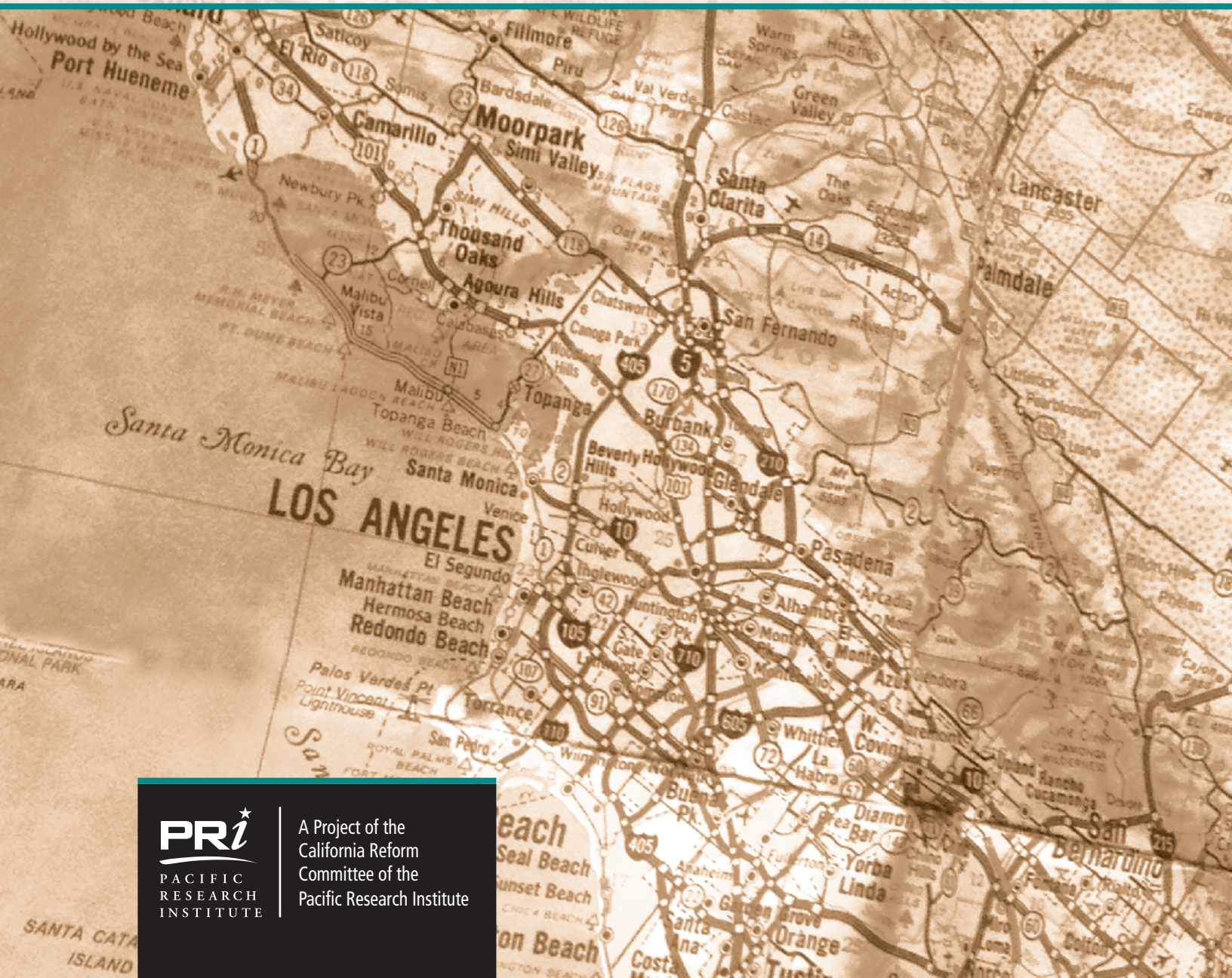
THE SEVEN LEAN YEARS

The Economic and Fiscal Consequences from California's Proposition 30

Wayne Winegarden, Ph.D.



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Pacific Research Institute
One Embarcadero Center, Suite 350
San Francisco, CA 94111
Tel: 415-989-0833
Fax: 415-989-2411
www.pacificresearch.org

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EXECUTIVE SUMMARY

California continues to reap the consequences from its punitive tax policies. Prop 30 is just the latest example. Prop 30 (officially titled "Temporary Taxes to Fund Education") was passed by California voters (55 percent to 45 percent) on November 6, 2012. Governor Jerry Brown was the leading advocate for its passage.

Prop 30 raised the sales tax rate by one-quarter of a percent for four years (from 7.25 percent to 7.50 percent) and marginal income tax rates for seven years for single filers who earned more than $250,000 a year. The marginal income tax rates increased from 9.3 percent to:

- 10.3 percent on individuals with incomes between $250,000 and $300,000;
- 11.3 percent on individuals with incomes between $300,000 and $500,000;
- 12.3 percent on individuals with incomes between $500,000 and $1,000,000; and,
- 13.3 percent on individuals with incomes over $1,000,000.

Tax rates on earnings over $1 million increased from 10.3 percent to 13.3 percent – the highest state marginal income tax rate in the country. Prop 30 was applied retroactively to the beginning of 2012 despite the fact that changing the rules of the game ex-post is patently unfair.

Prop 30 increased the progressivity of California's already progressive tax code, created additional budget rigidity, and decreased the incentives to work, invest, and save in California. California's own tax history, along with the experiences of the other 49 states, foretell that the consequences from such a policy are diminished economic growth, greater migration out of California, and a less stable state budget in the long term.

Diminished Economic Opportunity

Incentives matter. When profits for an entrepreneurial venture are high, people have a strong incentive to invest in that project. Alternatively, people have a strong incentive to avoid projects that offer little or no profits. Taxes reduce profits and, therefore, diminish the incentive to save, invest, or pursue entrepreneurial activities. By discouraging these activities, taxes reduce overall economic growth.

The same logic applies to Prop 30. Prop 30 reduced the after-tax income of the targeted taxpayers (millionaires) by $18,120 for every million dollars earned if the taxpayer is not subject to the Alternative Minimum Tax (AMT); if the taxpayer is subject to the AMT, their after-tax income was reduced by $30,000. Prop 30 has reduced the return from saving, investing, or working in California; and is, consequently, adversely influencing labor force participation and investment decisions.

Take an investment decision. All investments carry risks. To compensate for these risks, the return must be sufficient in order to encourage an investor to risk his or her money – the riskier the venture, the higher the return must be. Due to the 1.8 percentage point to 3.0 percentage point reduction in an investor's potential return, there are now potentially opportunities that would have met investors' risk/reward threshold prior to Prop 30, but now no longer meet their thresholds. A similar calculus is applying to a person's work versus leisure decisions.

Prop 30 could reduce the growth of personal income in California by $36.2 billion by 2017, or a $944 loss in potential income growth for every person currently living in the state.

The decision is not simply between engaging in the project and not engaging in the project. Another option is to move to another state. That same investor, or worker, can now earn $80,332 more for the same investment simply by relocating to Nevada, if not subject to the AMT. If the AMT does apply, then the investor can earn $133,000 more if he/she lived in Nevada.

And, many businesses are relocating away from California to other states, such as Texas, that impose lower taxes. For instance:

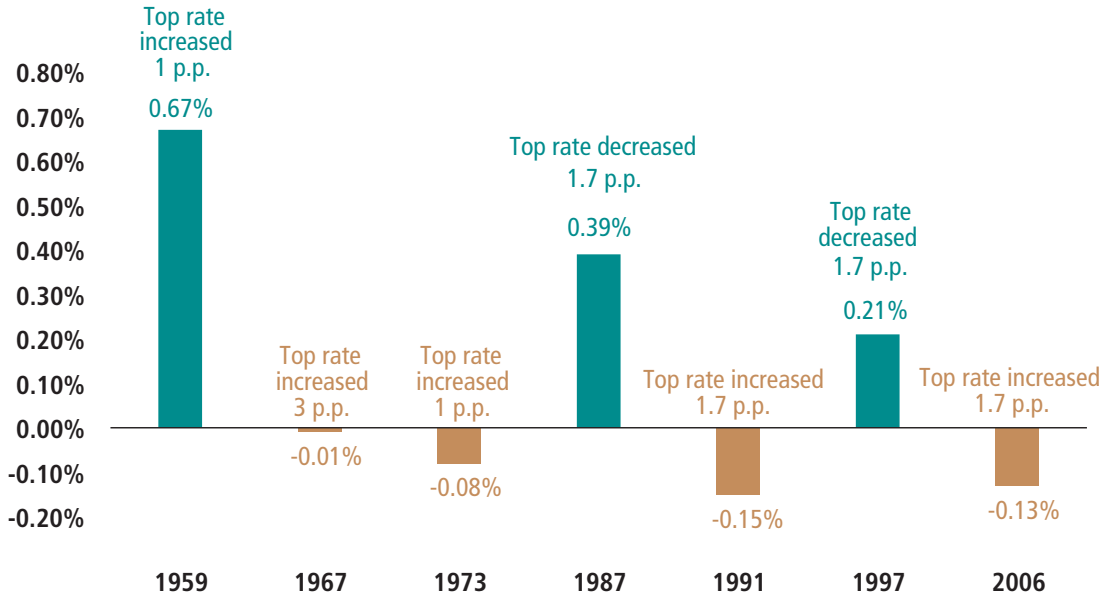
- In April 2014 Toyota decided to close its long-time complex in Torrance, California, which employed 5,300 people, and consolidate its operations in suburban Dallas.[1]
- CKE restaurants has stated that the company's "…intent is to build 300 [restaurants – Carl's Jr. and Hardees] in Texas in this decade, whereas in California we'll build very few restaurants."[2]
- "Occidental Petroleum Corp said it would spin off its oil and gas assets in California into a separately traded company and move its headquarters from Los Angeles to Houston, where it will be closer to its largest U.S. operations."[3]

California's historical experience shows a consistent pattern: when California's top personal income tax rate increases, California's share of the total personal income earned in the U.S. declines; the reverse is true when California's top personal income tax rate decreases, see Figure E1.

The experience following the 1959 top tax rate increase varied slightly from this pattern. The 1950s were a period of strong tailwinds for California's economy – California's share of total personal income was 2 percentage points higher in 1959 compared with 1950.[4] Following the increase in California's top personal income tax rate in 1959, California's relative growth premium slowed down.

The growth in California's share of national income declined from 4.0 percent between 1956 and 1958 to 2.9 percent between 1959 and 1961. The increase in California's top marginal personal income tax rate was, consequently, associated with a slowdown in California's growth premium.

FIGURE E1
Change in California's Share of Total U.S. Personal Income (Average Share 3-years Following Tax Increase Minus Average Share 3-years Prior to Tax Increase)[5]



California's economic outcomes following changes in the top marginal personal income tax rate are not unique. The experience of all 50 states following increases in the top tax rate provides additional evidence.

Since 1970, there were 286 episodes when a state's top marginal personal income tax rate changed. A more formalized assessment (see Appendix I for a detailed review) examined the impact on each state's relative personal income growth rate following a change in the state's top personal income tax rate based on a regression analysis.

The results from the regression analysis illustrated that a change in the top marginal personal income tax rate had a significant and negative impact on a state's share of total national personal income over a 1-year, 3-year, and 5-year period.

Between 1970 and 2013, those states that raised the top marginal personal income tax rate saw their share of total personal income in the U.S. decline. Alternatively, those states that lowered the top marginal personal income tax rate saw their share of total personal income in the U.S. increase. Importantly, the negative impact from a tax rate increase grows over time such that the reduction in each state's share of total personal income is larger in the fifth year than the first year. The opposite is true for a tax rate reduction.

The historical experience of all 50 states, therefore, is consistent with California's experience – increases in a state's top marginal income tax rate reduces that state's relative personal income growth rate – and this impact gets more pronounced over time. Based on this historical experience, *Prop 30 could reduce the growth of personal income in California by $36.2 billion by 2017, or a $944 loss in potential income growth for every person currently living in the state.*

These results are also consistent with a large, and growing, body of academic research (see Appendix II).

Migration Away from California

California's population flows are also correlated with changes in the top marginal personal income tax rate. The ultimate arbiter of a state's desirability is whether people want to live there. And, California was once a population magnet. In 1950, 7.0 percent of the U.S. population lived in California.[6] By 1990, 12.0 percent of the U.S. population lived there; since 1990 California's share of the U.S. population has been flat, although not without short-term volatility.

Changes in the top marginal personal income tax rate are also correlated with changes in California's population growth rate. And, some of the most sensitive emigrants are wealthier individuals that would have been subject to Prop 30 had they remained in California. For instance, although pro-golfer Phil Mickelson quickly apologized for claiming that Prop 30's tax rate was excessive,

> Just the increase of the top bracket to 13.3 percent from 10.3 percent cost Mickelson roughly $1.8 million of his $60 million income for 2012.
>
> Mickelson's longtime rival, Tiger Woods, acknowledged last week that he left California for Florida in 1996 upon turning pro because of the difference in state tax. At the time, California's top rate was 9.3 percent for individuals earning more than $32,000. Woods, who earned $56.4 million in 2012, kept roughly $7.5 million this year in funds he otherwise would have owed to the state of California. Mickelson, who will now pay the 13.3 percent rate, will owe the state about $8 million.[7]

As Table E1 illustrates, except for the 1.0 percentage point tax increase in 1973, California's share of the national population has followed a consistent pattern following every other change in California's top marginal personal income tax rate. The 3-year average population growth rate following a tax rate increase was lower than the 3-year average population growth rate just prior to a tax rate increase. The reverse was true following a tax rate decrease.

TABLE E1
Change in California's Share of the U.S. Population Before and After Changes In California's Top Marginal Personal Income Tax Rate (3-Year Average Change)

	Tax Change (in percentage points)	Change in California's Share of Population
1959	1.0	-0.04%
1967	3.0	-0.04%
1973	1.0	0.04%
1987	(1.7)	0.04%
1991	1.7	-0.17%
1997	(1.7)	0.09%
2006	1.7	-0.03%

Adjusting for the broader national economic trends, California's relative economic performance suffers following an income tax rate increase. There is no reason to believe California's economic experience with Prop 30 will be any different.

Less Stable State Budget

The proponents of Prop 30 failed to consider that California's budget problems were not about revenues. Between the 1984-85 budget year and the 2013-14 budget year, total expenditures in California from all funds adjusted for inflation and population grew 2.1 percent a year. Excluding Federal Funds, total expenditures adjusted for inflation and population grew 1.7 percent a year – and this includes the steep drop in inflation-adjusted expenditures per capita following the 2008-09 recession. This means that, on average, the California legislature was empowered to increase real spending per Californian by 2.1 percent each and every year for the past two decades.

California's problem is a lack of effective budgeting. Overly-restrictive budget rules and lack of spending control in other budget areas (especially health care) are driving California's budget problems and crowding out spending on everything else.

For instance, back in the 1984-85 budget, Health and Human Services (HHS) expenditures accounted for 29 percent of total state expenditures from All Funds, and 29 percent of total state expenditures from the General Fund. By the 2013-14 budget, HHS expenditures accounted for 44 percent of total state expenditures from All Funds – total state HHS expenditures remained 29 percent of the General Fund.

A primary source of HHS's growing share of California's budget is funded by the growth in support from Federal Funds, with the most notable growth occurring post-passage of the Affordable Care Act on March 23, 2010. This growth creates a future risk to California's budget, however.

In response to the Affordable Care Act, California has expanded Medi-Cal to more than 1.4 million additional residents.[8] However, as Charles Blahous (2013) noted:

> Though reductions in the growth of federal Medicaid spending are nearly certain, the extent to which they would result in increased state Medicaid costs cannot be precisely quantified. It is reasonable for states to expect, however, that these reductions could result in their carrying additional costs of the same order of magnitude as the ACA's Medicaid expansion.[9]

Should the federal government reduce its support of California's expanded Medi-Cal population, this will pressure California's budget even more.[10]

Overly-restrictive budget rules and lack of spending control in other budget areas (especially health care) are driving California's budget problems and crowding out spending on everything else.

Additionally, although Federal Funds are currently providing the lion's share of the revenues, HHS expenditures in 2013-14 comprised 7.2 percentage points more of the California funded portion of the budget (all non-Federal Funds) compared to 1984-85. Furthermore, HHS expenditures from all non-Federal Funds is 4.0 percentage points higher than just a decade ago.

Budgets are about trade-offs. During the same time period that HHS expenditures have been becoming a larger share of California's budget, which was also a time of expanding resources available to the state budget, California has de-emphasized education spending as a share of the budget.

This emphasis on other expenditures should not be confused with a revenue issue, however, which is what Prop 30 has done.

Additionally, at the time of Prop 30's passage, California's tax burden was already among the highest in the nation, the top marginal income tax rates were the highest state tax rates in the nation, and, the state's inflation-adjusted per capita expenditures were near all-time highs. Together, these facts illustrate that Prop 30's premise – that additional state revenues were necessary – was simply false.

What is driving California's spending growth is the aforementioned problem of health care spending crowding out all other state priorities, as well as California's overly-rigid budget process. And, Prop 30 has worsened California's budget rigidity problem.

In the short-term, Prop 30's higher tax rates are earmarked toward education programs. These revenues must be spent on the education budget line item regardless of any other pressing revenue needs. Consequently, Prop 30 makes it more difficult to fund any other pressing (perhaps unforeseen) spending priorities such as for corrections or transportation projects.

Furthermore, it may be difficult to allow the tax rate increases to sunset because specific spending programs will be attached to the new (and highest in the country) income tax rates. Greater pressure for higher tax rates and higher state expenditure growth, now exists due to the passage of Prop 30.

Taken together, these trends will increase California's already highly volatile budget. And, this volatility comes with a cost. Based on U.S. Census state expenditure data (for comparability) the annual percent change in California's total tax revenue (adjusted for inflation) are significantly more volatile than the average of the annual percent change in total tax revenue (adjusted for inflation) in the other 49 states. During times of robust personal income growth, California's tax revenues surge; however, during times when personal income is stagnating or declining, tax revenues collapse. This volatile tax system is a function of California's highly progressive tax system. As Laffer and Winegarden (2012) noted with respect to California:

> The tax code is steeply progressive, with the highest 10 percent of income earners paying almost 75 percent of all tax revenues resulting from the income tax. This tax structure showers riches on the state during periods of prosperity, which are, of course, immediately spent. Then when the downturn comes – as it inevitably does – state revenues are reduced disproportionately because of the loss of the high income earners. …
>
> Progressive taxes, because they automatically increase taxes as a share of income as income rises, also lead to a higher overall share of output going to the government than the electorate would prefer. Tax cuts are never as popular with politicians in good times as are tax increases in bad times. Volatile revenues – the alter ego of progressive taxes – inextricably lead to big government by increasing spending during prosperity and ratcheting up tax rates during slow times.[11]

Conclusion

Prop 30 misdiagnosed a budgeting problem as a revenue problem, and made California's rigid state budget even more inflexible. By retroactively raising the top tax rate, Prop 30 also reduces the incentives to work, produce, and invest in the California economy.

Prop 30's consequences are a further slowdown in income growth, greater pressure for businesses and people to migrate away from California, and an increase in revenue volatility that makes managing the state budget more difficult in the long run. Instead of Prop 30's approach of raising tax rates and increasing budget complexity, effective fiscal reforms should have been implemented.

First, California's budget sclerosis should have been addressed. A primary cause of California's budget sclerosis is the plethora of spending requirements and revenue earmarks that make it very difficult for legislators to effectively prioritize state spending. These spending requirements and budget earmarks should have been repealed.

There are also too many Commissions in California that are either over-reaching their intended authority or outliving their intended purpose. These Commissions are also wasting valuable budgetary funds. Therefore, sunset provisions should have been imposed upon all California Commissions.

Once a Commission has reached the end of its designated charter, any Commission whose mission is still deemed valuable could then be renewed. A sunset provision would make it easier, however, for the legis-

lature to ensure that every Commission is still fulfilling its designed purpose, and that the purpose of the Commission is still needed.

Had California's budget process been improved, the legislature would have been empowered to spend the taxpayers' money more wisely and establish spending priorities (such as a greater emphasis on effective education reform efforts) that more accurately reflect voters' preferences.

Second, fiscal reforms should have reduced the anti-growth incentives of California's tax code. The starting point should have been a reduction in marginal tax rates that brought California's tax bite closer, and ideally below, the national average. Ideally, the tax reforms would have transformed California's progressive income tax system into a flat income tax system. Such tax reforms would have improved incentives for working, saving, and investing in California.

Concurrent with a tax rate reduction, the inefficient narrowing of California's tax base (the alter-ego of a progressive tax system) should have been addressed. California's high marginal income tax rates coupled with the narrow tax base inefficiently alters people's economic decisions by encouraging them to engage in activities that minimize their heavy tax burdens, often at the expense of activities that maximize economic value. This combination also exerts consistent pressure to raise marginal tax rates to offset the inefficiently narrow tax base – pressure that manifests into policies such as Prop 30. Broadening California's tax base would have reduced these inefficiencies.

Effective tax reform would have incented more entrepreneurship and investment in California creating a more robust state economy. Stronger economic growth would improve the well-being of Californians and, due to the expanding economic base, would further improve the state's finances. In such a healthy economic environment, pressing problems – such as the need to adequately fund education – can also be addressed more effectively.

INTRODUCTION

Jean Baptiste Colbert, King Louis XIV's Minister of Finance, famously noted that "the art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the smallest possible amount of hissing."

California practices the art differently. In California "the art of taxation consists in so plucking the goose as to obtain the largest amount of feathers while ignoring the hissing." There is a cost to California's approach. States, like California, that attempt to confiscate too many feathers from the goose discover that, come winter, the goose has too few feathers to withstand the cold and he migrates to a more hospitable climate.

In the case of California, the impending cold winter days are being foreshadowed by a steady exodus of people and businesses to more favorable economic climates.

Consider Toyota's recent decision, in April 2014, to close its long-time complex in Torrance, California, which employed 5,300 people, and consolidate its operations in suburban Dallas.[12]

Or, consider CKE restaurants. Andrew Puzder, CEO of CKE, who told Shibani Joshi of Yahoo Finance (July 2014) that his company intends "to build 300 [restaurants – Carl's Jr. and Hardees] in Texas in this decade, whereas in California we'll build very few restaurants."

Proposition 30 (Prop 30), a California initiative officially titled "Temporary Taxes to Fund Education," is the latest attempt to pluck a few more feathers from the goose while ignoring the worsening economic consequences. Prop 30 raises the top income tax rates in California to as high as 13.3 percent – the highest and most progressive tax system in the country. Toyota's and CKE's actions exemplify the consequences.

California's highly progressive tax system is short-sighted and accentuates the state's economic and budget volatility. For example, the tax system does not differentiate capital gains from other forms of income and are, therefore, taxed via California's steeply progressive income tax system. Capital gains are exceptionally volatile, however, causing large changes in income tax revenues. The large tax revenue swings play havoc with the state budget. The *Economist* echoed these sentiments stating that,

> California's fortunes depend on the stock market. The state relies heavily on individual income taxes—this year [2014] they are expected to be two-thirds of general-fund revenues—and, in particular, the capital gains of the rich. (Prop 30 aggravated this problem.) This makes the state's revenues highly volatile…[13]

The revenue volatility also creates an incentive problem. The state's revenue boom during prosperous economic times encourages California's state government to spend lavishly. Due to the excitement that often accompanies the boom times, the lavish spending typically includes future spending commitments that are ultimately unaffordable to the state. Figure 1 illustrates this pattern for California's state expenditures between 1984 and 2014.

FIGURE 1
Cumulative Growth in California's State Budget Expenditures Compared to Cumulative Growth in California's Taxable Income (1984-85 through 2013-14 California Budgets, in 2009 dollars)[14]

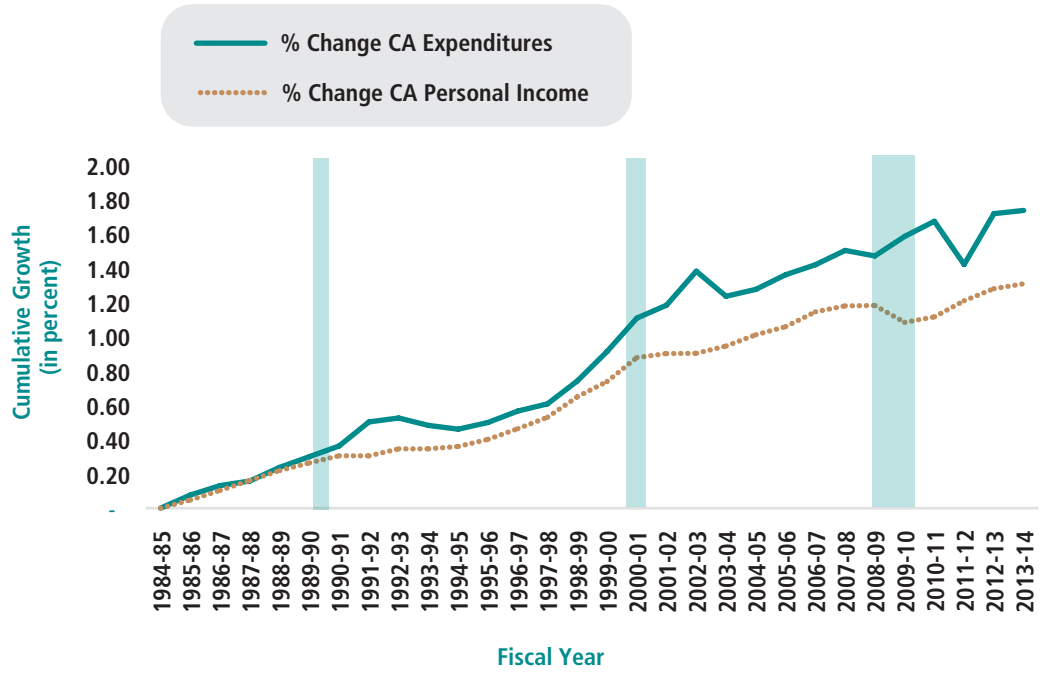


Figure 1 compares the cumulative growth in California state expenditures, adjusted for inflation, to the cumulative growth in California's personal income – the income received by residents of California – adjusted for inflation. As of 2014, while total expenditures from the state budget are 173 percent higher than total expenditures in 1984, total personal income (adjusted for inflation) is only 131 percent higher. Consequently, total state expenditures impose a significantly larger burden on income today than they did 30 years ago.

Figure 1 also illustrates that, during the boom years (the late-1990s and mid-2000s), expenditure growth accelerates relative to income growth. The unsustainability of the spending commitments becomes visible during less robust economic times and recessions. Despite the subsequent slowdown necessitated by slower economic growth, government expenditures over this time period never returned to parity with income.

Making matters worse, many revenue sources are tied to spending requirements by law creating budget rigidity and additional pressure for more unaffordable spending.

The response to the budget crisis that followed the housing bust that began in 2007 was Prop 30. Over the seven years of this "temporary tax", Prop 30 will only fuel more economic volatility and destabilize the California state budget in the long run.

Proposition 30 was sold to the voters of California as a solution to the state's continuous budget problems that would generate substantial additional revenues for education without, presumably, imposing excessive damage on the state's economy.[15] Based on the historical experience of California, as well as the 49 other states, such expectations have always been unrealistic.

A SUMMARY OF PROPOSITION 30

Prop 30 was passed by California voters (55 percent voting for, 45 percent voting against) on November 6, 2012. Governor Jerry Brown was the leading advocate for its passage. Prop 30 raised the sales tax rate by one-quarter of a percent for four years (from 7.25 percent to 7.50 percent) and marginal income tax rates for seven years for single filers who earned more than $250,000 a year. The marginal income tax rates increased from 9.3 percent to:

- 10.3 percent on individuals with incomes between $250,000 and $300,000;
- 11.3 percent on individuals with incomes between $300,000 and $500,000;
- 12.3 percent on individuals with incomes between $500,000 and $1,000,000; and,
- 13.3 percent on individuals with incomes over $1,000,000.

Tax rates on earnings over $1 million increased from 10.3 percent to 13.3 percent – the highest state marginal income tax rate in the country. Although the tax rate increases were not passed until November 2012, the rates were retroactively applied as of January 1, 2012. Applying the tax increase to past activities has caused resentment against California. For instance:

> Bryan Goldberg, who founded the Bleacher Report sports website and sold it to Turner Broadcasting for about $200 million in mid-2012, is moving his primary residence from San Francisco to New York this year. A major reason, he says, is Prop 30 and the way it was applied retroactively.
>
> Taxes in New York City, where he has started a new website, Bustle.com, are also high. Goldberg says his exodus "was more about creating a statement than it was about maximizing my personal income."[16]

Nevertheless, the *ex-post* tax increase was implemented. Prop 30 allocated these revenues to California K-12 public education (89 percent of the funds) and California community colleges (11 percent of the funds).

Advocates of Prop 30 believed that raising the sales tax rate, raising the top income tax rate, increasing the progressivity of California's already progressive tax code, and creating additional budget rigidity would im-

prove the health of the California state budget and encourage (or at least not discourage) economic growth in the state. And, following the implementation of Prop 30, California's billion dollar budget deficit disappeared in FY2013 (which is not unexpected when taxes are raised retroactively).

California's experiences following passage of Prop 30 are, unfortunately, remaining true to California's history. Back in November 2013, the *San Jose Mercury News* reported that Prop 30

> …stabilized school funding in California for the first time since the Great Recession began, allowing school districts to avert thousands of teacher layoffs. It helped the Legislature balance its budget for the first time in years without slashing social programs. And it helped a state whose fiscal mismanagement used to be fodder for late-night comedians suddenly become a poster child of sound budgeting that some say Washington, D.C. politicians should model.[17]

The celebrations were premature however. The revenue surge that immediately followed the passage of Proposition 30 stalled during the first six months of 2014.

According to the Rockefeller Institute, compared to January through March 2013, personal income tax revenues fell 11.1 percent driving down total tax collections 4.4 percent.[18]

Personal income tax revenues fared no better during the April through June 2014 period either. The Rockefeller Institute reported that personal income tax revenue fell 2.6 percent from April through June 2014 compared to revenues raised in the prior year.

A continuation of the January through June 2014 revenue stall would be consistent with the growing exodus of wealthier Californians due to Prop 30. For instance,

> Lee Schneider, a hedge fund salesman who works from home, also cited Prop. 30 as the "deciding factor" for his move from Walnut Creek to Austin, Texas, in 2012. The California native had recently built a $2 million house at the foot of Mount Diablo and took a loss on the sale, but "I can make half of it back in one year of tax savings," he says.
>
> Schneider's neighborhood in Texas, which has no state income tax, is full of cars with license-plate frames from California dealerships. On a flight from Austin to Los Angeles shortly before Christmas, 11 of the 12 seats in the emergency row were occupied by people who had moved from California to Texas, he says.[19]

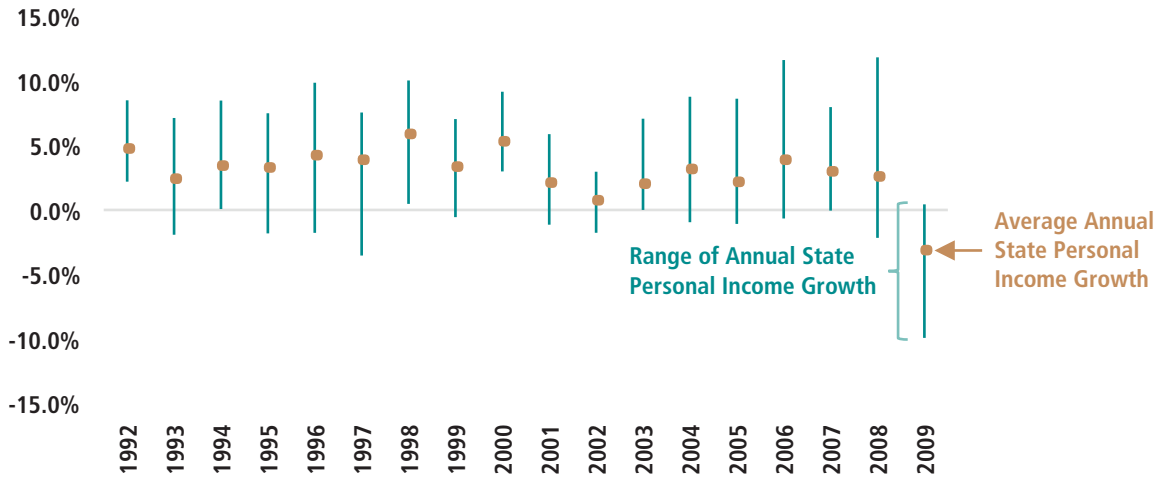
Continued revenue under-performance is also consistent with California's history following steep tax increases. The historical experience illustrates that any revenue surge would be temporary in nature, and that California's share of the national economy will likely stagnate, if not decline, over the next several years. Additionally, Prop 30 is sowing the seeds of the state's next revenue crisis, and creating further budget rigidities that will make it more difficult to address the next revenue crisis when it does occur.

ACCOUNTING FOR THE INFLUENCES ON ECONOMIC GROWTH: STATE TAX POLICIES MATTER

Many factors influence a state's potential economic growth rate; several of which are outside of a state's control. Some states, like California, are blessed with plentiful natural resources, enviable weather, good ports, and beneficial geography. All of these attributes positively impact a state's potential growth rate. The reverse is true in states that lack many of these attributes.[20]

National economic trends (the broader macroeconomic environment) will also meaningfully impact a state's economic performance. The 1990s economic boom supported growth across most of the 50 states, "the rising tide lifted all boats". The Great Recession had the opposite impact. Figure 2 illustrates how the economic performance of the states was related during these two cycles by presenting the lowest, average, and highest annual growth in personal income across all 50 states and Washington D.C. Clearly, the national business cycle meaningfully impacts state economic performance. And, while not to the same extent as natural endowments, national trends are also beyond the control of state government leaders.

FIGURE 2
Annual Growth in State Personal Income
Worst, Average, and Highest Growth Rates
1992 - 2009[21]



Also beyond the direct influence of state government leaders is the global macroeconomic environment. The global macroeconomic environment will disproportionately impact some states compared to others. For instance, the manufacturing sector was 10.6 percent of California's economy in 2012 compared to 16.5

percent of Michigan's.[22] Alternatively, the information sector was 7.2 percent of California's economy in 2012 compared to 2.6 percent in Michigan. Given the differences in economic composition, changes in manufacturing costs in China should be expected to impact the California economy differently than the Michigan economy.

National economic policy also influences state economic performance. With respect to monetary policy, the Federal Reserve (Fed) sets monetary policy for all states. Federal fiscal policy (the federal tax burden and federal expenditures) and regulatory policy are also applicable to all states.

Prop 30 raised tax rates and imposed spending mandates on the budget.

It should be noted that simply because monetary and fiscal policies are equally applicable to all states does not mean that the impacts from these policies will be similar across all states. For instance, the June 2014 proposed Environmental Protection Agency regulations on carbon dioxide, if implemented, may have a larger negative effect on employment, production, and incomes in Wyoming (a major coal-producing state) than California.[23] The same disproportionate impacts hold true for federal tax and spending policies. For the most part state government leaders only have an indirect influence on federal fiscal and regulatory policies at best.

State economic policies are implemented within the context of all of these trends and policies that define the broader macroeconomic environment. The lesson is that care must be taken when interpreting the impact from state economic policies to ensure that state economic decisions and outcomes are put into proper context. Tax policies at the federal level can change economic incentives that overwhelm any policy changes at the state level. Nevertheless, state economic policies still matter – and the evidence shows that they matter a lot (as demonstrated below).

State economic policies generally fall into two categories: state fiscal policies and state regulatory policies. State fiscal policies are the tax and expenditure decisions of state and local governments. State regulatory policies are the mandates and restrictions imposed by the state and local government including zoning regulations, minimum wage laws, right to work laws, and utility regulations. A state's fiscal and regulatory policies will appreciably influence a state's potential economic growth rate.

As summarized above, Prop 30 raised tax rates and imposed spending mandates on the budget. Consequently, this report focuses on the impact from state fiscal policies on a state's economic growth rate.

STATE TAX AND EXPENDITURE POLICIES IMPACT ECONOMIC PERFORMANCE

High or rising tax rates reduce the return to work and investment. Lower returns to work and investment are a disincentive to engage in these activities – or at least engage in these activities in California. Table 1 provides a simplified example of how Prop 30's changes to California's top marginal income tax rate worsened the incentives for work and investment.

It shows the top marginal income tax rate in California before and after Prop 30, and compares these tax rates to neighboring Nevada, which does not levy a personal income tax.[24] Table 1 then traces the impact from the state income tax system on the after-tax rate of return.[25]

TABLE 1
Illustrative Example of Prop 30's Impact on Incentives to Work and Invest

	California		Nevada	Nevada Premium	
Top Marginal Income Tax Rate	**10.30%**	**13.30%**	**0.00%**	**10.30%**	**13.30%**
Every $1 million taxed at top rate	$1,000,000	$1,000,000	$1,000,000		
California Taxes	$103,000	$133,000	$0	$103,000	$133,000
Federal Taxes (not subject to AMT)	$355,212	$343,332	$396,000	-$40,788	-$52,668
After-tax Income (not subject to AMT)	$541,788	$523,668	$604,000	$62,212	$80,332
Federal Taxes (subject to AMT)	$396,000	$396,000	$396,000	--------	--------
After-tax Income (subject to AMT)	$501,000	$471,000	$604,000	$103,000	$133,000
Loss in After-tax Income due to Prop 30					
Taxpayer not subject to AMT		-$18,120			
Taxpayer subject to AMT		-$30,000			

Prop 30's income tax provisions impact the highest income earners in California. Consequently, the table examines the impact for every $1 million that would be taxed at California's top marginal tax rate.

Studies have shown that the state deductibility of taxes, especially in high-income, high tax states like California can meaningfully impact after-tax returns. For instance, the Congressional Budget Office (CBO) has noted the state income tax deductibility from federal taxes "…not only benefits the taxpayers who claim it but also provides an indirect federal subsidy to the state and local governments that levy deductible taxes — because it decreases the net cost to taxpayers of paying those taxes. By lowering the net cost of certain state and local taxes, the taxes-paid deduction may encourage state and local governments to impose higher taxes and provide more services than they otherwise would."[26]

Furthermore, the Tax Policy Center noted that, "although taxpayers in all states claim the deduction, the benefits are concentrated in relatively few states: those with a disproportionate share of high-income households and relatively high state and local taxes. In 2005, taxpayers in California and New York together made up 20 percent of those claiming the deduction and accounted for 30 percent of its value."[27]

The federal subsidy to high taxing/high income states such as California mutes the disincentive impact from state tax increases by partially offsetting the higher state tax liability with a lower federal tax liability. Consequently, the incentive impact including the deductibility of state taxes from an income earner's federal income tax liability is included in Table 1.

However, the purpose of the Alternative Minimum Tax (AMT), which impacts approximately 50 percent of millionaires, is, in part, to eliminate the federal subsidization of state taxes.[28] The disincentive impact for many Californians subject to the AMT is significantly higher than those who do not pay the AMT. For this reason the total incentive impact excluding the deductibility of state taxes is also presented in Table 1.

Table 1 illustrates that Prop 30 reduces the after-tax income of the targeted taxpayers by $18,120 for every million dollars earned if the taxpayer is not subject to the AMT; their after-tax income was reduced by $30,000 if they are subject to the AMT. The difference ($11,880) being the federal subsidy provided to state taxpayers.

Prop 30, therefore, reduced the after-tax rate of return and altered the relative prices of labor and leisure. By altering these prices, Prop 30 is now adversely influencing the labor force participation and investment decisions.

Take an investment decision, for instance. All investments carry risks. To compensate for these risks, the return must be sufficient in order to encourage investors to risk their money – the riskier the venture, the higher the return must be. Due to the 1.8 percentage point to 3.0 percentage point reduction in an investors' potential return, there are now potentially opportunities that would have met investors' risk/reward thresholds prior to Prop 30, but now no longer meet their thresholds. A similar calculus is applying to work versus leisure decisions.

The decision, however, is not simply between engaging in the project and not engaging in the project. As illustrated in Table 1, another option is to move to another state. Those same investors, or workers, can now earn $80,332 more for the same investment simply by relocating to Nevada, if not subject to the AMT. If the AMT does apply, then the investors can earn $133,000 more if they lived in Nevada. In either scenario, the impact is the same for California – the California economy suffers due to less work effort and less investment activity.

And, as the CKE and Toyota examples cited above illustrate many companies are moving their business to other states, such as Texas, that impose lower taxes. Another is "Occidental Petroleum Corp, which said it would spin off its oil and gas assets in California into a separately traded company and move its headquarters from Los Angeles to Houston, where it will be closer to its largest U.S. operations."[29]

Summary of Academic Findings

The changed incentives in California due to Prop 30 have been shown to play an important role in determining a state's competitiveness and meaningfully influence a state's overall economic performance. Appendix II reviews several of these key studies.

The studies support the theory that due to the diminished economic incentives following a tax increase, states that raise income tax rates experience slower income growth, less job creation, fewer new business starts, and more business failures. Additionally, the incentives for people and investment to move into the tax-raising state diminishes, while the incentives for people and capital to move to other states increases.

A reduction in tax rates has the opposite effect. The cost of doing business declines, business profitability grows, business failures lessen, and job and income growth accelerates. The brighter economic prospects encourage people and investment to move to the state.

Summarizing the findings from these studies:

- States with lower marginal income tax rates or lower overall tax burdens perform noticeably better than those states with higher marginal income tax rates or higher overall tax burdens.
- Tax policies that discriminate against work, innovation, and capital accumulation will harm economic growth.
- The after-tax rate of return has a direct and significant impact on investment.

California's historical experience is consistent with these findings.

CALIFORNIA'S TAX HISTORY: TAX RATES AND TAX BURDENS MATTER

California's own history illustrates that incentives matter, and they matter a lot. Like many other states, California's income tax was established during the Great Depression. When initially passed in 1935 the top income tax rate was set at a punitive 15 percent.[30] The first change to the top marginal personal income tax rate occurred in 1943. Governor Earl Warren lowered the top marginal personal income tax rate 11 percentage points to 6 percent, which is the largest reduction in the top marginal tax rate in California's history. This relatively low top tax rate remained in effect for 16 years and marked the lowest rate that California's top marginal income tax rate would ever reach.

From this low rate, California's top marginal personal income tax rate has increased significantly, with the trend toward higher rates being interrupted twice by movements to lower the top marginal personal income tax rate.

The cycle of tax rate increases began in 1959 with Governor Pat Brown's increase in the top marginal income tax rate by one percentage point to 7 percent. Governor Reagan then continued increasing the top marginal income tax rate; first by three percentage points to 10 percent in 1967, and then by an additional percentage point to 11 percent in 1973.

Governor George Deukmejian was the first Governor since 1943 to reduce California's top marginal personal income tax rate. In 1986 Governor Deukmejian reduced the top rate to 9.3 percent. This tax reduction was short lived, however. Governor Pete Wilson raised the top income tax rate back to 11 percent in 1991; but, not wanting to leave office with the tax rate higher than when he entered office, he ushered in a reduction of the rate back to 9.3 percent in 1996.[31]

Governor Wilson's tax cut lasted until 2005. Subsequently, Governor Arnold Schwarzenegger (R) raised the top rate to 10.3 percent; and, Governor Jerry Brown (D) (via Prop 30) pushed the top tax rate to its current 13.3 percent, retroactively to the beginning of 2012 – ostensibly for seven years.

FIGURE 3
California's Personal Income Tax Rates
Top Marginal Tax Rate and Marginal Tax Rate for Households Earning Median Incomes[32]

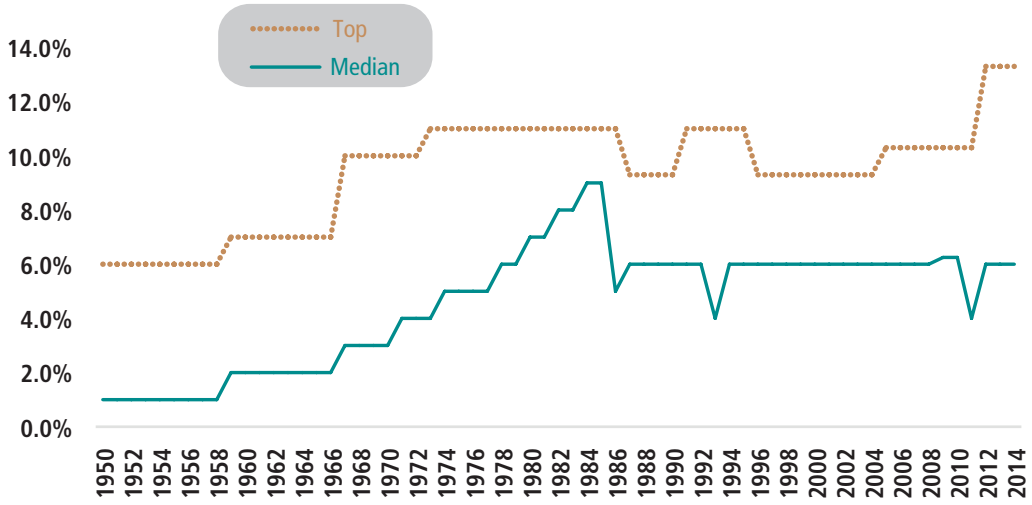


Figure 3 illustrates the significant increase in California's top marginal personal income tax rate during the post-WWII period. California's current top rate is more than twice as large as the rate back in 1950 (13.3 percent in 2014 versus 6.0 percent in 1950), and now resembles the anti-growth tax rate that prevailed in California during the Great Depression.

Figure 3 also raises a significant problem associated with California's progressive income tax (other problems with the progressivity of California's income tax are discussed in the state budget section below). The rampant inflation of the 1970s was reducing the real purchasing power of the incomes of Californians. But, in dollar terms, Californians' average incomes were rising quickly.[33] This had the adverse effect of pushing taxpayers into higher tax brackets and, therefore, imposing a higher tax rate on average taxpayers at the same time the purchasing power of their incomes was declining.

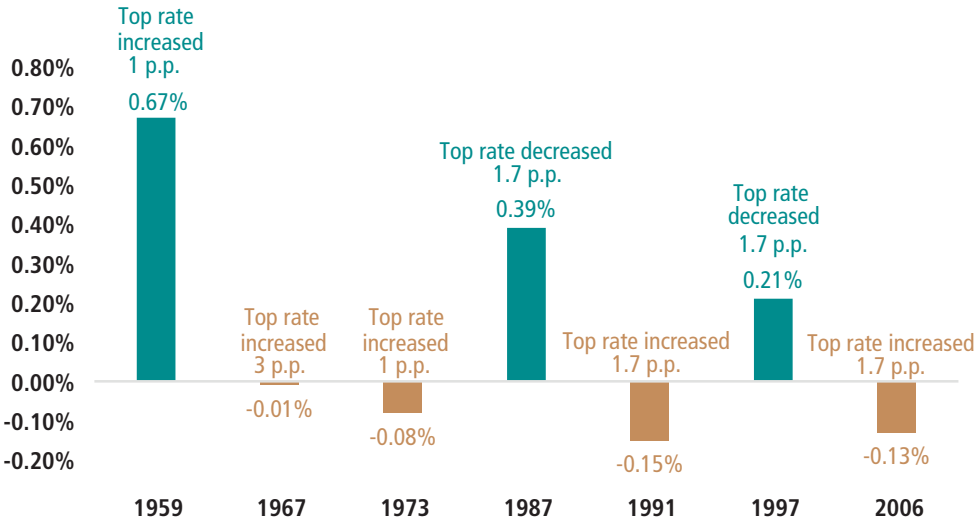
Rising tax burdens during recessions only worsen the economic climate; and California's steeply progressive income tax system encouraged this outcome. Unfortunately, California's tax system, while partially insulated against inflation today, still allows inflation to force taxpayers into higher tax brackets – an economically inefficient and arguably unfair tax policy.[34]

With respect to Prop 30, California's historical experience has illustrated a negative relationship between changes in California's top personal income tax rate and California's share of the total personal income earned in the U.S., see Figure 4. The periods when California reduced its top marginal personal income tax rate were periods when California's share of the total personal income earned in the U.S. grew. Conversely, the periods when California increased its top marginal personal income tax rate were periods when California's share of the total personal income earned in the U.S. declined.

The experience following the 1959 top tax rate increase varied slightly from this pattern. The 1950s were a period of strong tailwinds for California's economy – California's share of total personal income was 2 percentage points higher in 1959 compared with 1950.[35] Following the increase in California's top personal income tax rate in 1959, California's relative growth premium slowed down.

The growth in California's share of national income declined from 4.0 percent between 1956 and 1958 to 2.9 percent between 1959 and 1961. The increase in California's top marginal personal income tax rate was, consequently, associated with a slowdown in California's growth premium.

FIGURE 4
Change in California's Share of Total U.S. Personal Income (Average Share 3-years Following Tax Increase Minus Average Share 3-years Prior to Tax Increase)[36]



California's economic outcomes following changes in the top marginal personal income tax rate are not unique. The experience of all 50 states following increases in the top tax rate provides additional evidence.

Between 1970 and 2013, states changed their top marginal personal income tax rate 286 times.[37] Overwhelmingly, the economic performance of the states following changes in the top marginal personal income tax was consistent with California's experience.

Take Rhode Island for example. Rhode Island is an interesting example because it did not enact a state income tax until 1971. Following the enactment of its state income tax (with a top marginal tax rate of 10.5 percent), Rhode Island's relative share of total personal income declined. Effective 1971, Rhode Island's top marginal personal income tax rate went from zero, to 10.5 percent. Rhode Island's share of the national economy followed a predictable pattern (see Table 2):

- Rhode Island's share of total personal income was 0.47 percent following enactment compared to 0.48 percent of total personal income prior to enactment;
- Rhode Island's average share of total personal income for the first three years following enactment (between 1971 and 1973) was 0.46 percent, compared to an average of 0.48 percent over the three years prior to enactment (between 1968 and 1970); and,
- Rhode Island's share of total personal income for the first five years (between 1971 and 1975) following enactment was 0.44 percent, compared to an average of 0.48 percent over the five years preceding the enactment (between 1966 and 1970).

TABLE 2
Impact from Enacting Personal Income Tax in Rhode Island

	Rhode Island's Share of Total Personal Income (Prior Period)	Rhode Island's Share of Total Personal Income (Post Period)
1-Year Comparison	0.48%	0.47%
3-Year Comparison	0.48%	0.46%
5-Year Comparison	0.48%	0.44%

Table 2 summarizes Rhode Island's economic experience following the implementation of a personal income tax. Rhode Island's economy became smaller relative to the rest of the country – the same results that occurred in California following increases in the state's top marginal personal income tax rate. And, the growth differential expanded over time. These experiences are typical.

In order to assess the impact from all 286 instances when a state's top marginal personal income tax rate changed during the 1970 through 2013 period, a more formalized assessment was conducted (see Appendix I for a detailed review). This assessment examined the impact on each state's relative personal income growth rate following a change in the state's top personal income tax rate based on a regression analysis.

The results from the regression analysis illustrated that a change in the top marginal personal income tax rate had a significant and negative impact on a state's share of total national personal income over a 1-year, 3-year, and 5-year period.

Between 1970 and 2013, those states that raised the top marginal personal income tax rate saw their share of total personal income in the U.S. decline. Alternatively, those states that lowered the top marginal personal income tax rate saw their share of total personal income in the U.S. increase. Importantly, the negative impact from a tax rate increase grows over time such that the reduction in each state's share of total personal income is larger in the fifth year than the first year. The opposite is true for a tax rate reduction.

The historical experience of all 50 states, therefore, is consistent with California's experience – increases in a state's top marginal income tax rate reduces that state's relative personal income growth rate – and this impact gets more pronounced over time.

Quantifying this impact through 2017, the top marginal income tax rate increases contained in Prop 30 will likely reduce California's share of total U.S. personal income from 12.9 percent in 2012 to an estimated 12.7 percent in 2017.[38] Using the lower-end economic growth forecasts from the U.S. Federal Reserve as a guide, a decline in California's share of national personal income by 0.2 percentage points as of 2017 is consistent with a loss of $36.2 billion in potential income growth that will be foregone due to Prop 30 – the equivalent of $944 per current person living in California.[39]

The worsening income growth potential will also adversely impact California's housing market, employment prospects, and population growth.

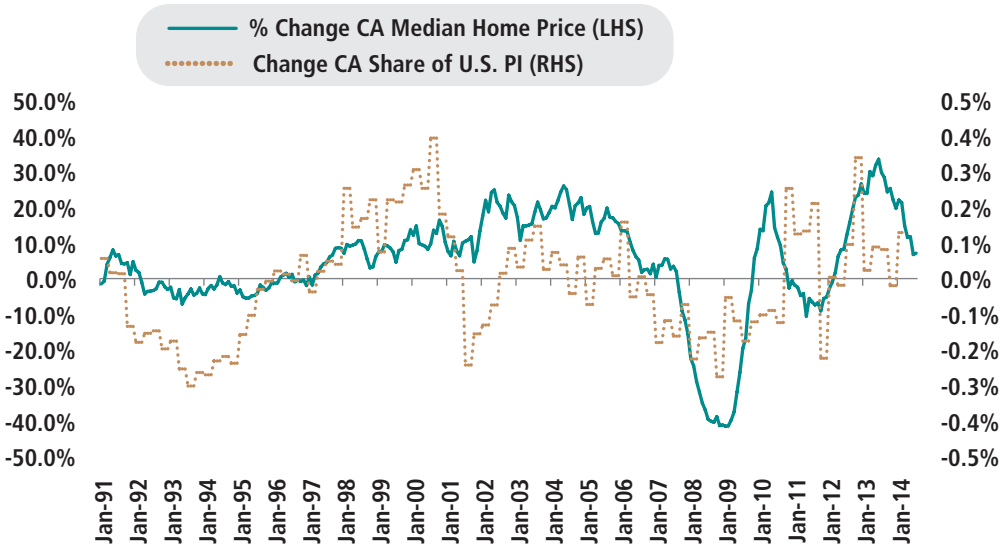
Starting with the housing market, California's anti-growth regulatory policies severely restrict supply and impose unnecessary burdens on California's housing market. Changes in home prices also move in tandem with changes in California's share of the national economy, however. When California's income growth is flourishing, California's housing market is robust. Conversely, when California's income growth is lagging the nation, prices for California's homes decline. Figure 5 illustrates the inter-connection between California's relative income growth and the growth in home prices in California.

Figure 5 compares the annual percent change in the price of California's median home between January 1990 and July 2014 to the quarterly change in California's share of total U.S. income over the same time period.[40] While some variations occur, changes in California's share of total U.S. personal income and changes in California's median home prices historically move in similar directions. Sustained home price growth in California is generally accompanied by California's share of total U.S. personal income rising, and periods of home price declines are generally accompanied by California's share of total U.S. personal income declining. And, this makes sense.

During California's prosperous times, the earnings of local residents are rising. Furthermore, the trend of people to move to California from across the country accelerates. Both trends tend to drive up both the relative income of Californians as well as the value of California homes.[41]

Prop 30 will have the opposite effect. The higher tax rates associated with Prop 30 will diminish California's relative income growth and, consequently, will exert downward pressure on home prices throughout the state.

FIGURE 5
Change in California's Share of Total U.S. Personal Income Compared to the Year-over-Year Percent Change in California's Median Home Price[42]

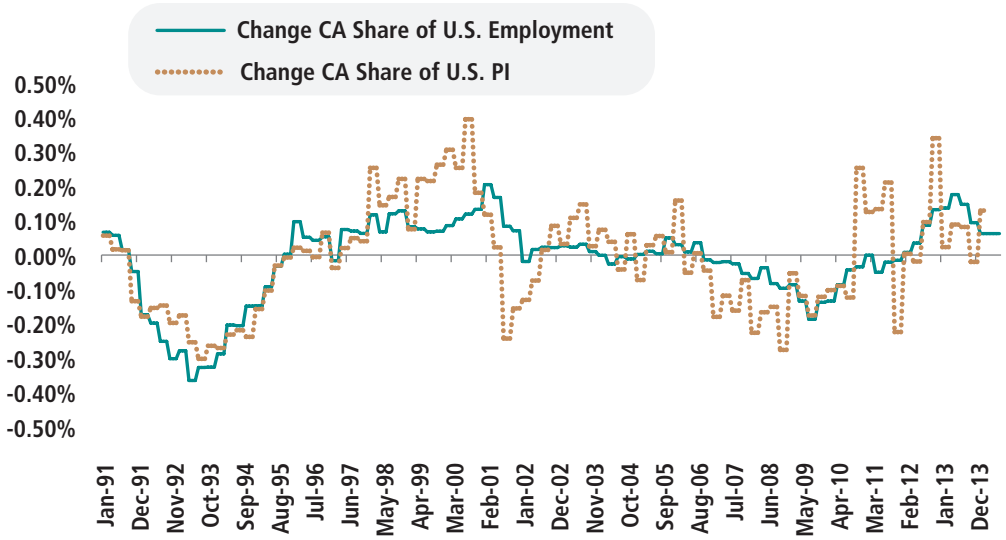


There is growing evidence that downward pressure on real estate prices is already occurring. For instance,

> On the Nevada side of Lake Tahoe, where there is no state income tax, 151 homes sold for more than $1 million in 2013. That was 86 percent higher than the previous year. On the California side, only 67 homes sold for more than $1 million, down 9 percent from 2012, according to Susan Lowe, a broker with Chase International.[43]

There is an even stronger connection between California's relative growth in employment and California's relative growth in personal income. Sustained income growth requires sustained employment growth, and vice versa. Consequently, California's employment market will also suffer as a result of Prop 30.

FIGURE 6
Change in California's Share of Total U.S. Personal Income Compared to Change in California's Share of Total Non-farm Employment[44]



Similarly, California's population flows are correlated with changes in the top marginal personal income tax rate. The ultimate arbiter of a state's desirability is whether people want to live there. And, California was once a population magnet. In 1950, 7.0 percent of the U.S. population lived in California.[45] By 1990, 12.0 percent of the U.S. population lived in California; since 1990 California's share of the U.S. population has been flat, although not without short-term volatility, see Figure 7.

FIGURE 7
California's Share of U.S. Population[46]

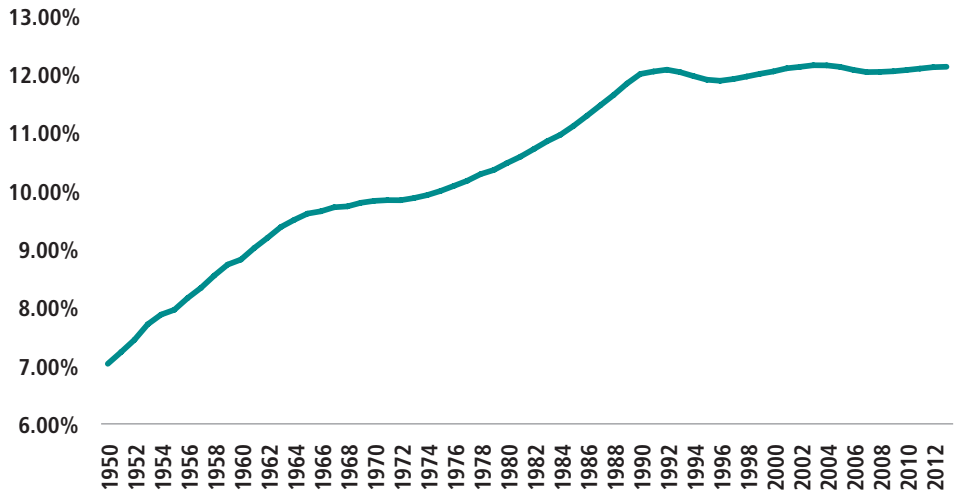


Figure 7 also reveals that there were several deviations from California's upward population growth trend between 1950 and 1990. With respect to Prop 30, changes in the top marginal personal income tax rate are also correlated with changes in California's population growth rate. And, some of the most sensitive emigrants are wealthier individuals that would have been subject to Prop 30 had they remained in California. Such considerations are particularly relevant for professional athletes. For instance,

> Under a hypothetical calculation, the tax difference for a single professional athlete making roughly $10 million a year between being a resident of California versus Florida is around $800,000 annually.
>
> "They'll start to see it more from paycheck to paycheck," Karaffa said of the state's tax bite. "And it'll actually help my practice because guys will ask more questions and be more attuned to this. You'll see more attention paid from professional athletes to their taxes this year because this is their largest expense."[47]

In another example:

> Former Los Angeles Angels outfielder Torii Hunter, who recently signed with the Detroit Tigers, made headlines last year when he announced a move to Texas because of the state's lack of income tax.
>
> Hunter did save taxes on his $12 million salary by leaving California to sign with Detroit, where the Michigan state income tax is a flat 4.35 percent. And more and more ballplayers are taking taxes into account when signing with new teams or giving their teams permission to trade them.[48]

Then there is the story of Phil Mickelson. Although he quickly apologized for claiming that Prop 30's tax rate was excessive,

> Just the increase of the top bracket to 13.3 percent from 10.3 percent cost Mickelson roughly $1.8 million of his $60 million income for 2012.
>
> Mickelson's longtime rival, Tiger Woods, acknowledged last week that he left California for Florida in 1996 upon turning pro because of the difference in state tax. At the time, California's top rate was 9.3 percent for individuals earning more than $32,000. Woods, who earned $56.4 million in 2012, kept roughly $7.5 million this year in funds he otherwise would have owed to the state of California. Mickelson, who will now pay the 13.3 percent rate, will owe the state about $8 million.[49]

As Table 3 illustrates, except for the 1.0 percentage point tax increase in 1973, California's share of the national population has followed a consistent pattern following every other change in California's top marginal personal income tax rate. The 3-year average population growth rate following a tax rate increase was lower than the 3-year average population growth rate just prior to a tax rate increase. The reverse was true following a tax rate decrease.

TABLE 3
Change in California's Share of the U.S. Population Before and After Changes In California's Top Marginal Personal Income Tax Rate
(3-Year Average Change)

	Tax Change (in percentage points)	Change in California's Share of Population
1959	1.0	-0.04%
1967	3.0	-0.04%
1973	1.0	0.04%
1987	(1.7)	0.04%
1991	1.7	-0.17%
1997	(1.7)	0.09%
2006	1.7	-0.03%

Adjusting for the broader national economic trends, there is a clear relationship between California's personal income tax and its relative economic performance. There is no reason to believe California's economic experience with Prop 30 will be any different.

California's economic recovery has been weaker than the national recovery.[50] This sub-par economic performance is the expected outcome from Prop 30's tax increases, and should therefore be expected to persist, and worsen, over the next several years. The likely result will be slower growth in incomes, employment, and home values.

THE HISTORY OF CALIFORNIA'S TAX BURDEN AND STATE BUDGET PERFORMANCE

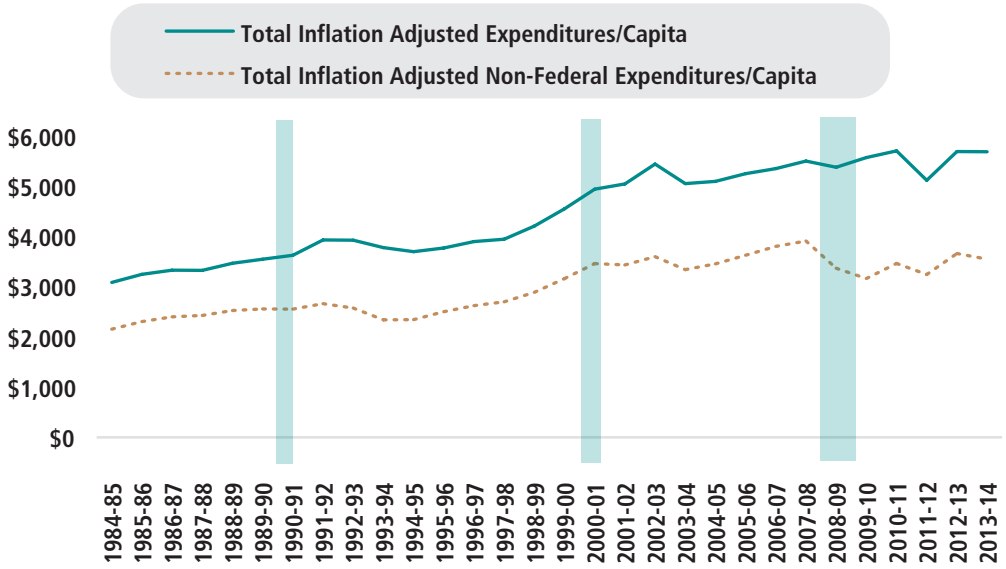
California's state budget is not immune from Prop 30's adverse effects. Prop 30 worsens two significant problems facing California's budget. First, California's budget is already plagued with excessive rigidity making effective budgeting difficult. Prop 30 created greater budget rigidity, which is making effective budgeting even more difficult for the state. Second, Prop 30 exacerbates the volatility problems that also already plague California's budget.

The premise of Prop 30 was that more expenditures on education were necessary. According to Ballotpedia.org an example of the pro-Prop 30 argument is: "Without Prop 30, our schools and colleges face an additional $6 billion in devastating cuts this year. Prop 30 is the only initiative that prevents those cuts and provides billions in new funding for our schools starting this year—money that can be spent on smaller class sizes, up-to-date textbooks, and rehiring teachers."[51]

Revenue Growth and Spending Prioritization

What the proponents of Prop 30 failed to consider is that California's budget problems were not about revenues. Between the 1984-85 budget year and the 2013-14 budget year, total expenditures in California from all funds adjusted for inflation and population grew 2.1 percent a year, see Figure 8. Excluding Federal Funds, total expenditures adjusted for inflation and population grew 1.7 percent a year – and this includes the steep drop in inflation-adjusted expenditures per capita following the 2008-09 recession. This means that, on average, the California legislature was empowered to increase real spending per Californian by 2.1 percent each and every year over this time period.

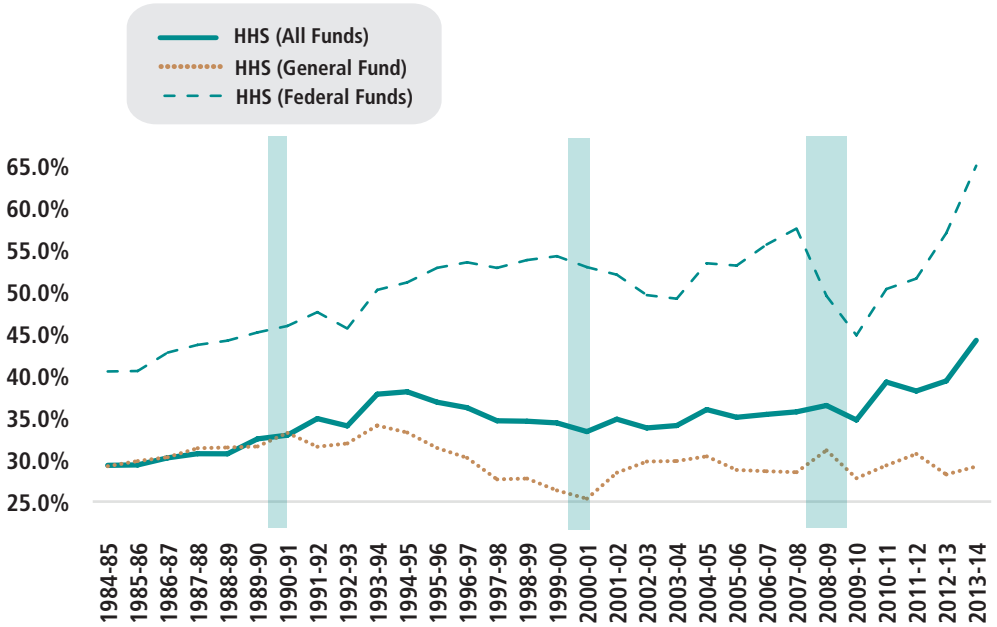
FIGURE 8
Total Inflation Adjusted Expenditures Per Capita
California State Budget: All Funds and Non-Federal Funds
(1984-85 through 2013-14)[52]



California's problem is a lack of effective budgeting. Overly-restrictive budget rules and lack of spending control in other budget areas (especially health care) are driving California's budget problems and crowding out spending on everything else.

For instance, back in the 1984-85 budget, Health and Human Services (HHS) expenditures accounted for 29 percent of total state expenditures from All Funds. By the 2013-14 budget, HHS expenditures accounted for 44 percent of total state expenditures from All Funds, see Figure 9.

FIGURE 9
Total HHS Expenditures as a Percentage of Total Expenditures California State Budget: All Funds, Federal Funds, and General Fund (1984-85 through 2013-14)[53]



Federal funds are currently providing the lion's share of the HHS revenue growth. HHS expenditures are 29 percent of total state expenditures from the General Fund in 2013-14 – the same share as 1984-85. However, HHS expenditures still comprised 7.2 percentage points more of the total California funded portion of the budget (all non-Federal Funds) in 2013-14 compared to 1984-85. Furthermore, expenditures from all non-Federal Funds is 4.0 percentage points higher than just a decade ago.

Additionally, a large share of the growth in HHS expenditure support from Federal Funds has occurred post-passage of the Affordable Care Act. And, this growth creates a future risk to California's budget.

In response to the Affordable Care Act, California has expanded Medi-Cal to more than 1.4 million additional residents.[54] However, as Charles Blahous (2013) noted:

> Medicaid, CHIP, and the ACA's new health exchange subsidies are all leading contributors to the mounting federal fiscal problem. To return the federal budget to sustainable historical norms in the absence of any cuts in the growth of Medicaid and the new health

> exchanges would require all other non-interest spending to be cut by nearly one-quarter by 2037 relative to projected levels, and by roughly 15 percent relative to current levels in relation to GDP. This is probably unrealistic.
>
> There also appears to be general bipartisan agreement that the current path of federal Medicaid spending is unsustainable and must be slowed. Constraints on Medicaid spending growth have been proposed in President Obama's submitted budgets, in the recommendations of the bipartisan Simpson–Bowles Commission, and in the budget resolution passed by the House of Representatives in 2012. The projected cost savings vary widely between these proposals, but each would trim a minimum of $100 billion from the projected cost of Medicaid over the coming decade, though practical budgetary considerations suggest that substantially greater savings will be needed.
>
> Though reductions in the growth of federal Medicaid spending are nearly certain, the extent to which they would result in increased state Medicaid costs cannot be precisely quantified. It is reasonable for states to expect, however, that these reductions could result in their carrying additional costs of the same order of magnitude as the ACA's Medicaid expansion.[55]

Should the federal government reduce its support of California's expanded Medi-Cal population, this will pressure California's budget even more.[56]

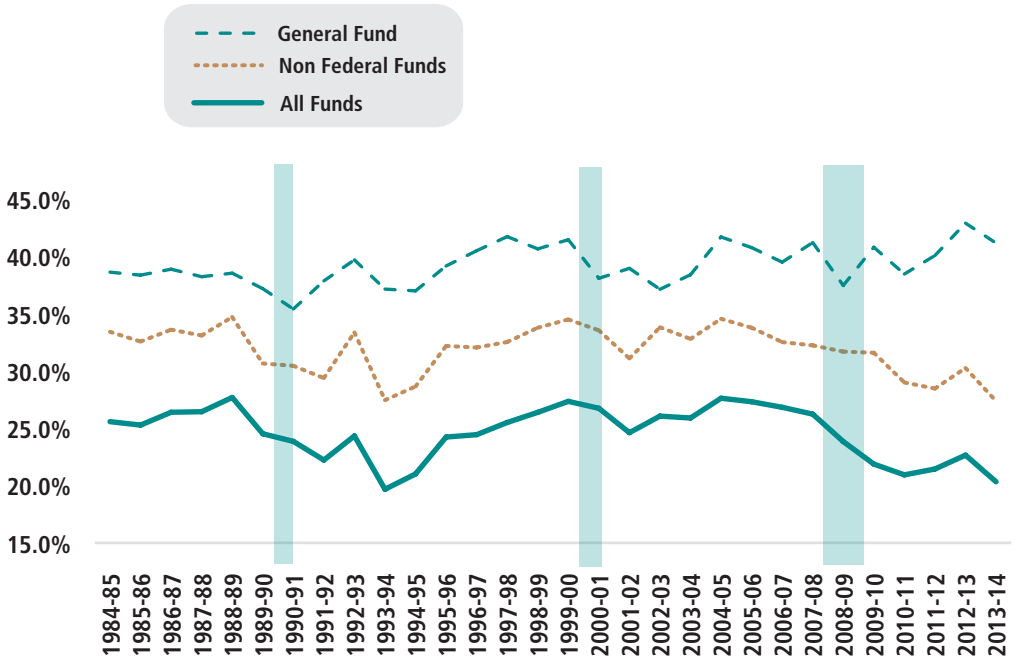
These budget warnings were echoed in a recent *Bloomberg* article stating that:

> The largest spending growth is in Medi-Cal, which is California's version of Medicaid. The program is the state's second-largest and fastest-rising expenditure, and accounts for most of the Department of Health Care Services' outlays, which grew 65 percent over the six-year period, to $24 billion a year, from $14 billion.
>
> Worse, the increase in Medi-Cal costs occurred before implementation of the Patient Protection and Affordable Care Act. The law is expected to cost the state budget an additional $2 billion to $4 billion in health-care spending a year, according to the Rand Corp. That means even less money for California's colleges and universities, parks, courts, transportation, environment, and welfare, and even more pressure for fee and tax increases.[57]

Budgets are about trade-offs. During the same time period that HHS expenditures have been becoming a larger share of California's budget, which was also a time of expanding resources available to the state budget, California has de-emphasized education spending as a share of the budget, see Figure 10.

FIGURE 10

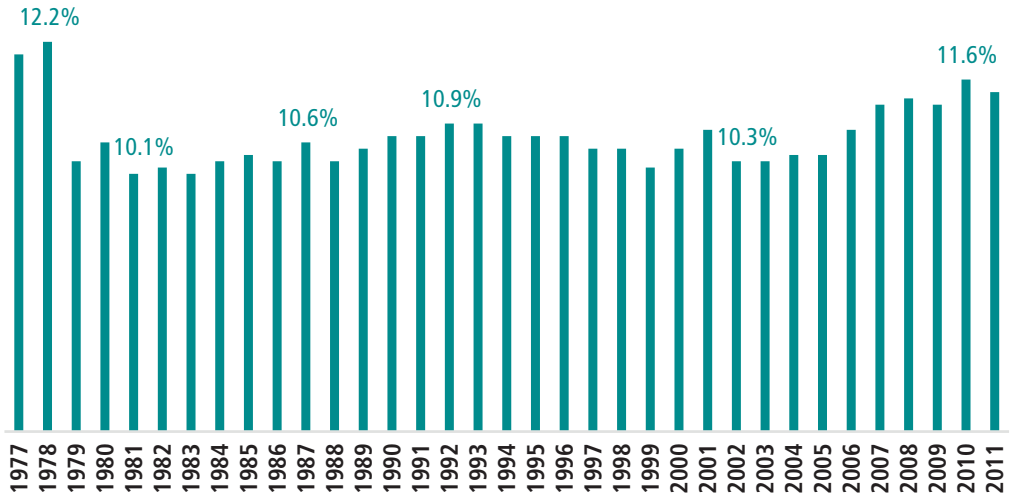
Total K-12 Expenditures as a Percentage of Total Expenditures-California State Budget: All Funds, Non-Federal Funds, and General Fund (1984-85 through 2013-14)[58]



While the General Fund has maintained its required 40 percent funding threshold (under Prop 98), California's total budget (both including and excluding Federal Funds) has been emphasizing other budget areas rather than K-12 education expenditures for nearly a decade.

This emphasis on other expenditures should not be confused with a revenue issue, however, which is what Prop 30 has done. As Figure 8 illustrated, the inflation-adjusted amount of money at California state government's disposal is near all-time highs. As Figure 11 illustrates, the state and local tax burden on California's residents was similarly growing. Californians were already enduring the fourth largest tax burden in the country behind New York, New Jersey, and Connecticut prior to the implementation of Prop 30.

FIGURE 11
California State and Local Tax Burden
(1977 through 2011)[59]



With respect to Prop 30, the fact that California's tax burden was already among the highest in the nation, the top marginal income tax rates were the highest state tax rates in the nation, and, the state's inflation-adjusted per capita expenditures were around all-time highs all illustrated that Prop 30's premise—that additional state revenues were necessary—were simply false.

What is driving California's spending growth is health care. In fact, California's health care spending is crowding out all other spending priorities. The spending for Health and Human Services is nearly 45 percent of the budget and due to the mandates from the Affordable Care Act, health care spending will likely continue to expand in the future.

The Problem with Earmarking Revenues

Prop 30 has worsened the budget rigidity problem. In the short-term, the higher tax rates are earmarked toward education programs. The adverse income impact discussed above implies that the revenues available to the education programs will be less than anticipated. Whatever revenues that are raised, however, must be spent on the education budget line item regardless of any other pressing revenue needs. Consequently, it will be difficult to fund any other pressing (perhaps unforeseen) spending priorities such as for corrections or transportation projects.

Furthermore, it may be difficult to allow the tax rate increases to sunset because specific spending programs will be attached to the new (and highest in the country) income tax rates. Greater pressure for higher tax rates, and higher state expenditure growth, now exists due to the passage of Prop 30.

To a large extent, the drive for Prop 30 arose due to the budget inflexibility that Prop 30 has only worsened. California's history is replete with examples of earmarked budget revenues failing to achieve the purported goals of the enabling legislation. This raises questions regarding whether the revenue raised from Prop 30 will be spent effectively.

One example of this problem occurred following the passage of Proposition 63 "The Millionaire's Tax" initiative of 2004. Prop 63 taxed people earning more than $1 million a year an additional 1 percentage point with the goal of funding mental health services. As a result of the Millionaire's Tax, California now spends $7.4 billion a year on mental health care.

The mental health care programs are designed to treat people who would otherwise be left to fend for themselves, burden their families, or move in and out of jail. However, oversight on these expenditures has been severely lacking. In an editorial, the *San Francisco Examiner* wrote "… no one in state government has bothered to account for all the money that has been spent. No one knows how much money has been directed to frivolous enterprises."[60]

It was also reported in the *Orange County Register* on January 22, 2013 that the California Taxpayers Association said Governor Jerry Brown has offered no explanation why Prop. 63 will bring in only $1.194 billion, rather than the projected $1.349 billion in 2012/13. CalTax said they suspect it is because fewer millionaires are paying California taxes.

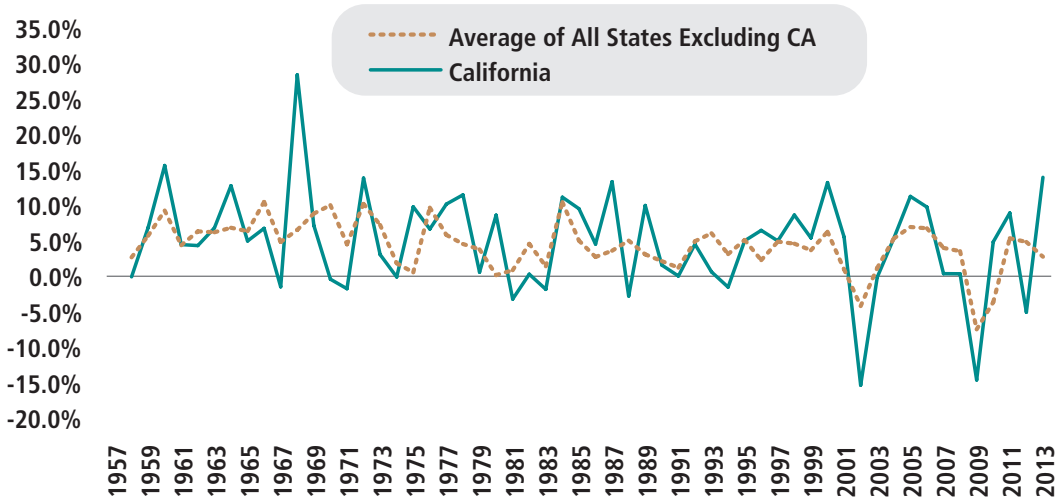
Propositions, such as 63 and 30, bind taxpayers to fund certain programs regardless of their effectiveness or whether they are still needed; or whether there are other more pressing problems that the state should be addressing. Additionally, earmarked revenues tend to raise the overall cost of government; and tend to increase the incidence of fraud, waste, and abuse within government programs.

Earmarks and other poor budgeting practices have had several adverse consequences for Californians, including a stronger underlying bias toward higher government taxing and spending; a budget that is more rigid and less able to adapt to the changing values and needs of Californians over time; and, an increase in the prevalence of spending waste and abuse in the state budget.

The Budget Consequences from California's Progressive Tax System

As noted in the introduction, California's budget is highly volatile, and this volatility comes with a cost. Figure 12 illustrates the volatile nature of California's state budget. Using U.S. Census state expenditure data (for comparability) Figure 12 compares the annual percent change in total tax revenue (adjusted for inflation) in California to the average of the annual percent change in total tax revenue (adjusted for inflation) in the other 49 states. As Figure 12 clearly shows, compared to the average state, California's tax revenues are highly volatile. During times of robust personal income growth, tax revenues surge; however, during times when personal income is stagnating or declining, tax revenues collapse. This volatile tax system is a function of California's highly progressive tax system.

FIGURE 12
Annual Percent Change in Inflation-Adjusted Total Tax Revenue
California Compared to Arithmetic Average Change in the Other 49 States(1957 through 2013)[61]



As Laffer and Winegarden (2012) noted with respect to California:

> The tax code is steeply progressive, with the highest 10 percent of income earners paying almost 75 percent of all tax revenues resulting from the income tax. This tax structure showers riches on the state during periods of prosperity, which are of course immediately spent. Then when the downturn comes – as it inevitably does – state revenues are reduced disproportionately because of the loss of the high income earners.
>
> Progressive taxes, because they automatically increase taxes as a share of income as income rises, also lead to a higher overall share of output going to the government than the electorate would prefer. Tax cuts are never as popular with politicians in good times as are tax increases in bad times. Volatile revenues – the alter ego of progressive taxes – inextricably lead to big government by increasing spending during prosperity and ratcheting up tax rates during slow times.[62]

The data presented above confirm these observations. Over time, California's tax revenues are growing faster than Californian's incomes (Figures 1 and 8) and creating excessive volatility on California's state budget (Figure 12). These observations are pertinent because Prop 30 worsened this situation. By raising the top tax rate significantly, and retroactively, California ensured a revenue surge in 2012 that will lead to a further slowdown in income growth and revenue crashes during the next economic slowdown – if not sooner.

PROPOSITION 30'S CONSEQUENCES: THE SEVEN LEAN YEARS TO COME

Prop. 30 exemplifies California's typical response to state budget problems. Periods of strong economic growth, coupled with California's progressive income tax, lead to surging state revenues. Giddy from the surge in revenues, the politicians in Sacramento turn short-term revenue surges into long-term spending commitments that are unaffordable. When the economic booms lose steam, as economic booms do, California's tax revenues crash to a larger extent than income, see Figure 12, setting the state up for a budget crisis.

In response to the budget crisis, tax rates are increased. And, due to these pressures, California now has the highest income tax rates in the country, the 8th highest sales tax rate in the country, and the 4th highest overall tax burden in the country. The high tax rates worsen California's economic incentives leading to slower economic performance and a strong incentive for California's entrepreneurs to leave the state. In fact, as of February 2013,

> According to the Greater Austin Chamber of Commerce, since the passage of Prop 30 in the November (2012) election, California-based company relocation inquiries have doubled, possibly tripled, in Central Texas. West Coast entrepreneurs feeling the personal financial stress of an out-of-control state budget and tax policy have heard Texas' message, and they're responding.[63]

These incentives are worsened by the plethora of earmarks that reduce the legislature's budget flexibility. The budget inflexibility leads to both wasteful spending as well as pressure to raise taxes to fund other government projects.

In response to the economic and budgetary problems caused by the housing bust and recession of 2008, Prop 30 offered more of the same. As opposed to implementing effective budgeting practices across the business cycle, Prop 30 raised taxes, ostensibly for seven years, and increased budget inflexibility. By raising the top marginal tax rate, California's economic incentives were weakened.

Without change, the consequences will be slower employment and income growth, declining housing values, and more budget instability – the seven lean years of Prop 30.

California can change this path and revitalize its entrepreneurial spirit, however. Instead of Prop 30's approach of raising tax rates and increasing budget complexity, effective fiscal reforms should be implemented.

First, California's budget sclerosis should be addressed. A primary cause of California's budget sclerosis is the plethora of spending requirements and revenue earmarks that make it very difficult for legislators to effectively prioritize state spending. These spending requirements and budget earmarks should be repealed.

There are also too many Commissions in California that are either over-reaching their intended authority or outliving their intended purpose. These Commissions are also wasting valuable budgetary funds. Therefore, sunset provisions should be imposed upon all California Commissions.

Once a Commission has reached the end of its designated charter, any Commission whose mission is still deemed valuable could then be renewed. A sunset provision would make it easier, however, for the legislature to ensure that every Commission is still fulfilling its designed purpose, and that the purpose of the Commission is still needed.

Improving California's budget process empowers the legislature to spend the taxpayers' money more wisely and establish spending priorities (such as a greater emphasis on education) that more accurately reflect voters' preferences.

Second, fiscal reforms should reduce the anti-growth incentives of California's tax code. The starting point should be a reduction in marginal tax rates that brings California's tax bite closer, and preferably below, the current national average. Ideally, the tax reforms would transform California's progressive income tax system into a flat income tax system. Such tax reforms will improve incentives for working, saving, and investing in California.

Concurrent with a tax rate reduction, the inefficient narrowing of California's tax base (the alter-ego of a progressive tax system) should be addressed. California's high marginal income tax rates coupled with the narrow tax base inefficiently alters people's economic decisions by encouraging them to engage in activities that minimize their heavy tax burdens, often at the expense of activities that maximize economic value. This combination also exerts consistent pressure to raise marginal tax rates to offset the inefficiently narrow tax base – pressure that manifests into policies such as Prop 30. Broadening California's tax base will reduce these inefficiencies.

Effective tax reform will incent more entrepreneurship and investment in California creating a more robust state economy. Stronger economic growth will improve the well-being of Californians and, due to the expanding economic base, will further improve the state's finances. In such a healthy economic environment, pressing problems – such as the need to adequately fund education – can also be addressed more effectively.

Without change, the consequences will be slower employment and income growth, declining housing values, and more budget instability – the seven lean years of Prop 30.

Effective budget and tax reforms that reduce the budget inflexibility and improve the incentives to work, save, and invest in California, when coupled with California's natural advantages, will help California regain its position as a national economic leader.

APPENDIX I: REGRESSION METHODOLOGY AND RESULTS

The statistical analysis examined the impact from a change in a state's top marginal personal income tax rate on that state's rate of personal income growth. Based on the economic theory discussed in the paper, the expected sign for the change in the top marginal income tax rate variable is negative – a state should experience slower personal income growth following a tax rate increase and faster personal income growth following a tax rate decrease.

Tax changes between 1970 and 2013 were included in the analysis. As discussed above, national economic trends impact state economic performance, and national economic performance varied widely over this time period. Consequently, personal income growth in all states would be expected to be lower during recessions (such as the 1981 recession) than during periods of robust economic growth (such as during the 1990s' Internet boom). To adjust for the differences in overall national economic performance that occurred during the time period of the analysis, the change in each state's share of the country's total personal income is used to measure personal income growth.

Of course, factors other than taxes influence relative personal income growth across the states. Some factors are under the influence of state policy makers (such as the regulatory environment or overall tax burden) and other factors are not (such as geographical location or resource endowments). Additionally, the consequences from these trends (both good and bad) tend to persist over time. To account for these impacts, the average change in a state's share of total personal income over the previous five-year period is included in the analysis (trend).

The expected sign for the trend variable is positive – a state's relative economic performance for the next year should be similar to the state's relative economic performance from the previous five-years. Therefore, states that are exhibiting rapid growth, such as California in the 1950s, should be expected to continue exhibiting rapid growth; whereas those states facing economic decline, such as Michigan in the 1990s, should be expected to continue exhibiting economic decline.

The size of states also matters. For instance, California accounted for 12.9 percent of total personal income in 2013 whereas Wyoming accounted for 0.21 percent of total personal income in 2013.[64] Therefore, a 0.2 percentage point increase in California's share of total personal income is much less transformative to California's economy than it would be to Wyoming's economy. To account for the size differences the change in each state's share of total personal income before and after a tax change are examined relative to the state's share of total personal income just prior to the tax change.

The impact from the change in tax rates could differ over time. To examine the difference over different time periods, the relative change in each state's share of total personal income is measured three different ways.

First the impact is examined for the year the tax change is implemented compared to the year just prior to the tax change.

Two longer time periods are examined to see if there is a longer-term impact from any tax change and to smooth out any short-term volatility that could arise from significant tax changes. For instance, if a tax increase were known in advance, people could realize more capital income gains in the year prior to the tax increase and, consequently, fewer capital gains would be realized in the first year following the tax increase's implementation. This incentive would cause the state's share of personal income to look artificially high in the previous year and artificially low in the year of the tax change. The opposite incentive would exist for a tax cut.

To adjust for these incentives, and to examine whether there are longer-term impacts from a change in a state's top marginal personal income tax rate, the change in a state's relative average share of total personal income for a three-year period and a five-year period is examined.[65] Consequently, the analysis was run once for each timeframe.

The analysis performed was a linear multi-variable regression. The results from the tests are presented in Tables A1 through A3. Both the trend and change in the top marginal income tax rate variables were statistically significant and had the expected signs across all three timeframes. The coefficient on the change in the marginal income tax rate variable was greater the longer the timeframe, implying that the negative impact from an increase in the top marginal income tax rate (or the positive impact from a decrease in the top marginal income tax rate) is stronger for a 3-year period compared to a 1-year period; and stronger for a 5-year period compared to a 3-year period.

TABLE A1
Regression Results 1-Year Impact

Included observations: 286
Dependent Variable: Change in state share of personal income

	Coefficient	Std. Error	t-Statistic	Prob.
Trend	0.747292	0.103711	7.205549	0
Change in the Top PIT Rate	-0.273967	0.076162	-3.597153	0.0004
R-squared	0.1803			
Adjusted R-squared	0.177414			
Durbin-Watson stat	2.011951			

TABLE A2
Regression Results 3-Year Impact

Included observations: 273
Dependent Variable: Change in state share of personal income

	Coefficient	Std. Error	t-Statistic	Prob.
Trend	1.680842	0.131194	12.81184	0
Change in the Top PIT Rate	-0.4789	0.094601	-5.062292	0
R-squared	0.401938			
Adjusted R-squared	0.399731			
Durbin-Watson stat	1.984288			

TABLE A3
Regression Results 5-Year Impact

Included observations: 265
Dependent Variable: Change in state share of personal income

	Coefficient	Std. Error	t-Statistic	Prob.
Trend	2.735855736	0.152533657	17.93607913	1.56E-47
Change in the Top PIT Rate	-0.600108093	0.111228155	-5.395289468	1.53E-07
R-squared	0.557829316			
Adjusted R-squared	0.556148059			
Durbin-Watson stat	2.033203893			

APPENDIX II: A REVIEW OF THE LITERATURE – TAX POLICY MATTERS FOR ECONOMIC GROWTH

Fiscal policies — governments' spending and taxing decisions — significantly impact relative economic growth rates. Not surprisingly, an extensive literature examining the impact from alternative fiscal policies on relative economic growth rates has emerged. In fact, the impact from fiscal policies on the economy has been a core part of economic analysis beginning with Adam Smith in 1776.

Many studies have found a negative relationship between government spending and economic growth including: Barro (1991), Gwartney, Lawson, and Holcombe (1998), Laffer (1971), Laffer (1979), Landau (1983), Mitchell (2005), and Scully (2006).[66]

This review, however, examines the impact from taxes (not spending) on economic growth. Many studies have also found a significant and negative relationship between higher government taxes and lower rates of economic growth.

Nobel laureate Edward Prescott uses a Growth Accounting framework to measure the impact of taxes on the economy.[67] Growth Accounting decomposes the drivers of growth into three primary factors: labor, capital, and technology. Prescott uses this decomposition to evaluate the impact from alternative tax rates on labor, capital, and technology on economic growth from a national perspective – particularly the causes of economic depressions. For instance, Prescott (2002) finds:

> The United States is prosperous relative to France because the U.S. intra-temporal tax wedge that distorts the tradeoff between consumption and leisure is much smaller than the French wedge. I will show that if France modified its intra-temporal tax wedge so that its value was the same as the U.S. value, French welfare in consumption equivalents would increase by 19 percent. Consumption would have to increase by 19 percent now and in all future periods to achieve as large a welfare gain as that resulting from this tax reform.
>
> The United States is prosperous relative to Japan because production efficiency is higher in the United States. In the United States, total factor productivity is approximately 20 percent higher than in Japan. If Japan suddenly became as efficient in production as the United States, its welfare gain in consumption equivalents would be 39 percent.

Prescott finds that tax policies matter because taxes impact the incentive to work, innovate, and accumulate capital. Countries whose tax policies discriminate against any of these factors of production discriminate against economic growth. Countries that impose significantly onerous tax policies (such as the labor taxes in France or the tax discrimination against productivity in Japan) risk "economic depressions" according to Prescott.

Mankiw and Weinzierl (2005) examined the dynamic impacts from tax cuts in a 2005 paper.[68] They found that in nearly all cases, tax cuts are partly self-financing due to the economy's dynamic responses – the lower tax rates appreciably increased the economy's rate of growth.

Romer and Romer (2007) examined the changes in the level of taxation on economic activity.[69] However, outside influences impact both economic growth and tax rates. Romer and Romer control for these biases by performing a narrative analysis. The narrative analysis reviews the motivation for all post-World War II tax changes and examines only those tax changes that were not motivated by economic conditions – therefore, the biases connecting these tax changes and economic growth would be less. The authors find that "tax increases are highly contractionary. The effects are strongly significant, highly robust, and much larger than those obtained using broader measures of tax changes. The large effect stems in considerable part from a powerful negative effect of tax increases on investment."[70]

Robbins and Robbins, in a series of papers, illustrates that there is an elastic response between taxes and labor supply and capital accumulation.[71] In this series of papers, Robbins and Robbins examine the relationship between taxes and savings, capital accumulation, and overall economic growth. The initial paper, (Report #131) updates an analysis by Boskin (1978). Boskin found the elasticity of savings between 1929 and 1969 was 0.4 – a 10 percent increase in the return to savings would cause a 4 percent increase in savings.

Robbins and Robbins estimate the return to savings as the return to all capital, which includes the returns to both equity and debt. Between 1947 and 1994 the average after-tax return to capital was 5.4 percent according to Robbins and Robbins. Perhaps just as important, the private savings rate over this time period moves in lock-step with changes in the after-tax return to capital – when the after-tax return to capital rises, the savings rate rises; and when the after-tax return to capital falls, the savings rate falls. In fact, Robbins and Robbins find that the elasticity of savings between 1949 and 1994 was 2.5 times greater than Boskin's (1978) estimates – between 0.7 and 1.1.

In the *TaxAction Analysis Policy Report #134*, Robbins and Robbins use their earlier results to link savings' sensitivity to changes in the after-tax rate of return (i.e. tax policy) and investment. However, since investment is driven by the marginal after-tax rate of return (not the average), Robbins and Robbins estimate the marginal after-tax rate of return from 1954 – 1995. Robbins and Robbins find that changes in the capital stock are very sensitive to changes in after-tax rate of return. On average, the long-run marginal after-tax rate of return to capital has been 3.4 percent. Furthermore, in response to tax policy changes, the capital stock adjusts quickly bringing the marginal after-tax rate of return back to the long-run average. Typically, this process is completed within five years according to Robbins and Robbins.

Robbins and Robbins (1996) leverage the estimates from *Policy Report #131 & #134* to derive a dynamic macroeconomic model of the U.S. economy. This model is predicated on changes in savings, investment, and capital formation being significantly more sensitive to their after-tax returns than the papers summarized above. Consequently, Robbins and Robbins (1996) finds that tax reforms that reduced the disincentives to savings would have a large and positive impact on economic growth.

Barber and Odean (2003) examined investors' responsiveness to tax policies.[72] Specifically, Barber and Odean examine whether "individual investors consider taxes when making asset location decisions", finding evidence that investors are sensitive to the tax implications of asset allocations. For instance, investors tend to locate assets that tend to provide annual taxable income distributions (such as taxable bonds and mutual funds) in tax free retirement accounts.

Desai and Gentry (2003a) investigate the relationship between taxes and economic growth by examining whether corporations respond to capital gains taxes.[73] Desai and Gentry establish that capital gains' taxes impact the incentives of companies:

> The taxation of corporate capital gains affects incentives in three broad categories. First, it affects 'real' decisions that impact investment and financing decisions and the allocation of capital across firms and throughout the economy. Second, taxes can affect the timing of corporate decisions. Third, tax policy towards corporate capital gains can affect corporate tax planning activities.[74]

Desai and Gentry conclude that:

> Corporate capital gains realizations are a significant component of corporate cash flow and increasingly so. Net long-term capital gains are significant compared to individual capital gains and are gaining in relative importance. As this paper outlines, the distortionary effects of such taxes largely subsume those associated with individual capital gains. Specifically, lock-in effects at the corporate level may alter productivity levels by changing the patterns of corporate and asset ownership in a manner that taxes on individual capital gains do not.
>
> The time series analysis of this paper suggests that the elasticities of corporate realizations to tax costs are higher than those derived in similar equations used to estimate the elasticities of individual capital gains. Micro analysis further suggests that firms time their sales and magnitudes of investments and PPE opportunistically. Moreover, the micro analysis suggests that the realization of gains appears to be particularly shaped by tax incentives. In sum, the corporate capital gains tax regime appears to significantly influence the decisions of firms to dispose of assets and realize gains and losses.[75]

Desai and Hines (2003b) examine the implications of taxing business income in a manner that is not consistent with international norms.[76] Desai and Hines posit that alternative tax treatments across countries impact the level and ownership of foreign direct investment (FDI). Specifically,

> Home–country taxation has the potential to affect the ownership of foreign assets by changing after–tax returns and thereby inducing the substitution of one investment for another. As a general matter, investors from countries that exempt foreign income from taxation have the most to gain from locating their foreign investments in low–tax countries, since such investors benefit in full from any foreign tax savings. Investors from countries

> (such as the United States) that tax foreign profits while providing foreign tax credits may benefit very little (in some cases not at all) from lower foreign tax rates, since foreign tax savings are offset by higher home–country taxation. These relative tax incentives, therefore, create incentives for investors from countries that exempt foreign income from taxation to concentrate their investments in low–tax countries, while investors from countries that tax foreign income while providing foreign tax credits have incentives to concentrate investments in high–tax countries.

However, such incentives can lead to allocations of capital and investment that are not consistent with global economic efficiency. Desai and Hines introduce two principles to guide tax policy: "capital ownership neutrality (CON), the principle that world welfare is maximized if the identities of capital owners are unaffected by tax rate differences, and national ownership neutrality (NON), the principle that national welfare is maximized by exempting foreign income from taxation." Desai and Hines suggest the ideals of CON and NON to ensure that the goals of national and global economic efficiency are met.

Viard (2009) illustrates the importance, when evaluating the economic consequences of income taxes, to comprehensively measure the adverse impacts on all forms of income, what is termed the elasticity of taxable income (ETI). Comprehensive measures of income reveal the negative and significant impacts from income taxes on economic growth:

> Some analyses of the behavioral effects of income taxation examine only the effect on hours worked and often find little impact. As Martin Feldstein observed, however, income taxes can induce people to reduce their taxable income through means other than a reduction in hours worked. People can reduce taxable income by holding tax-exempt municipal bonds rather than taxable bonds, receiving fringe benefits rather than cash wages, engaging in tax shelters, and spending more money on tax-deductible items. Economists could investigate each of these behavioral changes, one by one. Or, as Feldstein suggested, they can simply investigate the overall change in taxable income prompted by changes in tax rates. [5]
>
> Recent studies have, therefore, focused on the overall elasticity of taxable income, which roughly equals the percentage change in taxable income that results from a 1 percent change in (1 - t), where t is the tax rate. Suppose, for example, that the elasticity is 0.5, the estimate that I use below. Consider an increase in the marginal income tax rate from 25 percent to 26 percent, which reduces (1 - t) from 0.75 to 0.74, a decline of 1.33 percent. With a 0.5 elasticity, the rate increase reduces taxable income by roughly 0.67 percent (0.5 times 1.33 percent). [6]
>
> Two recent papers, one by Seth Giertz and one by Emmanuel Saez, Joel Slemrod, and Giertz, provide surveys of the numerous statistical studies that have used tax return data to estimate the elasticity of taxable income.[7] As these papers describe, early estimates were very high, often well above 1. Recent estimates have been more modest, with considerable variation across studies. There is strong evidence that the elasticity is higher for high-income groups. A recent Tax Foundation analysis assumes that the elasticity for taxpayers

> with incomes above $100,000 is 0.6.[8] The 0.6 value for high-income taxpayers appears to represent a reasonable middle ground, as some studies have estimated much higher values while others have estimated lower values.[9][77]

Directly citing the Saez, Slemrod, and Gertz (2009) study regarding the importance the elasticity of taxable income (ETI):

> Nevertheless, the essential insight underlying the ETI remains valid: that income tax rates cause taxpayers to respond on a wide range of margins and, under some conditions, all of these responses reflect inefficiency, because they would not have been undertaken absent the tax rates. This is especially true of high-income, financially savvy taxpayers who in most countries have access to sophisticated tax avoidance techniques. There is clear evidence of responses that would fall in the first two tiers of the Slemrod (1995) hierarchy/timing, shifting, avoidance/based on U.S. evidence since 1980, but only at the top end of the income distribution.[78]

Of course, the actual response of taxpayers varies. Gruber and Saez (2002) examined this issue.[79] A larger share of higher-income groups' income can be altered for tax purposes – the size, timing, and location of the income. The income of lower-income taxpayers, on the other hand, is primarily from wages. Consequently, you would expect the ETI for higher income taxpayers to be more sensitive to tax rates than lower income taxpayers. And, this is what Gruber and Saez found. The elasticity for those with incomes above $100,000 was around 0.6, while other taxpayers had an elasticity of approximately 0.2. Taxes will affect the behavior of all taxpayers, however, the impact on higher income taxpayers is the most sensitive – a result particularly relevant with respect to Proposition 30.

And, the changes in behavior create additional economic costs on taxpayers beyond the revenues raised. Carroll (2009) estimated the economic costs created by income taxes or what is called the *excess burden of the income tax* (in this case the federal income tax) finding these costs to be very large:

> The excess burden of the current individual income tax is not inconsequential, amounting to roughly 11 to 15 percent of total income tax revenues.
>
> This means that in the course of raising roughly $1 trillion in revenue through the individual income tax, an additional burden of $110 to $150 billion is imposed on taxpayers and the economy.
>
> Increased tax rates on higher-income households impose very large excess burdens that, under reasonable assumptions, nearly equal the revenue collected.
>
> The combined effect in 2011 of increasing the top two tax rates and the health care surtax is an additional excess burden of $76 billion. When combined with the $88 billion in additional revenue, the total burden of these higher tax rates is $164 billion.

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>
> The combined effect in 2011 of increasing the top two tax rates and the health care surtax is an additional excess burden of $76 billion. When combined with the $88 billion in additional revenue, the total burden of these higher tax rates is $164 billion.[80]

A series of studies on the impact of differential levels of taxation on the growth rates of various states illustrates that states with relatively uncompetitive state tax systems experience slower economic growth.

Becsi's (1996) analysis focused on whether state and local taxes affect relative state economic growth. Besci found

> …that relative marginal tax rates have a statistically significant negative relationship with relative state growth averaged for the period from 1961 to 1992. … Re-estimating the regressions when the sample period is split in half shows that the tax effects grow even stronger when compared with the convergence effect, which is insignificant in the latter half of the sample. Thus, it appears that state and local taxes have temporary growth effects that are stronger over shorter intervals and a permanent growth effect that does not die out over time, at least for the sample considered. This finding also supports the inference that part of growth is endogenous and susceptible to policy influence.[81]

Poulson and Kaplan (2008) directly examined the impact of higher average marginal state taxes on economic growth finding that:

> …differences in tax policy pursued by the states can lead to different paths of long-run equilibrium growth. Regression analysis is used to estimate the impact of taxes on economic growth in the states.
>
> The analysis reveals that higher marginal tax rates had a negative impact on economic growth in the states. The analysis also shows that greater regressivity had a positive impact on economic growth. States that held the rate of growth in revenue below the rate of growth in income achieved higher rates of economic growth.
>
> The analysis underscores the negative impact of income taxes on economic growth in the states. Most states introduced an income tax and came to rely on the income tax as the primary source of revenue. Jurisdictions that imposed an income tax to generate a given level of revenue experienced lower rates of economic growth relative to jurisdictions that relied on alternative taxes to generate the same revenue [82]

Dye (1999) explicitly examined the impact of a state income tax by examining the relative economic growth impacts on those states following the adoption of an income tax. Dye explains that

> Income taxation with graduated rates has a more harmful effect because it substantially lowers the rate of return on the work and savings of the most productive citizens. Even relatively modest overall tax burdens can have a very adverse effect on economic growth if these burdens are carried disproportionately by the most productive individuals and firms. These individuals and firms are usually the most mobile, and a state income tax with a high top rate creates a strong incentive to relocate.[83]

Overall, Dye found "…strong econometric evidence that an income tax does indeed drive up the size of state government. Further, it has a significant adverse effect on the state's economy."[84]

These findings are echoed in Laffer and Winegarden (2012).[85] Laffer and Winegarden examined the impact on relative economic growth in each one of the last 11 states that implemented an income tax finding that

> …the size of the economy in each one of these states [the last 11 states to implement an income tax] has declined as a share of the total U.S. economy compared to a time just prior to when each state introduced its income tax. Some of the declines are quite large. Connecticut, for example, went from 1.74 percent of U.S. GDP in the 1986-1990 period to 1.63 percent in 2010. New Jersey fell from 3.66 percent of U.S. GDP from the 1971-1975 period to 3.35 percent in 2010. From 1967 to 1971 Ohio was 5.42 percent of total U.S. GDP yet in 2010 it fell to 3.28 percent. Rhode Island and Pennsylvania respectively went from 0.44 percent and 5.72 percent of the U.S. in the 1966-70 period to 0.34 percent and 3.91 percent in 2010. Maine's and Illinois' pre-tax period was 1964-68 and they dropped respectively from 0.39 percent and 6.52 percent of the total U.S. GDP to 0.35 percent and 4.48 percent in 2010. Our beloved Michigan, which seems never to get a break, went from 5.08 percent in the 1962-1966 period to 2.64 percent in 2010. Leaping Lizards! And lastly, Indiana in 1963 and West Virginia in 1961 went from 2.61 percent and 0.79 percent to 1.89 percent and 0.48 percent, respectively. And, who could have thought that West Virginia could actually decline further from its state of abject poverty in the early 1960s? But it did.[86]

The Joint Committee on Taxation (JCT) 1997 Tax Modeling Project and 1997 Tax Symposium provided a comprehensive examination of the beneficial economic impact from pro-growth tax policies.[87] In response to congressional requests to incorporate dynamic analyses into JCT revenue forecasts, the JCT held a series of meetings to examine the methodologies and feasibility of incorporating a dynamic macroeconomic model into the revenue estimating procedures for alternative tax reforms – including consumption-based taxes. These meetings culminated in a symposium where the participating academics each presented the results of their individual models. All of the models incorporated were:

"…based on a set of commonly held assumptions about economic behavior…These properties include the following basic assumptions:

- reducing the cost of capital through less taxation of capital provides an incentive for additional investment;
- reducing the marginal tax rate on labor provides an incentive for increased labor effort;
- increasing the returns to labor through capital deepening can provide an incentive for more labor; and,
- reducing distortions in investment decisions by eliminating differential taxation of different types of capital promote a more efficient allocation of resources."[88]

Koenig and Huffman (1998) echo these findings as do Engen, Gravelle, and Smetters (1997).[89] Although the Koenig and Huffman model is designed to illustrate direction of change, not magnitude, they find that output, consumption, wages, stock prices, and the total capital stock will rise in the long-run due to the adoption of a consumption-based flat tax.

Engen, Gravelle, and Smetters use two different types of models (reduced form growth models and inter-temporal general equilibrium models) to examine the impact of transition to a consumption-based tax system. Again, in all of the models the tax reform has a positive impact on output, savings, consumption, and the growth in the capital stock in the long-run. Further studies by Dale Jorgenson (1995), Alan Auerbach (1996), Michael Boskin (1995), and Laurence Kotlikoff (1993) have all shown positive impacts on economic growth if the current tax code is replaced by a single-rate flat tax ranging from a total increase in economic output of 5.7 to 17 percent.[90]

Laffer (1984) proposed "The Complete Flat Tax" which replaced the current income tax system with a flat tax. This study illustrated that such a proposal would likely increase economic growth by between 8 and 15 percent in the long-run.[91]

Fully accounting for the adverse impact from income taxes (like all taxes) must also account for the difference between the actual tax incidences versus the statutory tax bases. For instance, Entin (2004) argues that the actual tax incidence of the progressive tax system falls on savings, workers, and lower income retirees.[92] Consequently, due to the dynamic adjustments of the economy, progressive tax systems both reduce our economy's economic growth potential and impose unwanted social outcomes. More troubling, the manner in which our tax system is currently displayed does not account for the tax incidence issues, suppressing the information necessary to rationally change our current tax system. Obviously, this change should be toward a flatter tax.

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ABOUT THE AUTHOR

Wayne Winegarden

Wayne H. Winegarden, Ph.D. is a Sr. Fellow in Business & Economics, Pacific Research Institute, as well as the Principal of Capitol Economic Advisors and a Contributing Editor for EconoSTATS at George Mason University.

Dr. Winegarden has 20 years of business, economic, and policy experience with an expertise in applying quantitative and macroeconomic analyses to create greater insights on corporate strategy, public policy, and strategic planning. He advises clients on the economic, business, and investment implications from changes in broader macroeconomic trends and government policies. Clients have included Fortune 500 companies, financial organizations, small businesses, state legislative leaders, political candidates and trade associations.

Dr. Winegarden's columns have been published in the *Wall Street Journal, Chicago Tribune, Investor's Business Daily,* Forbes.com, and Townhall.com. He was previously economics faculty at Marymount University, has testified before the U.S. Congress, has been interviewed and quoted in such media as CNN and Bloomberg Radio, and is asked to present his research findings at policy conferences and meetings. Previously, Dr. Winegarden worked as a business economist in Hong Kong and New York City; and a policy economist for policy and trade associations in Washington D.C. Dr. Winegarden received his B.A., M.A. and Ph.D. in Economics from George Mason University.

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