigarette excise tax. This proposal would only serve to make California's problems worse.

Figure 1

California General Fund Revenue (Plus Transfers): Forecast vs. Actual

(in $billions)



	Revenue Estimates as of					Actual
	Jan-01	May-01	Jan-02	May-02	Jan-03	
00-01 Revenues	$76.9	$78.0				$71.4
01-02 Revenues	$79.4	$74.8	$77.1	$73.8		$72.2
02-03 Revenues			$79.3	$78.6	$73.1	??
03-04 Revenues					$69.2	??

Table 1

California State and Local Government Taxes By Major Type, FY2000

	(in $millions)	(% of Total)
Personal Income Tax	$39,575	33.0%
Sales Taxes (General)	$30,440	25.4%
Property Taxes	$26,235	21.9%
Other Taxes	$10,875	9.1%
Corporate Income Tax	$6,639	5.5%
Motor Fuels & Vehicle License Taxes	$4,805	4.0%
Sin Taxes*	$1,499	1.2%
Total Taxes	$120,068	100.0%

*includes tax revenue from alcoholic beverages and tobacco products.

Source: "State and Local Government Finances in 1999-2000," U.S. Census Bureau

The California Flat Rate Tax

The notion of a California flat tax is an economic proposal just as promising today as it was when I presented it back in 1990. What is needed is a complete overhaul of California's tax system—not higher tax rates. Raising taxes, especially during trying economic conditions, makes no sense. Putting a company out of business helps no one because not only is the company worse off, the state doesn't even get to collect taxes from it. It's a lose/lose situation. Encouraging a person or business to move to another state through higher taxation is a squandering of opportunity. Yet now, once again, California is proposing ever-higher taxes on already-suffering residents and businesses.

It makes no sense putting California's fiscal house in order by putting California's citizens' houses in the red. The citizens are, in fact, the reason why state government exists.

Excessive taxation is detrimental to labor and capital, poor and rich, men and women, and old and young. Excessive taxation is an equal opportunity tormentor. In the short run, higher taxes on labor or capital lower after-tax earnings. In the longer run, mobile factors "vote with their feet" and leave the state, leaving immobile factors (such as low wage workers and land and property) to suffer the tax burden. I have produced decades of research demonstrating that states where taxes are high and/or increasing relative to the national norm experience relative income and population declines, rising relative unemployment and declines in housing values.[3]

The mode of taxation is as important as the amount of taxation, as noted by 19th century American (also a Californian) Economist Henry George:

> *The mode of taxation is, in fact, quite as important as the amount. As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be impoverished and their power of producing wealth destroyed by taxation, which, if levied in any other way, could be borne with ease.*[4]

While the world is dynamic and many of its ups and downs are outside the control of state government, there are a number of criteria for judging the efficacy of a state's tax system. These were summarized well by Henry George:

> *The best tax by which public revenues can be raised is evidently that which will closest conform to the following conditions:*
>
> *1. That it bear as lightly as possible upon production—so as least to check the increase of the general fund from which taxes must be paid and the community maintained.*
>
> *2. That it be easily and cheaply collected, and fall as directly as may be upon the ultimate payers—so as to take from the people as little as possible in addition to what it yields the government.*
>
> *3. That it be certain—so as to give the least opportunity for tyranny or corruption on the part of officials, and the least temptation to lawbreaking and evasion on the part of the taxpayers.*
>
> *4. That it bear equally—so as to give no citizen an advantage or put any at a disadvantage, as compared with others.*

I propose here a true economic flat rate tax that would replace the various state and local taxes currently in effect here in California. Many of these current taxes raise little revenue relative to their economic cost in terms of incentives, record keeping and collection. This flat tax would eliminate much of the inefficiency from California's tax system by both broadening the tax base and significantly lowering the highest marginal tax rates. By having the largest possible tax base combined with the lowest possible tax rate, people are provided the least opportunity to avoid paying taxes and the lowest incentive to do so. Reduced incentives to avoid or evade taxes results in a reduction in the associated costs of monitoring these activities. In addition, lower tax rates go hand in hand with greater incentives to work and produce. To summarize the strengths of this proposal:

- Fairness: Everyone will pay taxes (all taxes) at the same rate. (Modest income earners will have their taxes reduced considerably.)

- Simplicity: The straightforward calculation of the tax base and the application of a single tax rate simplifies the entire tax system.

- Transparency: By having only one source of revenue with a single tax rate, everyone will know exactly what taxes are in effect. There will be no hidden taxes whatsoever.
- Completeness: By eliminating all other state and local taxes and replacing them with the single flat rate on the broadened tax base, revenues will be assured for the appropriate level of all state and local government spending.

- Efficiency: The reduction of marginal tax rates coupled with the broadening of the tax base will minimize many of the distortions that make the current tax system counterproductive. The economy would undergo substantial expansion, resulting in an increase in revenues for the state and local governments.

- Stability: From the day the flat tax is enacted and beyond, state and local governments would not only get more revenues, but the revenue stream would be stable from year to year.

Theory Put Into Practice

A flat-rate tax applies a single tax rate equally to all sources of income, and that rate does not change as a result of the taxpayer's volume of income. All other taxes should be repealed. In their place would be two flat rate taxes of equal rates on personal unadjusted gross income and on business value added. There should be one and only one tax for people and businesses to pay.

Despite the seemingly uncomplicated nature of the theory behind the flat tax, practical application requires some unavoidable complications.

For example, mortgage interest rates have to remain deductible as long as interest income is taxable. If someone borrows $100,000 at 7% and lends $100,000 at 7%, clearly that person should not be liable for taxation. That person is simply a conduit for a loan. And yet if a person borrows $100,000 at 7% and lends $100,000 at 10%, then that person should be liable for taxation on the difference. All interest income should be taxable and all interest expense should be deductible. To avoid fraud and manipulation, for individuals interest deductions should be limited to mortgage interest.

Homeowners effectively rent from themselves with pre-tax dollars. Renters, on the other hand, pay their rent in after-tax dollars. Therefore, to be kept on an even footing with homeowners, renters should be allowed to deduct rent on their primary residence from their overall tax base. No longer would there be an economic distortion between home ownership and renters. Allowances should also be made for personal charitable contributions.

"Sin taxes," such as excise taxes on cigarettes and alcohol, exist not so much to raise revenue as to discourage certain behaviors. These "sin taxes" would need to remain in place along with fines, penalties, etc.

Table 2
Estimated California Personal Income Tax Base, 2000
(in $billions)

Personal Income	$1,099.4
Plus Capital Gains	118.0
Less Charitable Contributions	(19.4)
Less Mortgage Interest Payments	(54.3)
Less Transfer Payments (Tax Exempt)	(123.7) *
Less Imputed Income	(48.5) *
Equals Tax Base for Personal Income	$971.4

*Estimate based on ratio (CA/U.S.) of personal income times U.S. total
Source: U.S. Department of Commerce, NIPA tables; "SOI Bulletin," IRS, Fall 2002; California Franchise Tax Board Annual Report

For business value added there shouldn't be any specific deductions other than all purchases from other companies. One unusual feature of business value added under the flat tax is that all purchases from other companies—including capital equipment—would be expensed when purchased. This has the effect of leaving a lot of un-depreciated capital on the books of firms. Therefore, during a transition period this proposal would allow businesses to continue their depreciation over time, leaving the tax rate a little higher than it otherwise would be.

Table 3
Estimated California Business Value Added Tax Base, 2000
(in $billions)

Gross Product	$1,344.6
Less Business Investment	
Fixed Non-Residential	(171.2) *
Business-Fixed Residential	(14.8) *
Depreciation	(137.7) *
Less Business Transfers	(5.9) *
Equals Tax Base for Business Value Added	$1,015.0

*Estimate based on ratio (CA/U.S.) of gross product times U.S. total
Source: U.S. Department of Commerce, NIPA tables.

Starting with personal income and gross product as the base measures for the personal income tax base and business value added tax base, respectively, the appropriate adjustments are made as discussed above to arrive at approximations for both tax bases (Tables 2 and 3).
The appropriate flat tax rate is obtained by dividing targeted revenues by the total tax base. My previous analysis for FY1987 suggested that the business value-added tax base was a little larger than the personal income tax base (Table 4). My calculations therefore resulted in a recommended flat tax rate of slightly less than 6% on both the business value-added tax base and the personal income tax base.

Without going into the level of detail of my previous paper, I have updated these calculations through FY2000 using the most current state and local data available. To raise the targeted level of state and local revenue, the required flat tax rate on the personal income tax base and the business value added tax base has ranged between 5.81% and 6%. Therefore, a 6% flat tax rate would be more than enough to achieve the necessary state and local tax revenues.

Table 4
California Flat Tax Calculations, 1987 and 1998-2000
(in $billions)

	1987	1998	1999	2000
Personal Income Tax Base	408.3	777.1	862.3	971.4
Business Value Added Tax Base	480.6	852.7	925.0	1015.0
Total Tax Base	888.9	1629.8	1787.3	1986.5
Targeted State and Local Tax Revenue*	52.4	97.8	103.8	118.6
Flat Tax Rate	5.90%	6.00%	5.81%	5.97%

*State and local total tax revenue minus "sin tax" revenue (alcohol and cigarette taxes).

Other practical considerations, including the allocation of revenue between state and local government, can be found in my previous analysis.[5]

My flat tax proposal is designed to minimize the disincentives induced by tax rates and yet still provide the requisite amount of revenues to provide the services we all want and need. This revenue-neutral proposal will, by definition, raise the same amount of revenue as the current system. But, in truth, California has everything to gain from its implementation. The broad-based, low rate tax minimizes distortions and maximizes efficiency gains. The state's competitive environment would increase and California's economic activity and California-based asset values would increase. Tax revenues would soon exceed the most optimistic projections. The longer this new tax system is in place, the greater will be these gains.

ENDNOTES

1. "A Proposal For a California Complete Flat Tax," Laffer Associates, October 1990. Also see "The California Flat Tax Proposal," Laffer Associates, October 20, 1995.

2. Included among a number of studies on this subject: Arthur B. Laffer and Melissa Laffer, "A Study of California's Housing Prices," Laffer Associates, November 19, 1998; Arthur B. Laffer, Mark McNary and Lance Vitanza, "California D.P. (During Pete)," Laffer Associates, June 8 1994; Arthur B. Laffer, "The Great California Tax Experiment: From Karl Marx to Adam Smith and Back Again," Laffer Associates, May 28, 1993.

3. The State Competitive Environment model focuses on this topic. The most recent research paper along these lines: Arthur B. Laffer and Jeffrey Thomson, "The 2003 Laffer State Competitive Environment," Laffer Associates, January 31, 2003.

4. Henry George, *Progress and Poverty*.

5. "A Proposal For a California Complete Flat Tax," Laffer Associates, October 1990.

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Second Flat Tax Testimony of Dr. Arthur B. Laffer Before the California Commission on Tax Policy

California's fiscal crisis is the consequence of a hodge-podge of taxes. We have a projected general fund deficit in the state of $38 billion. Bill Safire used to refer to these numbers as "*MEGO*" numbers, which stood for My Eyes Glaze Over. When it comes to the discussion as to what we do to try to bring the budget back into balance, a lot of proposals include raising existing taxes. I can assure you, given the state of California today, you really don't want to raise taxes. That is not the right answer. It makes no sense to raise taxes on the last three guys working here in the state. It doesn't make their lives any better, it doesn't make anyone better. It makes no sense to raise taxes on a business that is already having a lot of difficulty. That business is having a hard time making it through, and higher taxes just push that business out. It is these businesses that create employment.

People and businesses vote with their feet—it is intuitive. Suppose you have two locations, A and B. If you raise taxes in B and you lower them in A, producers and manufacturers are going to move from B to A. We found that out in California in the early to mid-1990s when Governor Wilson raised taxes dramatically in the state. An economic super nova. We lost population to our neighboring states and we were sending out solar systems of economics to neighboring states. It was terrible! It didn't work. The revenues never came.

On another level, putting the state's fiscal house in order by putting all of the citizens' fiscal houses out of order also makes no sense whatsoever. The taxes this state would collect would come from the very people the state governs. Frankly it makes no sense to make the citizens go bankrupt by making the state solvent. You've got to remember it is double entry bookkeeping. For every dollar the state collects, there is someone who loses that dollar who has a budget just like everyone else. So, you've got a situation here where you either lose people (they go out of jobs, they leave the state) or you put one fiscal system out of order by trying to put the state's fiscal situation in order.

The real problem that has occurred in this state is that we have a tax code that has been creating highly volatile revenue streams. And unfortunately in politics, when you have huge surpluses, it is very hard for politicians not to want to spend that money and do what they think is right at the time. It's neither Republican nor Democrat—it's political. Yet a couple of years later when the shortfall comes, they don't have the reserves that are sufficient to really match it, and we are in a classic case today. It was very similar in the early 1990s. We had a very similar situation back then and we now have one where all the huge surpluses of fiscal years 1998, 1999, 2000 and 2001 were all spent and no one specifically is to blame—honesty, it's a political problem—all those monies were spent and now we have had a crash in revenues. What is amazing to me is that in fiscal year 2001, 24% of the revenues of the state of California in the general fund came from taxes on realized capital gains and exercised stock options. Not just capital gains, not just stock options, but actual exercised stock options and realized capital gains. A huge, huge number. Obviously we had lots of excess revenues then in regards to income taxes, sales taxes, and all the others, because the state did really, really well. And then we had the high-tech bubble burst and, of course, asset values fell dramatically and that major source of revenue disappeared as did the other revenues.

Now, in fiscal year 2002, what we did was we tried to save every which way we possibly could. We did accounting changes; we took care of rainy day funds. We did all that and we ended 2002 with a cumulative deficit of about, I don't know, $10 or $11 billion. And coming into this year, we know the revenue numbers are going to be down for a long, long time, we have a cumulative deficit of something like $38 billion, and that's on general fund spending of maybe $78 billion dollars.

Now, the interesting thing is that it isn't just the state that has fiscal difficulties, as you probably know. It is the cities, the counties, and the local districts in our state have huge fiscal problems as well. I mean one of the major potential state solutions is to stop subventions. To stop sharing spending is like a poor guy stealing from an even poorer guy—it's a catastrophic situation.

What I would like to talk to you about today, if it makes sense, is how we solve the problem generically; not how we cure today's number. I am going to also go through an example with you of what would have happened had we done what I propose today in 1995 or in the year 2000.

A Flat Rate Tax For California

My proposal is a flat tax here in California—a low rate flat tax. If you think about incentive economics, and let me if I can try you on this and see if it makes sense, there are two types of incentives in this world. There are positive incentives and there are negative incentives. By way of illustration: If you beat a dog, you know where the dog won't be—it won't be where you gave it the beating; but you have no idea where the dog will be. It is going to run, but you can't tell which direction it is going to run. Negative incentives tell you what not to do. On the other hand, with positive incentives, if you feed a dog you know exactly where the dog will be—it is going to be right where you gave it the hamburger. If you want to attract people to do something, you want to use positive incentives. If you want to repel them from doing something, you want to use negative incentives. It is the classic behavioral field forever and ever. Positive and negative, pleasure, pain; whatever you want to call it. Taxes are like beating the dog. You know exactly what people will not do. They will not report taxable income. But you don't know how they won't report the taxable income. They'll use evasion, avoidance. They'll use the underground economy, the will use tax loopholes and they might even go out of work and become unemployed or they might get up and move to a neighboring state. They will do all they can to avoid reporting taxable income. People don't like taxes. So the whole theory behind a flat tax is what you want to have, very simply, is the lowest possible tax rate on the broadest possible tax base. So you provide people with the least incentives to evade, avoid, and otherwise not report taxable income and symmetrically you give them the fewest places to which they can escape to avoid the tax. So you have a low rate, broad base flat tax.

Now, my proposal here for California, you will recognize, is very similar to the federal proposal by our former governor, Jerry Brown, when he ran for office in 1992. I had written that with him. The flat tax he had was a 13% flat tax. You'll notice that it's very similar. What it tries to do is solve the problems that we find ourselves in today. And those problems are simply very highly volatile revenues and coming up with crashing terrible problems at just the time you don't want them. The last time you want to have an overall shortfall of revenues is when you are having a bad time in the economy; that is exactly the time when you want the monies necessary to do the programs that are so terribly important for our citizens here in the state of California.

So what I am proposing is a revenue neutral flat tax. What I would do is have two bases of that flat tax. I would have one called personal unadjusted gross income, and I will go through a couple of the deductions with you, and the other one I would have is business value added. Now, for those of you who know your macroeconomics, it is really double counting, there are two sides. All accounting systems have a debit and a credit. You report income when you have expenditures and you report income when you receive income. All money that is spent is all money that is earned in income. So it is two sides. The business value added is the spending side and personal income is the income side of the equation. So what I am going to do here is I am going to tax income twice, but at half the rate. So I provide the least incentive to evade, avoid, or otherwise not report taxable income and I give you the broadest possible tax base.

A Brief Comment on Sin Taxes

Now the first thing I want to talk about the flat tax is that there are some taxes, while they do give you revenue, they were not put into effect primarily to raise revenue. These are called sin taxes: alcohol, tobacco, firearms, speeding tickets, fines by judges. All of these are there not so much to raise revenues as they are to discourage certain behavior. The reason you have a speeding ticket is to discourage people from speeding. It's not supposed to be as a major revenue source for government. So the first thing I would like to do is exclude all sin taxes from the tax base. I would like to remove them because the primary purpose of those sin taxes is to discourage behavior, not to raise revenue. They have as a side consequence raising revenues, so the first thing I would like to do is remove all sin taxes from the tax collections I'm talking about because they have a different purpose other then to raise revenues.

Two Flat Rate Taxes

I would like to go to two flat rate taxes: one a flat rate tax on personal unadjusted gross income and the other one a flat rate tax on business value added. Now on the business value added, what a corporation or a business would do, is they would report the revenues during the period, and then subtract the purchases they have from other tax paying businesses, and that's it. They don't report labor, they don't report returns on capital, and they don't report anything else. They take the revenues from products they sell, and subtract all purchases from other tax paying businesses. That differential is what we call business value added, on which they would pay a low flat rate tax. What they would be able to do in that flat rate tax, is they would be able to expense capital purchases 100% in the year of purchase. So in other words if you are a business person and you buy a piece of capital equipment, that capital equipment is 100% deductible in the year of purchase. There is no other depreciation schedule, none of that, it is a very simple, straightforward tax proposal on business.

On the individual side, what you would take is take your personal income, boom, and you take a single flat tax across the board on the first dollar you make and on the last dollar you make across the board.

Just A Few Deductions Allowed

I do have some deductions here, and I am going to try and explain the deductions to you and I hope they make sense. Some of the supposed flat tax proposals by people like Steve Forbes and Dick Army and some of these others are really not flat taxes. They have deductions, individual exemptions and exclusions…I don't think that really makes sense. I mean, you tell me. I may have missed this in Econ 1 when I was taking the class long ago, but I don't understand the benefit of a tax deduction to someone who has no income. To me, tax deductions help the more affluent of the poor, not the poorest of the poor. And therefore when you look at people with no income whatsoever, tax deductions do not help them. What tax deductions do is they cause a huge deadweight revenue loss across all individuals who get those tax deductions. And then what you have to do is make it up with much higher rates later on. If you want a truly flat tax you have got to have one rate on all income from dollar one to the last dollar you earn…period. It can't be like some of those politicians…I remember there was one in Washington, he proposed a flat tax, very proud of it, and he was so pleased because his flat tax had five different rates.

If you look at the flat tax you do not have many deductions, period, across the board. You pay the flat rate on all dollars earned. You do have a few deductions, however. Interest payments by individuals should be tax deductible. I will try to explain this and hope it makes sense to you this way. Let me give you two examples. Imagine that you have a person who borrows $100,000 at 10% and lends $100,000 at 10%. Has that person done anything of any economic consequence? No, absolutely not. That person has merely been is a conduit for a loan. And if you look at that person, should that person pay taxes on that transaction? The answer is no, they should not. What you have just told me by answering that question is that either interest income should not be taxable, or if interest income is taxable, interest expense must be deductible. One of those two must be true, to have that person not pay taxes. Let me give you the second example which will tell you which one is right. If I borrow $100,000 at 10% and I lend $100,000 at 20%, should I be liable for taxation? Yes, of course I should be. I am a financial intermediary, I am a bank, I'm insurance company, I'm a savings and loan, I am a mutual savings bank. Of course I should be liable for taxation. What I do is I borrow money and I lend it a higher rate and I have a value added on the transaction. What you have just told me with those two examples is all interest income should be taxable and all interest expense should be deductible.

Did I tell you the purposes to which those loans were put? No, it's really not relevant. From the standpoint of pure economic theory and good practical politics and economics, all interest income in the system should be taxable and all interest expense should be deductible. So on the individual tax return, as well as on business tax returns, all interest expense should be deductible, and that should be one item in the tax code as a deduction on the individual level. By the way all interest income should be taxable so it nets out.

Number two, when you look at this you sit there and ask yourself about charitable contributions. There are some terrible contributions that clearly should not be deductible. If you send your kids to private school, and the private school says wink, wink, wink, instead of charging you tuition, how about making your contribution to the school, that contribution to the school that substitutes for the tuition you should have paid should not be deductible. But obviously there are others that should be deductible. When a person gives altruistically and has no personal benefit whatsoever, and they give charitable contributions those charitable contributions that give no benefit whatsoever to the contributor, of course those should be deductible because they don't benefit the individual at all. When you look at charitable contributions they are very hard to tell which is which and from my standpoint, what I would do is I would make all charitable contributions in this system tax deductible for the individual, even though some of them might not be 100% proper, I just think you should make all of charitable contributions tax deductible as long as it's to a fully approved charity. That's my view on this.

There is one other one that I think is really important to have as a deduction. In this world of ours, if you own a home, you have very large tax benefits, and not because you can deduct the mortgage interest. The benefit you have from own your own home is that you are able to rent that home from yourself with pre-tax dollars. If you decided you liked your neighbor's home, and your neighbor liked your home, and you guys switched homes, and you rented your neighbor's home from him, and he rented your home from you, you would have a huge tax consequence because you would have to pay the rent from your next door neighbor in after-tax dollars and your neighbor would have to pay the rent from you in after-tax dollars. There would be a huge tax consequence. If your neighbor lives in his own home and you lived in your home, however, you won't have any tax consequences. The benefit of living in your own home is that you get to rent the home from yourself with pre-tax dollars. Now, there are some people who would like to tax the imputed rental value of owner occupied homes…let me tell you I would never want to do that in a million years—the imputed rental value should not be taxed. However, there is a real discrimination in our society between homeowner—people who rent the home from themselves—and people who rent their primary residence and who do not own homes. To bring about equity and fairness in this, my view is that to bring balance to homeowners and renters, we should allow the rent on primary residences to be deductible on your tax base. So people who

rent should not pay more taxes per square foot than people who own their own homes, and therefore I would make as a deduction on the personal income tax the rent on your primary residence if you happen to be a renter.

All Other Taxes Eliminated

So those are the deductions. I would make interest expense deductible, I would make charitable contributions deductible, and I would make rent on your primary residence deductible if you're a renter. With those deductions in mind, and looking at two flat taxes and doing the calculation here...It's not just for state taxes. I would do it for all taxes in the state (except for those sin taxes I would eliminate all state personal income tax.) There would be no state income tax, period. There would be no state payroll taxes, period. There would be no state gas tax, period. There would be no state tax on capital gains, there would be no state tax on exercised stock options, and there would be no state property tax—I would get rid of all property taxes. There would be no state sales tax—I would get rid of all state sales taxes; those accruing to the state and those accruing to cities, counties, and local districts. I would eliminate all taxes, entirely in the state of California, 100%. No corporate profits tax, no personal income, there would be none of those taxes. The only ones I would keep are the sin taxes, and in their stead, I would have two flat rate taxes on the tax bases I described. Those taxes would be on personal unadjusted gross income, with the deductions I mentioned, and business value added, with those deductions I mentioned.

A Look at the Numbers

Note: These data are reviewed in detail in "A Flat Rate Tax for California State and Local Governments," Laffer Associates, 4/28/03 and in several other presentations. Please contact Laffer Associates for more information.

In fiscal year 2000, you could match the revenues, all the revenues, state, cities, counties, local districts, all of the revenues in the state of California with a flat tax rate below 6%, about 5.85% my guess. If you did it back in 1995 it would be a little bit lower, but hey, it would be approximately that level. If you put that tax through, you would eliminate all the distortions in the system. My view is that it should be put through in a constitutional amendment form. What you would get from this is that there will be no more disincentives on the margin…Could you imagine what would happen if you had a flat rate tax of 5.85%, that's it, on all your income from the state. Nothing else, no sales taxes, no gas taxes, no payroll taxes, no income taxes, no corporate taxes—just the flat tax, which is revenue neutral.

In the years 1999, the year 2000, the year 2001, when we had all of these windfall gains from capital gains and exercised stock options, when we had huge soaring revenues, and these people were like grasshoppers, they got all of this extra revenue and they spent it. You remember what we spent on the energy crisis, and I mean it's natural, I'm not criticizing these politicians, and they're humans just like the rest of us. You know if you find a pot of money you're going go out and take your friends out to dinner, and that's exactly what they did. The trouble is when that pot of money disappeared, the spending didn't, and now we find ourselves in terrible trouble.

That is why I would do the flat tax. I would have that flat tax put into place. I have prepared for you some numbers here which would show what would happen if we put that flat tax in for the year 2000—I'll just go through that with you just a little bit. I am just using the state numbers because we don't have the cities, counties and local districts, at least I don't have the aggregate numbers right now. Based upon fiscal year 2000, where the revenues are exactly the same with the flat tax as the actual revenues were, that's where I got the number 5.85% approximately. If you get those numbers, and you look at what would happen in fiscal year 2001, my proposal would have provided the state general fund budget with about $4.4 billion less than they actually received. In fiscal year 2002 it would have provided the state budget with approximately $9.5 billion more than they actually received from the current system. In fiscal year 2003 it would have provided the state general fund about $11.8 billion more than they actually received, and for fiscal year 2004, which is projected, it would have provided the revenues with about $10.3 billion higher than the May revise as reported by the governor of the state of California today.

Cumulatively, for fiscal year 2004, that would have represented additional revenues of a little bit more than $27 billion, which would come very close to handling the problem that we find ourselves currently having. If you had done that flat tax proposal in 1995, the numbers would have been lower, because the rate would have been lower, and you wouldn't have gotten all the excess spending in 1998, 1999, 2000, 2001, but you would have had the same generic type of solution. What we have to do in this state (my home state that I just adore) is provide a very stable, steady source of revenues. That way the government can plan on programs so that they don't have to cut way back on critical programs in one year and expand them squanderously the next year, which is exactly what is currently happening. We want to provide a very stable, steady revenue source that moves a little bit with personal income, but it doesn't have the huge yo-yo effect that we have from the hodge-podge of taxes that we've put into the system. This is the proposal I'd like to make.

You know there are lots of issues and problems with a proposal like this. My view is it should be set into the constitution, so you have that flat rate and we can know exactly what should be done every year. The state and local governments get a percentage of the total revenues. By the way, everything I tell you about the state government, on having more revenues going forward and having less during the boom years, would have been true in spades about cities, counties, and local districts. They are suffering terribly, as you know, in our home state here. My flat tax would have provided them with very

stable, steady revenue so we would never risk school teachers or police being fired—all of that stuff that we have right now. It would cause a much more stable situation. What I beg of you, as the commission, is to not just look at how you can solve the budget problem this week, this month, this year, but to set into place a system that will not cause us to have this same crisis every decade in huge proportion. This is exactly the crisis we had in 1992 to 1995, when Pete Wilson made enormous mistakes along with the legislature by raising taxes. If you'll remember we had these exact same problems when, my hero, Ronald Reagan was governor. I think he handled them very badly back when he was governor.

If you have a low flat rate tax, it works beautifully, and it just gets rid of the generic problem.

With that if I may I would be glad to go into discussion, or answer questions, or do whatever you want.

Question and Answer

Commissioner Scott Peters (California Commission on Tax Policy): One thing I just wanted to point out that there are a lot of people who think that the gas tax is a sin tax. You might have to have some discussion about that.

Why would you have an expensing provision? Isn't that sort of inconsistent with accounting rules? Why wouldn't you be amortizing over a useful life?

Dr. Laffer: Because you get to deduct purchases from all other tax paying entities. If you buy a machine from another company, I was just giving you the implication of that. If you buy a machine from another company that machine producing company has to report that as income, and you get to deduct it. Anything you buy from another company you get to deduct and they have to report. You can only report it once, but you have to report it once. You can't miss reporting it. Now there is a trick here, or at least a little problem here. We have not done this in the state of California, so what you have is accumulated capital which has to be depreciated. We have depreciation schedules for existing capital. What you are going to have to do is have a little bit higher rate and allow those companies to depreciate that capital over the period and set into motion the lower rate once all of the existing depreciable expenses that have not been depreciated yet have been. But that's just a transition problem, it is not a conceptual problem. You should subtract all purchases from other entities.

Commissioner Peters: Is it your contemplation that the constitutional provision that you propose would contain a numerical rate?

Dr. Laffer: Yes sir. The reason for that is real simple. You know, under Prop 13 right now, we have a two-thirds majority requirement. But, you know when you get an extremely efficient tax system, as I am describing, and one that is fair, it bears very lightly on production. It treats all people equally and fairly and all of that. It also is extremely susceptible to abuse on the rate. And so therefore what you really want to do is separate the rate from abuse, and then you get all the benefits that have come from that flat tax rate and are shared between government and individuals.

Commissioner Peters: If you instituted it today would the rate you picked be based on the revenues we have today that have created a $38 billion deficit or would you…

Dr. Laffer: I would not do that. But that's what would be done if it were based on today. If it were based on the year 2001 it would give you much higher revenues and a higher number if you did it then. If you did it in 1995, it would give you a different…what I would do is pick a rate and average it over the last four, five years to get rid of the cyclical nature of our current, very inappropriate tax system. If you net that rate…and boom, go for it.

Commissioner Peters: Do you need to have adjustments for population growth or anything like this?

Dr. Laffer: Oh, that would take care of population growth and inflation growth. By having it as a rate on personal income, personal income reflects both population and inflation growth, and so the state just gets a flat percentage of all the increase in income, so that it can meet its expanding needs because of more people and higher incomes and higher prices, just as it should. One of the problems as I remember with the Gann spending limit is that it didn't include population growth, and it should. It should include total personal income growth, nominal as well as real. So this would take care of all of that. And it would set an amount…and because personal income growth in the state really is…well it wiggles a little bit…it doesn't have big ups and downs. You would have very stable, steady, solid, good revenue sources to run programs over the long run.

Commissioner Will Weintraub (California Commission on Tax Policy): Thank you for appearing Dr. Laffer. I have a whole series of questions, and they will all relate as well. First, in terms of the deductibility for business, does it matter if a business is purchasing from out of state? Because you were referring to all purchases from tax paying entities are deductible, so what if a California business purchases from Nevada or New York? Does that have any effect on this?

Dr. Laffer: No, you should be able to deduct it, and in the same breath you should be taxed on sales you make to other states.

Commissioner Weintraub: So, a California manufacturer selling to another state is going to charge and collect the same tax.

Dr. Laffer: Yes sir. You know when it's a country tax, like the one I did with Jerry Brown, for the U.S. and some of the stuff we have done for other countries, they do consider a border tax adjustment which would be offsetting the imports and taxing the exports. You know, it really makes it confusing if you are going to try and get different state locations and what about if it is just an outlet that's here in California but the producing company…to keep it really simple, so that even I can understand it, you'll want to make the rules extremely straightforward and simple. You get to deduct all purchases from other companies and you are taxed on all sales to other companies, period, wherever they are located.

Commissioner Weintraub: Will that in anyway discourage somebody from outside of California from purchasing from a California vendor because they now have to pay, in effect, this additional 6% tax.

Dr. Laffer: You know in a static sense, of course it would, but in a dynamic sense, no it wouldn't. I don't know how to answer this in an intuitive way, but it what's called in terms of technical economics, it is called the Lerner Symmetry Theorem. But let me just put it this way: a tax on exports is exactly the same as a tax on imports. And if you did it the other way, the net effect would be exactly the same as long as you have static revenues as I have described. I don't know how to say that intuitively. But the reason you sell products to people outside of California is so that you can buy products inside California produced by other states. And whichever way you do the tax, it's going to affect the price the same. I don't think I've probably…believe me it is a technical theorem, it works, but I don't think I can explain it really simply here.

Commissioner Weintraub: OK, let me move on to a few other areas. What would be the analysis of your allowing of deductions for certain things? What's the rationale for or against allowing the deductibility of medical expenses, for an individual…you allow charitable contributions? If somebody said, "well why not allow…"

Dr. Laffer: Well, because it is a benefit to the person who is working. You know the real question on charitable deductions, and you know, you can make an argument all sorts of ways, but does the person give the money altruistically without expecting personal gain, or does the person not? If you give to your kid's prep school, you are expecting benefits, at least in part. Maybe not wholly or totally, maybe you are giving to their scholarship program or something like that, where you are not going to accrue it, but there is a benefit potentially affected. Those you can argue about all day long. When a person gives altruistically, where they are working and earning income and giving in a sense that has no personal benefit, that is what should be deductible. Most of them, I believe, are really altruistic and to be honest with you I don't know how I could make a judgment of whether each dollar you did. I would use the charitable sources as being a source and just do it. Also, I really do think that a lot of these organizations that receive charitable deductions and you know even if you get to write if off on your blue book value, how do they do that…You know those organizations do serve a very good purpose and if you make a little mistake here or there, I don't think it is going to be of any great consequence. At a 5.85% deductibility rate, for every $100 you give you save $5.85 in taxes. I don't think that is going to be the critical decision.

Commissioner Weintraub: All right, let me clarify another point. The proposed deductibility for rent…somebody paying to use housing. If I just bought my house, I own it but I also owe the bank money, do I get as a homeowner…am I going to get any deduction for paying for the purchase of my house.

Dr. Laffer: Well, not for the purchase, but you will get a deduction for the interest payment on your mortgage…

Commissioner Weintraub: Well that's if I choose to borrow, but if I simply take savings and purchase the house…

Dr. Laffer: No. But the income you that you earn from renting that house from yourself is pre-tax. In other words you don't have to pay taxes for living in your own home because you're paying yourself rent. If you're a renter, you've got to pay that rent to your landlord in after-tax dollars, so you are paying a tax on the income that then goes to pay your rent. To equilibrate between homeowners and renters, to make it fair, and you know I am not a big fan of rent controls and stuff, but I do understand why renters are basically irritated with our tax codes because they pay all their rent in after-tax dollars and homeowners don't, and they do get a bad break.

Commissioner Weintraub: Do you have any thoughts on how allowing the deductibility of rent would affect the residential market in California?

Dr. Laffer: Oh, you know I think it will make the residential market better than if you didn't do it, but you know, it is not going to be a huge material effect because a rental unit and an owner occupied unit are pretty much the same. And in this wonderful state of ours, the price of the home that is rented probably sells for about the same price as a home that is lived in by the homeowner. So the effective rate on homeowners and renters will be arbitraged pretty much.

Commissioner Weintraub: I'm curious what would be your reaction to someone that might comment and say that a flat tax is regressive in a sense that the individual who earns $50,000 will be subjected to let's say a 6% tax, but that individual probably has committed all of his or her earnings to necessary spending versus someone who makes, lets say, $1 million dollars and owes $50,000 or $60,000 of tax which is coming out of, something we might describe as discretionary spending.

Dr. Laffer: You are hitting me on a bunch of technical points, but let me just put it this way. The incidence of a tax, where you place the tax, the person who actually writes the check, is not the person who bears the burden of the tax. If you tax someone in the state of California and they move to Tennessee, like my son just did because of taxes here in the state, if you do that, my son isn't going to pay that tax. The people who are going to pay that tax are the people who no longer are employed by my son's business, etc…The incidence of a tax is totally different than the burden of a tax. If you believe that if you tax rich people, and give that money to poor people, that you are helping poor people, you've got a different view of the world than I have. Bottom line is you cannot change the distribution of income, after tax, by changing the distribution of tax rates in the system. You can't do it. What you can do is you can change the volume of income. What we have found by trying to engineer our tax codes with thousands of little provisions all over the place, and I know you had testimony earlier today on the absolute arcane complicated tax code that has arisen by everyone trying to do a little bit of good in putting it all in. By doing that what you have not been able to do is change the distribution of income. We saw lots of poor people in California. But what you have done is you've destroyed the volume of income in California, and that is what we are trying to avoid.

The best thing for poor people in California is to have good, high paying jobs. And what my proposal would do is make us an employment magnet in this country. That we would no longer lose those jobs to the Nevada's…I hope no one here is from Nevada, but you know, if you look at Nevada there is no redeeming social grace of being in Nevada except that they are a tax haven from all the neighboring states. That's what they got. Why shouldn't we make our employment situation as good as Nevada, as good as Washington state, which has no income tax, as good as Texas, which has no income tax, Tennessee, Wyoming, Florida, New Hampshire, South Dakota. I mean, we should become the employment magnet so we can provide our poor, the minorities and the disenfranchised with good opportunities for employment. That's the best way to help the poor.

Commissioner Weintraub: I follow all of the arguments that the best way to help people is to provide permanent jobs, but do you think that your explanation will be understood, that the person that makes $50,000-$60,000 is paying tax out of non-discretionary spending versus the person making a lot more is paying out of discretionary funds. Do you think that the analysis that you provided is really going to be understood by the citizens of the state?

Dr. Laffer: Well totally. I think that the tax structure in the state of California is modestly regressive at present. I mean our sales tax is not paid by the richest people, as you know. Our payroll and property taxes are not paid by the richest people, as you know. The income taxes, I mean you have to be a lawyer or accountant to be able to know how to get around those. These guys have tax shelters…I mean seriously. The rich people can afford more lawyers and accountants than poor people. They can hire more assemblymen and senators than poor people. The tax codes there really don't get them. The poor guy whose is trying to make a good living and trying to get up the ladder, he faces taxes after taxes after taxes, and never gets the ability to do that. My guess is this tax code would be less regressive than the current tax system you've got. It would be far more pro-poor…now it does have things like rent deductibility and all of that in there. But the best thing is it creates jobs for people who are unemployed, and that is what you really want to do.

Commissioner Weintraub: Ok, one last question…I won't take all the time. What would you see as the major obstacles to transition…let's say, this could be approved and, and enacted, what are the transitional problems?

Dr. Laffer: The political obstacles, of course, are all of these special interest groups that exist there with all their taxes. I mean they live off the differences in taxes. This is every assemblyman, every senator, all the lobbying groups, all, you know get a lot of power by being able to manipulate tax codes and collect contributions and that's the real political problem in the system. On the transition period you have some people who have built up their expectations on the current tax codes. There are accounting firms that fill out tax returns for people who pay up to 9.3% here in the state and other things. There will be problems too. The bottom line, I think you'll find that the political obstacles are really minor.

Commissioner Weintraub: But, the, but the practical transition, I mean if we have the existing law, say where people are paying property tax, people are collecting sales tax, money is shared among the local communities, all of a sudden January 1 we are going to say whole new system and none of those systems apply, none of those processes apply, no longer collect payroll tax, no longer charge and collect sales tax. Right away we are just going to go into a, a…

Dr. Laffer: Bang…yes. Now there will be some transition issues, how much did you owe as of February 1 or February 7 and was the impute income a da da da da, all of that stuff, you will have some of those and you'll have people trying to game the system a little bit too. But you want to make it quick. You don't want to phase it in, you want it done right away, and I think you can get rid of these transition problems pretty easily, and if you want to make it so the rates are higher for the first six

months, so you make sure you don't lose revenues to the very necessary state programs, that's OK, but then it goes right down to the proper rate.

Rebuttal of Dr. Phil Spilberg
Director, Economic and Statistical Research Bureau, California Franchise Tax Board

The franchise tax board in California administers income taxes which include the personal income tax and the bank and corporation franchise tax. My role in the department is to direct the Economic and Statistical Research Bureau, which is largely charged with examining the impact of legislation on California's revenues.

Thank you for inviting me to provide comments on Dr. Laffer's presentation. Let me just start off by saying that the presentation is an intriguing concept, but at this state it is nothing more than a concept. In my opinion, it would require a lot of additional work before it was ready for implementation. My presentation will argue that Dr. Laffer's flat tax proposal would need to overcome certain conceptual and perception problems, would need substantially higher tax rates than the almost 6% tax rate that he has calculated, may prove difficult to administer, would create many winners and losers, would impose substantial transition costs, and would further reduce the link between taxpayers and consumers of public goods. I will close with some closing comments.

The tax that is being proposed, the tax system, is really two taxes. One is on personal income and the other one is on value added. Value added, as proposed by Dr. Laffer, would have a similar tax base as the sales tax currently has. It would be different—the revenue would be different—assuming on exports and imports into California, but it largely would present the same amount of revenue as the sales tax or the same tax base as the sales tax. In economic terms, income minus savings is consumption. And one of the first problems that the tax would need to overcome is the perception that it taxes income twice. And let me give you an example.

Take a doctor that currently is filing as a sole proprietorship. He has income of $100,000 and he has expenses of $40,000. So he has net income of $60,000. Under current law, as a sole proprietorship this doctor would pass on his income to his personal income tax return and pay tax on it there. Under this proposal, the doctor would fill out a value added return on which he would report $60,000 dollars of income and then he would also file a personal income tax return where he would also report the same $60,000 of income. So, to him, it would appear as though he is paying twice on the same income: Once on the value added tax and once under the personal income tax. In fact, under this proposal, the income of pass-through entities would be taxed twice, but the income of corporations would only be taxed to the extent that the corporation pays a dividend to the shareholder. So in essence it would reverse the situation that we have right now where income for corporations gets taxed more than once but income for pass-through entities gets taxed only once.

I would argue that the tax rate would potentially be higher than Dr. Laffer has calculated. The tax rate does not reflect the rental cost deduction, which he has within his proposal. It has no standard deduction, as our current tax system has. It has no exemptions, so someone with children would pay the same amount of tax as someone without children, somebody who is blind would pay the same as somebody who isn't. It would impose a tax on fringe benefits, such as health insurance. Right now health insurance provided by your employer is not taxable income to you, under this proposal it would be. The same goes for contributions to pension plans. Right now if you make a contribution to 401k plan, that's not taxable income and the income earned in your 401k plan is not taxable income. Under this proposal that would be taxable income. And so would be contributions by your employer to defined benefit plans. This tax would also impose a tax rate on interest on federal obligations, which is something that we as a state are not allowed to do because of the U.S. constitution. Those factors will tend to increase the tax rate that would have to be charged in order to raise the same level of revenues.

The way that Dr. Laffer has calculated the tax base started with personal income as reported for economic purposes. An alternative approach would be to start with California adjusted gross income (AGI), and then deduct the same deductions that Dr. Laffer would allow, which is for mortgage interest and charitable contributions, and derive a tax base. In this calculation it shows that the tax base—under this alternative approach—would require a tax rate which is 29% higher than what Dr. Laffer would has generated with his tax base. The big difference really between those two calculations would be the amount of income that is fringe benefits (health insurance, and pension plans, basically 401Ks and 401K contributions). This does not take into account all these other factors that I have mentioned before. So just those couple of elements would generated an increase in the tax rate of about 29%.

Let me now switch to the value-added tax. The value taxes can be grouped into two groups. One would be origin based and the other one would be destination based. An origin-based tax essentially taxes value added where the value added is earned, where the value is created. The destination-based value added tax taxes value added where the product is sold. In the United States there have been several proposals of an origin-based value added tax. The most prominent one would be the one proposed by Representative Armey in 1995 in his flat tax proposal. That was an origin-based tax. There is one origin-based tax which is actually in place and that is the Michigan single business tax that will be discussed later on. In

Europe and other places, the type of value added taxes that are in place are the destination-based taxes. In other words, the value added tax is collected where the product is sold.

The origin-based value added tax is not especially popular. One indication of that is that Michigan has had its tax in place for long time and no other state has implemented a similar tax structure. One of the reasons that it is not popular is that it looks a lot like an income tax return, but it generates a tax even when the firm doesn't have any income. Here is an example using the same doctor as before. The doctor has income of $100,000, and he has a couple of employees who he pays $80,000. He has the same other expenses of $40,000, so he has net income, in that year he has lost actually $20,000. And in fact, that is, that loss would be passed through to the personal income tax return. But under the value-added tax, the expense for wages is not permitted, so therefore he would be paying…$60,000 would be tax base that he would use for the value-added tax. He would be paying a tax under the value-added tax even though he has no income, and that's been shown to be unpopular.

No state has a destination based value added tax. In concept it is actually quite simple. What you do is, as Dr. Laffer said, you subtract out the value, or the price, of all the things that you are purchasing from other states. The problem with that is that there are many purchases that come from firms that you control, that you own. That creates a transfer-pricing problem. In many instances it is difficult to establish the price of an input, something that you are purchasing from outside, that is not otherwise available on the market. And those kinds of goods are unfortunately widely sold from one firm to another. On the income tax side, we have this problem with transfer pricing for international purchases, and that happens to be one of the most complex, if not the most complex area, of tax law. So this would be something that also would have to be implemented within that system and, I can tell you, it is far from simple.

Also, the value added tax rate would likely need to be higher. Included in value added is value added in government, so basically under this system, unless you said that government agencies—state and local government agencies—would need to, in essence, file these tax returns, you would need to increase the tax rate. Charitable organizations, such as churches and other charitable organizations, also create value, and under this system they would be taxable. Also what's included in value added is the value added for owner-occupied housing. This is the rental value of housing that Dr. Laffer described. That is actually included in the value-added. If you wanted to take that out—he did not want homeowners to calculate the rental value of their home ownership—that would reduce the base requiring a larger tax rate.

How much higher would the tax rate have to be? The pro-rated revenue amount of the value added-tax is about $61 billion. We had done an analysis of the Armey flat tax when that was being presented in 1995. Based upon this analysis, in order to raise $61 billion, the Armey flat tax would have needed to have a tax rate of around 13%. That is a value added tax, that's all it is. It is similar to Dr. Laffer's flat tax, but it actually has a base a little bit lower. So if Dr. Laffer's flat tax, the value-added tax portion of that tax, would be implemented as a pure tax, basically with no deductions, no exclusions, etc, it would need a tax rate of a bit lower than 13%. But as we know things as they are implemented normally don't come out as pure as they came in.

There would be many winners and losers. As a general rule, likely losers would include businesses, especially businesses that pass through their income to the personal income tax return, which would be smaller businesses. Low income taxpayers, because under this system they would have some tax liability, under our current law don't pay any, at least income taxes, but they do pay other taxes. Likely winners would be property owners, largely because this proposal would eliminate the property tax, and high income taxpayers.

Transition would be a problem. New administration systems and techniques would have to be developed for the value-added tax and just the computer programs themselves, just the administrative systems necessary to run a tax, are very expensive to develop and actually put in place. Also, during the transition period, both tax systems, our current tax system and this new system, would actually have to be administered. If you end the personal income tax at the end of 2003, that doesn't mean you can eliminate your personal income tax administration at the beginning of 2004. You are still going to have to deal with returns filed for 2003 and then later on with compliance activity having to do with 2003 and prior years. So for a while there you going to have to be running your old system and a new system.

Revenues could substantially deviate from estimates. We are, after all, talking about a new tax, and we make the best estimates that we can but something that is totally untried can, in fact, produce results which are different than we started off with. And it would create economics disruptions because the tax system that you actually had in played before is substantially different—you have all those winners and losers. Things would adjust, the economy would adjust, but during that adjustment process there would be costs.

There would be a loss of local control because largely—well, except for user fees, which Dr. Laffer didn't speak about that much, he spoke about sin taxes—but basically this system is going to be a state system with local revenue sharing, so there will be some loss of local control for the programs which are run at a local level. Economic theory suggests that the closer the link between the people paying the tax and the people receiving the services, the more efficient that system tends to be.

Just a closing remark, I tend to agree with Dr. Laffer that it's a good thing from an economic standpoint to increase the tax base and reduce tax rates. I would, however, caution you about recommending a total overhaul of our tax system. I think that an approach which focuses on all of the taxes that we have in place and thinking about how to broaden the base in each of those situations and lower tax rates is a better approach. Thank you.

Open Forum/Further Questions and Answers

Dr. Laffer: Let me just start off by saying that your example on the sole proprietor is totally correct. They would be taxed double, as I mentioned to you, you get it when it's income and expenditure. That's what it does. You have to collect the total amount of revenue to match the state—you collect it when it is spent and when it's earned. That's what is going to happen, and that example is correct. With regard to fringe benefits paid to employees—health benefits, contributions to pension funds—of course you are going to tax that. That is part of value added that accrues to the individual who does the work and they get the benefits from it, and that is part of the tax base. It is not a tax deduction. I would grandfather U.S. treasury bonds and anything else we can grandfather in that process.

The Michigan tax is flat tax in sea of bad taxes. And what you have is you don't have a flat tax system, you have one flat tax in a whole sea of taxes, and it is just not a comparable example of what I am talking about here. Let me give you the example on businesses, when you talk about deductions and things. As it stands right now, here in this country, in this state, if you have a company "A" that squanders our precious natural resources, and it makes a lousy product that no one wants, and it has huge losses, we subsidize the bejabers out of that company. If you get another company that cherishes our precious natural resources, that makes a wonderful product that everyone wants and it makes lots of profits, we tax that company beyond belief. You know, I can understand that logic between trying to redistribute income amongst individuals, but not between losers and winners. You should tax a company based upon the use of our natural resources, not based upon whether it's a really great company that makes lots of profits because it makes great products, or whether it squanders those resources and makes a lousy product that nobody wants. It seems silly to me that you would tax a company less that squanders our natural resources than one that uses them really well. I just don't understand the logic.

I am on the board of a number of companies, several New York Stock Exchange companies. If you don't think we have transfer pricing problems now amongst the states, I don't think you…we have a lot of transfer problems. Transfer problems exist in any tax system where you don't have the right to tax companies in other states. In fact, we tried to solve that in California once upon a time with the unitary tax, where we take worldwide profits and then we take percentage of sales, percentage of employment…there is no simple way of handling transfer problems.

With owner-occupied homes, I don't think you are right on that. Owner-occupied home, the people who do that get the benefits in pre-tax dollars. The reason I made the rental deduction is because frankly, they don't get the benefit of pre-tax payments.

The flat tax rate you have is higher—I don't think you are correct. Let me just go back to the state of California, if I can, in 1999. I'll use that number because we have the entire base here. The total state and local taxes collected in 1999 was about $105 billion. The total personal income of the state of California was about $1 trillion. That comes out to about a 10% total tax, total, on total personal income. If you divide that in two, between business value added and personal unadjusted gross income, you get a number slightly around 5%. If you take the deductions out, which you should, it raises that rate a little bit, and our number came out to about 5.85% to 6.00%, which is right in the right ballpark. That is exactly the type of number you're talking about. Depending on which year, it might be a little higher or a little lower. But there is nothing that would make those numbers substantially higher or lower.

In a static analysis it is true: If you are going to have the same amount of revenues, and you are going to collect it in a different tax system, someone is going to write a check that is larger than he/she wrote before and someone is going to write one that is smaller. But the whole purpose of a tax code is that you create an environment for growth, output, employment, production and lower unemployment rates. Everyone in this state will be a dynamic winner with this flat tax proposal. That is why we're proposing it. If everything were static it doesn't matter how you tax people. You can tax people 150% of everything they earn. If I were to use the franchise tax board model, if I tax people 150% of everything they earn they just pay more money than they earn. My best guess is you would probably stop working. The whole purpose of a flat tax is to create an incentive system for economic growth.

Commissioner Marilyn C. Brewer (California Commission on Tax Policy): Dr. Laffer, when I hear you talk I get really excited. And this idea has been around, as you say since 1992—I know I have been hearing about it for 10 or 12 years. I get really excited about it and my question may sound flippant, but I mean it seriously, if it is such a hot idea, why haven't we done it?
Dr. Laffer: Basically we haven't done it because we have been evolving in tax thinking for a long, long time. In 1940, when I was born, the highest marginal tax rate in our wonderful country, just federal, was 93%—the highest marginal income tax rate. Can you imagine the House of Representatives today, in the United States, where a majority of those house members would vote for a 93% marginal tax rate? Where the senators would vote for a marginal tax rate of 93%, and where our

president would vote and sign it into law? You know, back then a right-winger was someone who thought that the tax rate should be dropped a low as 90%.

Commissioner Brewer: Well Dr. Spilberg talks about what would happen if this was adopted, and it makes it sound like the sky is falling, that it is a catastrophe. We heard the same thing in 1978 when Prop. 13 went on the ballot. Are we ready for a tax revolt to do something this drastic, this dynamic?

Dr. Laffer: I think the only reason I am here today with all of you is because you think you are. There is a budget crisis in California. If he thinks that the transition is hell, he doesn't know what the budget crisis is. We have a problem that is triple, quadruple hell. You know, is any tax system wonderful? No, we all know that that all taxes are bad. And they all are bad, but some are worse than others.

Commissioner Brewer: What's it going to take to get this implemented?

Dr. Laffer: You just put it on the ballot. If we can get it through the legislature, they can put it on the ballot right now as a constitutional amendment and have it done. Or we can have the people who are doing all these ballot measures, running around trying to recall this guy, or that guy, or the other guy, to put something serious on the ballot.

Commissioner Brewer: Well, Joel Fox is in the audience, maybe we should give him a new charge.

Dr. Laffer: I would love to have Joel Fox do that. As you know, I worked very closely with Joel and Prop. 13 and Paul Gann, I co-sponsored three initiatives with his former boss, Howard Jarvis. I co-sponsored three with Paul Gann, as you know. I was very involved in Proposition 13. There are nine states in the United States today, nine, that have no income tax. How do they do it? I mean, my God, they must be crazy! States like Florida and New Hampshire and Washington State and Texas, why, they must be going bankrupt!

Lastly the loss in local funds is not true. There would be a direct formula supplying these monies directly to cities, counties, and local districts, and that they would get. The other thing is, yes there are transition problems, no question of that. And this isn't as beautiful probably as I am painting it and I put flowers on it and nice perfume and all that, but I'll tell you that it is a lot better than what you got. And he talks about throwing the baby out with the bath water, but, my view is I would much rather…I don't want to let the best for the enemy of the good. We can make a huge difference in this state today. You specifically can by going along with good economics and good political policy. And that's what I hope you do.

Dr. Spilberg: I don't know where to start. As far as the tax rate is concerned, my point was that if you reduce the base to take into account that we are currently not requiring income on fringe benefits—which is health insurance, contributions, and pension contributions—to be taxable, and if you take into account that federal tax exempt interest would not be taxable, then the base would have to shrink. and the tax rate would have to go up in order to raise the same amount of revenue. The same goes if you allow the exemptions, credits for children or any of those deductions and exemptions that we currently have in place. Those exemptions, to the extent that they're added into the system, they would reduce the base. As with respect to the value-added tax, it's just a fact that government does create value added in the tables used for economic purposes. It is also the case that homes create value and that is something that is also included in the value-added tax base. Also on charitable organizations, that would reduce the base requiring a larger tax.

On local control, my point there is that there is a difference between revenue sharing and control, as I am sure this board knows. If you collect the revenue for your school board, for your school, and then you are in charge of your budget, you're probably going to be more responsive with respect to your budget than if you are just getting paid by other people. That's the point as far as local control.

In terms of transition, I was just trying to point out that there are costs. There are costs to transition and there are costs to developing a system and there are costs to run two systems at the same time for a while. Those are real costs. I don't think that Dr. Laffer would argue that there would be costs involved in the short-run.

Dr. Laffer: Those deductions that he's talking about I have already taken them into account in calculating the rate, except for the ones that are like contributions to pension funds and those which are benefiting the people who work. But all the others, such as the state transfer payments, the rent, all of that stuff, I've done that in the calculation and that's why the rate is not a lot lower.

Commissioner Steve Kamp (California Commission on Tax Policy): But you don't have personal exemptions or deductions or for aged or blind, you don't have that in there.

Dr. Laffer: You shouldn't have those.

Commissioner Kamp: Well, that's my point. And that's ultimately once you put those in, because those are politically very popular, and for good reasons, the rate is going to be creeping up above 9.3%.

Dr. Laffer: I don't think that they are in there for good reason, to be very honest with you. A millionaire who is blind, I don't know why that should be an income tax deduction, to be honest with you. I think if you want to help people you should do it through the spending side. That is the correct way to do it and it's the right way to do it and it is also good. And no one disagrees with that. But, if that is the way you want to go and put all those deductions, you can have the state tax system right now, be proud of it. And you can have the consequences of what has happened, and that is exactly that type of thinking that has caused the problems of why we are where we are.

Commissioner Kamp: Well, I might add, when you were criticizing what Governor Wilson and the legislature did in the early 1990's, in fact the states economy and tax system…tax revenues boomed during the entire Clinton era, I might add, largely because of the tax increases and the increased economic growth that occurred. So to say, I might add that no legislator who voted for any of those lost their seat.

Dr Laffer: Let me if I can respond to Pete Wilson because I was very involved there, Prop. 111 and then Pete Wilson's tax increases. If you remember he put in a $6.5 billlion tax increase and the actual revenues went down the next year.

Commissioner Kamp: And they went up over the next decade.

Dr. Laffer: Oh, they cause incredible damage to this state. And if you like the way the taxes went up and then the crash again, that's what I am…

Commissioner Kamp: I don't like the crash, and we also had major infrastructure needs that your proposal doesn't even take into account.

Dr. Laffer: Well I am trying to do it revenue neutral. I am not trying to argue that this is a change for cutting spending or raising spending, or doing that, I trying to rationalize the tax codes so that you don't have the crashes and booms like you've had, and you have a tax code that attracts business and brings people in. Now if you don't think it works, vote against it or don't do it. It is your choice. I am just a professor that's working in this state and loves this state and thinks that this makes good economic sense.

Commissioner Sean O. Burton (California Commission on Tax Policy): Let me ask another question. It seems to me that, in all the proposals for different flat taxes, and some are flatter than others, to your point earlier, the big issue has always been the regressivity and the issue that you brought up of dynamic scoring versus static scoring. Lets talk about that a little bit, because that really is the crux issue. Are poor people going to have to pay more? You know, you say no because wages are going to rise…

Dr. Laffer: Poor people are going to pay more because they are going to have jobs and the will have income. Will they get less after-tax take home pay? No, they'll get a lot more. I am worried about how much they get paid after tax, not how much they pay in taxes.

Commissioner Burton: So that's the issue. Can you expand on that point?

Dr. Laffer: Sure, renters are poor too. I mean, so rent deduction is clearly helpful there. You have got a low flat rate tax, period, and the will have jobs. What else do you want?

Commissioner Burton: Well, I think if that comes true then everybody is happy, but it's a leap of faith. Is there evidence that that has that happened before? Does any country do this, does any state do this? Can you give us some specifics on that, because that is the leap of faith that I think people have trouble with.

Dr. Laffer: Under Clinton you saw what happened with the big tax cuts after 1993 and 1994. You saw what happened with NAFTA, when we cut interest rates dramatically, when we cut the capital gains tax rate dramatically in 1997, there was huge prosperity. You look at what happened under Reagan, you look at what happened under John F. Kennedy, the same type of macro policies. Take a look at what happened under Pete Wilson versus what happened under Jerry Brown. Jerry Brown had a prosperity in this state you wouldn't believe.

Commissioner Burton: …But you still had a progressive income tax throughout all of that…

Dr. Laffer: But we reduced that progressivity dramatically under Jerry Brown…

Commissioner Burton: Right, but at some point there is diminishing marginal returns and if you go all the way down to 6% and tax every…I mean that's the trouble I think people have with, with the flat tax and getting their hands around it…and that is a huge leap of faith.

Dr. Laffer: Well I don't think that it is a leap of faith. I mean, to say people don't like taxes, well, I don't think that is a leap of faith where you try to have the lowest rate on the broadest base. Now, if that's a leap of faith then economics is leap of faith.

Commissioner Burton: Well that piece of it isn't, but to say that you can lower the rate on everybody and everybody is going to make more money and have more after-tax dollars, that is the leap of faith.

Dr. Laffer: Why is that a leap of faith? Let's just imagine that we raise it. Lets tax everyone in the state at 120% of everything that they earn. Is it a leap of faith to say that we will lose money, and that we will have a disastrous economy? All I am saying is with a lower flat rate tax you will get more output, employment, and production than you will with a highly progressive tax structure that collects the same dollar amount.

Commissioner Burton: Dr. Spilberg, do you have an opinion on this?

Dr. Spilberg: Uh, yes. Let's go to the basis of income. Income is produced by how many hours people work. If you look at unemployment rates, if you have a higher unemployment rate, you are going have less income produced, or if people work longer hours, more income can be produced. There have been some claims made that if you reduce the tax rate for the very highest income individuals, they will work longer hours. There is very little evidence to that, within reasonable rates of taxation. You have states with higher income tax rates and states with lower income tax rates, there is no large differential in unemployment rates between those states. California was going through a boom period during the middle 1990s, we were a high tax state at that time. And by the way, in 1993 Clinton raised taxes not reduced taxes and we had that boom following that time period. So, to assume that if you reduce marginal tax rates you are going to get a big increase in income, especially for low-income people, I think it is a leap of faith.

Dr. Laffer: Can I respond just to that? There is a compendium of all studies on taxes and supply-side responses on labor, hours and all that, done by the Joint Economic Committee about three years ago…go look at it. They just do hundreds and hundreds of studies looking at it and they virtually across the board find supply-side responses as I am describing. There is a literature large enough to fill this building five times over, on economic studies by academics, by professors, by people who look at the subject on the effects of state taxes on migration, income, unemployment rates, that documents it. It's in every volume.

Commissioner Brewer: Well let me refrain the question. I think this is what I hear Sean saying. Someone who is now not paying personal income tax in California because they are below the $38,000 limit…under your proposal of a flat tax they will be paying tax, but will they end up with more disposable income because they are not paying sales tax, excise tax, and any other kind of tax?

Dr. Laffer: Yes. They pay a lot of taxes, they just don't pay the income tax now. And their incomes will go up and their other taxes will disappear. Our current tax system in California is not terribly progressive; believe me when I tell you. And this one is not, either.

Dr. Spilberg's Final Comments: As I said at the beginning, it is an intriguing concept. It is a long way, I think, from something that should be considered as either legislation or initiative at this point. I think it really does need a lot more additional work. I think some of these questions, some of these statements that Dr. Laffer and I have made can be researched more and either supported or refuted. I think that it is a concept and it just needs additional work.

Dr. Laffer's Final Comments: We are in a terrible crisis here in California, and you need to do something now. Why not go for the process that would solve it for eternity and just do it based upon good, sound economic theory and good numerical practice? If not now, when? And if not you, who is it going to be?

This is the time, if ever there were one, to get in there and correct this mess that is going on in Sacramento and in the cities, counties and local districts. And I just beg you not to shirk your responsibilities and do what is really right for this state and for the people of California. Thank you.

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Prior to the budget signing, California faced a $38.2 billion general fund budget deficit through FY2004. Using the latest general fund revenue and expenditure data from the May 2003 Governor's Budget Revision, but removing the estimated effects of the tax increases, cuts and savings, fund shifts, transfers and loans, program realignments and bond deficit financing from the data, yields the following figures:

	FY1995	FY1996	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004
Prior Year-End Balance									-$1,985.0	-$9,290.0
State General Fund Revenue, Governor's Budget	$42,710.0	$46,296.0	$49,220.0	$54,973.0	$58,615.0	$71,931.0	$71,428.0	$72,263.0	$70,751.0	$66,119.0
State General Fund Expenditures, Governor's Budget	$41,961.0	$45,393.0	$49,088.0	$52,874.0	$57,827.0	$66,494.0	$78,053.0	$76,752.0	$78,056.0	$93,116.0
Year-End Balance									$0.0	$1,911.0
Cumulative Budget Deficit									-$9,290.0	-$38,198.0

Actual Tax Revenue vs. Projected Flat Tax Revenue

(in $millions)

In order to assess the effect of the implementation of a flat tax in California, state and local tax data from the U.S. Census Bureau are used. Starting from a revenue-neutral base year, flat tax revenue is projected to grow at the same rate as state personal income. Growth estimates for state personal income for 2003 and 2004 are taken from the May 2003 Governor's Budget Summary. Growth estimates for state total tax revenue for FY2003 and FY2004 are taken from the Governor's Budget Summary and include the estimated static revenue effects of Gov. Davis' May 2003 proposed tax increases.

		FY1995	FY1996	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004
	State Personal Income (Calendar Year)	$771,470.2	$812,404.2	$861,557.4	$931,564.4	$995,325.9	$1,100,679.4	$1,129,868.2	$1,158,678.6	$1,201,549.7	$1,254,417.9
	Yr/yr Growth		5.3%	6.1%	8.1%	6.8%	10.6%	2.7%	2.5%	3.7%	4.4%
1995 Implementation											
Actual	State Total Tax Revenue, U.S. Census Bureau	$53,269.1	$57,746.7	$61,666.9	$67,713.4	$72,387.7	$83,808.0	$90,453.7	$77,755.4	$79,621.5	$85,274.7
	Local Total Tax Revenue, U.S. Census Bureau	$27,917.0	$28,468.0	$28,850.0	$31,002.6	$32,589.6	$36,259.6	n/a	n/a	n/a	n/a
	State and Local Total Tax Revenue	$81,186.1	$86,214.7	$90,516.9	$98,716.0	$104,977.3	$120,067.6	n/a	n/a	n/a	n/a
Projected From 1995 Base	State Flat Tax Revenue	$53,269.1	$56,095.5	$59,489.5	$64,323.4	$68,726.1	$76,000.6	$78,016.1	$80,005.4	$82,965.6	$86,616.1
	Local Flat Tax Revenue	$27,917.0	$29,398.3	$31,177.0	$33,710.3	$36,017.6	$39,830.0	$40,886.3	$41,928.8	$43,480.2	$45,393.3
	State and Local Flat Tax Revenue	$81,186.1	$85,493.8	$90,666.5	$98,033.7	$104,743.7	$115,830.6	$118,902.3	$121,934.2	$126,445.8	$132,009.4
2000 Implementation											
Actual	State Total Tax Revenue, U.S. Census Bureau						$83,808.0	$90,453.7	$77,755.4	$79,621.5	$85,274.7
	Local Total Tax Revenue, U.S. Census Bureau						$36,259.6	n/a	n/a	n/a	n/a
	State and Local Total Tax Revenue						$120,067.6	n/a	n/a	n/a	n/a
Projected From 2000 Base	State Flat Tax Revenue						$83,808.0	$86,030.5	$88,224.2	$91,488.5	$95,514.0
	Local Flat Tax Revenue						$36,259.6	$37,221.2	$38,170.3	$39,582.6	$41,324.2
	State and Local Flat Tax Revenue						$120,067.6	$123,251.7	$126,394.4	$131,071.0	$136,838.2

For more detailed analysis, please refer to: "A Flat Rate Tax for California State and Local Governments," Laffer Associates, April 2003; "A Proposal for a California Complete Flat Tax," Laffer Associates, November, 1990; others.

THE ONLY ANSWER: A CALIFORNIA FLAT TAX

By Arthur B. Laffer and Jeffrey Thomson

Just a few months after Gray Davis was reelected California's governor, there were 2,000,000-plus recall signatures collected (with less than 900,000 needed), 135 gubernatorial candidates on the ballot, and a Hollywood hype of biblical proportions. What a recall effort it is—and it is based 100% on the state's fiscal crisis. The vast majority of all states and national economies the world over face similar, albeit not so extreme, fiscal problems. California is a microcosm or metaphor for these problems.

Stated succinctly, California's steeply graduated progressive tax structure is the cause of the fiscal crisis which itself is the first-born of the union between fuzzy logic and misplaced emotions. I'll address the three most significant problems of California's highly progressive tax code, namely i.) the great volatility in revenues, ii.) the inevitable build-up of government spending, which leads to ever-higher taxes, and iii.) the tremendous inefficiency and unfairness—hurting the prosperous is not an honorable objective, and hurting the prosperous does not help the poor, which is an honorable objective.

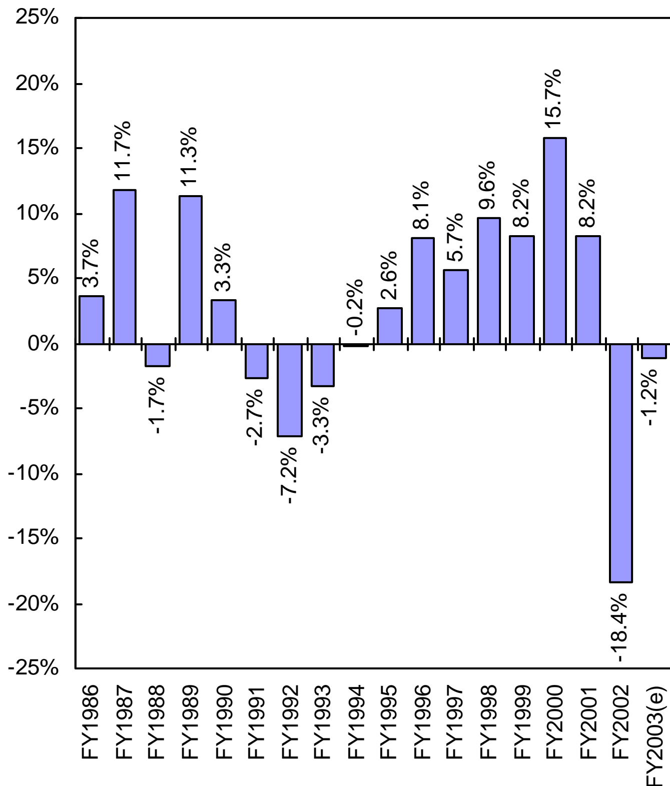
There is no solution to California's crisis save redressing the fundamental premise underlying California's progressive tax codes.

I. Boom and Bust…and Repeat

Because our tax codes in California are so progressive, the state has long periods of feast followed by periods of crushing famine. When the overall economy is good, California has seemingly endless surpluses. When Gray Davis first took office in January 1999, the state's budget was in surplus by some $12 billion out of a base of $59 billion. Revenues from realized capital gains and exercised stock options, following along with the rise in the stock market, soared in the late 1990s/early 2000s, and at their peak in FY2001 (ending June 30, 2001) these two sources alone accounted for 24% of California's total general fund revenues.

In contrast, when times turn sour, progressive tax codes combine with an economic slowdown for a surefire recipe for fiscal crisis. Even without mirrors and handkerchiefs, revenues vanish right before the bureaucrats' eyes. Over the two-year period from FY2001 through FY2003, adjusted state tax revenues per capita fell by 19.4% following seven straight years of increases (Figure 1). This drop represented more than $13 billion in tax revenues! One quick look at this series demonstrates just how volatile and unpredictable California's revenue stream can be from year to year.

Figure 1



These raw revenue data are taken directly from the tax revenue tables in the January California budget proposal, with adjustments to recent periods based on more current information. But let me make two important points. First, these data represent the "major taxes and licenses" category, a category which accounts for approximately 85% of California's total revenues. The remaining 15% is comprised of "minor revenues" and "transfers and loans," both of which are

ignored here. Ignoring "transfers and loans" results in the desired exclusion of any accounting loans, transfers or trickery sometimes found in this category (Electric Power Fund borrowing and the like), which can distort general fund and total revenue data from year to year. Second, I adjust the data by the amount of any static revenue legislated tax changes in a given year.

In addition to California's huge revenue swings, another byproduct of difficult economic times is that claims on government soar. California's unemployment rate rose from 4.9% to 6.8% between FY2001 and the end of FY2003. It's no wonder our surplus went from $12 billion to our well-publicized $38 billion projected deficit—on an expenditure level of $76 billion—practically overnight. If the California legislature were to reduce spending to match revenues, it would have to cut expenditures by 55% across the board!

Unfortunately, California has already made the easy cuts, used up the rainy day funds and implemented all the gimmicks, tricks, loans and accounting shifts. Now we have the hard stuff, we are down to the real meat. What had been budget padding with frivolous overspending during good times has became deep cuts in essential services. The slave has turned on his master.

It is this famine/feast syndrome so characteristic of economies with progressive taxes that has precipitated once again a California revolt. But the resolution is far from certain. The crisis of the late 1970s/early 1980s gave us lower property taxes following the passage of Proposition 13, the abolition of our state's inheritance tax, indexed personal income taxes and the Gann spending limit—all wonderful. Yet the crisis of the early 1990s gave us personal income tax increases, increases in the gas tax, sales tax increases and a disemboweling of the Gann spending limit—all horrible! Shocking as it may seem to party loyalists, the biggest tax increases in California came under Republican governors—especially Pete Wilson—while the biggest tax cuts were under Jerry Brown's leadership.

II. Spend…Then Tax…Then Spend…

Progressive taxes also lead to a higher overall share of output going to government than the electorate would prefer. Tax cuts are never as popular with politicians in good times as are tax increases in bad times. Volatile revenues—the alter ego of progressive taxes—inextricably lead to big government by increasing spending during prosperity and ratcheting up tax rates during slow times. Those who argue that California's government is more liberal than its electorate are wrong. Big government is a byproduct of a progressive tax code.

During Gray Davis' first four years in office (through the FY2003 budget), total government spending increased from $75.3 billion to $104.9 billion, an increase of 39.3% (29.8% on a per capita basis—see Figures 2 and 3). But who's to blame young Gray and his friends in the state Senate and Assembly for spending a little extra from the windfall? Whether conservative, liberal, Republican, Democrat, left-winger or right-winger, these people are grasshoppers. On top of that, you have a legislature and a governor who are term-limited. Who wants to turn the money over to someone else when they can spend it themselves? Bottom line, I don't know how you can ever expect a governor to put aside the types of funds that would have to be put aside to smooth spending over a cycle of maybe 10 or 12 years. There is no way you can put a year and a half's worth of revenues into a special rainy day fund for when you have the four or five year period of bad times. It is just not going to happen, period. Grasshoppers will be grasshoppers!

Figure 2
California Per Capita Total Total Expenditures
(fiscal year)

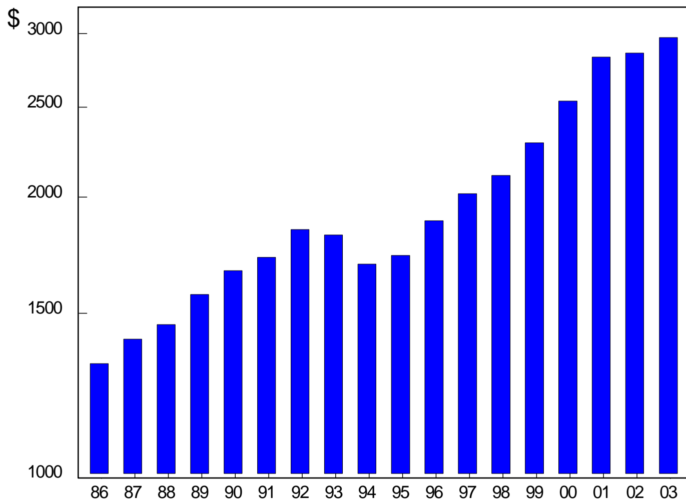
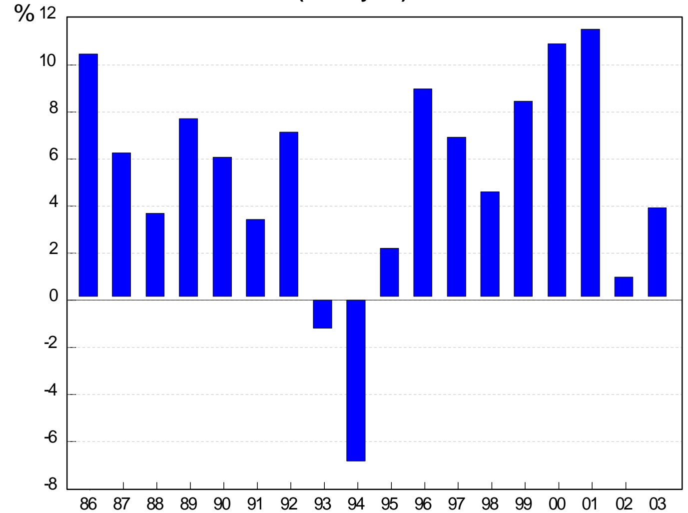


Figure 3
Yr/Yr Growth in California Per Capita Total Expenditures
(fiscal year)



Another rather insidious factor in the growth of spending results from the budgeting process. Because of the state's volatile revenues, California has a longstanding and successful budgetary tradition of overstating projected revenues during times of crisis in order to get higher spending approved by the legislature. Then, when revenues fall far short of projections (surprise!) the politicians turn to taxes to make up the difference. Figure 4 demonstrates this effect by showing current year (6 month) and budget year (18-month) revenue forecasts taken from each year's January budget proposal compared to actual revenues collected.

Figure 4
California General Fund Revenue (Plus Transfers): Forecast vs. Actual
(in $billions)

Current and Upcoming Year Revenue Forecast
Actual Revenues
May-03 Revision
Jan-03 Budget
Overforecasted Revenues
Underforecasted Revenues
Overforecasted Revenues
$85 $75 $65 $55 $45 $35 $25
87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05

Year of January Budget Forecast for Current and Upcoming Fiscal Year

	Revenue Estimates as of						Actual
	Jan-01	May-01	Jan-02	May-02	Jan-03	May-03	
00-01 Revenues	$76.9	$78.0					$71.4
01-02 Revenues	$79.4	$74.8	$77.1	$73.8			$72.3
02-03 Revenues			$79.3	$78.6	$73.1	$70.8	$70.9
03-04 Revenues					$69.2	$70.9	??

Progressive tax codes lead to a plethora of specific fees and taxes, many of which don't even raise enough revenue to pay for the costs of their collection. It's a crime, but true. It's always tough (but not impossible) to raise the big taxes—especially with the two-thirds majority vote requirement to raise taxes in California—but less visible taxes often can be snuck in under the tent late at night. During downturns, when legislators want to raise taxes for fiscal reasons, they often turn to less visible taxes. As a result, we have literally thousands of taxes and fees at the state and local level here in California (while it's impossible to compile a list of all of them, to get a flavor of what Californians face see Table A-1 in the appendix).

For example, attempts to raise sales, income and cigarette excise taxes may have failed, but last year tax loss carryforwards were suspended for two years and the current budget allowed the Manufacturers' Investment Credit to expire ($400 million annually) and tacked on an estimated $1 billion in various new fees—and that isn't even counting the $4 billion executive act to increase the vehicle license fee. Yet these smaller taxes and fees often fail to make the headlines. As written in the parable, we Californians die the death from a thousand cuts. The only difference between the parable and today's California is that we in California also get strangled, shot and kicked to death. The flourishing of all these taxes and fees can be attributed directly to the steeply progressive tax codes of California.

Taxation and Fairness—"Power Up the U-Haul"

California's highest corporate income tax rate is 8.84% (28% above the national average of 6.9%); its highest personal income tax rate stands at 9.3% (fourth highest in the nation behind Montana, Rhode Island and Vermont); its top tax rate on capital gains is also 9.3%. And had the Democrats had their way with the FY2004 budget, the latter two would now stand at 11%. In addition to these sky-high rates, Californians face tax rates among the highest in the nation in almost every other major tax category, including a top state and local sales tax of 8.50% (11th highest in the nation) and a cigarette excise tax of $0.87 per pack (19th highest in the nation). Both of these taxes also narrowly escaped having their rates raised in last year's budget negotiations Property tax rates are exceptionally low primarily because of Proposition 13, which was passed in 1978.

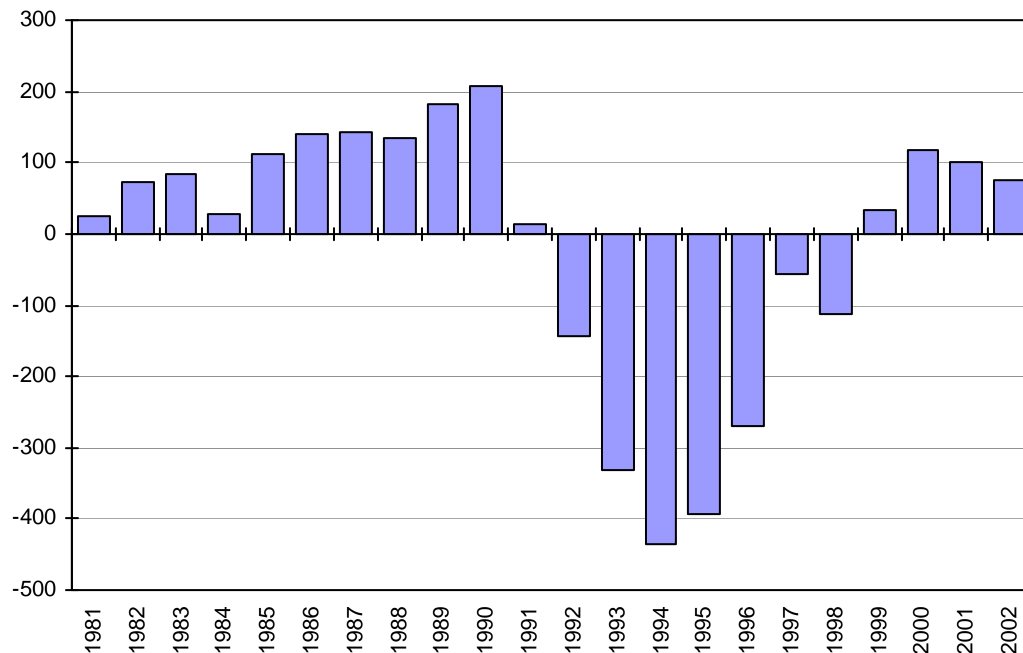
Because you have such a highly progressive tax structure in the state of California, the most successful and productive of the state's residents and businesses are the ones who are taxed the most on the margin. And they are the ones who make the decision whether to locate in California or, if they are already here, whether or not to stay.

With this in mind, juxtapose our high tax rates with the fact that there are nine states in the U.S. without a state personal income tax at all—including the biggies of Florida and Texas, in addition to California's neighbors, Nevada and Washington—and you can see why California once again is facing the very serious prospect of a brain drain. Just this past year my son took our family business and left California for Tennessee, a state with no income tax. It is a wonder that we have any entrepreneurs or venture capitalists in our state.

Primarily due to Pete Wilson's huge tax increases in California in 1990 and 1991 and more tax-friendly climates in neighboring states, Census Bureau data show that California went from importing a net of

207,000 people from other states in 1990 to losing 435,000 people in 1994 alone (Figure 5). And now we're back at square one because of progressive taxes. The consequences of these population inflows and outflows and their potential effects on state revenues should not be ignored. Considering that the wealthiest 3.1% of California's population pays 61.7% of the state's personal income taxes—by far the state's most important source of revenue—California can ill afford to tax the wealthy to the point where they choose to leave the state.[1] These wealthy residents, many of whom are baby boomers approaching retirement age, are mobile and could decide to become ex-Californians in a heartbeat.

Figure 5
California: Domestic Migration, 1981-2002
(in thousands of people)



Source: Demographic Research Unit, California Department of Finance

This same logic applies to the state's businesses as well. One of the major costs of a business is the tax bill it has to pay. If you raise taxes on businesses, especially during bad economic times, the cost of doing business rises *pari passu*. These businesses then raise their heads and look around, and it won't take long for them to realize that most states have a more business-friendly environment than does California. In fact, there is nary a state with as high a corporate income tax rate within 2,500 miles of California.

The Supply-Side Version of Robin Hood

And don't for a moment think that our highly progressive tax structure here in California helps the poor, the minorities, or the disenfranchised—it doesn't. Just on an intuitive level, it should be self-evident that if a government taxes people who work and pays people who don't work, there will be more people who don't work and fewer people who do work. The more workers are taxed and the more non-workers are paid, the more people there will be who don't work. It's as straightforward as 1-2-3.

The important question to address, and one critical to California and the U.S., is what is the best way to help the poor? All of us understand the importance of helping those who really do have difficulty helping themselves. The question is not whether you want to help the poor. The question is, how can you, literally, make the poor better off?

If the rich are taxed and the money is given to the poor, do not be surprised if there are a lot of poor people and very few rich people. People respond to incentives. Whether it fits with your view of what the world

[1] California Franchise Tax Board, "2000 Annual Report."

should be or not, it is the way the world works. If you make an activity less attractive, people will do less of it. If you make an activity more attractive, people will do more of it. Taxes make an activity less attractive and subsidies make an activity more attractive.

I'd like to retell the story of Robin Hood, only here the supply-side version of the story of Robin Hood. If you'll remember the story, it begins with Robin and his band of merry men in the English town on Nottingham. They would wake up in the morning and don their light green leisure suits and go zipping off into the Sherwood Forest, where they would wait for hapless travellers by the trans-forest throughway hiding in amongst the trees.

If a rich merchant came by—and by rich I mean a super richie (this guy didn't have a silver spoon in his mouth, he had a golden goblet down his throat)—Robin would stop him, chat with him for a few minutes and then take everything the guy had. He'd make the guy run naked back into the forest. But before you feel sorry for the guy, remember he is so rich that by the time he gets back to his castle there will be lots of other golden goblets, lots of other jewels and wealth. He'll be just fine, none the worse for the wear.

If a prosperous merchant came through the forest, one who was just rich but not super rich, Robin would take almost everything the guy had, but not quite everything. If a normal, everyday average businessman came through the forest, Robin would take just a moderate chunk of what the man had. And if a poor merchant came through the forest, one who could barely make it, Robin would just take a little token from that guy.

In the vernacular of our modern day society, Robin had a progressive stealing structure from the merchants who came through the forest. You recognize the model, don't you? Doesn't it sound like the California government to you?

At the end of the day, Robin and his men would take their contraband and go back into Nottingham where they'd wander the streets. If they found someone who was down-and-out and had absolutely nothing, Robin would stop him and say, "Hi, my name's Robin Hood. I'm your local redistributionist agent around here and I'd just like to tell you how much I love you." And then Robin would give the destitute man a whole pile of goodies.

When Robin and his men found another person whom we'd call "working poor," with an income around $10,000 a year at about minimum wage, they would give him a smaller bundle of goodies than they gave to the guy who had nothing. And if Robin Hood found some normal, everyday average citizen walking around the streets of Nottingham, Robin would give the man a small token equivalent to our modern day tax rebate. Robin would add, "You and your wife go out to dinner and the wine's on me." If Robin happened to bump into a rich person, he might just rip him off.

Once again using today's words, the more a person makes the less Robin gives him, and the less a person makes the more he gives him. You follow the model: he stole from the rich and gave to the poor. The richer you were the more he'd steal from you, the poorer you were the more he'd give you. This is the story of Robin Hood.

Now, put on your supply-side economics hat and imagine for a moment that you are a merchant back in the ancient days of Nottingham: HOW LONG WOULD IT TAKE YOU TO LEARN NOT TO GO THROUGH THE FOREST? Those merchants who couldn't afford armed guards would have to go around the forest in order to trade with the neighbouring villages. The route around the forest is a lot longer and full of rocks, bumps, logs, holes, etc.—it was far more costly doing commerce when you're travelling around the forest rather than going through the forest.

Those merchants who could afford armed guards (and by the way, today we call these armed guards lawyers, accountants and lobbyists) would go through the forest and Robin couldn't rip them off. And believe me when I tell you that those armed guards were as expensive then as they are today. So at the end of the second day, Robin Hood had no contraband whatsoever to give to the poor. All he had succeeded in doing was driving up the cost of doing business, which meant the poor had to pay higher prices and were literally worse off. By stealing from the rich and by giving to the poor, Robin Hood made the poor worse off.

And so it is in California as I write this paper. The poor, who rely on the state for their sustenance, are having their benefits cut to the bone; because of our state's business-unfriendly policies, our unemployment rate is higher than the national average; because of our bad governance, we have one of the worst K-12 education systems in the nation. I could go on and on, but the point is simple enough. Our progressive tax structure is not benefiting the truly needy.

Let me put the theorem to you precisely (and I could prove it to you mathematically if need be): By trying to redistribute income, government never, ever succeeds in redistributing income. But what government does accomplish when it tries to redistribute income is the destruction of the volume of income. Government cannot change the distribution of income with taxes but it always lowers the volume of income with taxes. As we look across the world at the progressive tax structure of California and other economies, it's amazing how the distribution of income, if anything, is made worse. And that's where we are today.

To me the best form of welfare is still a good, high paying job. There is no alternative to economic growth.

Ending the Crisis Cycle

If California ever wishes to break out of its fiscal crisis cycle it must redress the progressivity of its tax codes, pure and simple. Spending controls by themselves won't work. You can't expect politicians to set aside and then not spend a rainy day fund of $75 billion or more. And for sure they won't pass billions of unspent dollars on to their term-limited successors. It just ain't going to happen. No sooner was the Gann spending limit actually effective than Proposition 111 passed, rendering it totally ineffectual. The best form of spending control is the simplest form of spending control: don't give government the extra money during good times and don't shortchange essential programs during tough times. The case for a flat tax is nowhere more compelling than it is in California today.

My preferred flat tax structure would encompass all local taxes as well as state taxes. Today that number is somewhere around $120 billion with some $70 billion needed for the state's general fund, $20 billion for state special funds and $30 billion for local government. "Sin taxes" should be excluded from consideration as part of a flat tax because their purpose is more to alter behavior than it is to raise revenues. Fines for speeding, disturbing the peace and illegal parking, along with court ordered payments and taxes on alcohol, tobacco and firearms, are classic sin taxes and really do make sense. But other than these sin taxes, every state and local tax should be abolished. And I do mean abolished.

The new governor—or Gray Davis if he survives—should heed the warning of the recall and get rid of all sales taxes state and local, all income taxes business and personal, all payroll taxes, all property taxes commercial and residential, all excise taxes, and all those other taxes that boggle the mind both by their numbers and their inanity. Everything other than sin taxes should have "Hasta La Vista, Baby" shouted at them.

In their stead California should enact two single rate flat taxes, one placed on business net sales and one on personal unadjusted gross income. A company's net sales tax base would simply be total sales less purchases from other companies, i.e., net sales. No other deductions should be allowed, period.

Businesses would as a result expense 100% of all capital purchases because capital is purchased from other companies which have already paid the taxes. No double taxation. There would never be an issue of loss carryforwards or other such complications. Every company would pay its share of the tax burden based upon its use of California's precious natural resources. The distortions inherent in our current tax codes that discriminate against successful companies by taxing profits, and by the process of elimination subsidize inefficient companies, would be gone, gone, gone. The only issue for businesses might be some transition considerations resulting from the existing tax codes, but these are really not of any great import.

For individuals, no income should be exempt from taxation just because that income is below a certain threshold. In other words, the first $30,000 of income should be taxed at the same rate as every other $30,000 of income. Maybe I missed something in Econ 1, but I have never understood the benefit of a tax deduction to someone with no income. Deductions don't help the truly poor, they just require offsetting higher tax rates where those tax rates do the most damage.

For individuals the tax base would be total income minus deductions for home mortgage interest expense, charitable contributions and rent on one's primary residence (if the taxpayer is not a homeowner). Interest deductibility is the right thing to do from the standpoint of economics as well as from the standpoint of politics. If interest income is taxable then interest expense must be deductible. The rationale for deducting charitable contributions is self-evident. Rent on one's primary residence should also be deductible as long as homeowners aren't required to pay tax on the imputed rental value of their homes. While there are other complications for gamblers, independent contractors, transfer payments, government output, etc., these don't materially affect the principal. Both the business tax base and the personal tax base are each approximately equal to gross state product.

With California gross state product averaging some $1.35 trillion per year over the last five years and total state and local tax revenues less sin tax revenues averaging $120 billion per year over five years, to match revenues over time, without presuming a supply-side or Laffer Curve effect, the tax rate on business net sales and on personal unadjusted gross income would be somewhere in the range of 5.85% and 6.00%. For more on my California flat rate tax, including detailed revenue data and tax rate calculations, please see my two recent papers on this topic.[2] Most individuals wouldn't even have to file a tax return as long as they received all of their income from accredited employers who withheld. All personal taxes would be deductible on federal tax returns, thus providing additional benefit to California taxpayers. But most of all there would be no state income taxes, no state and local sales taxes, no property taxes, no state gas taxes and no state payroll taxes, none, none, none.

Conclusion

Can you imagine the dynamics of California in competition with other states? California's tax revenues would fluctuate mildly, right in line with the state's personal income. The incessant urge of government to overspend would be a thing of the past and the incentives to flee the state for more friendly shores would vanish. We truly would be the Golden State. And who knows, maybe someone in Washington, D.C. would pay notice.

[2] Arthur B. Laffer, "A Flat Rate Tax for California State and Local Governments," Laffer Associates, April 28, 2003; Arthur B. Laffer, "Will Gray Davis Survive?" Laffer Associates, August 6, 2003.

APPENDIX

Table A-1

A Partial Selection of California's State, County and City Taxes and Fees

abandoned vehicle fees
activity fee
additional assessments on fish and game fines
admission tax
aircraft jet fuel tax
alcoholic beverage taxes and fees
animal licenses
animal shelter fees and charges
architecture public building fees
ballast water management fee
beverage container redemption fees
breast cancer research cigarette stamp tax
building construction filing fees
business license tax
cable, city cable fee
cable, franchise fee
California children and families first cig. stamp tax
California State University Fees
California tire fee
candidate filing fees
childhood lead poisoning prevention fee
cigarette and tobacco products surtax
cigarette tax
city and county sales tax
construction permits
corporation tax
county clerk – miscellaneous fees
county transportation tax
court fees
court filing fees and surcharges
delinquent fees
disposal fee
district transactions and use tax
division of real estate examination fees
division of real estate license fees
domestic corporation fees
duck stamps
eating places licenses
electric, CA public benefit fee
electric, city tax
electric, franchise fee
electric, state regulatory fee
electric, underground surcharge
electric, user utility fee (UUT)
electrical energy surcharge
elevator and boiler inspection fees
employer's payroll tax
employment agency filing fees
employment agency license fees
engineering fees, inspection, and others
environmental fee
estate, inheritance and gift tax
explosive permit fees
facility free and tiered permit fees
farmers market and ag. commission fees
filing financing statements
fines and forfeitures
fingerprint ID card fees
fish and game violation fines
foreign corporation fees
franchises tax
garbage truck inspection fees
general fees – Secretary of State
general fish and game licenses tags permits
general fish and game taxes
generator fee
genetic disease testing fees
golf course fees
guardianship fees
hazardous material fees
hazardous waste control fees
health and dental fees
highway carrier uniform business license tax
horse racing (parimutuel) license fees
industrial homework fees
insurance company examination fees
insurance company license fees and penalties
insurance department fees, general
insurance department fees, Prop. 103
insurance fraud assessment, auto
insurance fraud assessment, general
insurance fraud assessment, workers comp.
insurance gross premium tax
integrated waste management fee
interest, penalties, and delinquent taxes
interstate user tax
library fines and fees
liquor license fee
local revenue fund state sales tax
marriage licenses
motor vehicle fuel tax (diesel)
motor vehicle fuel tax (gasoline)
motor vehicle license (in-lieu) fees
motor vehicle registration
museum hall and art commission fees
natural gas surcharge
new motor vehicle dealer license fee
notary public license fees
occupational lead poisoning prevention fee
off-highway vehicle fees
oil spill response fee
oil spill response, prevention, and admin. fees
open space cancellation fee
other property tax
other regulatory fees
other regulatory licenses and permits
other regulatory taxes
opera and civic auditorium fees
parental fees
parking lot revenues
parking permits
parking violations
parks and recreation fees
pay patients board charges
penalties and interest on personal income tax
penalties on public utility commission quarterly fe
penalties on traffic violations
penalty assessments
penalty assessments on fish and game fines
personal income tax
phone booth permits
phone, california high cost fund-A (CHCF-A)
phone, california high cost fund-B (CHCF-B)
phone, california relay svc. and comm. d.f. surcharge (DDTP)
phone, california teleconnect fund surcharge (CTF)
phone, city and county utility taxes
phone, emergency telephone users surcharge tax
phone, rate surcharge
phone, rate surcharge
phone, service provider number portability
phone, state regulatory fee (PUCURA)
phone, universal lifeline telephone service surcharge (ULTS)
plan checking fees
private rail car tax
private railroad car tax
proceeds from estates of deceased persons
public administrator fees
public safety fund sales tax
quarterly public utility commission fees
real property transfer tax
recording fees
renewal fees
retail sales and use tax
retail sales and use tax-realignment
revenue – abandoned property
sale of real and personal property
sales of documents
secured and unsecured property tax
sewer service charges and connection fees
solid waste collection
special district taxes
state beach and park service fees
state disaster relief tax
state energy surcharge
state tax
street and curb permits
street sweeping fee
subdivision filing fees
teacher credential fees
teacher examination fees
telecommunications tax
timber yield tax
towing fees
traffic violations
trailer coach license (in-lieu) fees
transient lodging tax
underground storage tank maintenance fee
uninsured motorist fees
voter approved indebtedness property tax
waste water system maintenance
water service charges
water, high elevation charge
water, special facility charge
zoning and subdivision fees

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