

San Antonio, Texas



Chapter Two  
Texas vs. California

# Texas vs. California

At the time of this book's publication, California was in the middle of its longest budget impasse ever. Gov. Schwarzenegger had warned the federal government that his state may need an emergency loan just to make ends meet. During this record-long – and yet oh so typical – budget crisis, the usual suspects in Sacramento and the media excoriated the governor as a modern-day Ebenezer Scrooge. To hear the popular press explain it, fiscal conservatives wanted to balance the budget on the backs of the poor, rather than having the rich pay their “fair share.” In fact, it was the governor who proposed a one-cent sales tax increase as a counter to the 12 percent highest marginal income tax rate proposed by the legislature's Democrats. Ah, if only this were true.

In reality, despite his campaign pledge to “cut up the credit cards,” the muscular governor lacked the political strength to resist a huge spending binge during his tenure. The budget that just passed amidst much gnashing of teeth, was a \$144 billion grab-bag that actually contains the most General Fund spending in state history. And the cold-hearted austerity measures touted by the governor's office as a “rainy day fund with teeth,” contain all sorts of loopholes that can be exploited by future legislatures to suit their spending desires.

Some of us have been arguing, literally for decades, that the citizens of California control their own destiny. People deserve the governments they get. It's true, there's not much California can do about periodic earthquakes.

However, they *do* have the power to stop their periodic *budgetary* earthquakes, if only they had the discipline. California's fiscal system creates the boom-bust cycle in tax revenue that causes the familiar pattern of spending hikes during the fat years, which inevitably lead to crises every time the economy slows down.

Specifically, the problem is that California has the most “progressive” (ah, what a deceptive term!) income tax code in the country. Tax progressivity exaggerates the normal ups-and-downs of the overall economy, and explains why income tax receipts in California are among the most volatile of all the 50 states. When times are good, California citizens earn more, pushing many of them into a higher tax bracket, thereby giving the state a larger fraction of a bigger pie. But then the opposite holds true during recession: People earn less income in general, thereby shrinking of the tax base, as many fall into lower tax brackets and pay a smaller fraction of smaller paychecks. This one-two punch explains why hard times seem to hit California harder than other states.

Of course, what seems obvious to us appears as right-wing science fiction to many California legislators and pundits. They claim that serious reform of the tax code is unrealistic, that a large state has many duties to fulfill, and that it is irresponsible to call for a return to a 19th century view of the role of government.

But here's where the present chapter comes in. The insiders in Sacramento don't need to look to the original Thirteen Colonies to see

small government in action. In fact, we direct their attention only three states to the east. Not only does Texas lack a highly progressive income tax – it doesn't have one at all! We hasten to add that the last time we checked, Texas still had literate kids, navigable roads and functioning hospitals, which one would think impossible given the hysterical rhetoric coming from defenders of California's punitive tax system. In fact, the Texas success story illustrates everything we have been recommending for California all these years. How do they do that?

### **The Economic Scorecard:**

#### **Texas vs. California**

In life, once every now and then, we come across something that is simple and says it all. In the 1950s, for example, when asked about life in Canada, the person who was asked the question answered that 90 percent of all Canadians live within 100 miles of the U.S.-Canadian border, while only 10 percent of all Americans live within 100 miles of the same border. That said it all.

When comparing California with Texas, U-Haul says it all. To rent a 26-foot truck one-way from San Francisco to Austin, the charge is \$3,236, and yet the one-way charge for that same truck from Austin to San Francisco is just \$399. Clearly what is happening is that far more people want to move from San Francisco to Austin than vice versa, so U-Haul has to pay its own employees to drive the empty trucks back from Texas. The great thing about this example is that it's a market price set in the real world – you don't need to rely on a fancy economic model to see our point. If two haughty-taughty food critics were arguing about restaurants A and B, the average Joe could ignore their jargon and just look at which place had a line out the door. When it comes to California and Texas, people are backed up, waiting to move out of the former and into the latter. We rest our case.

Economics isn't a zero-sum game. If one state does well economically, generally speak-

ing, that is a boon to the citizens of the other 49 states as well. Even so, we can compare the economic performance of different states to assess how well – or how poorly – their government policies promote a strong economy.

When it comes to interstate economic competition, there is no "finish line." It is a never-ending struggle requiring states to consistently maintain an advantageous economic environment *vis-à-vis* other states. States that establish and maintain the most pro-growth economic environments will be leaders in the inter-state economic competition. This is especially true with respect to key economic rivals. A key economic rivalry is the one between Texas and California – the two economic heavyweights of the United States.

Both Texas and California have the allure of geography, and the economies of both states have outperformed national trends. But, current policies matter for future economic performance. Texas' superior policies over the past several years are making the Lone Star State more resilient to the current economic downturn and will provide powerful tailwinds for the Texas economy going forward. The opposite is true for California.

The results of a head-to-head competition between the two economic heavyweights are not even close. Economically, Texas is just too much for California to handle. At the state level, there are six broad categories in which the states compete: taxes on labor income, taxes on capital income, taxes on consumption, overall tax environment, government spending policies and government regulatory policies. On net, Texas's economic environment is more competitive in all of these categories (see Table 10).

Current state economic policies have important implications for future economic performance. Texas's win over California is an encouraging sign for Texas's future and an ominous sign for California's. Texas's future prosperity looks bright: stronger income, wealth and employment growth will occur in the Lone Star

TABLE 10  
**TEXAS VS. CALIFORNIA**

COMPETITIVE EVENT	CALIFORNIA	TEXAS	WINNER
<b>Taxes on Labor</b>			
Top Marginal Personal Income Tax Rate	10.30%	0.00%	Texas
Marginal Personal Income Tax (average income earner)	9.30%	0.00%	
<b>Taxes on Capital</b>			
Property Tax Burden (per \$1,000 of personal income)	\$26.63	\$41.06	Texas
Estate/Inheritance Tax Levied	NO	NO	
Top Marginal Rate: Income, Dividends and Capital Gains	10.3%	0.0%	
Top Marginal Corporate Tax Rate	8.84%	5% <sup>1</sup>	
<b>Taxes on Consumption</b>			
State Sales Tax Rate	7.25%	6.25%	Texas
Sales Tax Burden (per \$1,000 of personal income)	\$23.72	\$23.31	
<b>Overall Tax Environment</b>			
Overall Tax Burden	\$118.33	\$99.49	Texas
Personal Income Tax Progressivity	\$34.88	\$0.00	
Recently Legislated Tax Changes (per \$1,000 of personal income)	+\$0.88	-\$3.92	
Number of Tax Expenditure Limits	2	1	
<b>Regulatory Environment</b>			
State Liability System Rank	44th	41st	Texas
State Minimum Wage	\$8.00	\$6.55	
Average Workers' Compensation Cost	\$2.72	\$2.61	
Right-to-Work State	NO	YES	
<b>Government Spending Policies</b>			
Total Expenditures per Capita	\$10,099.89	\$6,845.26	Texas
Average Growth in State Government Expenditures	7.04%	5.96%	

Sources: CCH Tax Research Network, Laffer Associates, Bureau of Economic Analysis, U.S. Census Bureau, Texas Public Policy Foundation

State relative to California, as well as the country as a whole. The opposite is true for California: weaker economic performance and less relative growth will ensue. The relative success of Texas gives California policy-makers a realistic goal to shoot for. If they can do it in Texas, they can do it in California, too.

### **Texas vs. California: Economic Growth Prospects for the 21st Century**

States fiercely compete with one another – they compete for jobs, they compete for businesses and they compete for people. The results of this economic competition have real implica-

tions for future state economic performance. As in other arenas of life, when it comes to state economies, strong competition is a good thing because it keeps everyone striving for excellence. States with strong competitive environments have flourishing economies, while states with weak competitive environments have struggling economies. A dismal competitive environment in Michigan, for instance, led to the Michigan Recession, while the rest of the country prospered.<sup>2</sup>

Arizona provides another historical example. Prior to Fife Symington's election as governor (in a runoff in 1991), Arizona was the textbook case on how to screw up a state. Govs. Babbitt (1978-1987), Mecham (1987-1988) and Mofford (1988-1991) were unmitigated disasters. Their playbooks raised taxes, and then when that didn't work, raised them some more. (Sounds familiar, eh?) The results were just what you would expect. Not only did Arizona bungle its fiscal situation badly, but it also became the buffoon of states – and there is some stiff competition in that category. The Martin Luther King Day fracas was truly embarrassing. Then came Gov. Mecham's impeachment, followed by the Keating crisis and the prominence of Arizona's senatorial contingent in the bad press of that time – two of the Keating Five were Arizona senators. Then came the sting on Arizona's legislature and the wholesale corruption the sting uncovered. Arizona was the worst of all the states, and asset values reflected the Arizona environment. You couldn't have gotten more depressed asset values if you had employed Mephistopheles himself. We believe asset values are a very good indication of expert opinion on the prospects of a region because investors are paying for ownership over a future flow of returns. Investors did not like what they saw in Arizona. Although economics is a neutral science, we can't help but point out that the same crew that was up to its neck in S&L corruption also helped themselves to more of the taxpayers' hard-earned money.<sup>3</sup>

Many factors impact a state's competitive environment. A number of these factors – such as climate, natural resources or geographical location – do not change. State economic policies (i.e. tax, expenditure and regulatory policies) vary across states and across time within a state and have significant implications for a state's economic prospects. For this reason, state economic policies are crucial economic competitiveness metrics. As we wrote earlier, California can't do much about its earthquakes, and Texas can't do much about hurricanes, but each state can control its economic future. As we have shown and will continue to explain, Texas has been doing a much better job on this front.

The result of a head-to-head competition between Texas and California is an economic blowout. The economic environment in Texas has significant advantages over California. The implications of this competitive advantage are clear: Texas's economic prospects are bright and the Texas economy will significantly outperform California's. Put another way: In a heavyweight competition between Texas and California, Texas wins!

### **State Economic Policies Really Do Matter!**

We have been preaching the low-tax, business-friendly religion for decades now, and it never ceases to amaze us how many seemingly intelligent, articulate people refuse to admit that state economic policies really do matter. During the current budget crisis in California, apologists for its tax-and-spend ways would dismiss supply-side “myths,” and instead blame California's woes on “the economy” – as if state policies don't affect the economy. Some analysts look at migratory data (which we'll examine in a bit) and say, “It's not high taxes driving people out – it's the lack of jobs.”

Talk about begging the question! But because this opposing view is so prevalent, some background information on the importance of the competitive events is appropriate. Whether

it is excessive taxation, excessive regulations or excessive expenditures, the result is the same – poor economic policies lead to poor economic outcomes.

Excessive taxation, regulations and expenditures are detrimental to labor and capital, poor and rich, men and women, and old and young. Poor economic policies are equal opportunity tormentors. In the short run, poor economic policies lead to higher taxes on labor or capital and lower after-tax earnings. In the longer run, mobile factors “vote with their feet” and leave the state, leaving immobile factors (such as low wage workers and land and property) to suffer the tax and regulatory burdens. Businesses suffer lower after-tax earnings, and residents suffer decreased employment growth. The incentives to work, save and produce are all diminished.

Government expenditures also directly impact the overall economic growth environment. In order to spend money, the government must first take it from the private sector, either through taxes or borrowing – there is no Tooth Fairy it can draft into service. Some people describe the process as robbing Peter to pay Paul, but it’s actually worse because the troll needs his toll as well. In other words, for the government to give \$1,000 to Paul, it needs to take, say, \$1,300 from Peter, because Philip the IRS agent needs to get his \$300 salary. To make matters worse still, we have to recognize that the higher the tax rate, the greater the “dead-weight loss,” meaning the fewer trades that occur, even though people in the private sector would mutually benefit from them. So to give Paul that \$1,000, and Philip, the tax man, his \$300 salary, we need to rob Peter of \$1,300, which leads him to turn down an offer to work overtime for Phineas. (At this point we’ll stop, since we’re running out of names that start with “P.”)

The above arguments don’t establish the case for anarchy – some things must be paid for by the government. Our point is that the

costs of government expenditures are typically understated. Depending upon how these revenues are spent, the contribution of the government expenditures to the economy may be less than the value of the money to the economy prior to its removal from the private sector. When this is the case, government expenditures create additional negative impacts on economic growth and development beyond the tax impacts already considered.

One of the present writers has produced decades of research demonstrating that states that impose high and/or increasing taxes, burdensome regulations and poor expenditure policies, experience relative income and population declines, rising relative unemployment and declines in housing values. Alternatively, states that impose a pro-growth economic policy consisting of low taxes, appropriate regulations and disciplined expenditure policies, experience accelerated income and population growth, declining unemployment and rising housing values.

Examining the economic growth performance in the states with the highest tax burdens compared to the economic growth performance in the states with the lowest tax burdens illustrates these trends. Not surprisingly, the economic performance of the low-tax states beats the economic performance of the high-tax states. For example, back in Table 8, we compare the performance of those states with the highest and lowest corporate income tax rates. Not surprisingly, we find that the states which penalize corporate profits have slower growth in income and population.

Further substantiating the relationship between personal income taxes and economic growth, we compared state tax rates to state personal income growth in Table 7. While other factors impact state personal income growth, there is a negative and significant relationship between a state’s top marginal personal income tax rate and the economic growth rate in the state – the higher the top marginal

personal income tax rate, the lower the expected economic growth rate.

Incidentally, the comparable unemployment rates (4.2 percent vs. 4.4 percent) per se, are no strike against our thesis. For one thing, the low-tax states had much higher population growth than the high-tax states, so they had more work to do to keep their unemployment rates down. Economic theory suggests that as long as wage rates can adjust, in the long-run, everybody can find a job who wants one. The difference is that people can get *better-paying* jobs in the low-tax states, as Tables 7 and 8 clearly show.

The pattern of low-tax states economically outperforming high-tax states is consistent with the theory of incentives, which provides the basis for establishing an optimal tax policy. Changes to marginal tax rates are critical for growth because they change incentives to demand, and supply work effort and capital.

Firms base their decisions to employ workers, in part, on the workers' total cost to the firm. Holding all else equal, the greater the cost to the firm of employing each additional worker, the fewer workers the firm will employ. Conversely, the lower the marginal cost per worker, the more workers the firm will hire. For the firm, the decision to employ is based upon gross wages paid, a concept which encompasses all costs borne by the firm.

Workers, on the other hand, care little about the cost to the firm of employing them. The worker really only cares about his *net* pay in exchange for the expected amount of effort, after all the deductions and taxes are taken out. The greater net wages received, the more willing a worker is to work. If wages received fall, workers find work effort less attractive and they will do less of it. The difference between what it costs a firm to employ a worker, and what that worker receives net, is the "tax wedge."

Government economic policies matter because these policies impact the incentives to work, save and invest for workers, employers and investors. States with greater incentives

to work, save and invest have higher economic growth rates.

With respect to the competition between Texas and California, the future economic prospects of these two powerhouse states are crucially dependent on the respective impact that each state's policies have on the incentives to work, save and produce. The competitive events analyzed below are designed to capture these impacts.

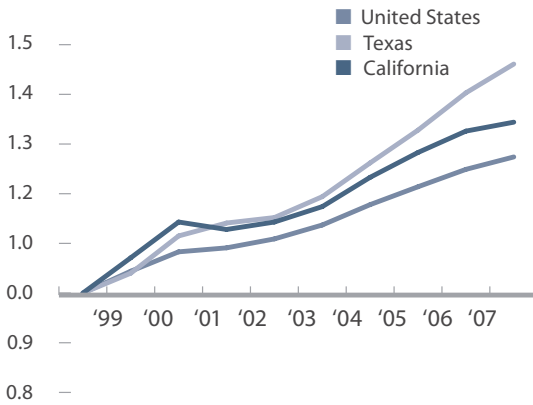
### Introducing the Competitors

Texas and California have a similar history. The U.S.-Mexican War began with Texas's entry into the United States – it ended with California's. The lure of climate, opportunity and resources helped both Texas and California grow into the two largest states in the country. Thanks to this extraordinary growth, the economies of Texas and California now dwarf the size of most countries. As of 2006, the California and Texas economies were the 7th and 10th largest economies in the world, respectively.<sup>4</sup> And yet, the recent performance of both of these states has varied.

### Overall Economic Growth

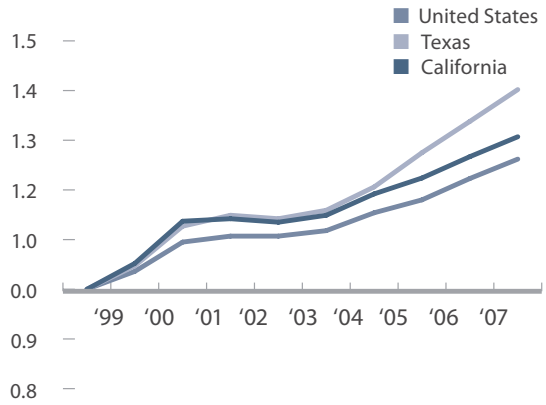
Texas's overall economy has grown more than California's since 1998 – even including the impacts of the Internet revolution on California's economy during the late 1990s (see Figure 4). On average, Texas's real economy has grown 4.3 percent a year since 1998. In contrast, California's real economy has grown at a slower rate of 3.6 percent, and the nation as a whole has grown at an even slower, but still impressive, rate of 2.9 percent. Since the end of the tech boom, the economic environment has skewed even further in Texas's favor. Since the end of the 9/11 recession, real economic growth accelerated in Texas (4.9 percent), while California's economic growth rate was slightly less strong at 3.3 percent. Income growth tells a similar story, albeit slightly more favorable to Texas (see Figure 5).

**FIGURE 4**  
**CUMULATIVE GDP GROWTH:**  
**TEXAS AND CALIFORNIA, 1998-2007**  
 scaled to 1.0 as of 1998



Source: Bureau of Economic Analysis

**FIGURE 5**  
**CUMULATIVE PERSONAL INCOME GROWTH:**  
**TEXAS AND CALIFORNIA, 1998-2007**  
 scaled to 1.0 as of 1998



Source: Bureau of Economic Analysis

Real personal income in Texas grew 4.24 percent a year on average between 1998 and 2007. This exceeded average personal income growth in California over this time period (3.51 percent) and for the nation as a whole (2.99 percent). Since 2002, Texas's real personal income growth premium has expanded further as personal income growth in Texas has continued expanding 4.2 percent a year while real personal income growth has slowed in California (2.87 percent) and for the nation as a whole (2.66 percent).

From a broad macroeconomic perspective, the Texas economy has been expanding at an accelerated rate compared to California and the nation overall.

### Employment

The employment trends of the competitors have been more erratic. Employment growth in both Texas and California have outpaced employment growth in the nation as a whole. Employment growth in Texas is currently outpacing employment growth in California, though this was not the case from 1997 through 2003.

Table 11 and Figure 6 each illustrate that

California's employment growth of 3.3 percent during the tech boom years was especially strong. Texas's employment growth rate of 3.1 percent was also exceptional, but did not keep pace with California's. Employment growth turned to declines from 2001 to 2003 in both Texas and California, as it did for the country as a whole. Since the "jobless recovery" has ended, Texas's employment record has been stellar – growing more than twice as fast as California and nearly twice as fast as employment growth for the country as a whole.

### Population Trends

Every day, people vote with their feet by moving, and over the past eight years, more people have voted for Texas than California. The total U.S. population is estimated to have grown one percent a year between 2000 and 2007. California's population grew at approximately the national average for a total population increase of 2.7 million people. Texas's average annual growth was nearly twice the national average (1.9 percent or a total population increase of 3.1 million people).

Total population increases include what the

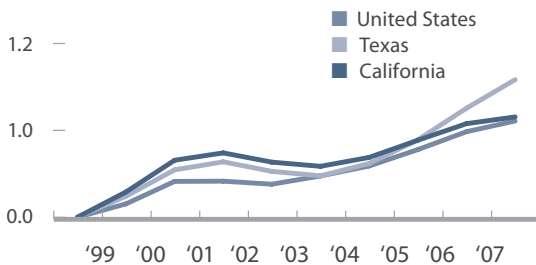
TABLE 11  
**AVERAGE ANNUAL EMPLOYMENT GROWTH  
 IN SELECT PERIODS: TEXAS AND CALIFORNIA**

	U.S.	Texas	California
1998-2000	2.4%	3.1%	3.3%
2001-2003	-0.7%	-0.8%	-0.7%
2004-2007	1.5%	2.9%	1.4%

Source: Bureau of Labor Statistics

FIGURE 6  
**CUMULATIVE EMPLOYMENT GROWTH:  
 TEXAS AND CALIFORNIA, 1998-2007**

scaled to 1.0 as of 1998



Source: Bureau of Labor Statistics

U.S. Census calls “natural increases,” or total births and deaths. Such measures do not reflect people *choosing* to enter or leave a state. The U.S. Census tracks a more accurate measure of Americans voting for states with their feet called “net internal migration,” which tracks the choices U.S. residents make with respect to the state in which they want to live. Net internal migration is measured as the number of residents moving to a state (from another U.S. state), minus the number of residents leaving the state (for another U.S. state). By this measure, California looks sickly, while Texas looks stellar. On net, over one-half million U.S. residents chose to move to Texas from some other state between 2000 and 2007 – the third highest total behind Flor-

ida and Arizona. California, on the other hand, lost over 1.2 million residents within the same time period. The net internal migration figure removes the noise from California’s influx of foreign immigrants, and allows us to see what people do once they’re in the Golden State.

Texas’s total package is attractive enough to retain, on net, all of its current U.S. residents, and attract one-half million more. California’s total package is not attractive enough to retain, on net, all of its current U.S. residents. Of course, we realize that relocating one’s life is a personal decision, but economics matters too. It’s true that an aspiring actress may move to Hollywood, regardless of marginal tax rates, or that a swooning boy may move to Texas to marry his Southern sweetheart, even though he is completely oblivious to job prospects. Even though individuals make decisions for all sorts of reasons, in the aggregate, economic policies will affect the totals.

In January 2006, Arthur Laffer made the decision to leave California and go to a zero income tax state (Tennessee) where he had never been before. At the age of 65, he and his family packed up their belongings and left the Golden State for good. And why? Because of taxes, and the transformation of Gov. Schwarzenegger from a proponent of pro-growth, supply-side policies, into a pandering, pro-union, big spending appeaser of anti-growth interests. Don’t get us wrong, we have worked closely with the famous actor, and have enjoyed a lot of good times. But in terms of the governor’s awful policies, Laffer decided enough was enough. And how does Laffer feel about his decision now? *Great*. Everything he knew about Tennessee before he left California turned out to be true, and the preponderance of things he was unsure of came out far better than he had expected.

The data presented above show that Texas’s economy has been stellar. Perhaps more importantly, the economic policy environment is very pro-growth, indicating that Texas will

experience future job and income growth. The same cannot be said of California. The economic environment in California has taken a turn for the worse. Out of control spending, rising regulatory burdens and rising taxes, all point toward diminished economic opportunities in California now and in the future. Such outcomes are the consequences of losing the state economic competition, and the rewards of winning.

### And Now the Main Event

The competition between Texas and California is measured in three broad categories:

- Tax Policy
- Regulatory Policy
- Expenditure Policy

Government policies, especially tax policies, have large and varied impacts on the competitive economic environment of a state. To account for these broad impacts, it is useful to track the impact of government tax policies on the economy's production process.

For instance, someone has to exert effort to create all of the goods and services in our economy. Economists generally classify this effort as the "labor input" of production. The other inputs of production are classified as capital or the tools and machines people use (which comes from savings and investments), and technology or the know-how/skills needed to create the things we need and want. Government policies matter because the taxes levied by governments, or the expenditures made by governments, or the regulations imposed by governments impact the inputs of production. These impacts either discourage or encourage the use of labor, capital and technology.

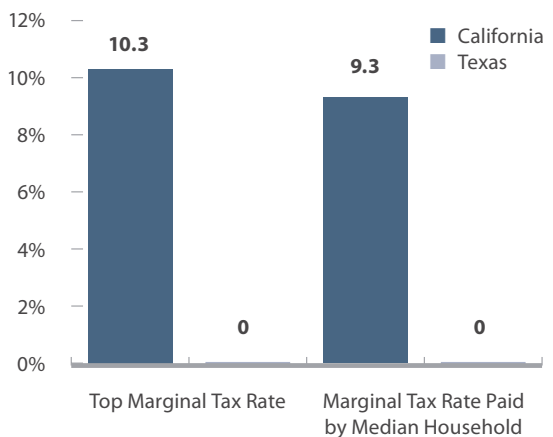
Due to the importance of labor and capital in the economic process, it is useful to further divide the tax-policy competition into its impact on labor and capital, the tax burden on consumption and the overall tax burden in the state.

### Competition I: The Tax Burden on Labor

People do not work to pay taxes. People work to earn the highest wages possible, after taxes. High (or rising) taxes on labor reduce workers' after-tax wages, thereby reducing their incentive to work. Because workers can receive a higher (or rising) after-tax wage for the same gross wage if they moved to a state with a lower (or falling) tax burden, the economic climates of other states are critical. People have an incentive to leave a state with high (or rising) taxes on labor income and relocate to a state where the taxes on labor income are lower (or falling). As people respond to these incentives, income growth, employment growth and overall economic growth suffer in the state with high or rising taxes.

California levies a progressive income tax system – as people's income increases, the tax rate on the higher income increases. It is this marginal tax rate that is relevant from an economic perspective. Because the marginal tax rate varies depending upon the income of the worker in California, we track two marginal income tax rates: the marginal tax rate faced by the highest income earners and the marginal tax rate faced by the average (or median) worker.

**FIGURE 7**  
**MARGINAL INCOME TAX RATES:**  
**TEXAS AND CALIFORNIA**



Source: CCH Tax Research Network

California imposes the highest top marginal state income tax rate in the country – 10.3 percent. The median household income in California in 2006 was \$55,319.<sup>5</sup> The average or median family faces a 9.3 percent marginal state income tax rate in California.

Texas does not impose a state income tax. By definition, the marginal income tax rate for both the highest income earners and the average worker is zero percent. Figure 7 summarizes the comparisons between Texas and California.

These comparative tax rates clearly illustrate Texas's economic attractiveness and California's economic unattractiveness. If there are two workers earning \$55,319 a year – one in California and one in Texas – then the Texas worker's after-tax income would be \$1,952 higher than the California worker's after-tax income.<sup>6</sup> Texas's tax savings provides workers with a 3.5 percent raise compared to their California counterparts. This is a huge difference, despite the pooh-poohing of our critics. With respect to the income taxes imposed on labor competition, Texas is the winner.

#### **COMPETITION I WINNER: TEXAS**

#### **Competition II: The Tax Burden on Capital**

Capital taxes are more complicated than taxes on labor income. State governments do not treat all forms of capital equally. Oftentimes, states (and the federal government) double or even triple tax capital income. All factories, equipment, land, etc., used to produce goods and services are considered capital from an economic perspective.<sup>7</sup> Purchases of capital require an investment on the part of businesses or individuals. Businesses do not invest as a matter of social conscience. They invest to earn the highest possible rate of return on their investments. Businesses and other investors will only purchase capital if the expected return on capital exceeds all costs – including all tax costs.

Taxing the return on capital is synonymous with taxing saving and investment. High taxes

on savings and investment lowers the after-tax rate of return from saving and investing, diminishing the incentives to invest. Lower investment translates into a smaller and less productive capital stock. Income, employment and economic growth are all subsequently reduced.

Returns on saving and investment are taxed in many ways. First, corporations earn profits, which are the returns to the investors or the owners of the “capital.” These profits are subject to corporate income taxes, or in the case of some firms, personal income taxes. If the profits are then distributed to investors as a taxable dividend, the income is taxed again through dividend taxes. Should the owner of the company – or any income generating asset – decide to sell his ownership rights to the capital, any increase in the value of the stream of payments from the capital (capital gains) are taxed. Similarly, the interest income from savings or bond investments faces income taxes. Finally, states will tax the value of some assets in addition to the income stream generated from those assets – another instance of states taxing the same income multiple times – by taxing property and imposing estate and gift taxes. Table 12 summarizes the tax burden on capital imposed on California versus Texas.

Neither California nor Texas imposes an estate tax – a very encouraging sign for both states. With respect to property taxation, thanks to Proposition 13, California is more competitive than Texas. The tax burden on property in Texas is \$41.06 per \$1,000 of personal income, while it is only \$26.63 per \$1,000 of personal income in California. With respect to all other forms of capital taxation, Texas is more competitive than California. Additionally, Texas passed tax legislation in the spring of 2006, later revised in 2007, aimed at reducing this property tax burden. The tax change cut the school property tax by 33 percent, from \$1.50 to \$1 out of every \$100. They also amended the state business tax, adopting a controversial one percent gross receipts, or margins tax.<sup>8</sup> The five percent rate

in Tables 12 and 13 represents the effective tax rate on business income if the gross receipts tax were adjusted to resemble a more normal corporate income tax rate structure. Also, both of these changes took effect after the latest period for which property tax revenue data was available. We would therefore expect the Texas property tax burden to fall noticeably in the near future.

California's property tax burden advantage is, however, overwhelmed by its excessive tax burden on income, dividends, capital gains and corporate income. Our statistics overwhelmingly illustrate California's significant competitive disadvantages.

As discussed above, the marginal tax rate a business or individual faces determines the incentives to engage in productive economic activity. In order to see the impacts from these taxes on incentives to acquire capital (i.e., save and invest) we incorporate the impact of federal taxes and simply follow the money.

Imagine two representative companies facing the highest marginal income tax brackets earning an additional \$1,000 in profits. One firm is located in California, the other in Texas. Each representative company faces a federal income tax liability. Depending upon the company's structure, the tax liability could be either the top marginal corporate income tax rate or top marginal personal income tax rate. In this example, the representative companies pay a weighted share of the corporate and personal income tax rates. The weights representing the share of total net income subject to the corporate income tax and the share of total net income subject to the personal income tax are calculated based on the share of total net corporate income subject to corporate taxes as reported by the Internal Revenue Service (IRS) Statistics of Income data.<sup>9</sup>

With respect to federal income tax rates, the division is irrelevant, as the top corporate and personal income tax rates are both 35 percent. The distinction for California and Texas

**TABLE 12**  
**TAXATION OF CAPITAL**

<b>Taxes on Capital</b>	<b>California</b>	<b>Texas</b>
Property Tax Burden (per \$1,000 of personal income)	\$26.63	\$41.06
Estate/Inheritance Tax Levied	NO	NO
Top Marginal Rate: Income, Dividends, and Cap. Gains	10.3%	0.0%
Top Marginal Corporate Tax Rate	8.84%	5.0%

Source: U.S. Census Bureau, CCH Tax Research Network

**TABLE 13**  
**TAXATION OF CORPORATE INCOME**

	<b>California</b>	<b>Texas</b>
<b>Additional Net Income</b>	<b>\$1,000.00</b>	<b>\$1,000.00</b>
<b>Federal Income Tax Liability</b>		
Corporate Income Tax (weighted)	13.7%	13.7%
Personal Income Tax (weighted)	21.3%	21.3%
<b>State Income Tax Liability</b>		
Corporate Income Tax (weighted)	3.5%	5.0%
Personal Income Tax (weighted)	6.3%	0.0%
<b>Additional Net Income After Taxes</b>	<b>\$586.76</b>	<b>\$637.17</b>

Source: U.S. Census Bureau, CCH Tax Research Network

income tax rates is relevant. In California, the top corporate income tax rate is 8.84 percent, while the top personal income tax rate is 10.3 percent. In Texas, there is no corporate income tax rate, but there is a one percent gross receipts tax. To put the gross receipts tax on a comparable basis to California's net income tax, we transform the gross receipts tax rate into an equivalent net income tax rate.<sup>10</sup> Based on this transformation, Texas's one percent margins tax is the "equivalent" of a five percent net in-

TABLE 14  
CORPORATE INCOME SUBJECT TO  
DIVIDEND TAXES

	California	Texas
<b>Additional Net Income After Taxes</b>	<b>\$586.76</b>	<b>\$637.17</b>
Earnings Paid Out	\$496.80	\$539.48
Earnings Paid Out Subject to Dividends Tax	\$156.83	\$170.30
<b>Individual Dividend Tax</b>		
Federal	15.0%	15.0%
State	10.3%	0.0%
<b>Total After-tax Income (incl. retained earnings)</b>	<b>\$547.09</b>	<b>\$611.62</b>

Source: Bureau of Economic Analysis

TABLE 15  
TAXATION OF INTEREST  
AND CAPITAL GAINS INCOME

	California	Texas
<b>Individual Interest Income</b>	<b>\$1,000.00</b>	<b>\$1,000.00</b>
Federal Interest Income Taxes	35.0%	35.0%
State Interest Income Taxes	10.3%	0.0%
<b>Individual Interest Income (after-tax)</b>	<b>\$583.05</b>	<b>\$650.00</b>
<b>Capital Gains Income</b>	<b>\$1,000.00</b>	<b>\$1,000.00</b>
Federal Capital Gains Taxes (long-term)	15.0%	15.0%
Federal Capital Gains Taxes (short term)	35.0%	35.0%
State Capital Gains Taxes	10.3%	0.0%
<b>Capital Gains Income (after-tax)*</b>	<b>\$748.88</b>	<b>\$834.87</b>

\*Based on estimates of long-term vs. short-term capital gains from the IRS.

Source: Internal Revenue Service

come tax. We use the five percent figure as the appropriate corporate income tax rate for our calculations (see Table 12).

The final line of Table 13 calculates the addi-

tional after-tax net income to each one of these companies if they were located in Texas versus California, and takes into account the deductibility of state income taxes. As Table 13 clearly shows, just by locating in Texas, companies can earn an extra \$50.41 per \$1,000 of net income, or an 8.6 percent higher after-tax return.

Texas's competitive advantage grows even more because the income tax burden imposed on this income is not finished. The owners of a corporation (individuals) that pay dividends face another round of taxation on this income. Using national payout-ratios based on the Bureau of Economic Analysis National Income and Product Account (NIPA) tables and the ratio of companies that are dividend-paying, we can estimate the percentage of net income subject to dividends taxes. These figures are summarized in Table 14.

This table also illustrates that in total, if both a company and the individual owning the company are located in Texas rather than California, then both the company and its stockholders can earn an extra \$64.53 per \$1,000 of net income, or an 11.8 percent higher after-tax return.

There are still more taxes on capital. California and the federal government also tax interest income and capital gains income – Texas does not. This provides another after-tax rate return advantage to the owners of capital from locating in Texas, compared to California. Using a similar methodology, we track \$1,000 of interest and capital gains income if it were earned by an individual living in Texas, compared to that same income if it were earned by an individual living in California. The results are summarized in Table 15.

This table also illustrates that the after-tax return to both interest income and capital gains income is significantly higher in Texas compared to California. The after-tax interest and capital gains income for a \$1,000 investment is 11.5 percent higher in Texas than in California for the exact same investment.

The significant after-tax return premium in Texas compared to California with respect to corporate income, interest income and capital gains income gives Texas a significant competitive advantage *vis-à-vis* California in attracting businesses and investors. California's advantages with respect to property tax burdens, which equates to an advantage of 1.4 percent of personal income, does not compensate for the significant disadvantages with respect to the remaining capital taxes in these two states.

The clear winner of Competition II: Texas has the more competitive capital tax environment.

### COMPETITION II WINNER: TEXAS

#### Competition III:

#### The Tax Burden on Consumption

Texas has to fund state operations. Here, the reader might suppose that *surely* California must impose a smaller tax on consumption than Texas, given California's loss in the tax on labor and tax on capital competitions. Yet such a hypothesis is incorrect. Texas's and California's tax burdens on consumption are actually very similar. Additionally, because Texas does not impose a state income tax, its residents are allowed to deduct state sales taxes from their federal income tax, thereby reducing their effective sales tax liability.

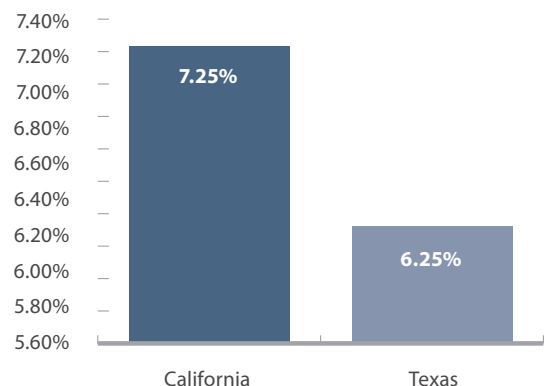
California's general state and universally applied local sales tax rate of 7.25 percent is higher than Texas' sales tax rate of 6.25 percent (see Figure 8). California's sales tax rate is also higher than Texas's when comparing the highest sales tax rates applied in the state (the state sales tax rate plus the highest local tax rate). Under this comparison, California's combined state and highest local sales tax rate is 9.25 percent, compared to 8.25 percent in Texas.

With respect to the actual rate applied, Texas has a distinct advantage compared to California. But, sales tax bases vary tremendously from state to state. Are groceries taxable? What about medicines? Taxing services is an even more complex issue. The result is that a one

percent sales tax in one state is not necessarily comparable to a one percent sales tax in another state. The tax base matters.

A comprehensive review of each state's sales tax base, if conducted with the right amount of diligence, would address these questions, but it would be a tremendous undertaking. There is a shortcut – examine both California's and Texas' sales tax revenues in comparison to the state's total personal income. By definition, total sales tax revenues are a function of the sales tax rate and the sales tax base. Personal income measures the amount of money available to consumers in the state to pay the sales tax. Consequently, we can obtain a sense of the sales tax burden by examining the sales tax revenues as a percentage of personal income. We need to be careful, however, because our shortcut isn't perfect. For example, if a state enacted a 500 percent sales tax just on Snickers bars, we're guessing the legislature wouldn't pull in very much revenue at all from the measure. Most people would switch to Three Musketeers or Paydays for their candy bar craving, and die-hard Snickers fans could stock up at gas stations across the state line. So in this contrived example, the observed low level of revenue from the Snickers tax wouldn't therefore prove that candy bars were lightly taxed in the

FIGURE 8  
STATE SALES TAX RATES



Source: The Sales Tax Clearinghouse

state. Despite these possible pitfalls, our chosen measure of tax burden – defined as total sales tax revenues divided by personal income – is good enough for our purposes.

Using our chosen measure, California's sales tax burden (\$23.72 per \$1,000 of personal income) is slightly more than Texas' sales tax burden (\$23.31 per \$1,000 of personal income; see Figure 9). However, the difference between the two is minimal – a little less than fifty cents per \$1,000 of personal income, which works out to less than 4/100 of one percent, or four basis points. The ranking of California and Texas compared to the other states further supports the similar, yet slightly more advantageous sales tax burden in Texas. With 1 representing the lowest sales tax burden and 50 representing the highest, California ranks 31st and Texas ranks 27th.

Because Texas has a lower sales tax rate and California has a marginally higher sales tax burden, the tax on consumption competition can be most accurately considered a Texas victory.

### COMPETITION III WINNER: TEXAS

#### Competition IV: The Overall Tax Burden

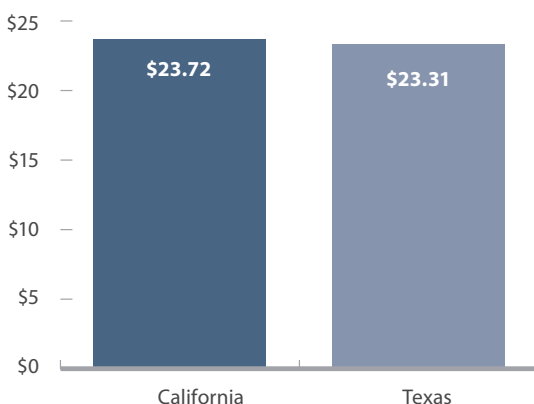
Our final tax competition examines the overall tax environments between California and

Texas. The overall tax environment competition measures the “other” aspects of tax policy that affect overall incentives in each state, but are not covered in the previous three competitions. These include:

- The total tax burden in the state, measured by total tax revenues divided by personal income;
- Personal income progressivity of the state, measured by the change in the tax liability between the top and average tax rates per \$1,000 of personal income;
- The net impact of recently legislated tax changes per \$1,000 of personal income; and
- The number of tax or expenditure (TEL) limits effective in the state.

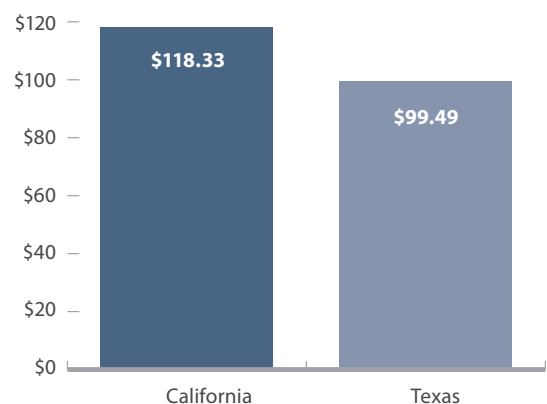
The overall tax burden provides a measure for the size of government in California compared to the size of government in Texas. Over-taxed states, per se, restrain economic growth. State tax systems are so complex, however, that it can be difficult to discern which

FIGURE 9  
STATE SALES TAX BURDEN



Source: U.S. Census Bureau

FIGURE 10  
OVERALL TAX BURDEN



Source: U.S. Census Bureau

states are more heavily taxed than others. (Recall our example of the hyper-tax on Snickers bars.) This is not the case with California which is over-taxed in comparison to Texas. California's relative over-taxation is clearly visible by looking at total tax revenues in each state as a share of total state personal income. California's current tax burden of \$118.33 per \$1,000 of personal income is nearly 20 percent higher than Texas's current tax burden of \$99.49 per \$1,000 of personal income. Such a large discrepancy gives Texas a distinct competitive advantage over California that boils down to one simple reason: More of every dollar earned by a Texan ends up in his pocket, compared to every dollar earned by a Californian.

Progressive state tax systems are one of the most problematic aspects of state tax policies. Despite our best efforts to end recessions, the United States still experiences a business cycle – the economy expands quickly, stagnates and then contracts. By definition of the business

cycle, when the economy is expanding, incomes are expanding at a faster than normal rate.

As the economy slows, so does the growth in income. When stagnant income turns to outright decline, personal income will oftentimes decline right along with the economy. These effects are magnified at the upper-income levels where swings in capital gains and corporate profits can have a pronounced impact on personal incomes.

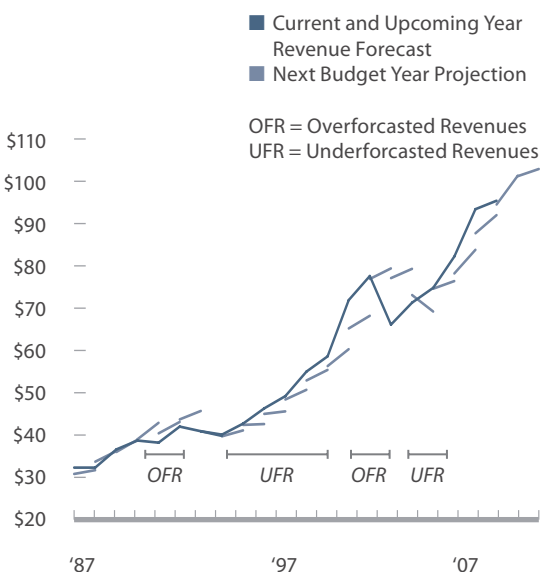
A progressive state tax system amplifies the business cycle's impact on state budget revenues. During the expansion phase of the business cycle, state tax revenues increase because the economy is growing and more people are moving into higher marginal income tax brackets. An even greater revenue surge flows into the state's coffers compared to the surge in economic growth. Human nature being what it is, all too often state governments spend too much (if not all) of this excess revenue surge.

Due to the dynamics of the business cycle, the revenue surge is only temporary. As the inevitable slowdown takes hold and personal income growth stagnates, state tax revenues decrease at an even faster pace while more people move into lower marginal income tax brackets. Because much of the revenue surge has been spent – perhaps even committing the state to higher-than-efficient spending – state budget crises emerge. Oftentimes these budget crises beget calls for state tax increases at precisely the wrong time economically. California is an excellent example of the budgetary problems that arise due to progressive state tax systems.

Figure 11 shows the massive over and underestimates of general fund revenues during the past 20 years. To partially explain these gigantic goofs, Figure 12 shows the large dependence of California revenue on exercised stock options and realized capital gains.

California's cautionary tales warn of the budget instabilities that can arise due to steeply progressive tax systems. The composition of a state's tax burden is as important as its overall

**FIGURE 11**  
**CALIFORNIA GENERAL FUND REVENUE**  
**(AND TRANSFERS): FORECAST VS. ACTUAL**



Source: Actual Data from <http://www.dof.ca.gov>, projections from CA Governor's Budget Summaries, 1987-present

burden. Broad, flat rate and consumption taxes compare favorably to taxes on capital creation and high marginal personal and corporate income tax rates. With respect to tax progressivity, Texas is significantly more competitive than California. Where California’s tax system is the most “progressive” (i.e. graduated) in the country, Texas’s is one of the best (see Figure 13).

Another key measure of the overall tax environment is the *direction* of the tax burden. Disregarding the level of taxes (whether the tax burden is rising or falling) is also important. States with rising (or falling) tax burdens are lowering (or increasing) the returns to workers, savers and investors. Consequently, previous decisions regarding working, saving and investing will be re-adjusted in light of the current tax implications of these decisions. Employment, income growth and population flows will all be positively or negatively impacted, depending upon whether the tax burden is falling or rising.

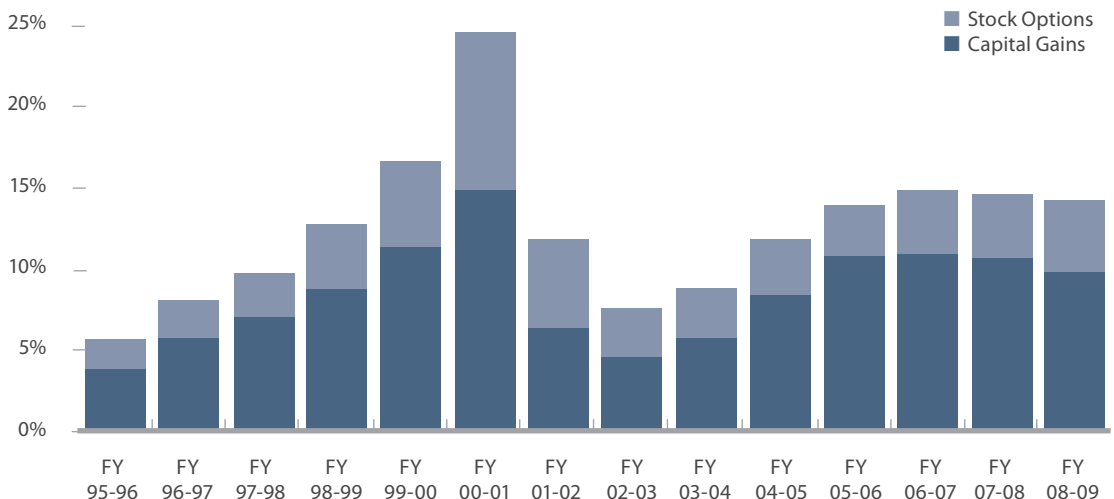
Once again, the tax environment in Texas beats the tax environment in California.

Whereas, the overall tax burden in California has been rising, tax burdens have been falling in Texas (see Figure 14).

The final key measure is the number of effective tax expenditure limits in the state. One successful strategy employed by some states to prevent squandering budget surpluses during times of economic expansion is a state tax or expenditure limitation (TEL). In general, tax and expenditure limits use some predetermined rate of growth to limit the government’s ability to raise taxes or increase spending. Creating effective tax limits reduces the ability of state legislators to implement anti-growth policies. Conversely, the ability to create a sound tax environment and a more competitive economic environment is enhanced when a state has effective tax and expenditure limits in place.

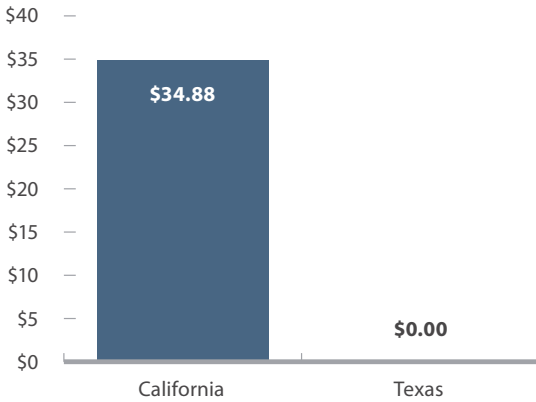
California truly is a state of exaggerated policy swings, moving from Karl Marx to Adam Smith and back again, in what in fiscal time is but a blink of an eye. (See the following chapter for a complete description of California’s history). The legacy of swinging to Adam Smith has

**FIGURE 12**  
**CALIFORNIA REVENUE FROM STOCK OPTIONS AND CAPITAL GAINS**  
**AS PERCENTAGE OF GENERAL FUND REVENUE**  
 actual through FY 06, estimates through FY 08



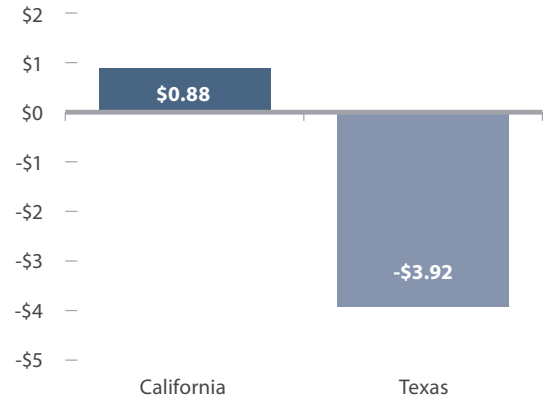
Source: Legislative Analyst’s Office of California

**FIGURE 13**  
**PERSONAL INCOME TAX PROGRESSIVITY**



Source: Thompson Tax and Accounting

**FIGURE 14**  
**RECENTLY LEGISLATED TAX CHANGES**  
per \$1,000 of personal income for 2007 and 2008



Source: Tax Analysts

left California with two expenditure limits – a very promising sign. Texas, on the other hand, has one tax and expenditure limit.

Judging by the purpose of TELs, Texas has clear advantages compared to California. TELs are designed to limit excessive growth in government, while increasing overall budget stability. Historically, the growth in overall state spending has been significantly more volatile in California than Texas. For instance, between 1996 and 2005, the standard deviation in state spending in California was 4.5 percent, compared to 2.4 percent in Texas. Sound budget practices have also led to an estimated \$10.7 billion surplus for Texas in the current fiscal year.<sup>11</sup> In the spirit of a sound TEL, Texas should use the surplus to reduce the corporate tax rate that was just created as part of the property tax reduction package.

Texas’s overall tax environment has economic advantages over California’s. Texas imposes a smaller burden that is declining and is not progressive. California imposes a large, rising and progressive tax burden. The implications are clear: Texas should experience relatively stronger economic growth with more stable budget revenues. California should ex-

perience relatively weaker economic growth with more volatile budget revenues. Texas is the clear winner of competition four.

**COMPETITION IV WINNER: TEXAS**

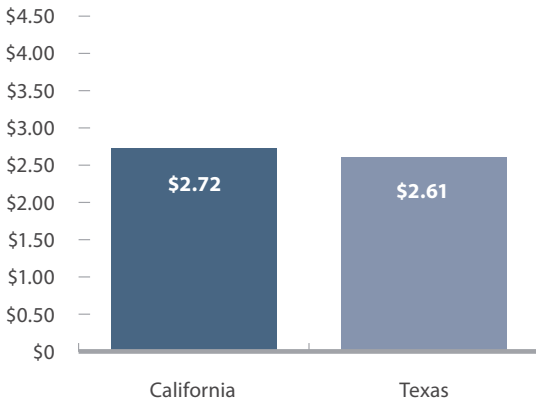
**Competition V:  
The Regulatory Policy Competition**

Regulatory burdens can also create positive or negative economic incentives. Burdensome regulations that excessively increase business costs reduce overall economic incentives. In this competition, we examine five regulatory issues that have important impacts on a state’s overall economic competitiveness:

- State Liability System
- Average Workers’ Compensation Cost
- State Minimum Wage
- Right-to-Work Status

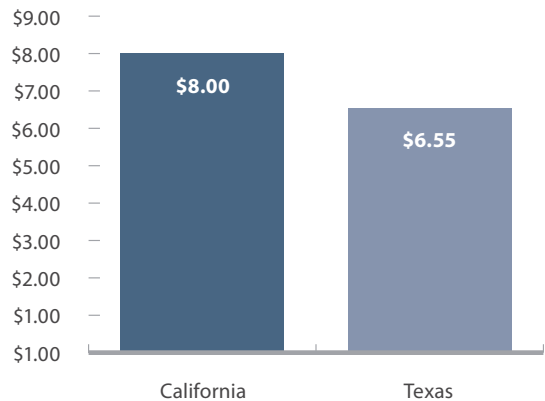
California has the 44th least competitive state liability tort system out of all 50 states.<sup>12</sup> Texas ranks a slightly more competitive 41st (where the state ranked number one had the most efficient state liability system). California’s below-average rank indicates that the tort liability system adds more than average

FIGURE 15  
**STATE WORKER'S COMPENSATION COSTS**  
 per \$100 of payroll



Source: Bureau of Labor Statistics

FIGURE 16  
**STATE MINIMUM WAGES**



Source: U.S. Department of Labor

costs to businesses that operate in the state compared to businesses that operate in other states, including Texas.

Workers' compensation costs impose additional costs on employers. When employers consider hiring additional workers, it is the total cost of increasing employment that is relevant, which includes all salaries, benefits, taxes and regulatory costs. Workers' compensation increases the cost of employing additional workers. Consequently, these regulations increase overall unemployment and decrease a state's potential economic growth.

Workers' compensation costs add \$2.72 per \$100 of payroll in California. These additional costs are a major discouragement to employment growth in the Golden State. Texas's workers' compensations costs are \$2.61 per \$100 of payroll (see Figure 15).

California mandates that businesses in the state pay a minimum wage of \$8.00 per hour, which exceeds the federal minimum wage standard. Texas, on the other hand, mandates that businesses in the state only need to meet the federal minimum wage standard, currently \$6.55 per hour, which is scheduled to rise to \$7.25 per hour in July 2009 (see Figure 16).

Minimum wage laws can have only one of two effects. The minimum wage can be below the wage that would be paid to any employee, so it is irrelevant. On the other hand, minimum wage laws can raise the wage costs for employers, leading to greater unemployment. By imposing a minimum wage in excess of the federal minimum wage, California is unnecessarily increasing employer costs. In so doing, business flexibility is reduced and overall employment in the state is reduced. These effects do not exist in Texas, providing Texas's regulatory environment with another comparative advantage *vis-à-vis* California's.

Despite the shrinking influence of unions on the American economy in general, their last bastion is the public sector, and they are still thriving in California in particular. According to the League of Women Voters, as of 2005 about 54 percent of California's government employees belonged to a union.<sup>13</sup> In both the private and public spheres, the Bureau of Labor Statistics reports that in 2007, 17.8 percent of California employees were either members of unions or were represented by them. In contrast, the figure for Texas was only 5.7 percent.<sup>14</sup>

States are divided into two distinct catego-

ries with respect to their union organizing laws. They are either right-to-work, which means workers have the right not to join a union, or non-right-to-work, which means that workers are forced to join a union and pay dues if they work in a unionized industry.<sup>15</sup> The evidence points overwhelmingly to the fact that right-to-work states have much greater growth of employment than non-right-to-work states. Texas is a right-to-work state; California is not.

Combining these divergent regulations, it is once again clear that Texas's economic environment is more competitive than California's. Texas has a more efficient tort litigation environment, lower worker's compensation costs, a lower minimum wage, and freedom from union coercion. Once again, Texas is the clear winner.

#### **COMPETITION V WINNER: TEXAS**

#### **Competition VI: The Spending Competition**

The final competition measures the amount of fiscal discipline exhibited in both California and Texas. We measure fiscal discipline in two broad categories. The first category measures the current size of the state governments by the total expenditures per capita. The second category measures the growth in government spending by the average growth in total expenditures per capita.

Government spending can negatively impact the state economy through two channels. First, in order for the government to have revenues to spend, it must take this money away from the private sector. As governments become larger, the value of the dollar taken away from the private sector is greater. As a consequence, government spending lowers the total potential output in the state. Second, larger government spending today oftentimes begets even greater government spending and activity tomorrow. In other words, the threat of higher tax and regulatory burdens grows as the size of the government grows.

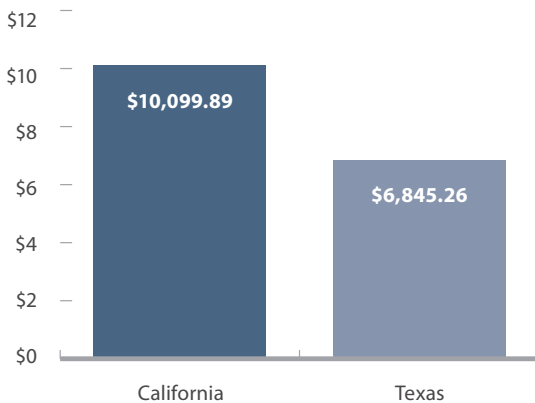
With respect to our competition, California's total expenditures, when adjusted for the size

of its population, are significantly higher than total expenditures in Texas. Currently, expenditures per capita in Texas are 32 percent lower than the expenditures per capita in California. This large discrepancy in the size and scope of government in Texas, compared to California, provides Texas with a significant economic comparative advantage (see Figure 17).

It's not simply the size of California's expenditures that are a comparative disadvantage for the Golden State. Based on data from the U.S. Census, state expenditures between 2001 and 2007 grew more than 7 percent a year on average in California, while they grew at about 6 percent a year in Texas.<sup>16</sup> The California state government's expenditures are much higher per capita than those in Texas and can be expected to continue to widen in the future. This is easy to conclude given the large expenditure increases that have been associated with traditional California budgets. Higher future taxes, increased fiscal crises, and slower economic growth will all follow as a result of the rising government expenditures in California. The reverse is true for Texas.

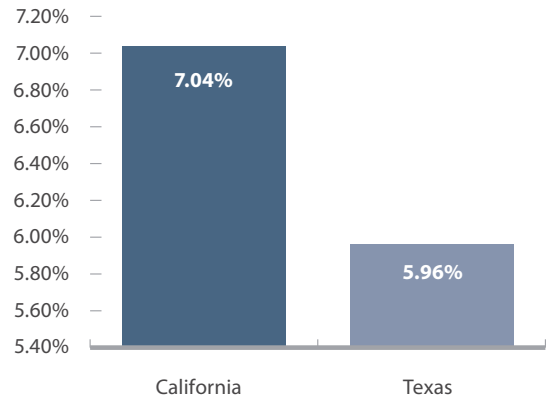
With respect to competition six, once again, Texas is the clear winner. As Figure 18 above illustrates, California's government expenditures are not only bigger, they have grown faster than spending in Texas. This is particularly notable, as Texas has a relatively larger number of public employees than California, with more than 560 public employees per 10,000 people in Texas. In contrast, there are approximately only 500 public employees per 10,000 people in California. The implications from these trends are clear: Texas's economic competitiveness will be improving, while California's will be weakening. However, Texas should be careful not to mistake this head-to-head match-up as a permanent victory. Significant growth at all levels of government in Texas has frustrated Texas taxpayers. Texas must set out to be more competitive, both compared to California and other states, as well as to the rest of the

FIGURE 17  
TOTAL EXPENDITURES PER CAPITA



Source: U.S. Census Bureau

FIGURE 18  
AVERAGE CHANGE IN TOTAL STATE SPENDING:  
2001-2007



Source: U.S. Census Bureau

world. As noted above, Texas could restrain the growth of the budget immediately by reducing the number of public employees, with hopes of moving from 27th nationally, to California's 9th (with the state ranking 1st having the fewest public employees per 10,000 of population).

#### COMPETITION VI WINNER: TEXAS

#### Living with the Results

Matched up in a head-to-head competition, Texas's economic environment beats California's – in fact, it is a knockout. Texas and California are case studies illustrating the cause-and-effect relationship between state tax policies and economic performance. We expect these stark differences to manifest themselves in continued superior economic performance in Texas *vis-à-vis* California.

Our competition between California and Texas demonstrates how economic theory actually works in the real world. Pro-growth tax, and economic and regulatory policy leads to rising employment, income, home values, population and tax revenues, while high levels of taxes and spending have the opposite effect.

The U.S. Census Bureau has recently released its latest information on estimated population changes of metropolitan areas.<sup>17</sup> These

numbers identify Texas as the big winner in 2007, again. Out of a total of over 360 metropolitan areas, four of the top 10 metropolitan areas with the largest population increases were in Texas. Viewing the Census's results in tandem with the results from our competition between Texas and California illustrates George Gilder's famous maxim: "High tax rates don't redistribute income; they redistribute people."

The stark differences in the fiscal, economic and regulatory policies in Texas compared to California explain the differing outlooks. California continues to increase regulations, raise taxes and spend profligately. These anti-growth policies will continue to sap the economic vitality of California. Texas, on the other hand, has a pro-growth economic environment with a competitive tax system, sound regulations and spending discipline that will help Texas maintain its superior economic performance well into the future.

More than the economic head-to-head comparisons, however, is the fact that *Texas is doing just fine with no personal income tax*. To repeat the point made previously, one would think – considering the recent budget fiasco in California – that a modern state needs a steeply progressive tax code just to survive. The case

of Texas is a clear counterexample, showing that these fears are simply a myth. In the long-run, there is no trade-off between healthy government finances and a competitive business environment. After all, punitive tax rates don't bring in much money when businesses relocate to other states.

## ENDNOTES

- 1 In Texas, there is no corporate income tax rate, but there is a one percent gross receipts tax (GRT). To put the gross receipts tax on a comparable basis to California's net income tax, we transform the gross receipts tax rate into an equivalent net income tax rate. Based on this transformation, Texas' one percent GRT is the "equivalent" of a five percent net income tax.
- 2 State Economic Growth Widespread in: Advance 2006 and Revised 2003-2005 GDP-by-State Estimates. *Bureau of Economic Analysis*. June 7, 2007. BEA 07-24.
- 3 For more on Arizona, see "Arizona Letter." A.B. Laffer and Associates. March 20, 1992.
- 4 Sources: IMF World Economic Outlook Database, October 2007, <http://www.imf.org>; and, U.S. Bureau of Economic Analysis, Regional National Income and Product Accounts (NIPA), <http://www.bea.org>.
- 5 U.S. Census, <http://www.census.gov/>.
- 6 This calculation assumes a joint household in the 9.3 percent marginal tax bracket for California state income taxes and the 15 percent marginal tax bracket for federal taxes and incorporates the deductibility of state income taxes from federal income taxes.
- 7 Human capital, oftentimes the most important input into production, is impacted by the tax burden on labor, not the tax burden on capital as it is defined here.
- 8 Atkins, Chris and Williams, Jonathan. "Tax Foundation Explains Flaws in Texas Tax Reform Commission's Tax Reform Recommendations." *Tax Analysts, State Tax Today*. May 11, 2006.
- 9 Petska Tom, Michael Parisi, Kelly Luttrell, Lucy Davitian, and Matt Scoffic. "An Analysis of Business Organizational Structure and Activity from Tax Data". IRS SOI. (2005).
- 10 Specifically, the GRT rate is multiplied by the ratio of GDP to total capital income and profits.
- 11 Robison, Clay "Oil prices help Texas rake in \$10.7 billion surplus: Sales tax revenue also aids projected overflow Perry hopes to share with you." *Houston Chronicle*. May 7, 2008.
- 12 McQuillan, Lawrence J. and Abramyan, Hovannes. U.S. Tort Liability Index: 2008 Report. Pacific Research Institute.
- 13 See <http://ca.lvw.org/action/prop0511/prop75.html>.
- 14 See Table 5, "Union affiliation of employed wage and salary workers by state," at: <http://www.bls.gov/news.release/union2.t05.htm>.
- 15 National Right to Work Foundation, 2006.
- 16 The most recent expenditure data available from the U.S. Census State Government Finances database is 2006, see: <http://www.census.gov/govs/www/state.html>. For inter-state comparisons, the U.S. Census data provides a more accurate assessment, as the differing state accounting methods are put on a comparative basis.
- 17 See <http://www.census.gov/population/www/estimates/CBSA-est2007-pop-chg.html>.