

CENTER FOR CONTINUING STUDY OF THE CALIFORNIA ECONOMY

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A Tax Increase Will Help the California Economy

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Californians will finally get a debate about taxes.

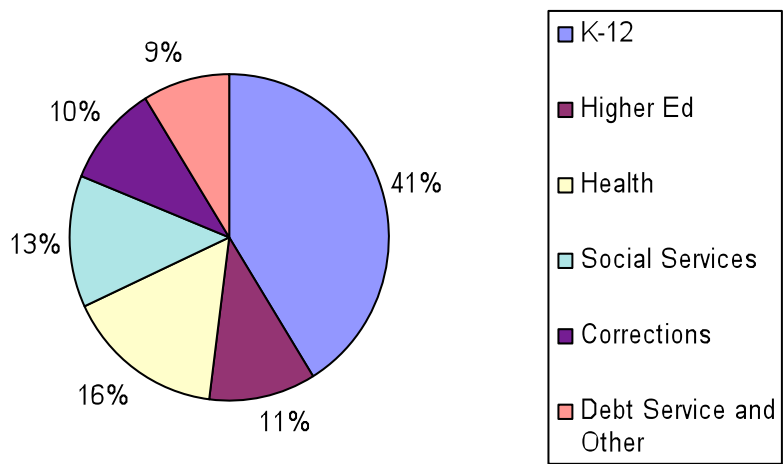
Facing a \$15.2 billion shortfall, both the Governor and the Democrats have proposed raising taxes. Governor Schwarzenegger has suggested raising \$6 billion per year with a temporary increase in the sales tax, a strategy some have labeled regressive. Democrats have proposed raising \$8 billion per year through increases in taxes on high-income households and corporations, a strategy others have labeled as anti-business. Republican legislators are holding firm to a “no-tax, no-way” pledge, arguing that any tax increase will hurt the economy.

The latter view – that tax increases hurt the economy – is often presented as a truth supported by all economists. But the allegation is not obvious and is, in fact, a bad guide to how Californians should react to proposed tax increases to balance the state budget.

Tax Increases Should be Judged on the Benefits They Provide

A tax increase now will help the California economy. After all, any revenue stream should be judged on the value of the spending it would support. In this case, half of the additional tax revenue will go to support investments in K-12 and higher education. Another 30% will go to maintain health and social services for low-income families and disabled residents. Part of the budget supports investments in transportation and the bonds we pass to rebuild our infrastructure.

**Allocation of Proposed General Fund
Spending 2008-09**



An educated workforce and world-class infrastructure are critical to attract private investment and jobs. And maintaining services for the poor reflects both our social values and means that every penny will be immediately put back into the local economy.

The education choice is particularly crucial. We can either cut spending by \$500 per student or raise taxes to prevent these cuts. Other states spend more on each student than California and our students have fewer teachers, counselors, librarians and total staff than students in other states. The Governor’s Committee on Academic Excellence has recommended a substantial increase in per pupil spending for at-risk students combined with major education reforms, partly so California can maintain its ability to compete in the world economy.

California
K-12 Education Staffing 2005-2006
(Staff per 1,000 Students)

	California	U.S.	Ranking (1 is Highest; 51 is Lowest)
All staff	90.0	124.7	50
Counselors	1.1	2.1	51
Librarians	0.2	1.1	51
Principals	2.2	3.4	49
Student/teacher ratio	20.8	15.7	49

Source: 2008 Resource Cards on California Schools; EdSource

Education, infrastructure, and social services are also critical to maintaining our California Dream. From a state that once prided itself as being a land of opportunity, we have slipped to being one of the most unequal states in the Union. The pattern is long-term but has been worsening in recent years: according to a recent study by the California Budget Project, adjusted gross income for the top one percent of taxpayers doubled between 1995 and 2006 while it rose by less than ten percent for those in the middle of the income distribution.

Addressing this is not simple a question of fairness. Spending on education, job training, and safety net coverage are critical for economic mobility – but this social justice imperative happens to square with our competitiveness strategy as well. Turning things around in the state long-term requires a future-looking attitude – and that requires more, not less public investment.

Do Tax Increases Hurt the Economy?

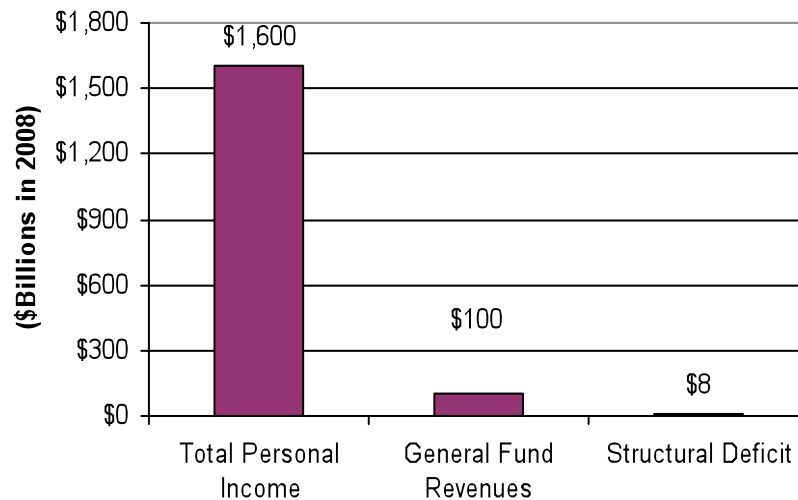
Some suggest that tax increases are particularly bad in a recession since people are struggling to pay bills. While this might favor income taxes on high-income households over sales taxes as the best choice for increasing taxes in 2008, it does not provide an answer as to whether we should increase taxes or reduce government spending. If taxes are increased to prevent cuts in public investments and services than there will be less private spending and more public spending. There will be more money spent in schools and less money

spent on consumer purchases. The money doesn't disappear from the economy; it gets reallocated.

Actually, in the short term an increase in income taxes on high-income earners to support state spending will have a small **positive** effect on economic growth. It would take money that would be partly saved or spent out of state and use the tax increase to support services where every penny would be spent immediately and in the state economy.

But it is mainly a question of priorities. Even the larger revenue increase proposed by the Democrats is relatively small in relation to our economy -- \$ 8 billion out of a \$1,600 billion economy--amounts to a penny out of every two dollars state residents earn. If the fight were about what was best for our economy, maintaining public investments would win hands-down. Instead, all the heat is about ideology and deeply held views about the role of government.

Living Within Our Means Which Measure to Use?



Fine, but don't pretend that the Governor and the Democrats are somehow job-killers. The Public Policy Institute of California has studied business relocation from California for all reasons, including taxes, and finds that relocations never accounted for more than one-tenth of 1 percent of jobs in the state in any year; they called these job losses "negligible".

As far as "living within our means" it doesn't matter whether the proposed tax increases go to erase the structural deficit or remain for consumers to spend. Our California family earns about \$1,600 billion each year and we live within our means whether we reallocate money to public investment or keep it for private

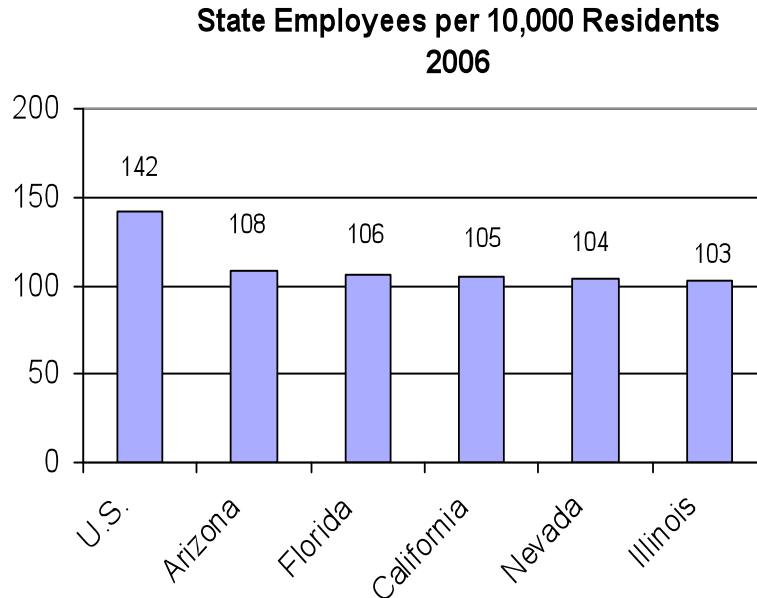
spending. Again, it is a question of priorities and where we get the most long-term value for our money facing today's choice about the state budget.

And remember that tax increases in the early 1990s – which demonstrated state responsibility in tough times – were followed by a large wave of venture capital investment and job creation throughout the state. The amount and mix of temporary versus permanent tax increases can be worked out next year by the tax reform commission supported by both the Governor and Democrats. Today we need to make the best choice we can.

The Illusive Waste, Fraud and Abuse

Can we avoid difficult choices by uncovering \$billions in waste, fraud and abuse? The Governor and others have been trying for years but, contrary to the expectations of voters that massive waste exists, no one has actually identified large savings that don't involve service cuts.

Moreover, California does not have a large number of state employees relative to our population. In fact according to the latest Census Bureau Survey, in 2006 California had the third lowest ratio of state employees to population in the nation, behind only Nevada and Illinois and far below the national average.



A recent Los Angeles Times editorial states “Schwarzenegger, like scores of angry reformers who preceded him, came to see that there weren’t really billions to be had in the fabled waste, fraud and abuse. The state really does have to strip aid to children, the elderly and poor (and shift the burden of unaddressed problems to future generations) or get additional revenue from taxpayers”.

We agree.

The Bottom Line

The debate is currently about balancing the budget but there is a deeper set of questions at stake: what sort of economy and society do we want in California?

Poorly educated workers, crumbling infrastructure and communities that aren’t great places to live and work will chase more investment away than small increases in taxes. As any family knows, life involves making choices – and a small tax increase today is the right choice to help the future of the California economy.