



California Tax Reform Association

926 J Street, Suite 710, Sacramento, CA 95814

Ph: 916.446.4300 Fax: 916.444.6611

Email: info@caltaxreform.org

<http://www.caltaxreform.org>

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Tax Policy for the 21st Century: Resolving California's Long-Term Structural Deficit

Executive Summary: The Flawed Economics of California's Tax System

No one likes taxes. Yet there is a broad consensus, dating back to at least the 1950's, that a healthy public sector is a critical part of California's long-term success. To maintain a high productivity economy and society, California must have a tax system that provides sufficient revenues for education, infrastructure and vital public services, and raises revenues in as efficient, effective, and equitable manner as possible.

Facing large deficits and a burden of debt, the state must engage in rigorous analysis of both its government spending and its tax system. The Schwarzenegger Administration has engaged that discussion on the spending side through the Performance Review and the budget process. The Administration and the Legislature must just as intensively examine the structural problems of the tax system as well.

Economic analysis reveals significant flaws that, if corrected, could generate substantial revenues to resolve the structural deficit and change the burden of taxes in ways which improve the investment climate. The Administration so far has taken the unsubstantiated position that any and all taxes will lead to job loss, irrespective of the negative economic impacts of a deteriorating public sector and a tax system with its burdens in the wrong place. Resolving the structural deficit and reforming the tax system are a necessity for California's future success.

We believe that a fair and open examination of the tax system, as currently contemplated in the Legislature, will lead to the inescapable conclusion that many of these reforms are appropriate. In tax policy perhaps more than in any other public policy arena, entrenched special interests dominate the action, capitalizing on the political aversion to taxes. So we hope the Administration will see beyond the special interests and the clichés and engage the discussion in a public manner. The alternative is the continued deterioration of the public sector, at great cost to our citizens and our future.

The major failures run as follows:

I. Loophole-Ridden and Irrational Non-Residential Property Tax. The assessment system for investment property is indefensible on any rational basis. Economically, our tax system places the burden on new investment while failing to capture windfall land rents—the complete opposite of any economists' notion of good tax policy. Legally, the assessment system is loophole-ridden and subject to endless manipulation—scandalous if it were not legal. Environmentally and fiscally, the failure to capture land rents encourages speculation, sprawl, and local reliance on retail, inflates

land prices, and short-circuits the potentially virtuous circle of infrastructure finance by which the rising land values resulting from infrastructure investment fund perpetual capital improvements.

A rational fix to this problem, namely the periodic reassessment of non-residential property at market value, would raise \$3-4 billion annually, as a key part of a local government and infrastructure solution. We have noted elsewhere that this change can be part of an overall business tax reform which will improve, not damage, the investment climate.

II. The State's Narrow Sales and Use Tax Base. The sales tax fails to reflect the changes in the economy, and has stagnated in its relation to budgetary growth despite booming consumer and business expenditures. The state's failure to tax telecommunications, cable and satellite, internet and electronic commerce have left us taxing a diminishing percentage of actual expenditures. To the extent that the sales tax is intended to be a reflection of economic reality, in which a small percentage share of consumption expenditures finances public expenditures, it fails dismally to reflect that reality.

Even within the current logic of the sales tax system, a number of so-called "services" go untaxed which should be part of the tax base. Without engaging the debate over taxing labor services, many "services" are actually the temporary use of tangible commodities, such as admission to sporting events, ski resorts, golf courses, amusement parks, gyms and concerts, and should be in the tax base.

The consistent application of sales taxes to a variety of electronic commodities and non-labor commodity rentals could raise \$4 billion annually.

III. The Tax System's Failure to Capture Pollution and Natural Resource Depletion Costs. Economists have long agreed that the tax system fails to reflect environmental reality, and that a rational system of taxation would tax "bads" as well as, or instead of, "goods". In economists' terms, the "external" costs imposed on society of the generation of pollutants should be taxed to provide the appropriate price signals—i.e. disincentives—to the generation of such pollutants. While such charges are only haphazardly applied to certain industries, through various fees, the rationale for such taxes increases with the growth of environmental hazards, particularly global warming emissions. And, despite booming windfalls from oil price increases, California continues to be the only oil-producing region in the world without either royalties or a severance tax on its oil.

The environmental organization Redefining Progress has estimated that carbon taxes and pollution charges together could generate as much as \$4 billion annually, with the potential need for offsets to overcome potential regressivity in the incidence of some of these taxes. A "Green Watchdog" report from a number of environmental groups has identified several billion dollars in similar "green taxes."

IV. Weaknesses in Personal Income Tax Base and Rate Structure. While the personal income tax remains California's most progressive and growth-elastic source of revenue, it has weaknesses in both its base and rate structure. In particular, its top brackets begin at levels of income which are essentially middle class--\$40,000 single, \$80,000 joint--and not reflective of the growth in income at the upper levels of a mal-distributed income distribution, particularly among those earning over \$200,000. At the same time, federal income tax cuts have provided enormous savings to the highest-income taxpayers, cuts which lead to California budgetary losses. California should

recapture some of those losses by structuring its top brackets to reflect the federal tax changes which are costly to California.

In addition, tax sheltering by wealthy individuals continues to be a significant problem, despite the success of the abusive tax shelter program of the Franchise Tax Board. The underground economy, which leads to substantial losses from non-payers at substantial costs to other taxpayers, must be aggressively addressed. And there are provisions in the tax base that generate significant revenue losses with no economic benefits.

Resolving these issues in the personal income tax could generate approximately \$3 billion on an ongoing basis.

V. Erosion of Corporate Tax Base. California's corporation tax has provided a declining share of the state's tax revenues for the last generation. Despite a rapidly growing economy, inflation-adjusted revenues from the corporation tax have increased only marginally since the 1980s. While California has in some ways a more effective basic corporate tax structure than many other states, it still has been eroded by a variety of loopholes and incentive programs of dubious economic value. And the ability to shelter corporate income, based in large part on an ineffective federal corporate tax system, continues to erode revenues.

Corporation tax reforms which limit the legal methods of tax sheltering, eliminate ineffective incentive programs, and more effectively measure true profit attributable to California could generate as much as \$2 billion annually.

How To Use This Document: Out of the \$17 billion or so in proposals discussed here, we know that many will have staunch opposition, create some thorny tax issues (as all tax policies do), or will be politically unpopular. Some reforms may be more appropriate in combination with others, in terms of potential burden on taxpayers, or impacts on, for example, local governments. In terms of resolving our long-term fiscal problems, the availability of significant amounts of revenue from correcting these flaws permits any number of combinations of ways of finding the necessary revenues, or of shifting tax burdens as well as increasing benefits.

We also rely on some data—particularly with regard to untaxed sales—which may be out of date but is the best we currently have available. Thus this discussion is always a work-in-progress, because estimates change and new data becomes available.

Also, with some exceptions, this document does not recapitulate many of the identified tax expenditures contained in the Department of Finance annual reports. However, that does not mean that many of those are not appropriate for elimination. To the extent a discussion on revenue options is generated, many of those—for example, the tax treatment of certain insurance income—require further exploration. There are always more issues to explore, and for that reason as well this is a work-in-progress.

The Senate this year is planning a broad-based exploration of the connections between the economy and the tax system. Hopefully, this document will be only one of many addressing tax issues we will see throughout the course of this year. We only ask that those who point out legitimate problems which suggest a tax cut (e.g. federal conformity issues) also suggest how they will be paid for, and how our structural deficit should be resolved.

Current Year vs. the Future. Too often, revenue options are rejected because they only materialize in the future, while policy makers focus on the immediate budget situation. In the current situation, decisions must be made for the longer-term as well as the immediate budget. A multi-year effort must be undertaken to solve the structural deficit and pay off the burden of debt, so tax measures can no longer be ignored which “only” bring in revenues in future years.

To the extent that such longer-term revenues are agreed upon, the LAO’s appropriate warning against continued borrowing this year might be moderated. That is, short-term borrowing backed by real revenues which materialize over the next several years could be part of a multi-year solution. In any case, the burden of debt already incurred will be paid off over many years, so the objection that revenues only materialize in the out-years is no longer a valid one. By default, we are now in an era of multi-year budgeting.

This report was written and researched by Lenny Goldberg and David Kersten of the California Tax Reform Association. We accept full responsibility for errors or inaccuracies, and will correct them as they are brought to our attention.

Resolving the Structural Deficit: Summary Chart of Tax Reforms for 2005-06 and Beyond

<u>Tax Proposal</u>	<u>Revenue Estimate</u>
<p><u>I. Property Tax</u></p> <p>A) Tighten Change of Ownership Laws or Periodically Reassess Non-residential Property</p> <p>B) Eliminate Homeowners' Exemption</p>	<p>\$1 billion/yr. or \$3-4 billion/yr. \$400 million/yr.</p>
<p><u>II. Expand the Narrow Sales and Use Tax Base</u></p> <p>A) Tax Selected Services and Rentals</p> <p>B) Tax Telecommunications, cable, etc.</p> <p>C) Aggressively Pursue Electronic Commerce Issues</p>	<p>\$825 million/yr. \$3 billion/yr. potentially billions</p>
<p><u>III. Natural Resource/Environmental Taxation</u></p> <p>A) Global Warming Fees: Comprehensive Carbon Permit Fees</p> <p>B) Multi-Pollutant Charges/Polluter Pays</p> <p>C) Oil Severance Tax on Oil Extracted From Private Lands</p> <p>D) Eliminate Special Tax Breaks for Oil</p>	<p>\$2.5 billion/yr. \$1.4 billion/yr. \$300-400 million/yr. \$40 million/yr.</p>
<p><u>IV. Personal Income Tax</u></p> <p>A) Reinstate the Top Income Tax Brackets</p> <p>B) Withholding on Independent Contractors/1099 penalties</p> <p>C) Disallow 1031 Exchanges on Out-of-State Property</p> <p>D) Limit Mortgage Interest Deduction</p>	<p>\$2 billion/yr. \$130 million/yr. \$30 million/yr. \$580 million/yr.</p>
<p><u>V. Corporation Tax</u></p> <p>A) Limit Excessive Use of Corporate Tax Credits</p> <p>B) Prohibit Use of "S" Corporation Tax Break for Large Businesses</p> <p>C) Eliminate Water's Edge Election --Alternative: Prevent Corporations From Parking Income In Tax Havens</p> <p>D) Use Book Income as the Measure for Apportionable Income</p> <p>E) Close the "Nowhere Income" Loophole</p> <p>F) Overhaul the State's Enterprise Zone Program</p> <p>E) Narrow the State's Research and Development Tax Credit</p>	<p>\$300-400 million/yr. \$300 million/yr. \$400 million/yr. \$50-100 million/yr. pending, likely \$1B/yr. \$30 million/yr. \$50-100 million/yr. \$100-\$200 million/yr.</p>
<p>Total Revenue Estimate</p>	<p>\$17+ billion annually</p>

Resolving the Structural Deficit: Brief Summary of Tax Reforms for 2005-06 and Beyond

I. Property Tax: The assessment system for the non-residential property tax is loophole-ridden, economically indefensible, and contributes to sprawl and the weakness of local government.

A) Reform the Assessment of Non-Residential Property

--Tighten Change of Ownership Laws (\$1 billion/yr.): This can be done by statute, as proposed in SB 17 (Escutia), to ensure that cumulative and partial transfers of investment property are reassessed and loopholes are more limited.

-- Periodically Reassess Non-Residential Property (\$3-4 billion/yr.): Place a constitutional amendment on the ballot which states that all non-residential property shall be periodically reassessed at market value. ACA 16 (Hancock) was introduced to do this last session. The higher revenue estimate is based on out-year assumptions, with the 2003 estimate at \$3 billion.

B) Eliminate the Homeowners' Exemption (\$400 million/yr.): The homeowners' exemption, which provides each homeowner with \$70 yearly in tax relief, irrespective of home value or tax burden, is obsolete in the Prop. 13 acquisition-value system.

II. Expand the Narrow Sales and Use Tax Base: The state's sales tax base has not kept pace with the changing economy and has gradually been eroded over time by the growth in services that escape state sales taxation.

A) Tax Selected Services and Rental Items (\$825 million/yr.): The state's narrow sales and use tax base should be expanded to include a number of admissions and rentals which do not directly tax labor services, such as amusement parks, theatres, movies, sporting events, arcades, bowling alleys, golf facilities, ski resorts, gyms, billboards, parking facilities, and self storage units.

B) Tax Telecommunications (\$3 billion/yr.): Taxing telecommunications in its various forms including cable and other program distributions services, telephone and telegraph, wireless carriers, satellite, and other forms of telecommunications.

C) Aggressively Pursue Electronic Commerce Issues (no estimate, potentially billions): The irrational distinctions between online and store purchases, types of products, and internet and telecommunications must be erased if the sales tax is to make sense in the "new" economy.

III. Natural Resource/Environmental Taxation: The state's tax system fails to capture pollution and natural resource depletion costs. Economists have long argued that the costs of pollution, such as carbon emissions and other pollutants, should be captured through the tax system.

A) Comprehensive Carbon Permit Fees (\$2.5 billion/yr. minus potential offsets): Enact a carbon permit fee system, similar to those that have found broad acceptance in Europe, which would set a cap on permitted carbon emissions and would then sell the permits to users to permit their share of emissions. Redefining Progress estimates that a gradual phase-down would have the effect of generating revenue on the order of \$20/ton of carbon—the equivalent of roughly 5 cents/gallon of gasoline. Offsets on the order of \$1 billion may be appropriate relative to impacts of slightly higher electricity and gas prices.

B) Multi-Pollutant Charges/Polluter Pays Fees (\$1.4 billion/yr. minus potential offsets): Enact pollution fees on a variety of air and water emissions including volatile organic compounds, toxic air and water emissions, and other pollutants. Redefining Progress has estimated the revenues based on rates developed by the Congressional Budget Office.

C) Enact a Severance Tax on Oil Extracted From Private Lands in the State (\$300-\$400 million/yr.): California is the only state which does not place a severance tax on oil removed from the ground. Enacting a severance tax at a rate of 6% of the wellhead price of a barrel of oil would raise \$300 million to \$400 million, depending on the price of oil.

D) Eliminate Special Tax Breaks for Oil (\$40 million/yr.): Eliminating the resource percentage depletion allowance for oil, which allows oil producers to take rapid deductions over and above their actual costs, would raise \$30 million annually. Eliminating the intangible drilling allowances for oil, which allows oil companies to write off expenses in one year as opposed to many years for other companies, would raise \$10 million annually.

IV. Personal Income Tax: The rate structure for the state’s personal income tax is relatively flat at the top and the state provides a tax break to affluent taxpayers for purchasing expensive first homes and second homes.

A) Reinstate the Top Income Tax Brackets (\$2 billion annually): Reinstate the top income tax brackets of 10% and 11% on the state’s top earners as proposed by AB 6 (Chan).

B) Require Withholding on Independent Contractors/Penalize Failure To Issue 1099’s (\$130 million/yr.): Require withholding on independent contractors and increasing penalties for failure to file payments to independent contacts (1099 forms). Ongoing revenue estimate approximate, could be higher if parts of \$6 billion of untaxed revenue is captured.

C) Disallow 1031 Exchanges on Out-of-State Property (\$30 million/yr.): Disallow “like-kind” exchanges (section 1031 exchanges) on California property which is exchanged for out-of-state property. Real estate investors can currently exchange one commercial property for another without paying any capital gains taxes on the exchanged asset.

D) Limit Mortgage Interest Deduction (\$580 million/yr.): Limit the mortgage interest deduction to interest on mortgages of up to \$600,000 for first home only. The state does not currently cap the deduction and provides a deduction for second homes as well. Revenue estimate from Legislative Analyst recommendation in 2004.

V. Corporation Tax: A series of loopholes and the increased use of abusive tax shelters has eroded the corporate tax base.

A) Limit the Excessive Use of Corporate Tax Credits (\$300-\$400 million/yr.):

Prohibiting businesses from using tax credits to erase more than 50% of their tax liability in a given year. Credits could be carried forward and used in future tax years but companies could not eliminate more than 50% of their taxable income with these credits.

B) Prohibit Use of “S” Corporation Tax Break for Large Businesses (\$300 million/yr.):

Restrict the “S” Corporation tax election to companies with total receipts of less than \$20 million in a given tax year. SB 516 (Speier), proposed in the last legislative session would have made this change.

C) Eliminate Water’s Edge Election for Multi-national Corporations (up to \$400 million/yr. in the outyears):

Prohibiting multi-national corporations from electing to be taxed on business activity which occurred within the “water’s edge,” namely the 50 US states, as opposed to their worldwide income, would greatly reduce the potential for sheltering income. The revenue savings would not be achieved right away because the state has entered into contracts with water’s edge taxpayers which would take time to expire.

--Alternative: Prevent Corporations from Parking Income in Tax Haven Countries (revenue estimate pending but thought to be in the \$50-\$100 million range):

Treat income attributed to tax haven countries such as Bermuda and the Cayman Islands as though it were in the “water’s edge” for tax purposes. This has been introduced as AB 34 (Ruskin).

D) Use Book Income as the Measure of Corporate Income (revenue estimate pending, could be as much as \$1 billion/yr.):

Corporations report relatively high earnings to their shareholders to maintain their stock prices but then find ways to avoid reporting those earnings to tax authorities. Using a business’ book income, as opposed to the federal taxable income base calculation, would reduce the potential for sheltering income from state taxation. Estimate based on the fact that reported taxable income is less than 80% of book income overall for corporations, and near zero for many companies.

E) Close the “Nowhere Income” Loophole (\$30 million):

Require companies to make the same Section 338 election (IRS Code Section) for state tax purposes as they do for federal purposes. Current law allows multi-state corporations who are based in California to sell out-of-state subsidiaries or assets without paying taxes.

F) Overhaul the State’s Enterprise Zone Program (\$50-100 million/yr.):

The state needs to reexamine each of the 39 enterprise zones throughout California to ensure that the zone boundaries only include truly economically depressed areas. Eligibility criteria for the payroll credit needs to be rewritten to ensure that businesses only receive credits for truly qualified individuals and controls need to be put into place to safeguard the program from abuse.

G) Narrow the State's Research and Development Credit (\$100-200 million plus/yr.):

The credit could be narrowed in a number of different ways to reduce the associated revenue losses of \$500-600 million yearly revenue losses, per recommendation of the Legislative Analyst's Office (LAO).

I. The Property Tax

A. Close Loopholes In The Commercial Property Tax/Reassess Non-Residential Property.

With the passage of Proposition 1A, the state not only can no longer borrow property taxes from local government; it must backfill revenues which it has taken from local government. Any long-term structural solution MUST address the most gaping hole in our tax system: the irrational method by which business property escapes regular assessment.

CTRA has researched and written extensively on this subject (www.caltaxreform.org). A study released by the California Tax Reform Association last year found that significant commercial properties throughout the state are massively undertaxed and are taxed at widely disparate amounts for similar properties. Also, in major counties of the state, including Los Angeles and Santa Clara, homeowners are bearing an increased property tax burden.

To summarize:

1. The system is indefensible from any economic perspective. We tax new investment heavily, at full market value plus fees and mitigations, and impose property and sales taxes on investment goods, while letting windfalls (“economic rents”) go entirely untaxed—the opposite of what any economist would recommend as tax policy. Similarly situated competitors pay widely differing tax burdens, violating basic principles of horizontal equity. For example, IBM Silicon Valley Laboratory is paying \$0.004/square foot of land in property taxes compared to many other companies in the area which are paying roughly \$0.60 a square foot—a disparity of 150 times.
2. Legally, the assessment system is loophole-ridden and subject to endless manipulation. The complex manner in which investment property is held and sold make “change of ownership” rules difficult to apply on any rational basis. Current law is extremely narrow in the transactions which generate re-assessment, such that properties routinely change ownership without reassessment. For example, in one transaction in Napa County in 2001, 12 shareholders of E & J Gallo Winery acquired the shares owned by approximately 20 shareholders of the Martini Winery, with the name changing and the deed changing, but since no shareholder bought over 50%, no reassessment took place.
3. Failing to tax land appropriately is a major contributor to speculation and sprawl, just as an under-performing property tax is the major reason local governments over-rely on the sales tax in their land use decisions. Urban in-fill properties are underutilized, and the land market fails to give appropriate signals for environmentally sound development, inflating land prices at the cost of productive investment.
4. Starting in 2006-2007, the state will no longer be able to borrow more than two times in 10 years from local government, and will have to provide appropriate resources to backfill their losses. An improved property tax, which provides growing revenues to local government as the result of commercial and industrial investment, is a major part of the local government solution.
5. Infrastructure should be financed by a virtuous circle of infrastructure investment and revenue from rising land values, but no such revenues are captured in this system. An

appropriate tax would recapture revenues from rising land values created from public investment, and continue to fund capital improvements throughout the state.

Proposals: The legislature must explore a two-step solution:

1. Tighten change of ownership law, which can be done by statute, as proposed in SB 17 (Escutia), so that cumulative and partial transfers of investment property can be reassessed.
2. Place a constitutional amendment on the ballot which would require the periodic reassessment of non-residential property at market value. ACA 16 (Hancock) was introduced to do so in the last session.

Revenue Estimates: \$1 billion annually or more for tightened change-of-ownership rules
\$3-4 billion annually for reassessment of non-residential property

Comments:

- a. It would take time for assessors to begin and complete the reassessment process, so revenues would have to be booked in the out-years.
- b. The \$4 billion (upper-end) estimate is based on potential growth through 2006-07; \$3 billion was the estimated amount for 2003 (Board of Equalization).
- c. A negotiated solution in the legislature would most likely include some business tax changes which would lower the net revenues, particularly changes which shifted the burden from new investment to land rents.

B. Eliminate the Homeowners' Exemption

Since Proposition 13, the homeowners' exemption has stood at \$7,000, or a property tax savings of \$70 for every homeowner. This exemption made sense in the days of full-market value assessment and was set at a meaningful level relative to home prices in the 1970s. Now it is thoroughly outdated. Because of the acquisition-value system, by which current homeowners are locked into assessment increases of no more than 2% per year, there has been little reason to raise the homeowners' exemption. There has been a consensus that the homeowners' exemption bears no useful purpose in the acquisition value system in which significant disparities among homeowners exist.

Proposal: Eliminate the homeowners' exemption

Revenue Estimate: \$400 million annually

Comment: This would have to be put before voters as a constitutional amendment, not likely to be popular despite the anachronistic nature of the policy.

II. Expand the Narrow Sales and Use Tax Base

Our sales tax system places its burden on use of the many tangible products which make up the “old” economy. While it taxes the hardware of the new economy, it fails to reflect a major part of the growth in the new economy: expenditures on telecommunications, electronic commerce, entertainment, and, broadly described, “services”.

Even for the “old” economy, the debate over taxing “services” has often missed critical distinctions about types of services. Much of the argument against such taxes focuses on whether labor should be taxed—e.g. auto mechanics, attorneys, or accountants--insofar as that labor is otherwise taxed through payroll and income taxes. There are many administrative and equity questions which are raised by the taxing of labor services.

However, before even engaging that debate, there are in fact many billions of dollars of taxable goods delivered independently of labor costs that are not subject to the sales tax. Some of these, like electricity and gas, may be exempt for equity reasons or as vital necessities, like food and prescription drugs. However, others, such as the use of a golf course or ski resort, should be taxed consistently with our method of taxation of goods, namely that short-term rentals and leases are subject to the sales tax. In these cases, the use of a sports facility or a seat at a concert is merely a discretionary short-term rental of a tangible good and should be taxed.

In terms of the “new” economy, one area of the most rapid growth in discretionary spending has been on various forms of communication, including cable, satellite, internet and wireless, as well as electronic commerce. Again, these goods are priced and delivered independently of labor inputs and represent a huge growth in untaxed sales.

We have examined lists of services from the Board of Equalization, and have distinguished between labor services and those services which are effectively sold as goods, that is, consumed by the user and paid for as a commodity, not as a labor charge.

The following list provide examples of the use of facilities, by way of rental of those facilities or end use consumption of a commodity, which are used independent of the amount of labor inputs.

In addition, sales taxes on telephone, wireless, cable, and satellite services—telecommunications in various of its forms—would generate approximately \$3 billion in revenue.

A note on the data: this data is from two spreadsheets provided by the Board of Equalization. Some of the data is combined in ways which make for limited specificity (e.g. in one section ski resorts are combined with other services). And the data is somewhat outdated, projected forward from the 1990s. We expect that as this debate is engaged the data will be updated and made more specific.

Revenue Estimates for Sales Taxes on Selected Services

Selected Services	Estimated Sales Tax Revenue				Total
	Estimated 2002-03 Receipts	State 5%	Local 2.25%	Special District 0.67%	
(all figures in millions of dollars)					
Admissions: Amusement Parks	1,661	83.0	37.4	11.1	131.5
Admissions: Live Theatre	527	26.4	11.9	3.5	41.7
Admissions: Movies	1,086	54.3	24.4	7.3	86.0
Admissions: Museums	19	0.9	0.4	0.1	1.5
Admissions: Music/Ballet	75	3.7	1.7	0.5	5.9
Admissions: Sporting Events	2,119	106.0	47.7	14.2	167.8
Arcades	223	11.1	5.0	1.5	17.6
Bowling Alleys	271	13.5	6.1	1.8	21.4
Golf Facilities	970	48.5	21.8	6.5	76.8
Gyms	1,704	85.2	38.3	11.4	135.0
Billboards	688	34.4	15.5	4.6	54.5
Parking Facilities	1,067	53.3	24.0	7.1	84.5
Lessors of miniwarehouses & self storage units	629	31.5	14.2	4.2	49.9
Total Revenue Estimate	11,039	551.8	248.4	73.8	874.1
<u>Selected Telecommunications Services</u>					
Cable & other program distribution services	5,629	281.5	126.7	37.7	445.8
Telephone & telegraph	28,074	1,403.7	631.7	188.1	2,223.4
Wireless telecommunications carriers	4,901	245.0	110.3	32.8	388.1
Satellite telecommunications	1,012	50.6	22.8	6.8	80.1
Other telecommunications	111	5.6	2.5	0.7	8.8
Total Revenue Estimate	34,875.1	1,986.4	894	266.1	3,146.2

Source: Board of Equalization

Comment: With regard to telecommunications, the industry argues that such communications are already taxed in a variety of ways, but these do not reach the General Fund as sales taxes. There are in fact a range of surcharges for particular state programs, federal taxes, and local taxes, but no uniform state sales tax. Again, if the tax system is intended to track and follow the types of economic activity we engage in, the failure to include telecommunications and entertainment is an indication of why our system is failing.

Other Long-Term Issues

a. Electronic Commerce/Internet Taxation. The so-called Internet Tax Freedom Act is an idea whose time should never have come but at least should be long gone, now that the internet is the backbone of our communications system.

There are two issues for the state to consider: the appropriate taxation of telecommunications in all forms, and the collection of sales tax from internet sales.

The distinctions between telecommunications and internet were never real, but they have become thoroughly unsustainable. Should a wireless phone call be subject to tax but a wireless text message not? Is there a meaningful difference for tax purposes between sending data and voice on the same line, via digital signals in both cases? Is the upcoming use of VOIP (voice over internet protocol) in which telephone calls will be placed through packet switching distinguishable from electronic impulses from handset telephones? And, is payment to an internet service provider different from a monthly payment to a phone, wireless and cable company?

While recognizing the limitations of federal law, the Administration could be highly influential in engaging a national discussion of the appropriate placement of sales taxes and public purpose surcharges on all telecommunications services, whether data or voice transmission, whether wireless, satellite or land line. The failure to engage the discussion of designing an appropriate sales tax base is a clear statement that our intention is precisely to keep the tax based on the old economy, not to update it to reflect the new economy.

b. Remote Sales, Internet and Mail Order. Within this discussion, the taxation of remote and electronic sales must be entered more aggressively, so long as states continue to rely on a sales tax. California has taken recent strides on this issue when it belatedly elected to join other states in forging a Streamlined Sales and Use Tax Agreement (SSUTA).

There are two major issues here. For tangible goods ordered from remote sellers, collecting tax does not mean that there are no new tax obligations, since use taxes are already required to be collected from the purchaser. California just passed legislation to add a use tax question to the tax form. However, as a practical matter that collection is difficult to enforce, which is why the SSUTA was formed.

This issue has been given by the courts to Congress, but Congress has failed for many years to establish a reasonable regime for collecting taxes on remote sales. Again, the Administration can use its considerable influence, as other Republican governors have, to weigh in on this issue. And the Board of Equalization must be aggressive in asserting appropriate nexus for those who are attempting to circumvent sales tax collections. So far, they have failed to do so.

With regard to electronic commerce, the distinctions are as meaningless as those between transmission of data or voice. Why should a CD bought at a music store or a program bought at a computer store be taxed while downloaded music and software is not taxed? Electronic commerce is ubiquitous now, and will only become more so. There surely are questions both of origination and destination for a sales tax which has historically been based on geography, and which is less definable in cyberspace. However, for the sales tax to be viable in the new era, it will need to solve these arbitrary distinctions which tax the same products differently depending on their mode of delivery.

Ultimately, according to various estimates, there are at least hundreds of millions, and most likely billions in revenue at stake.

III. Natural Resource/Environmental Taxation

Yet another economic failure in terms of the tax system is our failure to capture pollution and natural resource depletion costs. A large body of economic literature urges capturing the costs of pollution and depletion of natural resources through taxation, which changes the relative price of pollution and thereby mitigates against its continuation.

Except for limited environmental mitigation fees, California has failed to appreciate the win-win nature of environmental charges: the combined incentives for environmental improvement and revenue generation as a pollution charge. As environmentalists put it, we should tax “bads” instead of “goods”.

A. Global Warming Charges: Comprehensive Carbon Permit Fees

While much of the world has recognized the need for disincentives for global warming, neither the federal nor state government has begun to address the problem. A carbon permit fee system, which is under consideration by eastern seaboard states, would set up for California a “cap and trade” system which has broad acceptance in Europe.

Redefining Progress has estimated the revenue from a comprehensive permitting system in California, by which the state issues permits to emit carbon emissions at the wholesale and producer level. A global warming permit system would set a cap on permitted carbon emissions, and would then sell the permits to users to permit their share of emissions. The revenue achieved from these permits depends on the rate at which carbon emissions are lowered. Redefining Progress estimates a gradual phase-down that would have the effect of generating revenue on the order of \$20/ton of carbon, the equivalent of roughly 5 cents/gallon of gasoline.

These are presented as revenue options, but some environmentalists have argued for “revenue neutral” proposals which shift the tax burden from taxing positive economic activity to taxing negative economic activity. And, there are offsets necessary for the potentially regressive impacts of the proposal.

Revenue Estimate: (including transportation and energy sectors) \$2.5 billion annually (\$1.5 billion after progressive offsets)

Comments: To the extent that this system will be reflected in the prices of gasoline, electricity and natural gas, the impact is likely to be regressive and potentially burdensome on low and moderate income families. Thus offsets will need to be designed, most effectively through a refundable earned income tax credit and/or through extension of low-income electricity discounts. Net revenues thus may be as much as \$1 billion less.

Redefining Progress estimates that 1/3 of the carbon tax costs falls on households, with a lesser amount of that falling on low and moderate income households.

B. Multi-Pollutant Charges/Polluter Pays Fees

In the same spirit, Redefining Progress has estimated the revenues from potential pollution charges for emissions to air and water. The charges are based on rates developed from the Congressional Budget Office. They include charges on stationary sources of toxics and other pollutants, and a gas guzzler fee on large vehicles. (While they include emissions fees of automobiles, we assume they would be covered by the global warming permit system)

Proposal: Enact pollution fees on a variety of air and water emissions, including volatile organic compounds, toxic air and water emissions, and other pollutants.

Revenue Estimate: \$1.4 billion annually, with \$1 billion from air pollution charges and \$400 million from water pollution charges.

(see chart next page)

Revenues from Environmental Fees or Permitting Systems in California*		
<u>BASE</u>	<u>RATE</u>	<u>Revenue (\$Mill.)</u>
EMISSIONS TO AIR		
NOx (Not covered by SIP call, stationary)	0.75 \$/lb.	124
VOCs (stationary source)	1.05 \$/lb.	405
SOx (stationary source)	0.10 \$/lb.	
Not covered by Emissions Trading System		0
Covered by Federal ETS		6
Particulates (PM-10, stationary sources)	0.95 \$/lb.	76
Gas guzzler fee	Extend Fed fee to 6-10,000 lb. Cars & light trucks	72
Auto emissions one-time charge	Varies with emissions, \$300 average	413
Subtotal, emissions to air		1096
EMISSIONS TO WATER		
Toxic releases to water	\$32.35/lb.-equivalent	63
Organics, biological oxygen demand	\$0.66 /lb.-equivalent	233
Fertilizers	5%	41
Pesticides	5%	52
Subtotal, emissions to water		389
Total		1485

*Estimates are preliminary.

Comment: These issues have not been fully explored in the public policy process, so these estimates should be taken as instructive rather than definitive.

C. Enact An Oil Severance Tax On Oil Extracted From Private Lands In The State.

California is the fourth-largest oil producing state and the only oil-producing state which does not place a severance tax on oil production. Texas, Alaska, Wyoming, Louisiana and all other mineral and oil producing states have severance taxes. In fact, California appears to be the only place in the world which gets no payments, whether through taxes or royalties, from oil production! (Oil lands do pay local property taxes, and California receives royalties from production on state lands).

The legislature as far back as the 1960s, and again in the 1980s and 1990s introduced legislation to place a severance tax on oil. The legislature commissioned a study by the Rand Corporation in the early 1980's which noted that a severance tax would have minimal, if any, effects on prices and production in California.

The oil industry has argued that California's relatively heavy crude is expensive to produce, and therefore should be treated differently than all the other oil in the world. If that argument had questionable credibility at \$15 per barrel of oil, it has no credibility at long-term prices that are at \$30 per barrel, and have been substantially above that.

Proposal: Enact an severance tax (i.e. a tax on oil as it comes out of the ground) at a rate of 6% of the wellhead price of a barrel of oil. To satisfy concerns about California's heavier crude, one might design a tax that phases out when crude oil prices fall below \$18-20 per barrel, still well above costs of production.

Revenue Estimate: \$300 million to \$400 million annually, at a 6% rate, depending on the price of oil. At \$30/barrel, and 250 million barrels yearly, the tax would yield over \$400 million.

Comments: Various suggestions have been made that this measure be used to fund renewable energy production (e.g. the Governor's solar initiative) or environmental clean-up. In some states, oil revenues fund non-recurring items, such as investment in natural resources or capital outlay, based on the concept that the revenue source is depleting and should be invested in a permanent manner. In others the revenue is used for the general fund or for higher education. In any case, California's valuable oil has been depleted for the major part of a century without any revenue, other than the costs of regulation by the Division of Oil and Gas, accruing to the state.

D. Eliminate Special Tax Breaks for Oil.

California not only fails to tax the depletion of natural resources, we continue to give long-outmoded tax breaks for the exploitation of those resources. There has been no analysis, data or even rationale which speaks to the continuation of these breaks.

Proposals:

- 1) **Eliminate Resource Percentage Depletion Allowance for Oil (\$30 million annually):** Oil producers are allowed to take rapid deductions over and above their actual costs, even though they don't pay any royalties or taxes for extracting the oil from the ground. This measure would apply to independent (non-integrated) companies.
- 2) **Eliminate Intangible Drilling Allowances (\$10 million annually):** This benefit to oil companies allows them to write off expenses in one year, which other companies are forced to amortize over many years. This proposal would accelerate revenue and put the tax treatment of oil companies on more equal footing with other companies.

V. Personal Income Tax

California's personal income tax has some highly desirable features. Its burden is generally progressive, which only partially offsets the regressivity of our heavy dependence on the traditional sales tax. Its progressivity stems in part from its rate structure and in part from the substantial child credits which eliminate tax liability for working families below \$40,000, or, in the case of the refundable child care credit, provide some relief.

It is also relatively responsive to trends in the economy, and was said to be too much so during the run-up in capital gains at the end of the 1990s. However, aside from that historically unique period, it remains one of the more growth-elastic sources of revenue, and must be maintained in its reasonable form.

That said, there are still a number of problems in the personal income tax. Tax sheltering by wealthy individuals continues to be a problem: 65% of the \$1.6 billion which came in under the tax shelter compliance program was from the personal, not the corporate, tax. Individuals can still use complex tax avoidance schemes to avoid paying their fair share of taxes, through the use of such devices as offshore accounts and commercial real estate exchanges. And, since California generally conforms to federal law to the extent feasible, potential major changes in federal tax policy could threaten the strength of the personal income tax.

In addition, our rate structure tops out at 9.3% for individuals earning about \$40,000 and for couples earning about \$80,000. Thus, until taxpayers reach a \$1 million threshold, the system is relatively flat. Federal tax law has brackets which, for married filers, start at \$174,000 and \$311,000. The current system is anachronistic insofar as it fails to recognize that upper levels of family income are well above \$80,000, and the top brackets should reflect that.

There are also issues of non-filing and the underground economy which are not unique to the state income tax but mean significant revenue drain. An amnesty program enacted in 2004 is expected to bring in about \$300 million in revenues which would otherwise not materialize, with the hope that subsequently more taxpayers will be part of the system. However, there are other steps which can be taken to improve compliance.

A. Reinstate the Top Income Tax Brackets.

In 1991, Governor Wilson advocated for and signed top brackets in the income tax at 10% for joint filers over \$225,000 and 11% over \$450,000. Those brackets expired in 1996, and, in the election of 2004, a 1% surcharge for filers over \$1 million in taxable income was added to pay for mental health programs (Prop. 63 surcharge).

In terms of the economy, the current rate structure in no way reflects the income structures of today's families. A substantial proportion of the growth in income has been among those earning over \$200,000. The state's current top brackets pick up individual earnings of over \$40,000, unmarried head of household earnings of close to \$55,000, and two-income family earnings of \$80,000, which hardly reflects the top end of our income distribution.

Proposal: Reinstate the top income tax brackets of 10% and 11%. (AB 6, Chan, in the 2005-06 session). A 10% bracket would be added for the portion of taxable income of an individual that exceeds \$138,000 and for the portion of taxable income of married taxpayers filing jointly that exceeds \$277,000. An 11% bracket would be added for the portion of taxable income of an individual that exceeds \$277,000 and for the portion of taxable income of married persons filing jointly that exceeds \$554,000. Proposition 63's 1% surcharge on taxable incomes above \$1 million would still apply and make the top bracket 12% effectively.

Revenue Estimate: \$2 billion annually

Comments: These increases must be understood in the context of the recent federal tax cuts that provided huge tax reductions for high-income earners, and continued budget cuts which constrain the state as a result. California must take the opportunity to recapture some of the losses that occurred at the federal level. According to the California Budget Project, the top one percent of California taxpayers received an average federal tax cut of \$77,500 in 2004 and reinstating the top brackets would increase the average tax bill of the top one percent by \$8,300.

B. Require Withholding on Independent Contractors/Penalize Failure to Issue 1099s

The underground economy is a significant drain on revenue, and efforts to address it, such as amnesty in income tax payments and offers in compromise on child support payments are by nature incremental. This revenue is already due to the state, and the state has strengthened reporting for new hires of independent contractors. But not since the Wilson Administration proposed withholding of tax on payments to independent contractors in 1991 (subsequently withdrawn) has the state moved forward on a real enforcement program.

Last year's budget called for a study of withholding on independent contractors which was due in late October but has not yet been released by the Administration.

Proposals:

- a. Require withholding on independent contractors
- b. Increase penalties for failure to file payments to independent contractors (1099 forms)

Revenue Estimates:

- a. Awaiting estimate on independent contractor. Based on previous proposals, we include a "guesstimate" of \$100 million annually, with a large cash flow in the earlier years.
- b. Increased 1099 penalties: \$30 million annually

C. Disallow 1031 Exchanges (“like-kind” commercial real property exchanges) on Out-of-State Property

Real estate investors can exchange one commercial property for another without paying any capital gains taxes on the exchanged asset. This system allows extremely wealthy real estate owners to avoid paying taxes on most of their gains, which are contained within the capital gains on the property. The theory is that they roll over into subsequent properties, and are finally paid when those properties are sold. In the absence of both an estate tax and a stepped-up basis rule (as well as the ability to transfer to family trusts without reassessment), billions of dollars in gains from investment property may go untaxed forever.

Proposal: Do not permit the continued exclusion of capital gains from like-kind exchanges (section 1031 exchanges) on California property that is exchanged for out-of-state property. Alternatively, eliminate all 1031 exchanges for California taxpayers.

Revenue Estimate: \$30 million annually for out-of-state property.
Estimate pending for California taxation of capital gains of all such exchanges

Comments: We recognize that non-recognition of all those gains would be out of conformity with federal law, but believe that such gains are the income earned from engaging in the real estate business and should be taxed as such. At minimum, capital gains which are reaped in California are tax-free forever when the property exchanged is in another state. There is no rationale for failing to capture those out-of-state gains.

D. Limit the Mortgage Interest Deduction To First Homes.

The ostensible purpose of the mortgage interest deduction is to make housing more affordable. However, the deductibility of interest on mortgages up to \$1 million, and the availability of the deduction for second homes, more likely inflates the current cost of housing by lowering carrying costs, at the expense of revenues paid to the state.

Proposal: As recommended by the Legislative Analyst, restrict the deductibility of mortgages to mortgages of \$600,000, for first homes only.

Alternate Approach: We believe it is easier to cap the total amount of mortgage interest that is permitted to be deducted at, for example, \$50,000, whether for first or second homes or home equity lines of credit. (No revenue estimate currently available).

Revenue Estimate: \$580 million annually, per Legislative Analyst proposal

Comments: Equity build-up in housing is a major source of life savings for the middle-class, so the extent that this limitation affects housing values, limitations should be at a sufficiently high level so as not to affect equity gains for middle-class homeowners. Those gains are still protected by the ability to roll over capital gains and to avoid capital gains taxes on \$500,000 of capital gain, and significant amounts of mortgage interest are still permitted to be deducted.

Note on Stepped-Up Basis Rules/Intergenerational Capital Gains

With no estate and inheritance tax, the ability to avoid capital gains upon death provides the classic case of a true loophole—the tax on the appreciation of capital assets disappears (that is, is stepped up) when assets are left to an heir. The Department of Finance Tax Expenditure Report identifies the cost of this rule as \$1.5 billion, and the Legislative Analyst has identified it a number of times for elimination. However, discussions with the Franchise Tax Board indicate that, without similar federal action, the ability to track and identify the long-term capital gains escaping taxation would be very difficult. Thus, on the one hand, \$1.5 billion in potentially taxable gains escape taxation. On the other hand, it appears that the state would have a difficult time collecting this amount.

V. Corporation Tax

California's corporation tax has played an ever-diminishing role as a percentage of the state's general fund revenue, and has only marginally increased since the later 1980's despite a booming economy. But it is still expected to bring in \$9 billion this year, and \$11.5 by 2009 (LAO).

One major problem with the corporate tax is that California uses federal measures of income for multi-state and multi-national corporations, even though the federal government has permitted legal tax sheltering and has not taken action against abusive tax sheltering. The state's recent experience with the abusive tax shelter program has increased our understanding of the highly complex ways corporations can shelter their income from taxation. Of the \$1.6 billion in revenue received from the abusive tax sheltering initiative, 65% of that was from personal income taxpayers and only 35% from corporations. Yet we know that many of the largest and most profitable corporations paid no federal income taxes, according to a study done by Citizens for Tax Justice. It is not only the increase in the use of various credits and deductions which has diminished the growth in the corporate tax; it is the fact that these tax expenditure programs, and the ability to avoid reporting worldwide income for multinational corporations, increase the opportunities for sheltering.

A. Limitation on Excessive Use of Corporate Tax Credits.

A total of 3,622 profitable corporations in California paid no taxes in 2001, as the result of use of the many credits and incentive programs available in California law. These major corporations make substantial use of the state's infrastructure, education system, and services, but fail to contribute through the franchise tax, unlike the many thousands of other companies who are unable to use these special credit and incentive programs.

Proposal: Eliminate the ability of profitable corporations to pay no taxes by prohibiting businesses from using tax credits to erase more than 50% of their tax liability in a given year. (SB 1354 (Escutia) in the 2003-04 session proposed this limitation for the 2004 and 2005 tax years only). Credits can be carried forward but should not be permitted to eliminate all taxes from profitable businesses.

Revenue Estimate: \$400 million for 2005-06 budget year, diminishing in future years

Comments: This limitation might be appropriate for shorter-term revenues, to the extent that longer-term tax reform eliminates some of these inappropriate incentive programs. The limitation would only effect a narrow class of businesses—less than 1% of the state’s profitable businesses—who pay little or no state taxes every year. The Franchise Tax Board Estimates that only 4,520—out of more than 520,000 corporation filing returns in 2001—used tax credits to erase more than 50% of their tax liability. .

B. Prohibit Use Of “S” Corporation Tax Break For Large Businesses.

The “S” Corporation tax election, which allows a taxpayer to pay a 1.5% tax on profits as opposed to the prevailing 8.83% corporate tax rate, is intended to benefit small companies by allowing them to pass through income to a small number of shareholders who are taxed on the income under the personal income tax. Federal law liberalized the use of the “S” Corporation election in a way that allows larger companies with a significant number of shareholders to avoid paying the corporation tax.

Proposal: Restrict the “S” Corporation tax election to companies with total receipts of less than \$20 million in a given tax year.

Revenue Estimate: \$300 million annually

Comment: Restricting the use of the “S” Corporation election to medium-sized and smaller companies would ensure that this filing status achieves its intended purpose instead of being used as a way to avoid paying the corporation tax.

C. Eliminate Water’s Edge Election for Multinational Corporations

Since 1986, multinational corporations have been given a choice of whether to report either worldwide or domestic income for purposes of apportioning income to California for purposes of taxation. The problems with giving such a choice are several. First, using the federal basis for domestic income is an inadequate means of measuring real income, because of the massive difficulty of determining internal transactions among multinational corporations (“transfer pricing”). Second, corporations electing to use domestic income can park income in tax havens, or otherwise fail to repatriate profits, thereby avoiding substantial taxes. Third, although multinational corporations are required to elect for a 7-year period, giving the choice of domestic vs. worldwide reporting allows at least a limited ability to game the system that no other taxpayers have.

Proposal: Eliminate the choice between domestic and worldwide income apportionment, and require all companies to report on a worldwide basis, as required prior to 1986.

Revenue Estimate: \$400 million annually, when fully implemented

Comments: The full amount of revenues would be generated over time, depending on legal interpretation with regard to whether the time period on current elections is required to run out.

Generally, this proposal makes the issue of off-shore tax sheltering or the problem of “inverted” corporations (those which reorganize and attribute their profits to tax haven countries) moot.

--Alternative: Prevent Corporations From Parking Income In Tax Haven Countries.

The fourth largest foreign holder of U.S. debt, after China, Japan, and the U.K. is identified by the U.S. Treasury as “Caribbean Banking Centers”, who hold the billions in income held in offshore tax havens. The recent federal corporate tax legislation recognized the problem of income attributed to tax havens by permitting repatriation of profits at lower tax rates, effectively providing a tax break for companies which utilize tax havens. The state of Montana has passed legislation which places tax haven countries within the water’s edge.

Proposal: Define tax haven countries such as Bermuda and the Cayman Islands as part of the water’s edge, so that multinational companies which park income in tax havens have to count that income as part of their tax base. AB 34 (Ruskin) addresses this issue.

Revenue Estimate: pending, expected at \$50-100 million annually

Comment: This proposal can work in the intermediate term, until the ability to take a water’s edge election is fully eliminated.

D. Stop Corporate Tax Sheltering/ Use Book Income as the Measure of Apportionable Income

Corporations report very different earnings for their shareholders and for the government. In fact, their incentives are to over-report income to boost their stock prices, and to under-report and shelter income for their taxes. By one estimate, the reportable federal income tax base is less than 80% of reported corporate book income, and in many cases is a small fraction of that, for the many no-tax profitable corporations. Citizens for Tax Justice reports that 82 out of 275 profitable corporations paid no federal income taxes in one of three years, and the average effective tax rate was half of the statutory rate for these corporations. This tax avoidance significantly affects income reported to California as well.

Proposal: Use income reported to shareholders (book income) as the basis for apportionable income to California.

Alternative Proposal: Use book income as an alternative measure of income to prevent extensive sheltering.

Revenue Estimates: Estimates pending, but based on ratio of underreporting, could easily be over \$1 billion.

Comments: This proposal would lower compliance and auditing costs and make for greater simplification and far less conflict in the corporate tax.

E. Close the “Nowhere Income” Loophole.

The tax rules for apportioning the income of multi-state corporations are meant to assign all of a firm’s income among the states in which it does business, but California’s practice of allowing separate methods of how corporations treat asset sales for state and federal purposes (“section 338”) allows multi-state corporations to claim “nowhere income” that escapes state taxation in any state. This loophole benefits multi-state corporations who are based in California that sell out-of-state subsidiaries or assets to out-of-state corporations.

Proposal: Require companies to make the same Section 338 election (IRS Code section) for state tax purposes as they do for federal purposes.

Revenue Estimate: \$30 million annually

Comments: To the extent that corporations are allowed various choices in tax law, the Legislature required taxpayers to make the same choices for state and federal law, as part of tax conformity. However, the choice with regard to reporting the proceeds of asset sales is still permitted to be different, which allows gaming of the system.

F. Overhaul the State’s Enterprise Zone Program.

The state’s \$170 million a year Enterprise Zone program is billed as job creation program for economically depressed areas. However, CTRA has taken a closer examination of the program, and finds that large amounts of the benefits are going to areas which are in thriving, expensive areas of the state, thereby costing taxpayers tens of millions with few real benefits. The primary reason for this is that a substantial percentage of the revenue losses come from thriving local economies in three areas: downtown San Francisco, most of the city of Oakland, and downtown Long Beach.

In fact, the subsidies provided to these thriving areas only harm the ostensible benefits which are supposed to flow only to economically depressed areas. For example, San Francisco’s enterprise zone includes high-end hotels, some of the highest-priced land in the state, and the area in and around SBC Park. Long Beach’s enterprise zone includes much of downtown, the marina and the Port of Long Beach, a well-developed and prosperous local economy. And Oakland’s enterprise zone includes the port and airport, downtown, and areas that include homes which have recently sold for over \$1 million.

Loopholes in the program also allow companies to claim tax credits for hiring workers with six-figure incomes who currently have a job as well as for employees no longer working at the site. And banks and other lenders which lend to these high-end businesses receive credits for the income they receive on their loans, which are prudent loans hardly in need of state subsidy.

The state needs to reexamine each of the 39 enterprise zones throughout California to ensure that the zone boundaries only include truly economically depressed areas. Areas that are no longer in need of tax incentives should be removed from the enterprise zone. Eligibility criteria for the payroll credit needs to be rewritten to ensure that businesses receive credits for only truly qualified individuals and controls need to be put into place to safeguard the program from abuse.

Proposal: End Enterprise Zone status for high-value areas that claim a significant share of enterprise zone credits, and eliminate or modify the bank and hiring credit programs.

Revenue Estimate: \$50-\$100 million annually

Comments: The EZ program has had various analyses, with differing conclusions, including reports which question the entire value of the program. Proposed extensions of these zones, as contemplated in legislation, should continue to be rejected by the Legislature.

G. Narrow The State's Research and Development Tax Credit.

The Legislative Analyst's Office has done an extensive analysis of the state's research and development credit, and has described such a credit as "likely to be costly, overall, compared to the benefits it provides in terms of additional research activity." The LAO recommends "that the Legislature consider reducing the credit or phasing it out over time, especially given the substantial direct revenue losses associated with the program and the state's current budgetary position."

The credit has been expanded six times since 1990, and revenue losses now run in the range of \$500-600 million annually. Nearly 70% of the losses flow to firms with over \$1 billion in gross revenues. There are currently more than \$5 billion in unused research and development credits outstanding that may be claimed by taxpayers in future years. Many firms can draw on their store of banked credits to erase their entire tax liability for years to come.

The Legislature has particularly favored the R&D credit, because of the generally attractive nature of research and development. However, as the LAO notes, "very little is known about what the appropriate level is for the RDC." It appears to function in many cases as a reward rather than as an incentive.

Proposal: The credit could be narrowed in a number of different ways to reduce the associated revenue losses. Options include reducing the amount of the credit, since the 15% rate is particularly high relative to tax liability and the fact that a federal credit is similarly available; capping the amount of the credit that can be used in a given year; narrowing the list of qualified research activities that the credit can be claimed for, and limiting the number of years that unused credits can be carried forward for (there is currently no time limit).

Revenue Estimate: \$100-\$200 million, depending on level of limitation

Comment: The proposal to limit the use of credits to 50% of tax liability would similarly impact the R&D credit which, since the expiration of the Manufacturers' Investment Credit, represents a major way that profitable corporations eliminate all tax liability.

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