

Tax Reform Commissions in the Sweep of California's Fiscal History

by STEVEN M. SHEFFRIN*

Introduction

On September 29, 2009, the California Commission on the 21st Century ("Parsky Commission")¹ submitted to Governor Arnold Schwarzenegger and the Legislature its recommendations for reforming the California tax system.² When the Governor and the Legislature first appointed the Parsky Commission, there were very high expectations. California was experiencing a severe financial crisis, following on the heels of ongoing budgetary problems and a national recession. Many hoped that the Parsky Commission could provide some direction out of the crisis. There were broad indications that the recommendations of the Parsky Commission would be taken very seriously in Sacramento and would be considered seriously by the Legislature.³

The Parsky Commission proposed a very bold plan, introducing a new tax called the Business Net Receipts Tax ("BNRT") and using the proceeds from that tax to finance large reductions in personal

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1. The Chairman of the Commission was Gerald Parsky, former Chair of the U.C. Regents and one-time head of the California Republican Party.

2. Press Release, California Commission on the 21st Century, Commission on the 21st Century Economy, Commission on the 21st Century Economy Issues Recommendations to Modernize, Stabilize & Simplify California's Outdated Tax System (Sept. 29, 2009), *available at* http://www.cotce.ca.gov/documents/reports/documents/Final_Report-Press_Release.pdf.

3. Press Release, Office of Governor Schwarzenegger, Gov. Schwarzenegger and Legislative Leaders Announce Appointments to Bipartisan Commission on the 21st Century Economy (Dec. 11, 2008), *available at* <http://gov.ca.gov/index.php?/press-release/11233/>.

income tax rates and to outright eliminate the corporation tax and general state sales tax.⁴ The Parsky Commission's report devoted 337 of its 425 pages to specific bill language for its proposal, complete with detailed phase-in provisions, so that the Legislature could seriously consider the proposal as drafted.⁵ At the press conference announcing the report, there were pre-arranged endorsements from former Governor Gray Davis, former United States Secretary of State George Schultz, Senator Dianne Feinstein, and former legislator Willie Brown.⁶ At the same press conference, Governor Schwarzenegger urged its passage.

Outside of this group, however, the report was criticized heavily. Only nine of the fourteen members of the Parsky Commission signed on to its recommendations. One of those opposing the report was William Hauck, a gubernatorial appointee and Chairman of the California Business Roundtable.⁷ Two of the members, Professor of Law Richard Pomp, and former legislator and Treasurer of the County of Santa Cruz, Fred Keeley, were vehemently critical both of the substance of the report itself and the operation of the Parsky Commission.⁸ Groups representing labor and business were united in their opposition.⁹ The California Chamber of Commerce strongly opposed the report. Tax expert Jean Ross of the California Budget Project, a liberal think tank, was critical of virtually all of the

4. COMMISSION ON THE 21ST CENTURY ECONOMY, FINAL REPORT (Sept. 2009), available at http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf.

5. *Id.*

6. *Id.* The letter of endorsement, the report itself, the membership of the Commission, and correspondence and reports can be found on the website for the Commission at <http://www.cotce.ca.gov/>. The report is entitled "Commission on the 21st Century Economy, Report, September 2009."

7. George Skelton, *California Tax Reform Plan Much Too Bold For Capitol*, L.A. TIMES, Oct. 1, 2009, available at <http://articles.latimes.com/2009/oct/01/local/me-cap1>.

8. Pomp's critiques can be found on the Commission's website. See his September 14 and September 25 postings. Letter from Richard Pomp, Commissioner, to the Commission on the 21st Century Economy, (Sept 14, 2009 and Sept. 25, 2009) (hereinafter Pomp Letter) http://www.cotce.ca.gov/documents/correspondence/staff_and_commissioners/. Fred Keeley also expressed strong reservations about the process, and he raised charges that one of the Commissioners was in violation of the Open Meeting laws. See Calbuzz, *CB Excloo*: Did Tax Panel Break the Open Meeting Law?* (Oct. 14, 2009), <http://www.calbuzz.com/2009/10/cb-excloo-did-tax-panel-break-open-meeting-law/> (last visited Mar. 10, 2010).

9. See Skelton, *supra* note 7, at 1.

proposal's components.¹⁰ A letter sent to the Parsky Commission by UCLA Professor Kirk Stark on behalf of nine prominent academic legal and economic experts in state taxation questioned the wisdom of adopting the untested BNRT.¹¹

Furthermore, a Field Poll found that the public was opposed to the key Parsky Commission recommendations.¹² Sixty-four percent of respondents disapproved of the personal income tax changes, in particular, the proposal to raise the tax rate for lower income earners and lower it for higher income earners.¹³ Sixty-six percent opposed the Parsky Commission's key idea to introduce a new business tax to replace the corporate tax and the state general sales tax.¹⁴ Ultimately, while hearings were held by the Assembly Revenue and Taxation Committee and later by the Senate Revenue and Taxation Committee, no legislator introduced the bill for formal consideration. The Parsky Commission's report effectively had no constituency in Sacramento and, as a package, disappeared from serious consideration.

While this outcome was disappointing to many members of the Parsky Commission and its supporters, it raises some important questions about the role of tax reform commissions in California. First, what role have tax reform commissions played in California history? Have they ever led to fundamental tax policy changes in the state? Second, can tax reform commissions be said to "succeed" even if their recommendations are only partially adopted? Third, what were the causes of the most recent tax commission's apparent failure: Was it due to the substance of the Parsky Commission's recommendations, the process by which it operated, or both? And,

10. See Power Point, The California Budget Project, *Fatally Flawed: What Would the Commission On the 21st Century Economy's Recommendations Mean for California?* (Oct. 2009), available at http://www.cbp.org/pdfs/2009/091007_Fatally_Flawed.pdf (last visited Mar. 10, 2010).

11. See Letter from Kirk Stark, Professor of Law, to Gerald Parsky, Chair of the Commission on the 21st Century Economy (Sept. 5, 2009), (hereinafter Stark Letter) available at http://www.cotce.ca.gov/documents/correspondence/public/documents/STAR K9.5.09JointLettertoCaliforniaCommissionon21stCenturyEconomy_September52009_.pdf (last visited Mar. 10, 2010).

12. California Opinion Index, State Constitutional Reform and Related Issues, Volume 3, San Francisco: California, The Field Poll (Oct. 2009), available at <http://www.field.com/fieldpollonline/subscribers/COI-09-October-CA-ConstitutionReform.pdf>.

13. California Opinion Index, Field Poll, October 2009, Table 8, available at <http://www.field.com/fieldpollonline/subscribers/COI-09-October-CA-Constitution-Reform.pdf>

14. California Opinion Index, Field Poll, October 2009, Table 9, available at <http://www.field.com/fieldpollonline/subscribers/COI-09-October-CA-Constitution-Reform.pdf>

finally, can this most recent experience point to new directions—even if qualitatively different from the original recommendations—for California tax policy?

To address these questions, this paper first looks back at two important California tax commissions, the 1906 and 1929 Commissions, and places the results of their deliberations into the history of taxation in California. The recommendations of both the 1906 and 1929 Commissions were largely adopted but only after some modifications and, in the case of the 1929 Commission, considerable fiscal turmoil. Despite these modifications, both can be deemed quite successful in helping to set a new course for California fiscal history.

Two of the most dramatic changes in California tax history, however, took place outside of formal tax commissions. The first, the Riley-Stewart initiative, approved by voters in 1933, set the stage for the modern California tax system.¹⁵ The second was the passage of Proposition 13, which fundamentally altered the fiscal constraints facing policymakers. This paper will briefly highlight the key provisions of each and discuss how they changed the fiscal landscape. Understanding the dynamics of these changes is essential to assessing the role that tax commissions can play in political change. Tax commissions always act in a larger context, particularly in California, where initiatives have largely driven tax policy.

This paper then takes a close look at the recommendations and operation of the Parsky Commission for the 21st Century Economy, with particular focus on the difficulties associated with the BNRT and the failure of the Parsky Commission to treat with sufficient care the issue of the distribution of the tax burden.

Finally, this paper reviews the role that tax reform commissions can play in the overall dialogue about fiscal policy in California. It suggests that one positive, although unintended, outcome of the Parsky Commission's report could be consideration of instituting broader business taxes for California. However, unlike the scenario envisioned in the Parsky Commission's report, these taxes would likely be complements to, and not substitutes for, the current major taxes in place today.

15. For an analysis of both the voting patterns and the long-term implications of Riley-Stewart, see James E. Hartley, Steven M. Sheffrin & J. David Vasche, *Reform During Crisis: The Transformation of California's Fiscal System During the Great Depression*, 56 J. ECON. HIST. 657, 657–78 (1996).

I. Two Successful Tax Commissions

California's first tax commission was formed in 1905 and filed its report in 1906 ("1906 Commission"). The 1906 Commission's report was received favorably by the Legislature and a constitutional amendment incorporating its provisions was submitted to the voters in 1908. The measure was defeated, but was reintroduced with slight modifications and finally approved in 1910.¹⁶ The 1906 Commission was formed to deal with what had been generally recognized as the unsatisfactory state of property taxation in California. At that time, both the state and local governments relied primarily on the property tax to finance expenditures. The 1906 Commission identified a number of difficulties with the system. It believed the burden on agriculture was too high, the property tax unfairly fell primarily on real estate as personal property, financial assets escaped assessment, and the administration of the tax was highly inequitable.

One essential problem was that local assessors determined valuations for both local and state property taxes. There was thus an obvious incentive for local assessors to under-assess property so local residents would pay less in state taxes. While the State Board of Equalization in principle could have "equalized" assessments, in practice this was ineffective. As a result, there were competitive pressures to under-assess property across the state.¹⁷ The 1906 Commission echoed the general belief that the current system was antiquated and needed to be replaced with something new.

The 1906 Commission's solution to the problem was the "separation of sources," a radical division of state and local revenues. Local governments would have complete access to the property tax. However, "public utility property" such as railroads, gas and electric companies, telephone and telegraph properties, and car and express companies would be removed from local property tax rolls. These utilities would not be subject to property taxation and instead would be subject to a gross receipts tax the proceeds of which would accrue solely to the state.¹⁸

The gross receipts tax on public utility property would be designed to approximate the burden placed on property in general

16. ASSEMBLY INTERIM COMMITTEE REPORTS, VOL. 4, NO. 5, A RESUME OF CALIFORNIA'S TAX STRUCTURE, 1850-1955: REPORT OF THE ASSEMBLY INTERIM COMMITTEE ON REVENUE AND TAXATION TO THE CALIFORNIA LEGISLATURE, 26 (1956).

17. See 7 MARVEL M. STOCKWELL, STUDIES IN CALIFORNIA TAXATION 1910-1935, ch. 1, 2 (Univ. of Cal. Press 1939).

18. ASSEMBLY INTERIM COMMITTEE REPORTS, *supra* note 16, at 23-24.

throughout the state. Recognizing that gross receipts would bear a different relationship to the capitalized value of net income for different types of property, which the 1906 Commission took as a proxy for the value of property, different classes of utility property were to be assigned different gross receipts tax rates. However, the aim was not to tax the value of transactions per se—as in modern gross receipts taxes—but to use gross receipts to approximate a property tax.¹⁹

The recommendations of the 1906 Commission transformed the California tax system. Once this system was installed in 1910, it stayed in place in California until 1933. However, some flaws in the system were recognized in short time. A 1917 Tax Commission (“1917 Commission”) highlighted the differences in effective property tax rates engendered by the gross receipts tax across classes of utility property and also within classes of property. For example, it found that smaller firms within any class paid a higher rate of effective taxation than larger firms. While the 1917 Commission believed that the “separation of sources” was an improvement over the tax system that was in place before 1910, it recommended changes to the rates that applied to the different classes of utility companies and suggested some other changes to the tax system as well.²⁰ Unlike its immediate predecessor, the recommendations of the 1917 Commission were largely ignored.

In contrast, the 1929 Tax Commission (“1929 Commission”) proved to be very influential. It began by reinforcing the conclusions of the 1917 Commission—namely, that the system of gross receipts taxation and separation of sources was broken.²¹ It pointed out some of the same flaws that the prior commission had—unequal tax burdens both across and within classes—but also pointed to an essential absurdity of the system.²² Since gross receipts rates were chosen simply to approximate property tax rates, why not tax property directly? The 1929 Commission recommended that public utility property be returned to local rolls and that the State Board of

19. The 1906 Commission engaged in some ingenious economic analysis. The tax rate T for gross receipts for each class of property was given by the formula $T = (N/i)*R$ where N is the ratio of net income to gross receipts, i is an interest rate, and R is the state average property tax rate. With this tax rate for gross receipts, total tax payments would equal the capitalized income of an enterprise times the average tax rate for property in the state. Since N differed across classes of property, so would T .

20. ASSEMBLY INTERIM COMMITTEE REPORTS, *supra* note 16, at 23–25.

21. *Id.* at 37–38.

22. *Id.* at 37–38.

Equalization be given the role of assessing the property.²³ That way, local governments would enjoy the benefits of the property tax revenue, but it would be assessed fairly at the state level.²⁴

In the midst of the 1929 Commission's deliberations, California was faced with a series of challenges to its system for taxing state banks. In 1925, the state attempted to tax financial intangibles with the Solvents Credit Act, but the banks successfully argued before the courts that this created inequities, in that certain financial assets, such as mortgages, were not subject to the tax.²⁵ The 1929 Commission was asked to address this issue and developed an alternative approach to bank taxation that would tax banks and all other corporations by means of a franchise tax based on net income.²⁶ This approach eventually became law.²⁷

The 1929 Commission also sketched out a broad vision for a new schema of taxation in California.²⁸ It recognized that the obligations the state was undertaking in 1929 were far more extensive than those envisioned in 1906. State revenue under the "separation of sources" plan depended primarily upon the revenues from the gross receipts tax. However, that revenue stream was constrained by the property tax rates chosen by localities, as the gross receipts tax was designed to approximate the rate of local property taxation. Regardless of the changing demands on the state, the revenue source was fixed. As a consequence, the 1929 Commission understood that a new tax system was needed.

The 1929 Commission envisioned three important components for the California tax system. First, there was the property tax, which would be focused primarily on real property and devoted to local government.²⁹ The "separation of sources" approach would be abandoned. Second, there would be a tax on business based on each business' net income, initially applied to corporations and banks but perhaps later to unincorporated businesses, which would provide

23. *Id.* at 38.

24. *Id.* at 40–41.

25. FINAL REPORT OF THE CALIFORNIA TAX COMMISSION 2 (1929).

26. *Id.* at 2, 250–64.

27. *Id.* at 2.

28. For a concise summary, see ASSEMBLY INTERIM COMMITTEE REPORTS, *supra* note 16, at 40–41. The 1929 Commission's complete proposals can be found at FINAL REPORT OF THE CALIFORNIA TAX COMMISSION, *supra* note 25, at 74–134.

29. FINAL REPORT OF THE CALIFORNIA TAX COMMISSION, *supra* note 25, at 74–100.

revenue for the state.³⁰ Third, the 1929 Commission raised the idea of a personal income tax to “personalize” the tax burden according to the ability-to-pay principle.³¹ The personal income tax was necessary because prior to this time, the property tax was effectively performing two tasks. It was an objective tax on the value of property—a reasonable measure of the benefits accruing to property from the state—but it was also supposed to tax wealth on an ability-to-pay rationale. Since property wealth was only a small part of total wealth, however, and since voters were not truly interested in nor were fiscal authorities capable of taxing intangible wealth, the property tax performed poorly as a wealth tax. The 1929 Commission recommended narrowing the scope of the property tax to real property and introducing an income tax to address the ability-to-pay-concerns.³²

All three parts of this system were eventually adopted in the next decade. The gross receipts tax and the separation of sources doctrine ended in 1935 with the passage of the Riley-Stewart Amendment in 1933.³³ The franchise tax on corporations, banks, and other California-chartered enterprises was adopted in 1929. It was later reformed and complemented by a corporation income tax in 1937, which taxed all corporations, regardless of their charter, on income derived from California sources.³⁴ Finally, a personal income tax was passed by the Legislature in 1933. It was vetoed by Governor James Rolph, but eventually became law in 1935.³⁵

One of the reasons the 1929 Commission was both effective and prophetic is that it had superb intellectual guidance from Professor Robert Murray Haig of Columbia University, who was the advisor and director of research. Professor Haig is known today for his contributions to the theory of income taxation and the “Haig-Simons” principle.³⁶ The report reflects the institutional and strategic vision for tax policy that Professor Haig brought to the 1929 Commission, as well as a clear understanding of tax developments

30. *Id.*

31. *Id.*

32. *Id.*

33. See *infra* Section II (discussion of Riley-Stewart).

34. ASSEMBLY INTERIM COMMITTEE REPORTS, *supra* note 16, at 46–47.

35. Hartley, Sheffrin & Vasche, *supra* note 15, at 661.

36. For a discussion of the Haig-Simons principles, see JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 536–39 (2004).

around the country and the strengths and weaknesses of various taxes.

II. Two Fiscal Earthquakes: Riley-Stewart and Proposition 13

One phenomenon the 1929 Commission did not envisage was the Great Depression. The 1930s was a time of great turmoil both in terms of economics and taxation. In particular, as incomes fell, the relative burden of property taxes increased, which proved disastrous for a fiscal system largely based on property taxation. Change was inevitable and it came rapidly.

By the early 1930s, demands for property tax relief became pronounced. As personal income fell during the depression, property tax delinquencies rose in California, as they did throughout the country. California experienced less severe problems, however, than did many other jurisdictions. In Los Angeles County, for example, the percentage of uncollected levies rose from 4.3 percent in 1931–32 to 10.1 percent in 1932–33. This was a far cry from the experience in the Midwest, with a 37.6 percent rate in Milwaukee in 1931–32 and a 40.6 percent rate and widespread tax resistance in Chicago in 1931–32.³⁷ Nonetheless, persistent demands for property tax relief emerged in California.

The primary demand was for increased state aid for elementary and secondary schools, a policy that was recommended by the 1931 Legislative Tax Commission.³⁸ Groups supporting property tax relief and increased state aid placed an initiative, Proposition 9, on the November 8, 1932 general election ballot. This initiative not only provided property tax relief but also permitted the introduction of personal income taxes and a sales tax. It was defeated by a nearly 2-1 vote.³⁹

Early in the next year, Governor Rolph faced the first state fiscal crisis of the depression. The governor's own proposals to deal with the fiscal crisis were ignored, and the legislature worked through the spring in fashioning both a budget and the language for the Riley-Stewart initiative, named after State Controller Ray Riley and Board of Equalization Member Fred Stewart.⁴⁰

37. For data on property tax delinquencies, see TAX DIGEST, Jan. 1935, at 29.

38. ASSEMBLY INTERIM COMMITTEE REPORTS, *supra* note 16, at 43.

39. Hartley, Sheffrin & Vasche, *supra* note 15, at 660.

40. *Id.* at 668.

The Riley-Stewart initiative, which the voters approved in a special election on June 27, 1933, had four main components: public utility property was to be returned to local property tax rolls and the gross receipts tax abolished in 1935; the state would provide additional support for elementary and secondary schools; limits were placed on expenditure increases both at the state and local levels; and the legislature was authorized to raise additional revenue to meet the cost for school aid. The source of this revenue was not described in the initiative, but it was generally acknowledged that a sales or income tax would be necessary.⁴¹

The amendment was presented to the voters as a way to end the dependence on the property tax. The ballot measure in favor of the amendment stated:

The ownership of property has become a liability and progress towards recovery is impossible unless this is corrected at an early date The entire structure of the State is based on land values. Much of the difficulty that now confronts us is the tremendous amount of frozen assets that can not be liquidated because of the terrific burden of unsound and confiscatory taxation.⁴²

After the Riley-Stewart Amendment passed by nearly a two to one margin, the legislature faced an enlarged state deficit from the additional school aid. It quickly adopted a retail sales tax based on New York's model and also passed a personal income tax.⁴³ The personal income tax bill was vetoed by the Governor.⁴⁴ There were other revenue increases as well, but they were insufficient to cover expenditures during the biennium, and the state fiscal situation continued to deteriorate. In early 1935, Governor Frank Merriam proposed an increase in taxes of \$107 million that included instituting a personal income tax and raising the sales tax rate from two percent to three percent. The Legislature adopted these policies. After introduction of the sales tax, the personal income tax, and the

41. *Id.*

42. The argument for the ballot measure for Riley-Stewart can be found on the site of the University of California Hasting College of the Law Library. See PROPOSED AMENDMENTS TO CONSTITUTION AND PROPOSITIONS 3 (June, 27 1933), available at http://traynor.uchastings.edu/ballot_pdf/1933s.pdf.

43. Hartley, Sheffrin & Vasche, *supra* note 15, at 661.

44. *Id.*

franchise and corporation income taxes, the basic framework of California taxation persisted for forty years.

The next major fiscal earthquake came directly from the grass roots—Proposition 13. If deflation and falling incomes caused the revolt against property taxes in the 1930s, the revolt in the 1970s was due to the opposite phenomenon, inflation. To understand the genesis of Proposition 13, it is necessary to understand how the property tax system functioned in California prior to the decade-long inflation of the 1970s. First, consider a system in which local governments desire to raise a fixed amount of revenue to provide local services—what economists call a *revenue-based system*. In this system, it clearly would not matter whether properties are assessed at 100% of market value and taxed at a one percent rate or assessed at fifty percent of market value and taxed at a two percent rate—in either case, the revenue raised by local governments would be identical, as the tax rate multiplied by the tax base (assessed value) is the same. Under a revenue-based system, if assessments increase but revenue needs stay the same, tax rates are reduced accordingly. In contrast, in a *tax-rate system*, tax rates are fixed and thus changes in assessments which change the tax base generate changes in revenues. In a tax-rate system, tax rates are autonomous, unlike in a revenue-based system.

As Isaac Martin effectively demonstrated, prior to Proposition 13, the fragmented structure of local government did not fit the model of a revenue-based property tax system.⁴⁵ Instead, it was closer to a tax-rate based system, in which increases in assessed value lead to higher revenues, at least over short periods of time. Martin showed that as property values rose rapidly in the 1970s as part of the general inflationary environment of the decade, the property tax system experienced stress. Within each county there were multiple authorities with the power to raise or lower tax rates—city and county governments, school districts, and multiple special districts—as well as independently elected assessors. There was no overall coordination between these multiple authorities. In principle, political authorities could have lowered tax rates as assessments increased, but they failed to do so in a timely manner. Thus, as inflation rose and the assessors reassessed properties on differing time frames and with different methodologies, the result was a sharp

45. See ISAAC WILLIAM MARTIN, *THE PERMANENT TAX REVOLT: HOW THE PROPERTY TAX TRANSFORMED AMERICAN POLITICS* (2008).

increase in tax bills and a shift of the tax burden on homeowners. These increases and shifts in the tax burden, often idiosyncratic and unpredictable, drove the passion of the tax revolts.⁴⁶

In particular, there was a clear shift away from taxation on commercial and industrial property to taxation of homeowners. Across taxing jurisdictions, assessors varied in how frequently they re-assessed properties. The birth of mass appraisals for single-family properties through regression techniques led to more rapid re-assessments which, in turn, created more inequities across jurisdictions as well as between properties within jurisdictions. This system, which worked effectively when there was little inflation, failed miserably when inflation became a predominant feature of the economic landscape. When inflation was low, political jurisdictions had sufficient time to adjust tax rates to avoid disrupting the existing tax shares paid by various properties and interests. But when inflation accelerated, time was compressed, and the political system was simply unable to cope with the rapid changes.⁴⁷

When Proposition 13 was passed by the voters in 1978, it fundamentally changed the fiscal landscape in California. Extensive analysis of the fiscal effects of Proposition 13 on the state as well as local governments has been published elsewhere, and a full analysis is beyond the scope of this paper.⁴⁸ However, a few key points are relevant here. In retrospect, what is striking is how many of the concerns echoed those of the Riley-Stewart amendment. First and foremost, Proposition 13 reduced the tax burden on property by responding directly to voters' concerns about a perceived unsustainable tax burden.⁴⁹ Secondly, Proposition 13 changed the relationship between state and local governments and effectively reduced the autonomy of local governments, with the state now taking a leading role in financing elementary and secondary education.⁵⁰ Third, Proposition 13 reduced total state and local revenues and placed an additional revenue burden on the state.⁵¹ Unlike Riley-Stewart, no new taxes were implemented immediately—

46. *Id.* at 6–10.

47. See Steven Sheffrin, *Review of The Permanent Tax Revolt: How the Property Tax Transformed American Politics*, 86:1 CAL. HIST. 72 (2008) (book review).

48. See, e.g., ARTHUR O'SULLIVAN, TERRI A. SEXTON & STEVEN M. SHEFFRIN, *PROPERTY TAXES AND TAX REVOLTS: THE LEGACY OF PROPOSITION 13* (1995).

49. *Id.* at 1–5.

50. *Id.* at 103–04.

51. *Id.* at 97–98.

although cities and counties began to increase their fees and charges to offset some of the loss in property tax revenues.⁵² Over time, however, the state became increasingly reliant on the personal income tax to finance the state budget—an issue addressed by the Parsky Commission.

There is one final, important similarity between Riley-Stewart and Proposition 13. Riley-Stewart's expenditure limitations required a two-thirds vote of the legislature for a budget if appropriations exceeded five percent of prior year spending.⁵³ This provision is regarded as the beginning of the two-thirds voting requirement to pass a budget in force today.⁵⁴ In 1962, the references to the five percent appropriation limit were deleted from the state constitution by Proposition 16, leaving the two-thirds voting requirement in place.⁵⁵ Proposition 13 is the genesis of the two-thirds vote for tax increases in the state legislature and for special districts at the local level.⁵⁶ Both measures aimed to constrain future tax increases either through budgetary control or direct control over taxes. In the author's view, they were both fueled by populist sentiments that were suspicious of larger government.⁵⁷

A ballot argument in favor of Proposition 13 from State Senator John Briggs conveys this populist flavor: "What Ronald Reagan describes as the 'spenders coalition' of spendthrift politicians and powerful special interests are spending millions to defeat Proposition 13. . . . More than 15% of all government spending is wasted!"⁵⁸ These comments echo much popular sentiment to this day that state and local government budgets can be reduced without sacrificing the

52. *Id.* at 98.

53. DAVID R. DOERR, CALIFORNIA'S TAX MACHINE: A HISTORY OF TAXING AND SPENDING IN THE GOLDEN STATE 40 (2d ed. 2008). *See also* Fred Silva, *California's Two-Thirds Legislative Vote Requirement and Its Role in the State Budget Process*, WESTERN CITY MAGAZINE, LEAGUE OF CALIFORNIA CITIES (Nov. 2008), available at <http://www.cacities.org/index.jsp?zone=wcm&previewStory=27483#>.

54. *Id.* at 40.

55. *Id.*

56. *Id.* at 176–77.

57. Evidence for this position is found in the ballot measure discussed in the next paragraph.

58. CALIFORNIA VOTERS PAMPHLET, PRIMARY ELECTION 57 (1978), http://traynor.uchastings.edu/ballot_pdf/1978p.pdf.

quality of government programs. UC Berkeley political scientist Jack Citrin has made these same points repeatedly.⁵⁹

III. The Parsky Commission Report

The primary mission of the Parsky Commission, as established by its animating Executive Order, was to address the volatility of California's tax system.⁶⁰ The Executive Order mentions other issues, including the changing nature of the economy and the need for better incentives to strengthen the economy and generate revenue, but its emphasis was on volatility.⁶¹ This focus on volatility is somewhat unusual. While governments typically favor stable revenue sources, economists recognize that volatile government revenue streams mean less volatile income streams for households and firms.⁶² The principle of "automatic stabilizers" in macroeconomics is based on this premise.⁶³

Volatility became an issue largely for reasons of political economy. The rationale is that politicians are unable to resist spending tax revenue during good times, thereby locking the state into an unsustainable expenditure pattern. A downturn will then plunge the state into a fiscal crisis. This was the critique of the fiscal woes prevailing under Governor Gray Davis.⁶⁴ Despite recognizing this problem, Governor Schwarzenegger viewed himself powerless to change it, and he continued to run structural budget deficits after succeeding Governor Davis.⁶⁵ Relatively buoyant economic times and clever budget gimmicks concealed the structural deficit, but it

59. For a recent statement, see Jack Citrin, *Proposition 13 and the Transformation of California Government*, 1:1 CAL. J. POL. & POL'Y (2009), available at <http://www.bepress.com/cgi/viewcontent.cgi?article=1013&context=cjpp>.

60. See Exec. Order No. S-15-09, (July 29, 2009), available at <http://www.gov.ca.gov/executive-order/12921/> (the Governor's Executive Order S-15-09 forming the Commission).

61. Commission Report, op cit, pp. i-ii.

62. ARTHUR O'SULLIVAN, STEVEN M. SHEFFRIN & STEPHEN J. PEREZ, *ECONOMICS: PRINCIPLES, APPLICATIONS, AND TOOLS* 222-23 (6th ed. 2009).

63. *Id.* States as well as the federal government can provide automatic stabilizers.

64. See Steven Sheffrin, *State Budget Deficit Dynamics and the California Debacle*, 18 J. ECON. PERSPECTIVE 205-26 (Spring 2004).

65. For a representative assessment, see Dan Walters, *Governor Yet To Do What He Promised*, FRESNO BEE, Jan. 2, 2010, available at <http://www.fresnobee.com/columnists/walters/story/1767634.html>.

dramatically re-emerged during the most recent financial and economic crisis.⁶⁶

In retrospect, the strong emphasis on volatility predetermined the direction of the Parsky Commission's recommendations. Over time, California has become increasingly reliant on the personal income tax ("PIT") as the primary funding source for the state general fund. In 2007-08, the PIT provided fifty-three percent of the general fund.⁶⁷ Because California includes capital gains and stock options as part of the personal income tax base, this component of the revenue stream is highly volatile.⁶⁸ Furthermore, the lion share of the PIT revenue originates from the very top of the income distribution—in 2006, the top one percent of taxpayers comprised twenty-five percent of adjusted gross income but forty-eight percent of personal income tax revenues.⁶⁹ Consequently, an obvious "solution" to California's volatility problem was to reduce reliance on the PIT either through changing the treatment of capital gains and stock options or through lowering personal income tax rates. The Parsky Commission chose the latter course.⁷⁰ But how would such a change be financed and how would the Parsky Commission deal with the obvious distributional issues?

The key recommendations of the Parsky Commission affecting tax revenues consisted of four components. First, there were personal income tax reductions. The Parsky Commission proposed reducing the number of tax brackets to two—a 2.75% rate up to \$60,000 in taxable income and a 6.5% rate above that—with a standard deduction of \$45,000.⁷¹ Deductions were allowed only for mortgage interest, charitable contributions, and property taxes.⁷² Second, the state portion of the general sales tax was eliminated.⁷³ Third, the

66. MAC TAYLOR, CALIFORNIA LEGISLATIVE ANALYST'S OFFICE, THE 2010-11 BUDGET: CALIFORNIA'S FISCAL OUTLOOK 3-10 (Nov. 2009), http://lao.ca.gov/2009/bud/fiscal_outlook/fiscal_outlook_111809.pdf (last visited Mar. 10, 2010).

67. COMMISSION ON THE 21ST CENTURY ECONOMY, *supra* note 4, at 14.

68. See ELIZABETH G. HILL, CALIFORNIA LEGISLATIVE ANALYST'S OFFICE, REVENUE VOLATILITY IN CALIFORNIA 8-10 (Jan. 2005), http://www.lao.ca.gov/2005/rev_vol/rev_volatility_012005.pdf (last visited Mar. 10, 2010).

69. COMMISSION ON THE 21ST CENTURY ECONOMY, *supra* note 4, at 18.

70. *Id.* at 41-43.

71. *Id.* at 43.

72. *Id.*

73. *Id.* at 44.

corporation tax was eliminated.⁷⁴ Finally, there would be a new tax—the Business Net Receipts Tax (“BNRT”).⁷⁵

These proposals, if implemented, would have brought sweeping and dramatic changes to California’s tax system. The personal income tax reductions, the elimination of the state general sales tax, and the elimination of the state corporate income tax all would have sharply reduced revenue.⁷⁶ The new BNRT was designed to make up the revenue shortfall and maintain overall revenue neutrality in the process.⁷⁷

What exactly is the BNRT? It is a tax that would be applied to the “net receipts” of a business, consisting of gross receipts minus purchases of goods and services from other firms, including investment goods.⁷⁸ By allowing a full deduction for investment goods, it was designed to be a consumption-based value-added tax.⁷⁹ The BNRT would be imposed on all business entities, not just corporations—including flow-through entities such as S-Corporations, partnerships of all types, and sole proprietorships.⁸⁰ In terms of implementation, it would use combined reporting and the unitary business principle, familiar from California’s current corporate income tax, but limit its application to the “water’s edge.”⁸¹ The BNRT would be apportioned to the State of California by the use of a destination sales factor.⁸² The nexus rules, which dictate whether

74. *Id.* at 43–44.

75. *Id.* at 44–46.

76. COMMISSION ON THE 21ST CENTURY ECONOMY, COMMISSION TAX PROPOSAL (Sept. 29, 2009) (hereinafter COMMISSION TAX PROPOSAL) http://www.cotce.ca.gov/documents/reports/documents/Final_Report-Presentation.pdf (last visited Mar. 10, 2010).

77. *Id.*

78. Appendix to the COMMISSION ON THE 21ST CENTURY ECONOMY, *supra* note 4, at A3–A12.

79. *Id.* at A4.

80. *Id.* at A5.

81. *Id.* at A6. “Water’s edge” means that the tax applies only to companies operating within the United States, although there are exceptions to handle complex entities related to trade promotion or sheltered income. See California Taxpayer Association, “The Role of the Water’s Edge Election in California’s Unitary Taxation Method,” *available at* <http://www.caltax.org/issues/legislation/WatersEdgeUnitaryTax.pdf>. For a detailed description, see California Franchise Tax Board’s Water’s Edge Manual, <http://www.ftb.ca.gov/aboutFTB/manuals/audit/water/> (last visited Mar. 21, 2010).

82. Appendix to the COMMISSION ON THE 21ST CENTURY ECONOMY, *supra* note 4, at A7–A8.

California has jurisdiction to tax a business, would be based on the presence of payroll, property, or sales in the state.⁸³

As soon as the BNRT was announced, it began to draw considerable attention. A letter addressed to the Parsky Commission from the nine academic tax lawyers and economists highlighted a number of key problems with the tax:

(1) Unlike a European credit-invoice tax, it would penalize firms exporting from California and not be purely a consumption tax, but in part a tax on production.

(2) The expansive nexus provisions, designed to capture firms selling into California from outside the state, would be the subject of considerable and unpredictable legal controversy. Would the tax be viewed as a sales tax and thus subject to the restrictions imposed by *Quill v. North Dakota*, or would it be considered an income tax, subject to the restrictions of PL 82-272?⁸⁴ In either case, overextending the reach of the tax would subject it to considerable legal risk.

(3) The BNRT would create incentives to substitute independent contractors for employees, as payments for independent contractors were deductible, unlike compensation of employees. Similarly, there would be incentives to engage in transactions with firms outside the reach of the tax, such as firms beyond the “water’s edge” or having no nexus with California.

(4) As a new tax, the BNRT would be subject to additional potential gaming, again in unpredictable ways.

Based on these concerns, the experts viewed the sweeping implementation of the BNRT and replacement of other taxes as too risky.⁸⁵

In subsequent testimony and discussion, many other concerns were raised. The BNRT was only designed to replace the general state sales tax, but not the state portion of the sales tax devoted to transportation or local sales taxes.⁸⁶ Eliminating the state portion of the general sales tax would create administrative complications for

83. *Id.* at A5.

84. *Quill v. North Dakota*, 504 U.S. 298 (1991) (placing limits on the ability of states to collect tax from out-of-state sellers); Pub. L. No. 86-272, 73 Stat. 555-56 (1959) (limiting states’ ability to tax the income of out-of-state sellers who simply solicited the market in another state).

85. Stark Letter, *supra* note 11.

86. Steven Sheffrin, Testimony at the California State Assembly Revenue and Taxation Committee (Oct. 14, 2009), (hereinafter Sheffrin Testimony) *available at* <http://www.assembly.ca.gov/acs/newcomframeset.asp?committee=21>.

the state. Either cities, counties, and special districts would have to create their own duplicative administrative structures to manage the sales tax or rely on a state government that would have virtually no long-term interest in managing this revenue source.⁸⁷ Either of these changes would inevitably lead to reduced efforts in auditing, monitoring, and enforcing existing laws. In addition, the changes would hamper efforts to modernize the sales tax, such as through the Streamlined Sales Tax Project.⁸⁸ Absent a system that encourages strong state interest, sales tax administration would likely be balkanized across counties, with the consequence of spreading anachronistic practices imposing additional compliance costs on businesses. Once the state no longer receives ongoing revenue from the sales tax, it cannot be counted on to provide necessary oversight for local taxes, as it does now.

The Parsky Commission in its own report bemoaned the fact that the existing corporate tax was expensive to administer because the current system requires: First, that corporate income be apportioned between California and jurisdictions outside of California and second, under California law, that the corporate tax be calculated by apportioning the income of combinations of corporations that form a unitary group.⁸⁹ Perhaps the Parsky Commission had not considered this part of their report when they proposed the BNRT. Except for details in the calculation of the tax base, the BNRT looks exactly like a state corporation tax. However, the BNRT expanded the scope of these identical provisions—apportionment and combination—to all business entities of sufficient size, not just corporations. This would sharply expand the number of taxpayers subject to the rather intricate rules of apportionment, business and non-business income, and combination, as well as the unitary business principle. It is well known that issues of combination and the determination of whether entities are part of a unitary group are often most difficult for smaller business entities.⁹⁰ Many court cases document the difficulty of making unitary determinations in these settings.⁹¹ Flow-through entities such as LLCs, LLPs, S-corporations, partnerships, and sole proprietorships would test the limits of the unitary business principle

87. *Id.*

88. *Id.*

89. COMMISSION ON THE 21ST CENTURY ECONOMY, *supra* note 4, at 21–23.

90. *Id.* at A7–A8.

91. Sheffrin Testimony, *supra* note 86.

and the additional compliance burden would be significant. It can also be anticipated that many of these flow-through entities would be created and designed explicitly to test the limits of the reach of the BNRT by either exploiting nexus limitations or by locating outside the “water’s edge” reach of the tax.

Some commentators were also concerned that any proposed new tax would quickly be attacked by lobbyists and special interests, particularly because its underlying theoretical basis is not clear.⁹² There is much to be said in favor of the maxim that an “old tax is a good tax.” Moving away from familiar taxes whose parameters have been established through litigation to a new and untested tax would create additional uncertainty for firms and increase lobbying and rent-seeking on the part of special interests. The Parsky Commission’s own recommendation for a Research and Development credit, despite virtually no evidence on its current efficacy as part of the Corporation Income Tax, as well as possible deductions for employee health insurance, previewed the types of interventions that could be expected.⁹³ One would also anticipate strong pressure from labor interests to push for deductibility of some forms of employee compensation, particularly if outsourcing becomes an important consideration. As a result of the inevitable changes that would be introduced to get the tax enacted, firms considering investing in California will not be able to count on a stable framework for taxation. This additional uncertainty could easily act as a punitive “tax” on doing business in California.

Modern tax reform proposals almost always contain a clear discussion of the distributional aspects of the tax.⁹⁴ This was a glaring omission from the Parsky Commission’s report. The report itself did not discuss the changes in tax burden associated with the proposed tax changes and only implied that the new tax preserved the same degree of progressivity.⁹⁵ Only by looking at a PowerPoint presentation prepared by the Parsky Commission could one detect its

92. Pomp Letter, *supra* note 8.

93. Letter from George Halvorson, Chairman and Chief Executive Officer, Kaiser Permanente, to the Honorable Gerald Parsky, Chair, and Commissioners, California Commission on the 21st Century Economy (Sept. 28, 2009), *available at* http://www.cotce.ca.gov/documents/correspondence/staff_and_commissioners/.

94. *See, e.g.*, PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 19–40 (Nov. 2005), http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_1_11-1.pdf (last visited Mar. 21, 2010).

95. COMMISSION ON THE 21ST CENTURY ECONOMY, *supra* note 4, at 42.

claim that the proposal would shift an additional \$6.8 billion of taxes to the federal government or non-residents.⁹⁶ The additional part absorbed by the federal government became known as the “federal offset.”⁹⁷ The Parsky Commission’s claim was based on an unpublished report from Ernst & Young LLP and on a later overview written by the Parsky Commission staff, but was supported by no evidence in the report itself.⁹⁸ The claim is premised on the idea that the BNRT would be deductible from the federal income tax.⁹⁹

Why was this claim about shifting the burden of the tax to the federal government or non-residents important? If some or all of the \$6.8 billion was not shifted to the federal government or non-residents, then a substantial portion of the non-shifted tax would likely be borne by consumers or workers in California. This result is what one would normally expect from the Parsky Commission’s proposal to shift from income taxes toward taxes more closely aligned with consumption. This would have the effect of shifting the overall burden of taxation in California from groups earning above \$100,000 to those earning below \$100,000 and would certainly not be a distributionally neutral tax change.¹⁰⁰

Although economists disagree on many things, they do agree that assessing the ultimate burden of taxation is an extremely difficult matter and depends upon the assumptions built into the analysis.¹⁰¹ It appears, however, that the methods employed by the staff and their consultants did not fully take into account how changes in tax structure will, even at a first approximation, affect baseline taxable incomes.

For example, simply replacing a retail sales tax with a receipts-based tax like the BNRT would increase firms’ taxable incomes along with their deductions and not lead to any additional federal tax deductions or “federal offset.” To see this, suppose that a product sold for \$100 before tax and that a six percent sales tax was imposed.

96. COMMISSION TAX PROPOSAL, *supra* note 76.

97. See Ernst & Young, LLP, Analysis of the Incidence of Selected Tax Proposals Prepared for the California Commission on the 21st Century Economy (Sept. 25, 2009) (on file at Institute of Governmental Affairs Library, UC Davis, Davis Ca. 95616); see also Report from the staff of the Commission, Commission on the 21st Century Economy Commission Tax Proposal: Outline of Incidence and Distributional Analysis, (on file at Institute of Governmental Affairs Library, UC Davis, Davis Ca. 95616) (undated).

98. *Id.*

99. *Id.*

100. COMMISSION TAX PROPOSAL, *supra* note 76.

101. See O’SULLIVAN, SHEFFRIN & PEREZ, *supra* note 62, at 476–80.

If the cost of the tax was shifted to consumers, prices would rise to \$106, with the firm turning over \$6 to the government, leaving its net sales at \$100. Now, replace the sales tax with a six percent receipts tax. Prices still rise to \$106 as before but now the firm's total receipts are the full \$106. The firm is allowed a \$6 deduction, leaving its net sales exactly at \$100 as before. Just because firms can deduct the business net receipts tax from their income does not mean that they shift any of its burdens to the federal government.

At best, the Parsky Commission's claim that the changes are distributionally neutral—again, not discussed explicitly in the report—were unproven. As a result, the public's general impression was that the BNRT was in large part financing substantial tax cuts for the highest income levels in California.¹⁰² Of the approximately \$14 billion in personal income tax reductions, \$4 billion went to those with annual incomes over \$1 million and \$9.5 billion to those with annual incomes exceeding \$100,000.¹⁰³ The Parsky Commission failed to meet its burden of proving that imposition of the BNRT would offset these obvious tax decreases for the wealthy.

In summary, the Parsky Commission's report came under attack because it relied heavily on a new and untested tax to replace well-established existing taxes, paid insufficient consideration to long-term administrative issues, and failed to deal in an adequate manner with the changes to the distribution of the tax burden. The novelty of the tax disturbed many. Currently only Michigan has a similar tax, but it imposes a rate of 0.8% on "modified gross receipts" and is fully integrated with a more traditional business income tax of 4.95% that applies to all business entities.¹⁰⁴ But Michigan only recently adopted this tax as a replacement for its earlier Single Business Tax, another type of value-added state tax.¹⁰⁵ There has not been sufficient experience to judge the proposed tax's economic impact and administrative effects, experience necessary to create comfort with such a radical change.

102. See Jean Ross, Cal. Budget Project, COTCE Proposals Would Increase Budget Gaps, Tax Low- and Middle-income Californians (2009), http://www.cbp.org/pdfs/2009/CaliforniaBudgetBites/090911_CBP_Analysis_Cotce_proposals.pdf (last visited Mar. 21, 2010).

103. COMMISSION TAX PROPOSAL, *supra* note 76.

104. Sheffrin Testimony, *supra* note 86.

105. *Id.*

IV. Looking Back and Looking Ahead

In its Summary of Recommendations, the 1929 Commission prefaced its specific recommendations with the comment, "Such a system would comprehend no measures which have not been thoroughly tested by experience in other states."¹⁰⁶ The Parsky Commission, with its relatively short time frame, did not have the luxury or inclination to thoroughly examine the practices of other states, instead choosing to go forward with an untested tax which would raise so much revenue that it would require abolishing the corporate tax and the general state sales tax while financing dramatic reductions in personal income taxes. This approach inevitably generated strong reactions. The Parsky Commission did not have the time or budget to prepare detailed and in-depth studies, such as those represented in the twelve volumes of the Assembly's Major Tax Study from 1963-65.¹⁰⁷ Apparently neither state governments nor tax commissions are as reflective as they were in the 1960s.

As previously noted, the Parsky Commission's instruction to focus on the "volatility" in the California tax system largely dictated its final conclusions. But volatility is an abstract concept and not one that connects with ordinary voters. The two successful tax commissions, as well as the Riley-Stewart Amendment and Proposition 13, operated on a more fundamental level, responding directly to voter's concerns. Both tax commissions focused on property taxes, which directly impinged upon the welfare of citizens. The 1906 Commission focused on inequities across jurisdictions, while the 1929 Commission focused on inequities across both jurisdictions and firms. These inequities translated directly into tax bills. The two successful voter initiatives, Riley-Stewart and Proposition 13, both promised tax relief for voters.

The two earlier tax commissions were also forward looking in terms of envisioning the relationships between local governments and the state. Both commissions recognized that the state needed its own source of revenue distinct from local government; this was the genesis of the "separation of sources" in 1906 and the proposals for a net income tax on corporations and banks in 1929.¹⁰⁸ In contrast, the Parsky Commission largely neglected local government and, indeed,

106. FINAL REPORT OF THE CALIFORNIA TAX COMMISSION, *supra* note 25, at xxi.

107. DOERR, *supra* note 53, at 708.

108. See discussion *infra* Section II.

left local governments with the remainder of an eviscerated sales tax, having given no thought to longer term administrative issues.

A successful tax reform commission or a successful movement to change the tax structure in California should heed the lessons of California history. It should deal with perceived inequities that concern taxpayers and should understand the changing role that the state government plays in the constantly evolving state-local and even state-federal relationship. Finally, it must find some way to resonate with public sentiments of a populist nature.

Other constraints will naturally limit the scope of any feasible tax reform. Despite its well-known inequities, the post-Proposition 13 taxation system for residential property is highly regarded by voters.¹⁰⁹ It is not possible to reinstitute the pre-1978 local government tax structure. The state will continue to play a controlling role in local finance. The state will face other increasing burdens, as the federal government forces it to take a greater role in health care through expansions of Medicaid.¹¹⁰

With these constraints in mind, I offer for consideration two proposals: a reform of the system of property taxation for commercial and industrial property and a new broad-based business tax. The first proposal addresses the issue of perceived inequities in the tax system, while the second recognizes the additional and growing responsibilities undertaken by the state and the need for a new revenue source.

A. Taxing Commercial and Industrial Property at Market Value

The first proposal recommends taxing commercial and industrial properties at their current market values, as opposed to the modified acquisition value of Proposition 13. It is unfortunate that the so-called “split roll” has become such a political lightning rod because it has a strong intellectual basis and could raise substantial revenue without creating great economic dislocations.¹¹¹ My recommendation

109. See Steven M. Sheffrin, *Re-Thinking the Fairness of Proposition 13*, in *AFTER THE TAX REVOLT: CALIFORNIA'S PROPOSITION 13 TURNS 30*, 117–32 (Jack Citrin & Isaac William Martin eds., 2009).

110. President Obama's health proposal would require additional state funding for Medicaid. See Stu Woo, *Schwarzenegger Airs Medicaid Cost Concern, But Still Backs Action*, WALL ST. J., Oct. 28, 2009, at A5, available at <http://online.wsj.com/article/SB12566629178410871.html>.

111. Steven Sheffrin, *Economic Aspects of a Split-Roll Property Tax* (2009), available at <http://www.cotce.ca.gov/documents/reports/documents/EconomicAspectsofASplit.pdf/> (last visited Mar. 21, 2010).

is that the one percent tax rate be maintained for commercial and industrial property, but that those properties are assessed at their current market value on a yearly basis. The increased revenue from this change is subject to some uncertainty, but most estimates today fall in the \$4 billion to \$7 billion range on an annual basis.¹¹² Previous work has demonstrated the gross inequities caused by Proposition 13 for commercial and industrial properties, with the greatest beneficiaries being the largest firms.¹¹³

Taxing commercial and industrial property at market value is not the same as simply raising the tax rate. If the tax rate were increased, both buyers and sellers would rationally pay less for property, and property values would fall. However, under Proposition 13, buyers of properties pay taxes on the sale price—that is, the current market value.¹¹⁴ Property prices will reflect what the buyer demands, not the tax-advantages enjoyed by long-time holders of property, who constitute a minority of property holders, and not the “marginal” seller.¹¹⁵ The tax advantages of the long-term property owners are not transferrable and will not affect market price.

Of course, ending the acquisition value treatment for commercial and industrial property would mean that commercial and industrial property owners currently enjoying tax-favored treatment would pay more in taxes. But these taxes would not affect their marginal incentives to invest—as all new investment pays property taxes at current market value. The increased tax payments would be equivalent to a capital-levy on firms for their under-assessed property. Shareholders or owners of the property would pay more tax, but it would have minimal effects on economic efficiency. Indeed, the only possible disadvantage to new purchasers would occur if future price increases for property exceed two percent a year.¹¹⁶ However, this result is unlikely in the near future, and the effects on the cost of new investment would be minimal.

It is true that county assessors would have increased workload and would need to be compensated for their extra work. However, a

112. Terri A. Sexton & Steven M. Sheffrin, *The Market Value of Commercial Real Property in Los Angeles County in 2002*, 28 STATE TAX NOTES MAGAZINE 85–89 (2003), available at <http://www.iga.ucdavis.edu/Research/CSLT/Publications/MarketValueCommercialRealPropertyPaper.pdf>.

113. O’SULLIVAN, SHEFFRIN & PEREZ, *supra* note 62, at 55–70.

114. *Id.* at 5–6.

115. SHEFFRIN, *supra* note 111.

116. *Id.*

very small fraction of the additional revenue could finance this added expense.¹¹⁷ Only California extends acquisition-value treatment to non-homeowners; other states restrict it to homeowners.¹¹⁸ Whether rental property or single-family non-homeowner property should still retain acquisition-value protection would have to be determined before bringing this issue to the voters.

B. A Broad-Base, Low-Rate Source Tax

Let me now turn to my second proposal. Following the lead of the Parsky Commission, it is worthwhile to consider a broad-base tax that touches all segments of the economy and all types of enterprises. The Parsky Commission's proposal did reach a new range of lightly-taxed businesses—importantly—the service industry. It was the Parsky Commission's judgment that it would be difficult to reach the service sector through legislation reforming the sales tax.¹¹⁹ Although other states, for example Texas, have extended the reach of the sales tax to include a myriad of services, attempts to extend it broadly in a single legislative package—such as in Florida and Massachusetts—were not successful.¹²⁰ Thus, the Parsky Commission deemed it worthwhile to consider a broad-based tax as an alternative.

My proposal differs from the BNRT proposed by the Parsky Commission in important ways. Specifically, I recommend that California consider a low-rate, less than one percent, source-based tax for all businesses with a base composed of economic value-added: the sum of compensation, interest, and depreciation. Let's call this the BBT, the business benefit tax, and its rationale would be that all businesses in California enjoy the benefits of the state's economic and legal system.

In economics tax-jargon, the proposed tax is a source-based, addition method, income value-added tax. It would apply to *all*

117. See CAL. ASSESSOR'S ASS'N, *SPLIT ROLL-SPLIT RATE INITIATIVES WHITE PAPER* (2005), <http://www.calassessor.org/positions/split%20roll.pdf> (last visited Mar. 21, 2010) (providing an estimate of additional administrative expenses).

118. O'SULLIVAN, SHEFFRIN & PEREZ, *supra* note 62, at 15–38.

119. The Commission was aware that piecemeal revisions had been discussed in earlier years, but stated that there was a sense of “urgency” to their deliberations which required bold action. Press Release, California Commission on the 21st Century, *supra* note 2, at 3.

120. For a discussion by former Executive Director of the Federation of Tax Administrators for the President's Advisory Panel on Tax Reform, see Harley Duncan, Fed'n of Tax Admin., *Federal Tax Reform and State Taxes* (2005), <http://www.taxadmin.org/fta/rate/taxreformpanel.pdf> (last visited Mar. 21, 2010).

businesses (including corporations, partnerships, and sole proprietorships) and would utilize combined-reporting, with the tax apportioned to California ideally based on payroll, property, and possibly also by sales. These apportionment factors are chosen to reflect that the tax is based on value-added generated in California. Value-added consists of compensation and capital income, so it is natural to apportion it by payroll and property measures. A sales factor could be included in the apportionment schema, as businesses selling into the state from outside still enjoy the benefits of the market. However, introduction of a sales factor into what is essentially a value-added tax does raise the peculiarities that were addressed in *Trinova v. Michigan Department of Treasury*.¹²¹

In its combined report, a business would start with net income and add back in compensation of employees and depreciation. Non-profits and government entities would be subject to the tax; however, the tax rate would only apply to their compensation. This would place non-profits and profit-making firms on a roughly equal footing. This is important for the health care and educational industries. Unlike the BNRT, it would not attempt to reach out-of-state taxpayers through an aggressive sales-only apportionment factor or through the use of a risky theory of nexus as the basis of the tax. Instead, it is designed to be a fair, broad-based tax based on the benefit principle. The tax base—*income value-added*—is perhaps the best measure to capture the benefits that accrue to businesses operating in California.¹²² This tax is not designed to be a consumption tax because capital purchases are not deducted from the tax base. Thus, the BBT is not designed as a replacement for the sales tax. Again, this is an important difference from the BNRT.

The BBT could be designed as an *addition* to California's existing taxes and not necessarily as a substitute. All taxes cause distortions and source-based taxes in open economies can cause disincentives for businesses and workers.¹²³ But the rate proposed

121. *Trinova Corp. v. Dep't of Treasury*, 498 U.S. 358 (1991). In that case, the taxpayer, Trinova Corporation, demonstrated that its payroll and property were predominately located in Ohio, but the sales factor has the effect of bringing a large part of its tax base into Michigan. While the Supreme Court did allow the use of a three-factor formula in this case, using payroll and property as the primary factors avoids this problem. *Id.*

122. George Zodrow, *Revenue Options for the State of Texas*, 34 STATE TAX NOTES MAGAZINE 799-821 (2004).

123. See Steven Sheffrin, *Book Review: State Sales and Income Taxes*, 53 NAT'L TAX J. 965 (2000) (book review) (reviewing GEORGE ZODROW, *STATE SALES TAXES AND INCOME TAXES* (1999)).

would be very low and reach sectors that are currently very lightly taxed—for example, services. If the BBT proved to bring in sufficient revenues, it could be used to finance reductions in the personal income tax, the sales tax, or the existing corporation tax, alleviating some of these distortions.

Conclusion

The 1929 Commission report did consider favorably the possibility of a low-rate broad-based tax reaching non-incorporated businesses.¹²⁴ Today, these entities are even more important in the functioning of the economy. The 1929 Commission did not ultimately include this plan in its final recommendations but did raise it as a viable possibility.¹²⁵ Eighty years later, the idea of a low-rate broad-based tax on a stable base as an important source of revenue for the state is worth reconsidering.

With the exception of the reform of the bank tax during the deliberations of the 1929 Commission, all of the recommendations of prior commissions took a number of years to become effective. The recommendations of the 1906 Commission were enacted through the passage of Amendment 1 in 1910.¹²⁶ The recommendations of the 1929 Commission were tentatively rejected by a legislative committee in 1931 that wished to refine, but not eliminate, the gross receipts tax and the separation of sources.¹²⁷ But Riley and Stewart drew upon the work of the 1929 Commission for their initiative. It is unlikely the Parsky Commission's recommendation will surface again in the near future, given its initial reception. But despite the Parsky Commission's intentions, it may have planted the seeds for a broad-based business tax to supplement state revenue.

What is missing from the two proposals suggested here—the reform of the property tax for commercial and industrial property and a new broad-based origin-based value-added tax—is a mechanism to tie it to the voters' ongoing concerns. In the past, major changes have always been tied to populist concerns while limiting the scope and reach of government. Finding convincing mechanisms for limiting government in a context where the responsibilities of state government have increased is a challenging task. Even the far-sighted ideas of the 1929 Commission needed the populist spirit of

124. FINAL REPORT OF THE CALIFORNIA TAX COMMISSION, *supra* note 25, at 79–80.

125. *Id.*

126. ASSEMBLY INTERIM COMMITTEE REPORTS, *supra* note 16, at 26.

127. STOCKWELL, *supra* note 17, at 4–5.

Riley-Stewart, including the expenditure limitations that evolved into the two-thirds voting requirement for budget passage, to eventually be enacted into law. Good ideas require political passion in order to become law.