TAX REFORM COMMISSIONS AS PRECURSORS TO STRUCTURAL REFORM: SUCCESSFUL AND UNSUCCESSFUL CALIFORNIA EXAMPLES

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DURING RECURRING FISCAL AND FINANCIAL crises, opportunities may arise for fundamental transformation of a state's fiscal system. While ideas for such a transformation can potentially come from many different sources, a systematic approach or plan recommended by a fiscal commission may provide the impetus for such a change.

In over 100 years in California there have been a number of fiscal commissions and extended studies of the California tax system. Some of these fiscal commissions and study groups were extremely successful. The two most successful ones in promoting change were the 1906 and 1929 Tax Commissions. Others, including a 1917 Commission, and more recently, the 2009 California Commission on the 21st Century Economy ("2009 Tax Commission"), attempted, but did not succeed, in promoting fundamental change. Through a review of the two successful tax commissions, we will argue that the successful ones shared some fundamental characteristics. They tackled key structural issues facing California, brought to bear the latest developments in public finance and economics, proposed new systems of taxation, and took their time to develop serious, consensus recommendations. Although the 2009 Tax Commission wished to make fundamental changes to the California tax structure and potentially was in a position to promote important innovations, they failed to embrace the lessons of successful earlier commissions.

TWO SUCCESSFUL TAX COMMISSION[1]

California's first tax commission was formed in 1905 and filed its report in 1906. The Commission's report was received favorably by the legislature and a constitutional amendment was submitted to the voters in 1908. It was defeated but then slightly modified and, finally, approved in 1910 (Assembly Interim Committee Reports, 1956).

This 1906 tax commission was formed to deal with what had been generally recognized as the unsatisfactory state of property taxation in California. At that time, both state and local governments relied primarily on the property tax to finance expenditures. The commission identified a number of difficulties with the current system. They believed that the burden on agriculture was too high, that the property tax unfairly fell primarily on real estate and personal property, that financial assets escaped assessment, and that the administration of the tax was highly inequitable.

These complaints were not unique to California. In particular, ever since the property tax began to be used extensively in the late 19th century, there was a tension about whether the tax was meant to apply to all property—and effectively be a wealth tax—or to focus simply on more easily taxable real property and some personal property.

The 1906 Commission did not focus on this problem, but instead concentrated on another issues: the relationship between state and local governments. One essential problem with the existing system was that local assessors determined valuations for both local and state property taxes. Thus, there was an obvious incentive for local assessors to under-assess property so that local residents would pay less in state taxes. While the State Board of Equalization, in principle, could have "equalized" assessments, in practice the Board did not have the resources or expertise to make this effective. As a result, there were competitive pressures to under-assess property across the state (Stockwell, 1939). The commission echoed the general belief that the current system was antiquated and needed to be replaced with something new.

Their solution to the problem was the radical "separation of sources" of state and local revenues. Under this system, 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. Instead, they would be subject to a gross receipts tax, the proceeds of which would accrue solely to the state.

The gross receipts tax on public utility property would be designed to approximate the burden placed on property in general throughout the state. Recognizing that gross receipts would bear a different relationship to net income for different types of property, different classes of utility property would be assigned different gross receipts 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.

To get a sense for the sophistication of the Commission, consider how they recommended setting tax rates for the gross receipts tax. 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 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. The state would be charged with determining the appropriate value of N across different classes of property and deciding upon the appropriate capitalization rate.

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 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. While the 1917 Commission believed 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 companies and suggested some other changes to the tax system as well. Unlike its immediate predecessor, the recommendations of the 1917 Tax Commission were largely ignored, as war time concerns were dominant.

In contrast, the 1929 Tax Commission proved to be very influential. They first began by reinforcing the conclusions of the 1917 Tax Commission — namely, that the system of gross receipts taxation and separation of sources was broken. They pointed out some of the same flaws as prior commissions — unequal tax burdens both across and within classes — but also an essential absurdity of the system. Gross receipts rates were chosen simply to approximate property tax rates, so why not tax property directly? The 1929 Commission recommended that public utility property be returned to local rolls, but that the State Board of Equalization be given the role of assessing the property. That way, local governments would enjoy the benefits of the property tax revenue, but it would be assessed fairly at the state level.

In the midst of 1929 Commission's deliberations, California was faced with a series of challenges to its system for taxation of 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 discrimination in that certain financial assets, such as mortgages, were not subject to tax. The 1929 Tax 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. This bold approach eventually became law — clear evidence of the respect that the legislature had for the tax commission.

Perhaps more importantly, the 1929 Tax Commission also sketched out a broad vision for a new schema of taxation for California (Final Report of the California Tax Commission, 1929). It recognized that the obligations the state was undertaking in 1929 were far more extensive than 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 Commission understood that a new tax system was needed.

The Commission saw three important components for a future California tax system. First, there was the property tax that would be directed for local government and focused primarily on real property. The "separation of sources" approach would be abandoned. Second, there would be a tax on business, initially for corporations and banks but perhaps later for unincorporated businesses, based on the net income of the business and intended to provide revenue for the state. Third, they raised the idea of a personal income tax to "personalize" the tax burden according to the ability-to-pay principle. The personal income tax was necessary because, prior to this time, the property tax was asked to effectively perform two tasks. It was to be an objective tax on the value of property — a reasonable measure of the benefits accruing to property from the state — but also was supposed to tax wealth on an ability-to-pay rationale. However, since property wealth was only a small part of total wealth 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. Thus, the Commission recommended narrowing the scope of the property tax to real property and introducing an income tax to address the ability-to-pay concerns.

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. The franchise tax for corporations and banks for California-charted enterprises was adopted in 1929 and later reformed and complemented with a corporation income tax in 1937, which taxed all corporations, regardless of their charter, on income derived from California sources. Finally, in 1935, a personal income tax was eventually enacted.

One of the reasons that 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 for the Commission. Professor Haig is known today for his contributions to the theory of income taxation and the "Haig-Simons" principle. The report reflected a clear understanding of the strengths and weaknesses of various taxes, tax developments around the country, and an institutional and strategic vision for tax policy that Professor Haig brought to the Commission.

The report reflected the broad consensus of the public finance community at the time. It contained discussions of the two key rationales for taxation: the benefit principle and ability-to-pay, with the former the guiding principle for business taxation and the latter for personal income taxation. It made recommendations that were sound in 1929 and still offered today; for example, eliminating personal property taxes for business and instead increasing their franchise tax rates and creating a formal Tax Commission to replace the Board of Equalization. It also was respectful of popular sovereignty by calling for voter approval for a plan to institute a personal income tax and remove intangible personal property officially from the tax base.

The Commission did <u>not</u> discuss the possibility of a general sales tax, which was in fact introduced in California in the 1930s. In their discussion of the possibility of a future tax on unincorporated businesses to complement the corporation tax, they discussed alternative methods of imposing such a tax. The most natural method would be an income tax on unincorporated businesses, but in the event that this proved difficult to administer, the Commission did raise the possibility of a gross receipts tax, following the model of a recently enacted gross receipts tax in Connecticut. But the Commission noted that the burden of such a tax would likely be shifted quickly to individuals, and the Commission preferred to deal with taxation of individuals through a personal income tax.

What did these two successful fiscal commissions have in common? First, they tackled major issues — the 1907 Commission developing the "separation of sources" doctrine and the 1929 Commission recommending eliminating that doctrine and, instead, developing a vision for a tri-partite modern state taxation system. Second, they each took sufficient time to develop their recommendations — in each case, approximately two years of work and consultation. Third, they developed their recommendations in close consultation with the legislature and key constituent groups. And finally, as we discussed, their approaches were state of the art for their time bringing full expertise for their tasks.

SUBSEQUENT FISCAL TRANSFORMATION IN CALIFORNIA

While the 1929 Commission set the stage for future developments, their reforms were not enacted immediately. 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 — this proved disastrous for a fiscal system largely based on property taxation. Change was inevitable and it came rapidly.

In 1932, 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 a budget and the language for the Riley-Stewart Initiative, named after State Controller, Ray Riley, and Board of Equalization member, Fred Stewart.

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 to be placed on expenditure increases both at the state and local levels; and the legislature was to be 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 tax would be necessary.

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. The personal income tax bill was vetoed by the governor, but later enacted. With the introduction of the sales tax, the personal income, and the franchise and corporation income taxes, the basic framework of California taxation persisted for 40 years.

The next major transformation of the California fiscal system came directly from the grass roots — the passage of Proposition 13 in 1978. As discussed in more detail in Sheffrin (2010), the system of property taxation that existed prior to 1970 was not capable of handling the fiscal and political stresses brought about by rapid inflation and related shifts in relative prices.

Could Proposition 13 have been avoided through prior study? There was a major tax study commissioned by the Assembly that delivered its 12 volume report in 1965 and recommended property tax relief and less overall reliance on the property tax. The tax study aimed at the high standards set by the 1906 and 1929 commissions in that it was directed by a respected expert, Professor Harold Somers, the Chair of the Economics Department at UCLA, and took two years to produce its work. Legislation was advanced in AB2270 (Petris-Unruh) that would have provided some property tax relief and raised additional revenue. The bill passed the Assembly but was defeated in the Senate. Unlike the prior commissions, however, it did not seek to make fundamental, structural changes to California's tax system.[2]

THE 2009 COMMISSION

California faced a number of fiscal challenges since the passage of Proposition 13, including recessions in the early 1980s and 1990s and a sharp decline in defense contracting in the early 1990s as well. But California's most recent phase of difficulties began in the late 1990s with the collapse of the high-tech bubble, the rise and fall of the real estate industry from 2001 through 2007, and the national financial and economic turmoil beginning in 2008. These events created both economic fluctuations but also budgetary fluctuations for the state. It was these budgetary fluctuations that determined the mission for the 2009 Tax Commission.

The mission of the Commission of the 21st Century, established in the Executive Order forming the Commission, was to address the volatility of California's tax system as its first and primary problem. The Executive Order mentions other issues, including the changing nature of the economy and the need for better incentives for strengthening the economy and generating revenue, but the emphasis was on volatility (Commission on the 21st Century Economy, 2009).

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 that prevailed under Governor Gray Davis (Sheffrin, 2004). Despite recognizing this problem, Governor Arnold Schwarzenegger viewed himself powerless to change it, and he continued to run structural budget deficits after succeeding Governor Davis.

As discussed in Sheffrin (2010), the 2009 Commission attempted to deal with this volatility by lowering personal income tax rates, including those at the high end and eliminating some deductions. They also recommended eliminating the state portion of the sales tax and eliminating the state corporate income tax. To replace the revenue from these tax reductions, the Commission recommended a new tax: the business net receipts tax (BNRT).

The BNRT was a tax that applied to the "net receipts" of a business, which was the gross receipts of a business minus purchases of goods and services from other firms including investment goods. By allowing a full deduction for investment goods, it was designed to be a consumption-based value added tax. It 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. 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. The BNRT would be apportioned to California by a destination sales factor. The nexus rules, determining whether California has jurisdiction to tax, would be based on the presence of payroll, property, or sales.[3]

As detailed in Sheffrin (2010), the debate surrounding the Commission's recommendations centered on issues of distributional neutrality and the fundamental uncertainty of abandoning large components of the existing tax system to implement a new tax with no real track record across the country. These factors, along with the general satisfaction the business community had with their ability to navigate the existing tax structure, led the Commission's proposals to a quick death with no real supporters in the legislature.

Could the Commission have approached their task differently and made a more compelling case for changes in California's tax system? While reducing volatility was the official mission of the Commission, its proposed changes were to move California more towards a consumption-based system rather than just keep relying on an undeniably volatile personal income tax system. While a consumption tax base in principle might be less volatile than an income tax base, most economists would not recommend a major shift in a state's taxation system based on just volatility. But a stronger case could have been made for a shift toward more reliance on consumption taxation.

Public finance economists have long recognized that income taxes, both income and corporate, have important limitations in small, open economies. High personal income taxes can cause out migration to states with lower tax rates. These effects were discussed within the Commission and are well-known to the general public, although the Commission did not present any evidence of their importance. Less well-known to the general public are the effects of taxes on capital. In a small, open economy a tax on capital causes a capital outflow and the burden of the tax is shifted to non-mobile factors, typically labor. From a welfare point of view, it would be better to tax the immobile factors directly and avoid the loss of capital from the state. For this reason, capital taxes are inefficient in a small, open economy. One solution to this problem is to move toward a consumption tax base and avoid the inefficiencies of capital taxation.

The Commission could have taken the position that California was now facing a new challenge that its existing tax system could not handle. California no longer could develop its tax policy in isolation, but needed to do so in context of the global economy in which it was situated. While California's gross state product exceeds the gross national product of a vast number of countries in the world, it still functions largely as a small, open economy. The Commission could have developed this line of thought in more detail and provided an analytical and factual basis for these claims.

Furthermore, they could have recognized that there was a small likelihood of passage of any major reform immediately, but that their ideas could have set the stage for future debate. This is precisely what happened to the recommendations of the 1929 Commission.

If the Commission had chosen this route, it would have had to develop the analytical foundations of the BNRT in more detail. In particular, it would have had to explain how the BNRT differed, if at all, from an ideal retail sales tax or a value added tax. It was not enough to say that the BNRT was just a consumption tax. It clearly operated differently than a retail sales tax or a standard credit-invoice value added tax. The BNRT had the form of a subtraction value added tax and was to be apportioned at the state level by destination sales. Neither the Commission nor its critics really understood precisely how this system would operate, either in theory or practice. During the Commission's deliberations, Kirk Stark (2009) wrote a letter on behalf of academic tax lawyers and economists to the Commission that emphasized that the BNRT was not a straightforward value added tax, and highlighted the potential to game the tax through interstate transactions and other means. Neither group analyzed in precise detail the differences between the BNRT and more familiar consumption taxes.[4]

Alan Auerbach's (2011) analysis of state consumption taxes represents the type of work that the Commission could have conducted or solicited. Auerbach compared the BNRT to the existing corporate tax and found that the BNRT had some advantages, that it could be applied easily to non-corporate entities and, with its base of wage plus capital income, would be less volatile than the existing corporate tax with just a base on capital. This decrease in volatility, however, was associated with a shift in the burden toward labor and away from capital. As mentioned in a table in his paper and shown in the technical appendix, Auerbach also demonstrates how the BNRT implicitly taxes business inputs, a point referred to in the Stark letter.

How else did the 2009 Commission go wrong in comparison to its successful predecessors? There were several problems. First, the Commission rushed its deliberations, starting official discussions in January but delivering its final report in September of the same year. This was not sufficient time to develop a full analytical apparatus, particularly since the BNRT was not introduced until late in the process. The Commission was lured by the prospect of having the legislature consider their outcome in total as a single bill, but this turned out to be a false and dangerous attraction. By rushing the report, they were not able to generate consensus on the committee and there were notable and important dissenting voices.

Second, they did not lay the proper foundation for a distributional analysis, which seemed central to the project. After all, there were large cuts in personal tax rates that benefitted high-income Californians, and, as Auerbach noted, a BNRT without a deduction for wages will be more regressive than a corporate tax. At the time of the deliberations, they relied almost exclusively on presentations from Ernst & Young that were not easily understood and came under immediate challenge.[5] The Commission perhaps could have provided some countervailing evidence or at least dealt with the question openly, but instead proceeded with its recommendations without sufficient background research.

Part of the issue was that those involved in tax reform projects have raised their expectations as to what must be included in an analysis. Standards are higher than they were in 1906 and 1929, and this is particularly important when a new tax and radical restructuring of the system are being proposed. Stakeholders and informed observers in the process need to be provided with a clear sense of the methods and data used to reach the conclusions of a study. Finally, the Commission failed to develop a full rationale, other than volatility, for such a major transformation of the tax system. I have suggested that the growing internationalization of the economy might have provided such a rationale and set the stage for a serious consideration of new tax system. But the Commission did not make its case for such a fundamental transformation.

Notes

1. This section draws on Sheffrin (2010).
2. The study and legislation are described in Doerr (2008), especially in chapter 22. Dave Doerr was a consultant to the Assembly during that period and one of the authors of the property tax section of the report.
3. A description of the proposed tax is contained in the appendix to the Commission on the 21st Century Economy, Final Report, 2009, pp. A3-A12.
4. See McClure (2010) for a thorough critique.
5. See Sheffrin (2010) for a full discussion. One issue was whether the deductibility of the BNRT generated a "federal offset" that would neutralize the distributional changes.

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