CITIZENS'
Budget
2003–05

A 10-Point Plan to Balance the California Budget and Protect Quality-of-Life Priorities

Reason

The Performance Institute

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Part 10

Stabilize Revenues by Creating the Most Jobs-friendly State in the Nation

"[Since March 2001,] when the downturn began, California has lost a net 370,000 private-sector jobs. That's 75 percent of the loss in the early 1990s recession, regarded by many economists as the worst in the state since the Depression."

– David Friedman, Los Angeles Times*, March 9. 2003*

Summary of Citizen Budget Recommendations in This Section:

1. **Resist Tax or Fee Increases** which would only worsen the state's economic condition.
2. **Reform Workers Compensation System** that has robbed the state of billions in revenue and increased the cost of creating jobs in California.
3. Create **Regulatory Review and Innovation Commission** a cross department body that would systematically review regulations for their cost-effectiveness and negotiate and enforce **"Performance Incentive Agreements"** with businesses to achieve regulatory results without high regulatory costs.

California Budget FACTS:



-489,000

The number of jobs lost from *high-wage, high-skills* industries in California since March 2001.

-370,000

The number of jobs lost in all private sector industries since March 2001.

+125,000

The number of government employees (mostly new teachers) added since March 2001.

As noted in the introduction to the Citizens' Budget, a budget should provide a vision for how California will make investments and create conditions necessary for a better quality of life. One of the major elements of a quality of life is a growing economy, where anyone who wants a job can get a job. Focusing on creating jobs also solves the state's need for increased resources—not through tax rate increases—but by expanding the tax base. As more Californians get more jobs and higher paying jobs, the state will naturally see an increase in revenues collected. Finally, a strong economy will allow for lower expenditures on social safety net programs, as individuals become more self-sufficient they will rely less on government aid. Indeed, the best safety net is a good job and a strong economy.

As a result, California needs a balanced approach to addressing both the short-term and Long-term fiscal challenges of the state. This balance must include fiscal responsibility, as discussed in other sections of this report, and stabilizing revenues with an ambitious agenda of removing impediments to greater economic

growth. While most of the recommendations contained in the Citizens' Budget focus on improving spending controls, changes also need to be made that will create conditions for stable revenue.



One of the most important ways to secure a better quality of life is a growing economy, where anyone who wants a job can get a job.

Economic Growth, Not Higher Taxes, Grows Revenue

A steadily growing economy provides steady revenue to the state, while an economy subject to the whims of state spending, taxation, and regulations is doomed to provide cyclical or erratic revenue. Nowhere is that more true than with taxes. Taxes that cover needed provision of infrastructure, protection of property, and investment in education improve the productivity of the state economy. But beyond that point, especially as taxes focus on redistribution and trying to mold people's behavior, numerous studies suggest that taxes lower the rate of economic growth.[160]

Lessons From the Early 1990s

There is a growing and convincing body of evidence that reveals the deleterious effects of tax increases on job creation, population growth, personal income growth, bond ratings, and even state tax revenues. A study by the Federal Reserve Bank of Atlanta that analyzed state economic performance from 1960 to 1992 concluded that "relative marginal tax rates have a statistically significant negative relationship with relative state growth" and advised: "if [a state's] Long-term growth rates seem too low relative to other states, lowering aggregate state and local marginal tax rates is likely to have a positive effect on Long-term growth rates."[161] Or, as simply stated by another study, "When states reduce their aggregate and marginal tax burdens, they improve their economic performance."[162] Indeed, a Joint Economic Committee report found that when states lowered their taxes by 1 percent, personal income rose 3.6 percent.[163]

During the recession of the early 1990s nearly half the states raised taxes to try to increase revenues and avoid budget cuts, and those states tended to have the most persistent budget woes and the slowest economic recoveries.[164] Meanwhile, those that reacted to the recession by cutting income taxes had double the population growth, nearly three times the job growth, and about 25 percent faster income growth than the states that raised tax rates.[165]

The best example from the early 1990s recession is the "Michigan Miracle." Then-Governor John Engler made substantial spending cuts and a series of tax cuts. In part, due to taking those tough measures, Michigan's economy boomed. Unemployment fell and per capita incomes rose from 2.9 percent below the national average to 2.8 percent above the national average by 1995.[166]

In contrast, then-Governor Pete Wilson and the legislature enacted a $7 billion tax increase—the largest in history for any state—in California in 1990. The parallels to Governor Davis's plan are frightening. Compare Governor Wilson's $7 billion tax increase to Governor Davis's proposed $8.3 billion increase in taxes and fees. In 1990, Governor Wilson and the legislature raised taxes on the top income bracket from 9.5 percent to 11 percent. Governor Davis proposes to raise taxes on top income earners from 9.3 percent to 10 percent or 11 percent through the addition of two tax brackets.



"At least half of the nation's governors (Republicans and Democrats alike) believe they can tax their way back to prosperity. Recent history suggests otherwise. Governors attempted to enact 'soak the rich' tax hikes in the early 1990s only to see their states plunge into even deeper pools of red ink and endure further economic contraction."

– Steve Moore, American Legislative Exchange Council

According to a report by the American Legislative Exchange Council, the 1990 tax increase

> *…was noteworthy because* it failed to raise any new revenue while sinking the state deeper into recession. *The already ailing economy continued to decline; from 1990 to 1993 the state lost 350,000 jobs. In 1995 the tax hike was repealed, and over the next four years the state gained more than 200,000 jobs and the unemployment rate fell sharply.*[167] *[emphasis added]*

Hopefully, California will not make the same mistake again.

Certainly, tax increases are no way to deal with a budget crisis. In testimony given before the U.S. Senate Finance Committee earlier this year, Cato Institute Director of Fiscal Policy Chris Edwards advised:

> *Current state budget woes are not the result of revenue shortfalls, but of spending excesses built up during the 1990s. The solution for states should fit the problem: State spending should be frozen or cut.*[168]

Similarly, an American Legislative Exchange Council report concluded:

> *At least half of the nation's governors (Republicans and Democrats alike) believe they can tax their way back to prosperity. Recent history suggests otherwise. Governors attempted to enact 'soak the rich' tax hikes in the early 1990s only to see their states plunge into even deeper pools of red ink and endure further economic contraction.*[169]

California, and other states in similar financial straits for that matter, should heed the counsel of Mr. Edwards and ALEC and focus on reducing both spending and the tax burden if they are to return to strong economic growth and financial stability.

California's Situation: A Job-killing State

California already suffers from high taxation. California ranked 44th among the 50 states in terms of economic freedom.[170] The state's worst scores were from high taxes as a percent of personal income, relatively high taxes on low-income residents, and high special taxes and fees such as on utilities, gasoline, tobacco, and alcohol. A recent *Los Angeles Times* article noted that California ranks near the top of states in terms of state and local taxes and that personal income taxes especially are among the highest in the nation.[171] In fact, California had the sixth highest per-capita tax collections in the 50 states for fiscal year 2001.[172] In addition, an economic model analysis estimates that the sales and income tax increases proposed by Governor Davis and Democrats in the legislature will destroy 590,000 California jobs over three years and shrink the capital stock by 1.2 percent," which leads to our next point.[173]

The state's business climate is also hostile to jobs creation. In 1998, the Department of Finance, in its 1996-97 Single Audit Report astutely noted:

> *Maintaining California's growth cannot be taken for granted. California's success depends on the individual decisions of investors and households who find the state an attractive place to live, work, build new businesses, and expand existing ones. They have been encouraged by decisions of the Governor and the legislature that have promoted a positive business climate while taking care to improve the environment, rebuild highways, enhance the quality of public schools, and find new ways to replace the commands of regulation with the market forces of competition.*[174]

That was then, this is now.

Not long ago, California was still considered a pretty good place to do business. Sadly, things have changed for the worse. A survey of 287 top business executives saw their rating of California's business climate fall from second best in 1999 to worst in the nation in 2002.[175] More than half of the executives flagged California as the worst business climate in the nation, while only one-third chose New York as the second worst. The report's author said that it "revives the state's reputation as a job-killer gained in the recession of the early '90s."[176] In addition, the California Business Roundtable/California Chamber of Commerce 12th Annual Business Climate Survey found that "California businesses have been hit hard by recent events and the economic downturn. With 67 percent of California business leaders agreeing that business conditions in California have worsened—a startling jump of 39 percent since the 2000 survey—we have to be worried about keeping jobs and companies in our state."

Such business perceptions are substantiated by the facts. There are already at least 20 major U.S. markets where it is cheaper for corporations to locate than in California's cheapest major market—San Diego.[177] California's other major markets are even more costly corporate locations. Julie Meier Wright, head of the San Diego Regional Economic Development Council cautions that, with further tax increases, "we could see the early 1990s all over again, when there was an exodus from the state."[178]

Immediate Action Needed to Create Better Jobs Climate

Instead of reversing this perilous situation—and in sharp contrast to conclusions drawn from years of economic data outlined above—Governor Davis's budget plan proposes a broad range of tax and fee increases. What is worse, after only three months of the legislature being in office, over 70 bills have been introduced to raise taxes or impose fees in California. If enacted, these proposal would only aggravate an already difficult job and business climate through several billion dollars worth of additional tax and fee increases. (See Appendix A for a list of job-killing proposals.)

Governor Davis's budget plan also includes spurious plans to stimulate job growth via increasing the government workforce. In his State of the State Address, Governor Davis announced a goal of "creating" 500,000 jobs over the next four years—125,000 jobs per year, but his own Finance Department predicts that even before his proposals, baseline job growth would be about 220,000 jobs per year. In other words, the Governor proposes to LOWER the state's goal for job creation by almost half! That's not setting a high standard. What's worse, "creating" *government* jobs does not add to the economy—every dollar the state pays someone it must first take from someone. Davis's proposal is not about economic growth, but

government growth. That's not hard—and has nothing to do with creating a jobs-friendly state. While reducing tax burden during this fiscal crisis might be difficult, three recommendations should be considered:

1. **Do *not* raise taxes and fees.** The energy being spent on devising increases in sales taxes, Internet sales taxes, sin taxes, raising fees, and other desperate measures to raise revenue would be better spent finding ways to manage spending and devising ways to create the conditions for economic growth.

2. **Create a Regulatory Review and Innovation Commission (RRIC).** During the Wilson Administration, a "Red Team" was created to streamline and expedite regulation compliance and permit applications. This provided some degree of flexibility on the part of the state and served to enhance service to businesses, which in turn, enhanced services to consumers. Colorado, Virginia, Pennsylvania and other states have also used systematic reviews of existing legislation and regulations to improve their business climate and job growth. California should return to this model and establish a Regulatory Review and Innovation Commission to conduct a thorough but streamlined nonpolitical economic and technical analysis and identify existing laws and regulations that are outdated or no longer worthwhile.[179]

   Most importantly, the state should allow the RRIC to negotiate "Performance Incentive Agreements" with interested industries or individual businesses where alternatives to command-and-control regulation (such as self-audit, ISO standards, etc.) could be used in lieu of state regulations but *only if the outcome result intended by the regulation is achieved.* This option would recognize that one-size regulations do not fit all businesses and the market can sometimes (when incentivized) come up with better, more cost-efficient ways to comply than government.

3. **Revisit reform of workers' compensation insurance.** California's workers' compensation costs are already very high. Premiums have increased 80 percent since 1999 and some firms are now refusing to provide coverage in California. Legislation signed last year will increase workers' compensation insurance costs for California businesses by more than $3 billion per year. The law increases employee benefits and is scheduled to cost employers $600 million this year, $1.7 billion next year and $3.2 billion in fiscal year 2006-07.[180] This law should be repealed and more serious workers' compensation reforms undertaken. Workplace safety is best promoted by well-functioning workers' compensation markets where rates closely reflect expected claim costs, and thus loss control decisions, by employers, employees, and insurers. Price and service competition among insurers is the best method of achieving a close alignment between rates and expected claim costs, and thus strong incentives for efficient loss control.[181]

About the Authors

Carl DeMaio is the founder and president of The Performance Institute—a private think tank dedicated to reforming government programs through the principles of performance, transparency, competition and accountability. Under his leadership the Institute has grown to be the largest government reform think tank in the nation-leading thought on public administration at federal, state and local levels of government and training over 10,000 elected and career government officials each year in the principles of performance-based management.

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