

Los Angeles, California



Chapter Three
The Ghosts of California

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In the previous chapter, we illustrated the superior past performance, and likely future performance, of Texas versus California, in terms of population, income and job growth. We argued this disparity wasn't due to dumb luck, or even to unidentifiable factors outside of human control. On the contrary, the empirical outcomes display just what economic theory leads us to expect: When you tax something, you get less of it. That's why the government jacks up taxes on cigarettes to discourage teen smoking and fines drivers who are caught speeding. By the very same logic, when California politicians impose the largest marginal income tax rate in the nation on the most productive members of the community, they shouldn't be shocked to see high-skilled laborers and innovative entrepreneurs flocking to other states.

The prior chapter demonstrated that you can run a fully-functioning modern state without excessive taxation. Yet, despite all of the evidence we marshaled in the previous chapter, we can just *hear* our critics complaining, "California is different! If we adopted your advice and copied Texas, our state would fall apart!"

In this chapter we tackle the objection head-on. In chapter two, we compared *current* trends in California and Texas. Now we compare California of today with *California of the past*. Indeed, the history of California – centered on the tax revolt crystallized in Proposition 13 – shows a laboratory experiment in which the state went from fiscal malaise to fiscal health

– then back to malaise again. By showing the current class of legislators the ghost of California past, we hope they can begin picturing the ghosts of California's future as identified by much lower taxes and much higher economic growth.

The Historical Context of Proposition 13: The Tax Revolt Heard 'Round the World

Because it will play such a pivotal role in our story, some background on Proposition (Prop.) 13 is in order.

It was more than 30 years ago – June 6, 1978 – that Arthur Laffer won the one-dollar bill framed on his office wall and America was jolted by this political equivalent of a sonic boom. Political analysts often argue when the modern-day conservative movement in America was officially launched. Some say it was Barry Goldwater's campaign in 1964. Others cite the election of Ronald Reagan in November 1980. We believe the strongest case can be made that the conservative, anti-big government tide began in 1978, when almost 60 percent of voters declared thumbs up to the brainchild of Howard Jarvis and Paul Gann.

Specifically, Prop. 13 reduced property tax rates on homes, businesses and farms by more than 50 percent, to a rate not to exceed one percent of the property's market value. For properties where sales had not occurred more recently than 1976, the 1976 assessed value plus a presumed appreciation of no more than two percent per year was used for tax purposes.

Property tax increases on any given property, therefore, were limited to two percent a year, as long as the property was not sold. In addition, Prop. 13 required all tax increases, whether they be property tax increases or increases in any other taxes, to be approved by a two-thirds vote of the electorate or legislature. In 1979, the legislature passed an addendum to Prop. 13, permanently exempting business inventories from property tax, effective July 1, 1980.

This last point on the inventory exemption may seem minor, but let us share a little history you won't find in most economics textbooks. Every December 31 prior to 1980, you could find miles and miles of trucks lined up along the state's border, waiting to enter California at 12:01 a.m. on January 1, in order to avoid the prior year's inventory tax. Yikes! Even Rube Goldberg would be embarrassed. How can some of these doubting Thomases in academia continue to deny that tax policies significantly alter business behavior?

This was arguably the greatest tax revolt since the Boston Tea Party. As in so many other ways, here too, California was a trend-setter: The spirit of Prop. 13 was rapidly exported to the rest of the country. Within five years of Prop. 13's passage, nearly half the states strapped a similar straitjacket on politicians' tax-raising capabilities by cutting income, property taxes, or both. In many ways, Prop. 13 presaged the improbable presidential election of Ronald Reagan, who sailed to the White House on the crest of a national anti-tax wave by promising supply-side 30 percent income tax cuts for all. Once again, the old maxim was proven true: As goes California, so goes the nation.

Two patriots led this tax revolt – Paul Gann and Howard Jarvis – men described by the *Los Angeles Times* as “the chief spokesmen for this expanding group of angry and disgruntled taxpayers across the state who believe they are paying too much for the cost of government.” And that was the essence of the Prop. 13 revolt. After a decade-long voracious expansion in the

size of the Great Society welfare state, coupled with years of double-digit inflation and escalating tax burdens through bracket creep, while erasing family purchasing power, Americans no longer believed government was giving them anywhere near their money's worth. In the 1970s, family tax burdens rose at almost twice the pace of real family income. In California, uncapped property tax assessments were driving thousands of residents out of their homes – particularly fixed income seniors who had little capacity to pay the double-digit rates of increase in the taxes on their homes.

One of the authors, Arthur Laffer, was extensively involved with Prop. 13, having worked closely with each of its authors. In fact, he co-authored no fewer than three other propositions with Gann and Jarvis and succeeded Jarvis as director of the California Taxpayers Association.

Almost everyone of consequence in both political parties, and almost every organized interest group in the state condemned the measure as reckless. Even Ronald Reagan was originally skeptical. Joel Fox, the longtime director of the Howard Jarvis Taxpayers Association, writes in his book, *The Legend of Proposition 13*: “Surprising to many, was that big business stood opposed. Businesses not only lent their names to the ‘NO on 13’ campaign, they helped finance it.” The opponents warned voters of the doom that awaited the state if Prop. 13 passed: San Francisco's schools and libraries would be closed on June 6, 2,500 Los Angeles policemen would be laid off, the prison gates would be opened up for lack of funds and the UCLA Business School predicted a loss of 450,000 jobs in the state.

Fortunately, few voters listened to the hysteria. Taxes were so suffocatingly high in California that even firefighters in Los Angeles voted two to one in favor of Prop. 13.

Once they got started, California voters put further restraints on the gluttonous politicians. In 1978, all personal income tax brackets, stan-

dard deductions and personal credit amounts were indexed to the California consumer price index, less three percent. The legislature removed the three percent threshold for 1980 and 1981. Voters then made full indexation permanent when they passed Prop. 7 in June 1982. Voters also overwhelmingly passed Prop. 6, which repealed inheritance and gift taxes.

Political aversion to heavy taxes went hand in hand with a desire to tighten the reins on spending. In November 1979, Prop. 4 placed a constitutional limit on state and local government spending. This limit, commonly referred to as the Gann limit, allowed spending to increase each year based on 1) the statewide population growth and 2) inflation as measured by the lesser of the Consumer Price Index (CPI) for the United States or California per capita personal income. Appropriations for unrestricted subventions to school districts and community college districts were exempted from the Gann spending limit, as were debt service and funding for court and federal mandates.

The two tax expenditure limits listed for California cover the gamut. The hugely effective Prop. 13, authored by Howard Jarvis and Paul Gann in 1978, has been a stalwart of tax limitations. Property taxes in 1978 were legislated not to exceed one percent of the property's value – ever – and if the property didn't change hands, the total property taxes couldn't grow more than two percent in any one year. In addition to this truly effective tax limitation, Prop. 13 also required any tax increase to have at least a two-thirds majority of the vote. Not bad!

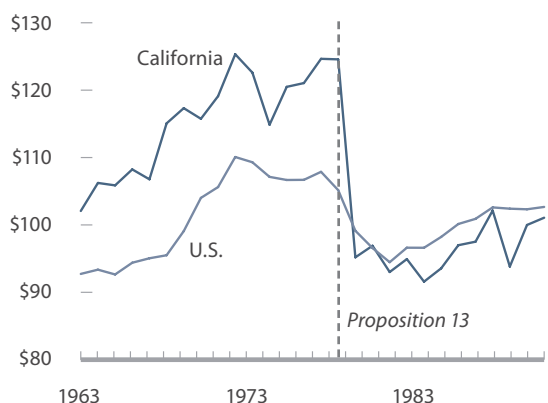
In contrast, Prop. 4, a spending limit authored by Paul Gann, passed a few years later but was eviscerated by Prop. 98, having done almost no good. While still on the books, Prop. 4 is now as meaningless as the 10th Amendment at the federal level. Beyond the truly rare and fascinating economics experiment – the focus of the present chapter – the California experience of the late 1970s through early 2000s could provide fodder for several political science dissertations.

So ... Did it Work?!

As we noted above, this bold proposal terrified many people, including conservative Republicans. At the same time, many readers may be surprised to learn that Democrat Gov. Jerry Brown was instrumental in passing Prop. 13 and the rest of the pro-growth initiatives. Amid the dire forecasts of financial catastrophe, Gov. Brown saw to it that the state assessor sent out tax notices the week before the election, indicating a five-fold increase in property taxes. This clever move allowed Brown to say he had a much larger surplus than people had originally thought. The point, of course, was to disarm the critics who said Prop. 13 was fiscally irresponsible.

In 1976, Arthur Laffer was quite recognizable to the television-viewing public, since he had been the presence voicing opposition to the Cesar Chavez movement. When Prop. 13 passed, Gov. Brown and his chief of staff, Gray Davis, invited Laffer (an outspoken proponent of the measure) to Sacramento, where they held discussions over the course of three days. On the way to a joint press conference, Gov. Brown remarked, "Professor Laffer, I hope you don't take this opportunity to dump all over me." His

FIGURE 19
STATE & LOCAL TAX BURDEN CALIFORNIA VS. U.S.
per \$1,000 of personal income; FY 1963-FY 1990



Source: U.S. Census Bureau, State and Local Government Finances

awkwardness was only exceeded by his good governance. Gov. Brown made sure Prop. 13 would be implemented correctly.

While drumming up support for Prop. 13, Laffer wrote a pamphlet for the United Organization of Taxpayers in March 1978 – 10 weeks before the vote. He predicted the static revenue forecasts overstated the losses to the state treasury from Prop. 13, because of supply-side effects:

Property tax revenues will fall by less than [the static forecasted] \$7 billion because property values will rise and new construction activity will expand. Both of these effects will expand the tax base, and thus lead to less property tax revenue loss. In the out-years, property tax receipts will fall by far less than \$7 billion annually. Take, for example, a \$100,000 home, paying taxes of 3.5 percent of market value. Taxes would be \$3,500 per year without Jarvis. If Jarvis passes, the tax rate would fall to one percent of market, but tax receipts would be greater than \$1,000. Using a discount rate of 10 percent, the approximate receipts would initially be \$1,250, reflecting a rise in the market value of the house to \$125,000.

In short order, the higher values of homes would encourage more new construction and an enlarged property base. As this process progressed, total property values would rise by far more than the 25 percent of the example.

Tax revenues elsewhere would expand absolutely. Social welfare mandated spending would fall. With property taxes lower, businesses will expand their activities within the State. This expansion will create new jobs, more investment, and higher real wages. Sales, incomes, and other forms of activity will expand. Sales taxes, income taxes, etc., all will rise. In addition, state outlays for

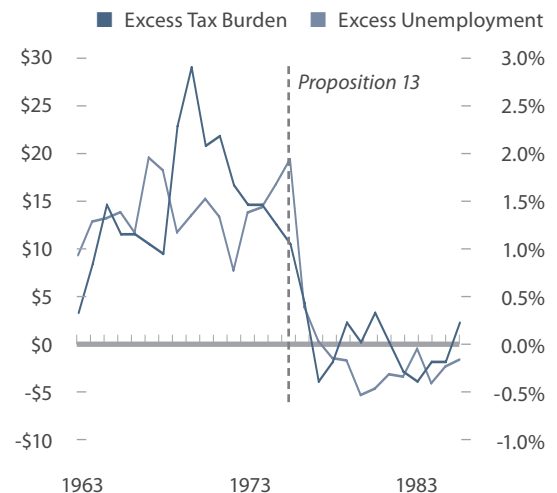
social welfare will fall (unemployment compensation, rent subsidies, medical, etc.).

Tax revenues in future years will be reduced by less or, quite conceivably, even expanded as a result of Jarvis-Gann. When combined with the healthier economic base and, as a direct consequence, less social welfare expenditures, the state should shortly be back in a surplus condition.

We are happy to report that history vindicated Laffer's supply-side analysis. This is clearly captured in Figure 20, which shows that the tremendous tax cut for Californians led to a substantial economic recovery relative to the rest of the nation.

The fiscal outcome also played out just as Laffer predicted: Prop. 13 passed on June 6, 1978, one month prior to the end of FY 1978. State and local property tax revenues fell \$5.0 billion, from \$11.0 billion in FY 1978 to \$6.0 billion in FY 1979, far short of the static revenue loss forecasts of \$7.0 billion. In addition,

FIGURE 20
EXCESS STATE & LOCAL TAX BURDEN
VS. EXCESS UNEMPLOYMENT
per \$1,000 of personal income; FY 1963-FY 1990



Source: U.S. Census Bureau, State and Local Government Finances

this drop was largely offset by higher revenues in every other major tax category. Total state and local revenues fell by only \$1.1 billion that first year.

Looking at the bigger picture, the combined state and local tax burden per \$1,000 of personal income fell from \$124.57 in FY 1978 to \$94.93 in FY 1982, a 24 percent reduction. Yet in spite of the precipitous fall in the state's average tax rate, state and local revenues did not fall proportionately. In fact, total tax revenue grew by 19 percent from \$27.4 billion in FY 1978 to \$32.5 billion in FY 1982. The tax base expanded by more than enough to offset the

reduction in tax rates. Even after adjusting for inflation, which can distort economic data during this high inflationary period, tax revenues fell much less than the reduction in the state and local tax burden.

Economic expansion and higher property values led to healthy property tax growth over the following years, and by FY 1985, property tax collections were back to their FY 1978 \$11.0 billion level. The disruptive shortage of funds so widely anticipated never materialized. During the interim, while property taxes were catching back up, Gov. Brown made sure that local governments – who rely heavily on property

TABLE 16
CALIFORNIA LOCAL GOVERNMENT REVENUES¹
millions of dollars

	1976	1977	1978	1979	1980	1981	1982	1983
Total General Revenue	\$22,915	\$25,029	\$28,820	\$27,914	\$31,461	\$36,067	\$37,877	\$45,252
Federal transfers	1,414	1,655	2,275	2,116	2,356	2,699	2,131	2,063
State transfers	8,237	8,819	9,848	13,354	14,874	16,920	16,928	17,230
Local own source revs	13,264	14,555	16,157	12,444	14,231	16,449	18,818	20,112
Property tax revenues	8,561	9,586	10,476	5,428	5,800	6,498	7,616	7,990
Non-property tax revs	4,703	4,969	5,681	7,016	8,431	9,951	11,202	12,122

Source: U.S. Census Bureau

TABLE 17
CALIFORNIA LOCAL GOVERNMENT SPENDING²
millions of dollars

	1977	1978	1979	1980	1981	1982	1983
Total General Direct Expenditures	\$22,590	\$25,218	\$25,880	\$29,346	\$32,754	\$35,221	\$37,290
Education	9,443	10,478	10,307	11,526	12,668	13,302	13,686
Highways	821	942	1,021	1,150	1,275	1,300	1,400
Public welfare	2,545	2,775	2,736	3,163	3,736	4,135	4,169
Health and hospital	1,636	1,886	2,202	2,571	2,816	3,292	3,669
Police and fire	1,869	2,066	2,153	2,399	2,766	3,109	3,325
Other	6,276	7,071	7,461	8,537	9,493	10,083	11,041

Source: U.S. Census Bureau

taxes – were “made whole” by a state subvention of revenues. We realize how impossible it all sounds to those unfamiliar with supply-side economics, but Table 16 speaks for itself. The drop in property tax revenues from 1978 to 1979 is stark indeed, and was what all the critics had warned about. But what the critics failed to realize – which Laffer confidently explained *before it happened* – was that the boost in overall economic activity would cause large increases in other tax categories. It was the wisdom of Gov. Brown to reallocate those windfalls, in order not to make local governments bear the brunt of the huge – and well-deserved – program of tax relief for the citizens.

Turning our attention to spending, total state and local direct general expenditures were not slashed between FY 1978 and FY 1979 as skeptics had predicted. In fact, expenditures increased 1.6 percent from \$36.9 billion to \$37.5 billion over this period. Even better, spending on police and fire services increased 3.7 percent in FY 1979. We specifically mentioned fire trucks because in the midst of the battle surrounding Prop. 13, Harvard Professor John Kenneth Galbraith sent Laffer a toy fire engine, which was his contribution to make up for all of the real fire engines that would (allegedly) no longer be purchased, as a consequence of Laffer’s “irresponsible” economics. To wit, much later when all the data were in, Laffer responded to Galbraith and the other doomsayers, “Neener, neener, neener.” As Table 17 reveals, the tax reduction which had invigorated the state’s economy so profoundly did not impose any significant reduction in government services.

For Californians, the legacy of Prop. 13 has been to save the average homeowner in California tens of thousands of dollars in property tax payments over the past 30 years. This is money that would have fueled an even more rapid escalation in California’s state and local public bureaucracies if those dollars had been sent to Sacramento and city hall. Californians

intuitively understand this. That is why every major poll has confirmed that a large majority of residents in California say they would still vote for Prop. 13 again if it were on the ballot today – 30 years later.

Taxpayers nationwide also owe a debt of gratitude to Howard Jarvis and Paul Gann. They helped reverse the economically disabling era of unrestrained over-taxation, overspending and overregulation of government at all levels in America that dragged the nation into a malaise at the end of the 1970s. Just as importantly, they taught us all an enduring civics lesson we should never forget: In America, you really can fight city hall. Unfortunately, Californians would forget this lesson just more than a decade later.

What Went Wrong?

Pete Wilson’s One-Two Punch

The great tax revolt of the late 1970s gradually faded away during the 1980s, as memories of the pre-Prop. 13 troubled economy vanished. State spending and taxes crept up. California once again had become the proverbial frog who was slowly being boiled to death. Then, Gov. Pete Wilson did his best to enact the mirror image of the Prop. 13 era reforms.³ Unfortunately, the results were also the mirror image of the prosperity flowing from the Jarvis-Gann initiative.

First, the legislature was very clever in obeying the letter, but certainly not the spirit, of Prop. 4. Recall that the Gann limit addressed the appropriation of tax revenues. Ah, here was a loophole the politicians drove a Mack truck through! From FY 1980 to FY 1989, state and local tax revenues – which provided the basis for Gann’s spending straitjacket – grew by 45 percent in real terms. But non-tax revenues – fees, charges, fines, etc. – grew by 100 percent in real terms over the same period. As a percentage of overall revenues, the Gann-applicable tax portion shrunk from 63 percent in FY 1981, down to 57 percent by FY 1990.⁴ As we wrote earlier, this isn’t just economics. This is

interesting from a purely political viewpoint, too. We can just see a term paper now: “To Raise Taxes or Hike Fees? Incentives Matter.”

The beginning of the end actually occurred under Gov. Deukmejian, with the passage of Prop. 98 and Prop. 111. The audacious Prop. 98 required that K-12 schools and community colleges receive 41 percent of all general revenue funds. This minimum share of the budget must go to schools regardless of the state’s fiscal circumstances or the impact on other programs. When Prop. 98 first passed, times were good and it didn’t appear onerous. But when revenues stagnated, other state services disproportionately felt the brunt so schools could get their automatic allotment.

In June of 1990, Prop. 111 passed, further eroding the Gann spending limit. Instead of using the lesser of inflation as measured by the CPI or California’s per capita personal income, only per capita personal income would be used to revise the limit. Spending by local governments would also have the local option of per capita personal income or an alternate growth factor which would account for the change in the assessed valuation of local commercial construction. In addition, Prop. 111 exempted from the spending limit appropriations for “qualified capital outlay projects.” Thus, highway spending was removed from the Gann spending limit without lowering the limit. Virtually any and every spending category was given free rein. For all practical purposes, this meant the Gann limit was no longer operational.

California, year in, year out, has used the education industry as a focal point of the state’s politics. California’s state universities have always viewed themselves as the best of the best and have used their reputation to extract ever increasing funds from the state government.

But the real political powerhouse in California’s education industry is the California Teachers Association, a union with megabucks and a perpetual craving for tax revenue. As Table 18 shows, California’s teachers are the high-

est paid in the United States. Yet California’s K-12 students consistently rank among the group of the very lowest achievers in the nation. In the 2005 special election called by then reform-minded Gov. Schwarzenegger, the California Teachers union almost single-handedly engineered the defeat of 1) anti-gerrymandering redistricting reform, 2) a meaningful state spending limit, 3) the rights of union members to withhold dues used for political purposes they don’t support and 4) teacher tenure after five years instead of only two years on the job. And in 2007, based on comprehensive testing results carried out by the Department of Education, California’s K-12 students were only able to test higher than the students in one other state – Mississippi (see Table 19).

On the tax side, Prop. 111 increased the state tax on gasoline and diesel fuel five cents per gallon, followed by one cent increases on the first day of each of the next four years. It also increased the truck weight tax by 40 percent and raised ethanol and methanol taxes. The increase in fuel taxes was estimated to generate \$687 million during FY 1991 and \$970 million during FY 1992.

Yet the tax hikers were just getting warmed up. On July 1, 1991 – the first day of the 1992 fiscal year – the ’92 budget agreement took effect. The top rates on the personal income tax, the corporate tax and capital gains tax were raised from 9.3 to 11 percent, while certain credits and deductions were suspended. The Alternative Minimum Tax (AMT) on personal income was increased from seven percent to 8.5 percent. The per-gallon excise tax on beer was increased from four cents to 20 cents, while the tax on distilled spirits increased from \$2.00 to \$3.30 per gallon, and rose from 1 to 20 cents for wine. Two weeks later, the state sales tax went up to 6 percent from 4.75 percent.

To understand the magnitude of these hikes, consider that on a static revenue basis, total state tax collections were projected to rise some \$8.6 billion from FY 1991 to FY 1992;

\$2.2 billion of the projected increase was due to natural growth, while the remaining \$6.4 billion from the tax increase (based on a static analysis). This represented a 15 percent increase over total tax revenues collected in FY 1990, making it the largest state tax increase in U.S. history. In terms of percentages, Prop. 111 and subsequent tax increases were nearly

four times larger than the record-breaking tax increases being proposed at that time by President Clinton for the U.S. economy.

Gov. Wilson imposed such massive tax increases ostensibly to balance the budget. This approach is totally unjustified in terms of economics – you don't want to kick the economy when it's already down. After all, how is it good

TABLE 18
AVERAGE TEACHER SALARY BY STATE : 2007

Rank	State	Salary	Rank	State	Salary
1	California	59,825	27	North Carolina	43,922
2	Connecticut	59,304	28	Virginia*	43,823
3	District of Columbia*	59,000	29	Florida	43,302
4	Illinois	58,686	30	Wyoming	43,255
5	New Jersey	58,156	31	South Carolina	43,011
6	New York	57,354	32	Arkansas	42,768
7	Massachusetts	56,369	33	Kentucky	42,592
8	Michigan	54,739	34	Tennessee	42,537
9	Rhode Island*	54,730	35	Texas	41,744
10	Maryland	54,333	36	New Mexico	41,637
11	Delaware	54,264	37	Kansas	41,467
12	Pennsylvania*	54,027	38	Idaho*	41,150
13	Alaska*	53,553	39	Iowa	41,083
14	Ohio*	50,314	40	Maine	40,737
15	Oregon	50,044	41	Mississippi	40,576
16	Hawaii	49,292	42	Missouri	40,462
17	Minnesota*	48,489	43	Nebraska	40,382
18	Georgia	48,300	44	Alabama	40,347
19	Indiana	47,255	45	Louisiana	40,029
20	Vermont*	46,622	46	Utah	40,007
21	Wisconsin*	46,390	47	Montana	39,832
22	Washington	46,326	48	Oklahoma	38,772
23	New Hampshire	45,263	49	West Virginia	38,284
24	Arizona*	44,672	50	North Dakota	37,764
25	Colorado	44,439	51	South Dakota	34,709
26	Nevada	44,426	U.S.		49,026*

* NEA estimate where no data is available from state Department of Education.

Source: National Education Association; Figures are average salaries of public school teachers from 2005-2006.

TABLE 19

OVERALL STUDENT NAEP TEST SCORES BY STATE

based on most recent 4th and 8th grade performance in math, reading, science and writing

Rank	State	4th Grade Test Scores			8th Grade Test Scores				Overall
		Math	Reading	Science	Math	Reading	Science	Writing	
1	Massachusetts	252	236	160	298	273	161	167	1547
2	Vermont	246	228	160	291	273	162	162	1522
3	New Jersey	249	231	154	289	270	153	175	1521
4	New Hampshire	249	229	161	288	270	162	160	1519
5	North Dakota	245	226	160	292	268	163	154	1509
6	Montana	244	227	160	287	271	162	157	1506
7	Minnesota	247	225	156	292	268	158	156	1503
8	Maine	242	226	160	286	270	158	161	1502
9	Virginia	244	227	161	288	267	155	157	1499
10	Connecticut	243	227	155	282	267	152	172	1497
11	Wyoming	244	225	157	287	266	159	158	1496
12	South Dakota	241	223	158	288	270	161	155	1496
13	Ohio	245	226	157	285	268	155	156	1491
14	Wisconsin	244	223	158	286	264	158	158	1491
15	Kansas	248	225	151	290	267	150	156	1487
16	Colorado	240	224	155	286	266	155	161	1487
17	Pennsylvania	244	226	151	286	268	150	159	1485
18	Washington	243	224	153	285	265	154	158	1481
19	Idaho	241	223	155	284	265	158	154	1480
20	Delaware	242	225	152	283	265	152	158	1477
21	Iowa	243	225	151	285	267	150	155	1476
22	Indiana	245	222	152	285	264	150	155	1473
23	Missouri	239	221	158	281	263	154	153	1469
24	Nebraska	238	223	151	284	267	150	155	1468
25	New York	243	224	151	280	264	150	154	1466

Source: National Assessment of Education Progress (NAEP)

governance to balance the government's budget at the expense of every household's budget? In any event, the actual revenues from the massive hikes fell short of their projections. Not only did they fall far short of projections, *actual tax receipts fell* in spite of a (static) \$6.4 billion tax increase on a budget in the \$35 billion range. And who says there's no Laffer Curve?²⁵ Go figure!

Wilson's successor, Gray Davis, actually was more a victim of circumstance than a bad governor. Although he had pushed for tax hikes that (fortunately) were blocked because of Prop. 13's supermajority requirement, it was not Gray Davis's fault that some 25 percent of his general fund revenues in 2001 came from *exercised* stock options and *realized* capital gains (refer back to Figure 12). When the stock market crashed and

Rank	State	4th Grade Test Scores			8th Grade Test Scores				Overall
		Math	Reading	Science	Math	Reading	Science	Writing	
26	Utah	239	221	155	281	262	154	152	1465
27	Maryland	240	225	149	286	265	145	155	1464
28	Kentucky	235	222	158	279	262	153	151	1461
29	Oregon	236	215	151	284	266	153	155	1460
30	Illinois	237	219	148	280	263	148	160	1455
31	Texas	242	220	150	286	261	143	151	1453
32	Michigan	238	220	152	277	260	155	151	1453
33	Florida	242	224	150	277	260	141	158	1452
34	Alaska	237	214	151	283	259	150	155	1449
35	North Carolina	242	218	149	284	259	144	153	1448
36	Oklahoma	237	217	150	275	260	147	153	1438
37	Rhode Island	236	219	146	275	258	146	154	1434
38	Georgia	235	219	148	275	259	144	153	1433
39	Tennessee	233	216	150	274	259	145	156	1433
40	South Carolina	237	214	148	282	257	145	148	1431
41	Arkansas	238	217	147	274	258	144	151	1429
42	West Virginia	236	215	151	270	255	147	146	1421
43	Arizona	232	210	139	276	255	140	148	1400
44	Alabama	229	216	142	266	252	138	148	1391
45	Louisiana	230	207	143	272	253	138	147	1390
46	Hawaii	234	213	142	269	251	136	144	1390
47	Nevada	232	211	140	271	252	138	143	1387
48	New Mexico	228	212	141	268	251	138	143	1380
49	California	230	209	137	270	251	136	148	1380
50	Mississippi	228	208	133	265	250	132	142	1358

took his budget surplus with it, the catastrophe was outside of his control. Even so, in fairness, we must remember that it was others who created the explosive tax code that Davis inherited. No matter what exogenous circumstances he inherited, however, Davis could have exercised more fiscal responsibility in the face of such a financial crisis.

By the end of Davis's tenure, out of control state spending and general fiscal frivolity,

along with recurring energy problems, had laid the groundwork for California's worst debt position in state history. As of December 31, 2003, the amount of California's outstanding general obligation (GO) debt was \$31.7 billion, with another \$22.2 billion slated for 2004.⁶ California's debt rating was BBB at the end of 2003, the lowest debt rating of any state and tied for the lowest credit rating any state had ever been assigned.⁷

This brings us up to the Schwarzenegger period. Despite heavy rhetoric, debt levels remain high and a GO debt downgrade appears to be looming. The yield spread between California's outstanding debt and a AAA GO debt municipal benchmark is a measure of the premium investors must receive to hold California debt versus the lowest risk municipal debt (see Figure 21). California's Standard and Poor's debt rating is also shown. California's spread over the AAA benchmark at the time of Davis' departure was as high as it had ever been, and the spread appears headed back to that level.

State Economic Policies Matter

As with our comparison of Texas vs. California in the previous chapter, here too we find that a state's economic policies really do matter. Now that we understand the historical background and their associated tax-and-spend policies, we can look at the results of this grand experiment. Just as economic theory predicts, we find that the California economy prospered during the period of fiscal discipline, and then fell into repeated stagnation and budget crises once the

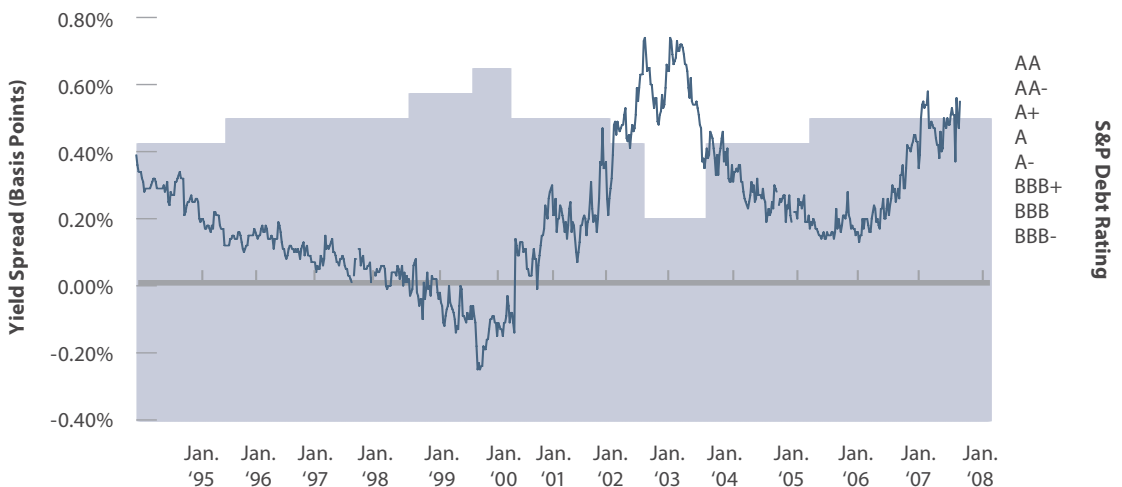
legislators returned to their profligate ways.

Tax-and-Spend Democrats?

Fiscally conservative Republicans may be surprised by the following charts. Contrary to popular belief, Democrats (at least in California) are not the only ones to spend like drunken sailors.

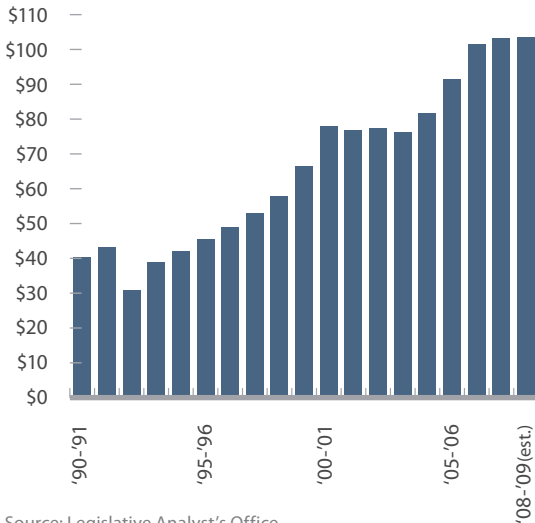
This cavalier attitude toward public spending has left the California state government, as well as many of its municipalities, a little worse for the wear, to say the least. In the beginning of December 2008, Gov. Schwarzenegger was forced to declare a fiscal emergency, allowing him to call a Prop. 58 special legislative session to address the crisis. The current fiscal year budget shortfall is projected to reach \$11.2 billion, while over the next 18 months, analysts project it could reach an almost insurmountable \$40 billion. In fact, budget conditions have gotten so bad, that in early December, the Los Angeles City Council voted to halt further funding for a planned \$42 million exhibit at the Los Angeles Zoo – \$12 million of which has already been spent. This year, the city is look-

**FIGURE 21
CALIFORNIA'S GENERAL OBLIGATION (GO) DEBT RATING AND YIELD SPREAD
BETWEEN STATE GO DEBT AND AAA GO BENCHMARK**



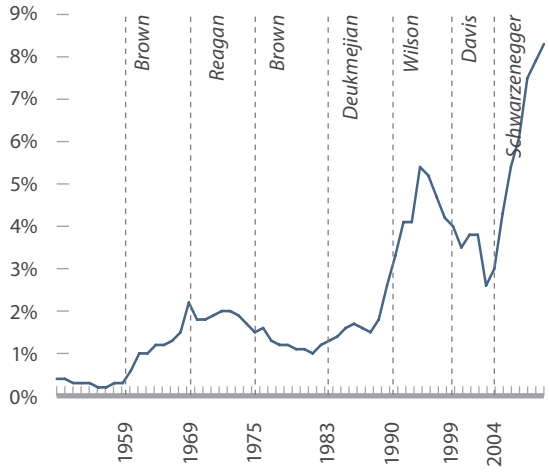
Source: Standard and Poors

FIGURE 22
CALIFORNIA GENERAL FUND EXPENDITURES
 in \$billions; FY 1990/91-FY 2007/08; FY 2008/09 estimated



Source: Legislative Analyst's Office

FIGURE 23
GENERAL FUND DEBT SERVICE RATIOS:
FY 1958/59-FY 2008/09



Source: Legislative Analyst's Office

ing at a shortfall of about \$110 million out of its \$7 billion budget and a potential \$300 million shortfall in the next fiscal year. The City Council is widely expected to cut funding for a variety of public services including crossing guards and public libraries. They are also discussing privatization options for the zoo as well as plans that would involve freeing the zoo's last elephant, 21-year-old Billy, who was supposed to reside in the now suspended new exhibit.⁸

And how does the current governor plan to close such budget gaps? Recent proposals to come out of Schwarzenegger's office have involved a \$4.4 billion tax hike, which includes a three year, 1.5 percent increase in the state sales tax, mineral extraction taxes on local oil companies, and the acceleration of about \$1 billion in infrastructure spending.⁹ Has he learned nothing from his last five years in office?

But perhaps the most extreme example of fiscal irresponsibility in the State of California belongs to the city of Vallejo. The city, which lies approximately 35 miles northeast

of San Francisco and contains a population of 120,000, is experiencing a budget crisis so large, they were forced to declare bankruptcy this past spring. In fact, the city estimates its budget deficit stood somewhere around \$17 million for FY 2008. In the past, municipalities have filed for Chapter 9 due to poor investment decisions or perhaps some unlucky legal rulings, but this is not the case for Vallejo. Their dilemma is primarily the result of declining revenues and an overburdened public payroll. According to Dean Gloster, a Vallejo city union lawyer, "Vallejo was sort of the canary in the coal mine ... even better-run cities are going to be facing similar issues as health care costs rise and the baby boomer generation reaches retirement age."¹⁰

The main problem lies in the city's large employee salaries and benefit packages, which comprise 75 percent of the general fund budget. Base pay for firefighters is more than \$80,000 per year. Furthermore, public employees can retire at age 50 with a pension equal to 90 percent of salary. The city is now fighting to legally

void collective-bargaining agreements that are responsible for overly high employee pay. Inflated public sector wages and benefits are creating budgetary pressure in local governments across the country. In a recent survey of the nation's cities, the National League of Cities found that bloated public payrolls are plaguing our country's city budgets. Almost 95 percent of finance officers said employee-related costs, including wages, have increased over the previous year, 86 percent said health benefit costs have increased, and 79 percent said pensions have risen over the previous year.¹¹

Sacramento Pols:

Only You Can Prevent Unemployment

We have been in this game for a while, and we've heard all sorts of excuses to explain why high taxes and stifling regulations aren't *really* responsible for job losses and stagnant economic growth. Apologists for big government will usually blame everything on "the recession" or some other exogenous feature. But there's an obvious way to correct for this: We can look at

standard measures of economic health, such as growth and unemployment rates, and compare California's numbers against the U.S. average. This allows us to isolate the effect of state-level policies, to determine if a high-unemployment year, for example, should be attributed to a nationwide calamity, or to something that California politicians could control.

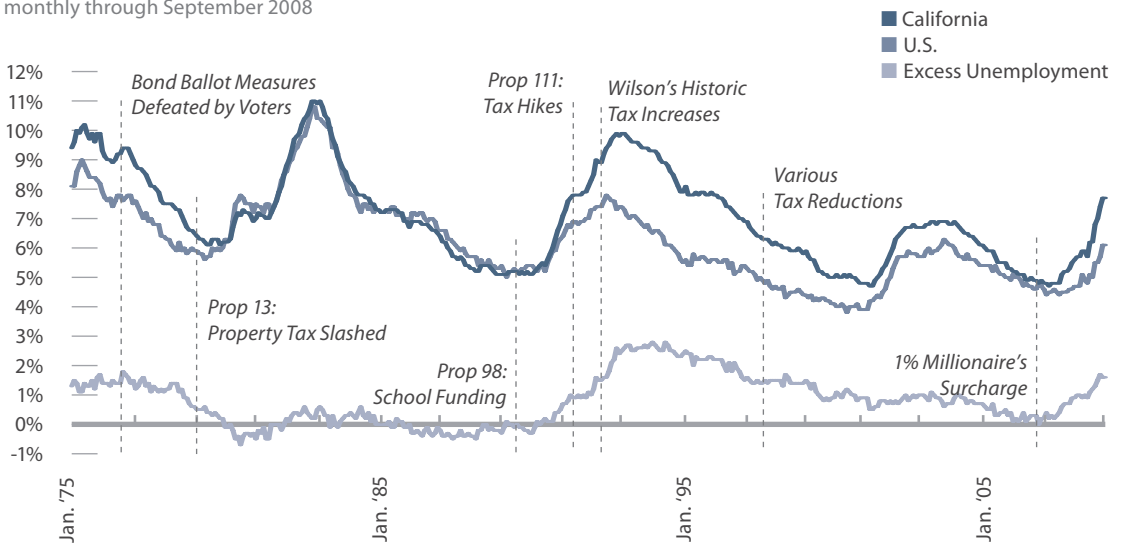
Using this approach, Figures 24 and 25 illustrate that economic theory works. When California's legislature was shackled by Prop. 13 and other measures, it fared well compared to the rest of the United States. But when the politicians broke free from the chains its voters had placed on them in the late 1970s, all hell broke loose too, economically speaking. California's unemployment shot up well above the U.S. average, and its growth fell well below it.

A Crucial Part of the Story:

Population Flows

California is a state whose economy is driven by population growth. In his 2006 State of the State address, the governor laid out the proposi-

FIGURE 24
UNEMPLOYMENT & EXCESS UNEMPLOYMENT RATES: CALIFORNIA VS. UNITED STATES
 monthly through September 2008



Source: Legislative Analyst's Office

tion that, “California’s population is expected to increase by as much as 30 percent over the next 20 years.” In fact, it is this population forecast that is the basis for the huge increase in infrastructure that had been proposed by the governor. Population growth is the end-all-and-be-all of California’s economy. But in this regard, there are ominous harbingers of things to come.

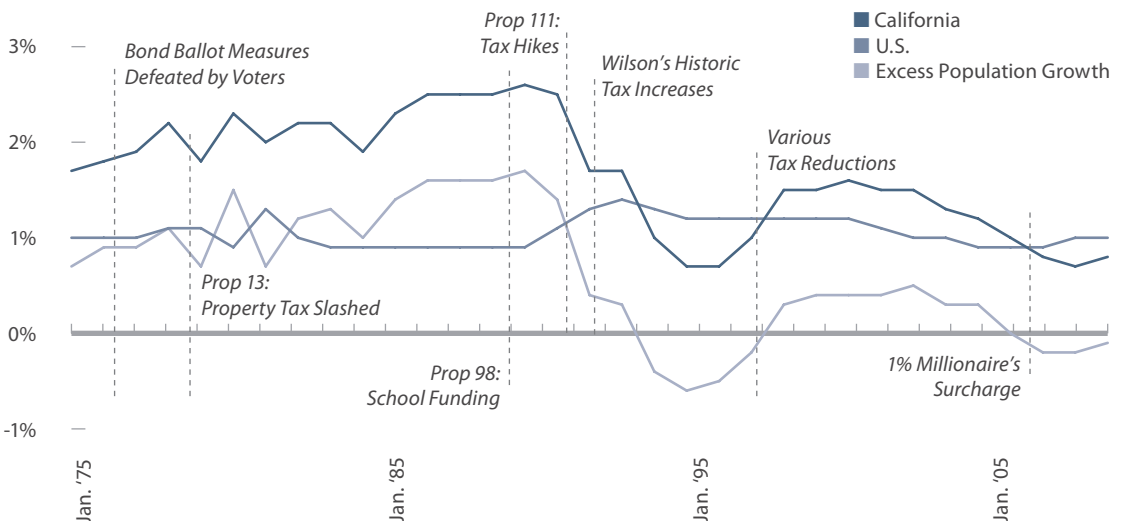
First and foremost, even if California maintained its relative attractiveness *vis-à-vis* the rest of the country – which it most definitely has NOT – it is a wild stretch to believe that California’s population could grow by 30 percent in the next two decades. It is true that over the past decade, California’s population has grown 12.5 percent (through 2007). But California is now a much larger share of the overall country, and the rest of the country is relatively smaller. The same, or even higher, growth rates as those that occurred during the past decade correspond to a much larger absolute population movement than anything that has ever occurred both from the standpoint of the receiving state and the dispensing states.

On the basis of the latest population data, California’s population growth rates are heading south. According to Census Bureau estimates of population growth from July 2000 to July 2001, California was the 9th fastest growing state in the nation. Six years later, through July 2007, California’s annual growth rank slipped to 25th. In Figure 25, we have plotted population growth rates for California and the United States, and then the difference between the two.

The state’s changing growth rate reflects changes to the growth rates of the components that make up changes to total population – a fact not unfamiliar to those who have studied California’s past. State population growth has three components: 1) natural increase (births minus deaths of state residents), 2) net foreign immigration (net immigration into and out of California from foreign countries) and 3) net domestic migration (net migration into and out of California from the rest of the United States).

As one might expect, California’s “natural increase” is relatively constant over time, sub-

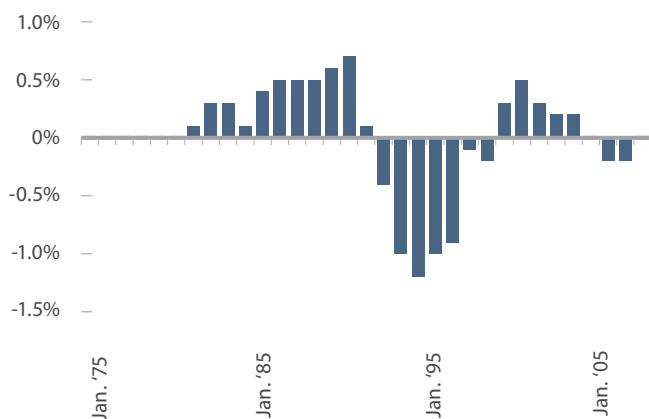
FIGURE 25
POPULATION GROWTH & EXCESS POPULATION GROWTH RATES: CALIFORNIA VS. UNITED STATES
 monthly through September 2008



Source: U.S. Census Bureau

FIGURE 26
NET CALIFORNIA DOMESTIC MIGRATION
AS PERCENTAGE OF EACH YEAR'S TOTAL POPULATION

data began in 1981, annual through FY 2007



Source: California State Department of Finance, Demographic Research Unit

ject to the slow whims of decades-long demographic trends. Similarly, foreigners looking for a better life in California are not particularly swayed by the economic fortunes of the times, and represent a constant new inflow. It is quite clear net domestic migration is the true driver of changes in the rate of population growth in California (see Figure 26).

Just look at that domestic migration chart and see if you aren't shocked. Our past research has demonstrated that California's excess population growth (or lack thereof) closely mirrors the relative performance of the state's economy. At the peak of California's struggles in FY 1994, a net 362,000 Californians – or more than one percent of the state's total population – picked up and moved elsewhere. According to the U.S. Census Bureau, this figure was even larger – 434,000 Californians.¹²

Today, in addition to California's annual population growth continuing to come in below the U.S. average, an increasing number of Californians are choosing to leave the state. The California Demographic Research Unit estimates that in FY 2007, this net outflow was 89,000 people. The U.S. Census Bureau deter-

mined the outflow to be even larger – 263,000. (While it's unfortunate that between these two organizations a more exact figure cannot be reached, the underlying trend in either series is virtually the same.)

As if those charts aren't enough, we can also give some anecdotal evidence to buttress our theme. There were some 44,000 millionaires in California in 2000, and they contributed \$15 billion to the state treasury in that year. That is an unbelievable statistic when you think about it. It means that the richest 0.15 percent of Californians contributed roughly 20 percent of the state's income tax revenues! According to data provided to the audit committee by the State

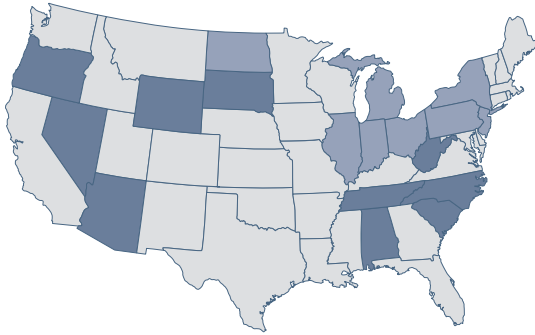
Board of Equalization, about 80 percent of the state's revenue losses between 2001 and 2003 were a result of disappearing millionaires. The number of reported millionaires in California astonishingly dropped from 44,000 in 2000 to 29,000 in 2002. These tax émigrés represented a loss of roughly \$6 billion in annual tax revenue collections.¹³

Some of the loss of millionaires in this decade wasn't a result of people leaving, but people losing money in the dot-com bust that thrust many Californians into a horrific riches to rags spiral. In the late 1990s, stock options from high-tech ventures reached their peak, creating a huge spike in temporary millionaires and centimillionaires. It is estimated revenues from stock options and capital gains generated a \$5 to \$10 billion one-time revenue windfall in the late 1990s. But we also know from the Census Bureau data that high wealth individuals have been leaving the state en masse. Figure 27 shows where these displaced Californians have been going.

We can illustrate our story by relying on the annual official press release from United Van Lines. As you might expect, United Van

FIGURE 27
2007 MIGRATION TRENDS
 United Van Lines Shipment Data

- Inbound States: moving outbound <45%
- Outbound States: moving outbound >55%
- Neutral States: moving outbound >45%, <55%



Lines keeps close track of where its customers are moving and shipping their belongings in terms of inbound and outbound moves for each state. Fortunately for us, they make these data available on a very timely basis. In Figure 27, we have shaded light blue those states where outbound shipments accounted for 55 percent or more of all shipments in 2007, and we have shaded dark blue those states where inbound shipments accounted for 55 percent or more of all shipments in 2007. Those states that are light grey were somewhere between 45 percent and 55 percent. Doesn't this just say it all? As occurred in the early 1990s, California's neighbors once again stand to benefit tremendously from California's troubles.

These displays and anecdotes all tell the same story. California is moving into a zone where people are voting against the government of California with their feet. Why? The reason is as simple as the basic proposition of economics: taxes, taxes and more taxes.

Progressive Taxes will Drive You Progressively Broke

If we had to sum up the booms and busts of California's volatile history, one word would

TABLE 20
TOP 10 MIGRATION "WINNERS" AND "LOSERS"

Rank	State	% of Moves Outbound
Winners		
1	North Carolina	38.40%
2	Nevada	40.60%
3	Oregon	41.60%
4	Alabama	42.10%
5	South Carolina	42.20%
6	South Dakota	42.60%
7	Wyoming	42.80%
8	Arizona	44.20%
9	West Virginia	44.30%
10	Tennessee	44.90%
Losers		
50	Michigan	67.80%
49	North Dakota	67.20%
48	New Jersey	61.00%
47	New York	59.40%
46	Illinois	57.60%
45	Ohio	57.00%
44	Pennsylvania	56.60%
43	Indiana	56.40%
42	Wisconsin	54.60%
41	Maryland	54.10%

Note: Alaska and Hawaii not part of the study.
 Source: "2007 Migration Study," United Van Lines

suffice: *taxes*. When the state and local tax burden was low, California prospered by just about any measure you like. And the opposite holds true as well, the present situation being yet more proof of that principle. Although macroeconomists lament they have no truly controlled experiments to study the effects of different fiscal policies, the case of California comes pretty close to fitting the bill.

Our basic story runs as follows: Politicians in Sacramento inevitably paint themselves into a corner. The tax code is steeply progressive. California has the highest marginal income and capital gains tax rates in the nation, and the rich-

est 10 percent of earners pay almost 75 percent of the income tax. This setup showers riches on the state during periods of prosperity, which are of course immediately spent. Then, when the downturn comes, state revenues are hit disproportionately because of the loss of high income earners. Yet since budgets are much easier to expand than contract, the revenue shortfalls lead to massive deficits. To close the gap, the “solution” all too often is to hike taxes even more, which serves to further discourage employment and output – and hence the tax base. Because of the dynamic effects (as illustrated by the Laffer Curve), the tax hikes don’t raise as much revenue as predicted, and thus the budget deficits persist. At the same time, welfare rolls and other support programs expand because of rising unemployment. The downward spiral is arrested when the public is finally fed up and demands drastic tax relief. Yet, old habits die hard; the vicious cycle resumes once again in a few years when the public has forgotten the lesson. But at each new cycle, the tax and spending problems ratchet up further and further. California may just be testing how far this vicious cycle can go.

In our opinion, relying on the vigilance of the voters to “guard the guardians” is naive. A more promising approach is to completely revamp California’s tax code, replacing it with a flat tax. By reducing the highest marginal tax rates, such a reform would immediately energize the state’s most productive individuals, as well as attract more talent from outside its borders. Beyond the boost to average incomes and growth, the switch to a flat tax would also reduce the volatility in California’s tax revenue stream.

In Figure 12, we showed the shocking dependence of California revenue on exercised stock options and realized capital gains.

Our quick lesson leads to the obvious conclusion: If Gov. Schwarzenegger wants to balance his budget and revitalize the California economy, he cannot increase tax rates – ideally he would replace the whole mess with a flat tax. Reducing tax burdens and rationalizing tax policy has worked wonders before and will work wonders again.

All of this circles back to the policy mess in Sacramento, especially to its steeply progressive income tax that encourages budget boom and bust. The Golden State applies a top marginal income tax rate of 10.3 percent, the highest on earnings of any state (excluding some local levies, such as New York City), according to the Tax Foundation. A rising share of those who pay the 10.3 percent rate are now hit by the federal Alternative Minimum Tax, so about one-third of California’s income tax is no longer deductible from federal tax liability. This is one more reason for taxpayers to flee the state.

Conclusion

In a very real sense, California went from Karl Marx to Adam Smith, and back to Marx again. The effects are just what economic theory predicts. Whether you look at California versus low-tax states like Texas, or California versus its earlier, low-tax incarnation, the results are the same. The economy grows, and the legislature has fewer budget crises with tax and spending restraint. When asked how well California would ever survive without an income tax, property tax or a sales tax, you now have the answer: “Very well, thank you.”

ENDNOTES

- 1 Adapted from Table 2 of “The Great California Tax Experiment,” A.B. Laffer and Associates. May 28, 1993. p. 5.
- 2 Reproduced from Table 1 in “The Great California Tax Experiment.” p. 4.
- 3 On a personal level, Pete Wilson is one of the nicest, well-meaning people we know. In fact, prior to his becoming governor, Arthur Laffer personally did several appearances at fundraisers for him. Little did he know.
- 4 See “The Great California Tax Experiment.” p. 6.
- 5 Some have cautioned that the supply-side effects we are discussing would be muted if all states raised (or lowered) their tax rates accordingly. In the extreme, there’s no reason to move out of California if every other state is run by socialists too. We concede the point. However, our advice is not a beggar-thy-neighbor policy. If all states simultaneously implemented huge marginal tax rate reductions, their citizens would benefit greatly, and we don’t think the state politicians would regret their actions either. It’s analogous to getting vaccinated – if you’re the only person to do it, it’s really worth your while, but even if most others are doing it, it’s still a good idea.
- 6 Taken from Schedule 11 of the “FY2004-05 Governor’s Budget Summary.”
- 7 Also rated BBB were Alaska in the 1960s and Massachusetts in the early 1990s. Source: “The State of California’s Bonds.” Bernstein Municipal Bond Research. November 2003.
- 8 Sanders, Peter. “City Budget Crunch Hits the Zoo Los Angeles Weighs Setting Billy the Elephant Free as Funds Become Extinct.” *Wall Street Journal*. December 4, 2008.
- 9 Lin, Judy. “Schwarzenegger: \$4.4b in tax hikes to end deficit.” *Associated Press*. November 6, 2008.
- 10 Sostek, Anya. “Vallejo’s Fiscal Freefall.” November 2008.
- 11 Pagano, Michael A. and Hoene, Christopher W. “City Fiscal Conditions in 2008.” National League of Cities. September 2008.
- 12 The California Demographic Research Unit of the California Department of Finance estimates components of population change using four main components: drivers license “surrenders,” IRS tax filings, Medicare recipient addresses, and student loan information. The U.S. Census Bureau uses primarily just IRS tax filings. Estimates of domestic migration from these two sources, while significantly different in absolute terms, demonstrate very similar trends over time. In our research, except when comparing states, we have usually used the Demographic Research Unit data.
- 13 See Laffer, Arthur and Moore, Stephen. “California, Who Are You? Part II.” Laffer Associates, January 18, 2008.