California: Beware of the 5.2 percent rule

BY ANTONY DAVIES
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California might be the largest state in the nation, but it is also facing the country's largest budget deficit for the coming fiscal year – $26.6 billion. To bridge this gap, Gov. Jerry Brown has put forth a package of worthy and necessary spending cuts, but he also has included an old Golden State standby: higher taxes. Specifically, the governor wants voters to extend for five years the increases in sales, income and vehicle taxes first enacted in 2009.

There's just one problem with this plan: It won't work. Throughout the state's history, tax receipts have been remarkably constant at 5.2 percent, in times of both higher and lower taxation. Seen in this light, the appropriate tax policy becomes crystal clear. Call it the 5.2 percent rule: If California will always receive a certain percentage of the state's output in tax revenue, the goal of policymakers should be to grow the state's output as quickly and consistently as possible.

Changes in the tax code are nothing new to Californians. The state's top income tax bracket ranged from a low of 9.3 percent in the late 1980s to a high of almost 12 percent in the first half of the 1990s. The top bracket now sits at 10.3 percent, still among the highest tax rates in the country. The tax rate on capital gains was 7.2 percent in the late 1970s, rose to almost 12 percent in the 1990s, and then was lowered to 10 percent in recent years.

Amid these changes in tax rates, you'd assume that the size of the state coffers fluctuated accordingly. But you'd be wrong: Across the last 30 years, publicly available data show that California's tax revenue has remained fairly constant at 5.2 percent of the state's gross domestic product (plus or minus 0.6 percent). Good times or bad, high taxes or low, California's government has taken a constant 5.2 percent slice of the economic pie.

How to explain this paradox?

Consider that in 2010, 1 percent of Californians accounted for almost 50 percent of California's tax revenue. If half these rich Californians moved away, the state's tax revenues would fall 25 percent. That's a problem because the rich are far more mobile than the rest of us. Faced with higher tax rates, as they frequently have been in the Golden State, they can easily move themselves (and their tax dollars) to friendlier environments.

Additionally, when a government changes tax rates markedly and erratically, it makes it harder for people and businesses to plan for the future. In response, people are less likely to want to commit to large purchases, and businesses are less likely to want to invest in creating new products and new jobs – meaning less income for the state government to tax.

This inconvenient truth about state tax revenue means that the conventional wisdom about raising taxes to close a budget gap isn't merely wrong – it's also harmful. According to an analysis by the American

Legislative Exchange Council, 1.4 million people left the state of California for another state between 1999 and 2008. As tax rates get higher, the population will shrink further, and the government will take a 5.2 percent slice of an ever-smaller pie – forcing spending cuts that are even more difficult than what the state is already considering.

The key to fixing the state's budget crisis isn't to try to take more money from wealthy Californians – the key is to stimulate economic growth so that there are more resources available to fund the state's priorities. That means pursuing tax rates that are less progressive, change less frequently, contain fewer loopholes and are generally lower across the board.

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