

THE ONLY ANSWER: A CALIFORNIA FLAT TAX

By Arthur B. Laffer and Jeffrey Thomson

Just a few months after Gray Davis was reelected California's governor, there were 2,000,000-plus recall signatures collected (with less than 900,000 needed), 135 gubernatorial candidates on the ballot, and a Hollywood hype of biblical proportions. What a recall effort it is—and it is based 100% on the state's fiscal crisis. The vast majority of all states and national economies the world over face similar, albeit not so extreme, fiscal problems. California is a microcosm or metaphor for these problems.

Stated succinctly, California's steeply graduated progressive tax structure is the cause of the fiscal crisis which itself is the first-born of the union between fuzzy logic and misplaced emotions. I'll address the three most significant problems of California's highly progressive tax code, namely i.) the great volatility in revenues, ii.) the inevitable build-up of government spending, which leads to ever-higher taxes, and iii.) the tremendous inefficiency and unfairness—hurting the prosperous is not an honorable objective, and hurting the prosperous does not help the poor, which is an honorable objective.

There is no solution to California's crisis save redressing the fundamental premise underlying California's progressive tax codes.

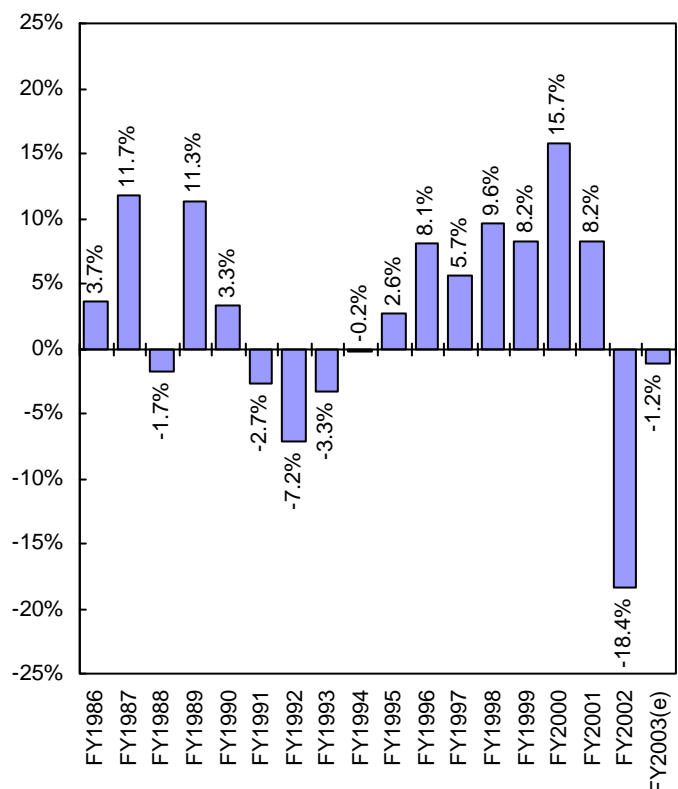
I. Boom and Bust...and Repeat

Because our tax codes in California are so progressive, the state has long periods of feast followed by periods of crushing famine. When the overall economy is good, California has seemingly endless surpluses. When Gray Davis first took office in January 1999, the state's budget was in surplus by some \$12 billion out of a base of \$59 billion. Revenues from realized capital gains and exercised stock options, following along with the rise in the stock market, soared in the late 1990s/early 2000s, and at their peak in FY2001 (ending June 30, 2001) these two sources alone accounted for 24% of California's total general fund revenues.

In contrast, when times turn sour, progressive tax codes combine with an economic slowdown for a surefire recipe for fiscal crisis. Even without mirrors and handkerchiefs, revenues vanish right before the bureaucrats' eyes. Over the two-year period from FY2001 through FY2003, adjusted state tax revenues per capita fell by 19.4% following seven straight years of increases (Figure 1). This drop represented more than \$13 billion in tax revenues! One quick look at this series demonstrates just how volatile and unpredictable California's revenue stream can be from year to year.

These raw revenue data are taken directly from the tax revenue tables in the January California budget proposal, with adjustments to recent periods based on more current information. But let me make two important points. First, these data represent the "major taxes and licenses" category, a category which accounts for approximately 85% of California's total revenues. The remaining 15% is comprised of "minor revenues" and "transfers and loans," both of which are ignored here. Ignoring "transfers and loans" results in the desired exclusion of any accounting loans, transfers or trickery sometimes found in this category (Electric Power Fund borrowing and the like), which can distort general fund and total revenue data from year to year. Second, I adjust the data by the amount of any static revenue legislated tax changes in a given year.

Figure 1
Yr/Yr Growth in California Tax Revenues Per Capita
(adjusted for static revenue legislated tax changes)



In addition to California's huge revenue swings, another byproduct of difficult economic times is that claims on government soar. California's unemployment rate rose from 4.9% to 6.8% between FY2001 and the end of FY2003. It's no wonder our surplus went from \$12 billion to our well-publicized \$38 billion projected deficit—on an expenditure level of \$76 billion—practically overnight. If the California legislature were to reduce spending to match revenues, it would have to cut expenditures by 55% across the board!

Unfortunately, California has already made the easy cuts, used up the rainy day funds and implemented all the gimmicks, tricks, loans and accounting shifts. Now we have the hard stuff, we are down to the real meat. What had been budget padding with frivolous overspending during good times has become deep cuts in essential services. The slave has turned on his master.

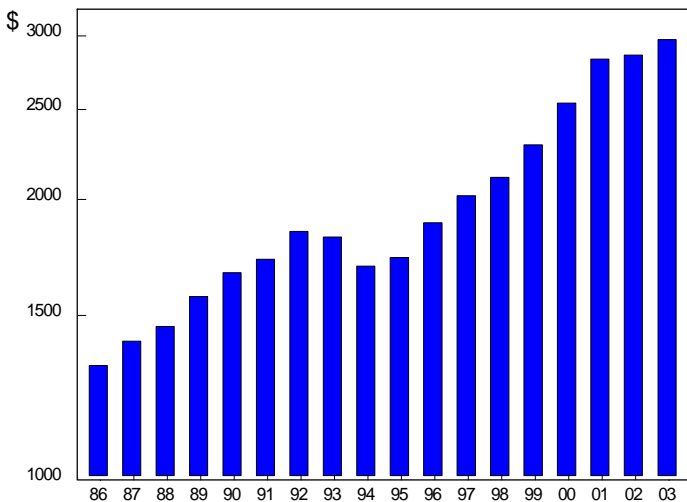
It is this famine/feast syndrome so characteristic of economies with progressive taxes that has precipitated once again a California revolt. But the resolution is far from certain. The crisis of the late 1970s/early 1980s gave us lower property taxes following the passage of Proposition 13, the abolition of our state's inheritance tax, indexed personal income taxes and the Gann spending limit—all wonderful. Yet the crisis of the early 1990s gave us personal income tax increases, increases in the gas tax, sales tax increases and a disemboweling of the Gann spending limit—all horrible! Shocking as it may seem to party loyalists, the biggest tax increases in California came under Republican governors—especially Pete Wilson—while the biggest tax cuts were under Jerry Brown's leadership.

II. Spend...Then Tax...Then Spend...

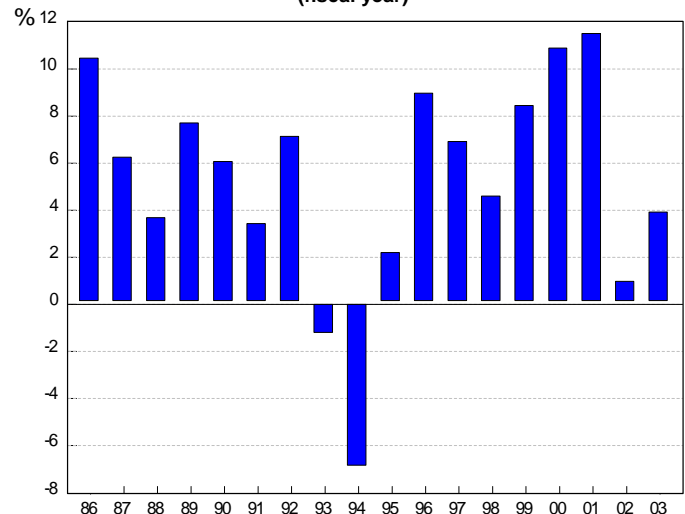
Progressive taxes also lead to a higher overall share of output going to government than the electorate would prefer. Tax cuts are never as popular with politicians in good times as are tax increases in bad times. Volatile revenues—the alter ego of progressive taxes—inextricably lead to big government by increasing spending during prosperity and ratcheting up tax rates during slow times. Those who argue that California's government is more liberal than its electorate are wrong. Big government is a byproduct of a progressive tax code.

During Gray Davis' first four years in office (through the FY2003 budget), total government spending increased from \$75.3 billion to \$104.9 billion, an increase of 39.3% (29.8% on a per capita basis—see Figures 2 and 3). But who's to blame young Gray and his friends in the state Senate and Assembly for spending a little extra from the windfall? Whether conservative, liberal, Republican, Democrat, left-winger or right-winger, these people are grasshoppers. On top of that, you have a legislature and a governor who are term-limited. Who wants to turn the money over to someone else when they can spend it themselves? Bottom line, I don't know how you can ever expect a governor to put aside the types of funds that would have to be put aside to smooth spending over a cycle of maybe 10 or 12 years. There is no way you can put a year and a half's worth of revenues into a special rainy day fund for when you have the four or five year period of bad times. It is just not going to happen, period. Grasshoppers will be grasshoppers!

**Figure 2
California Per Capita Total
Total Expenditures
(fiscal year)**

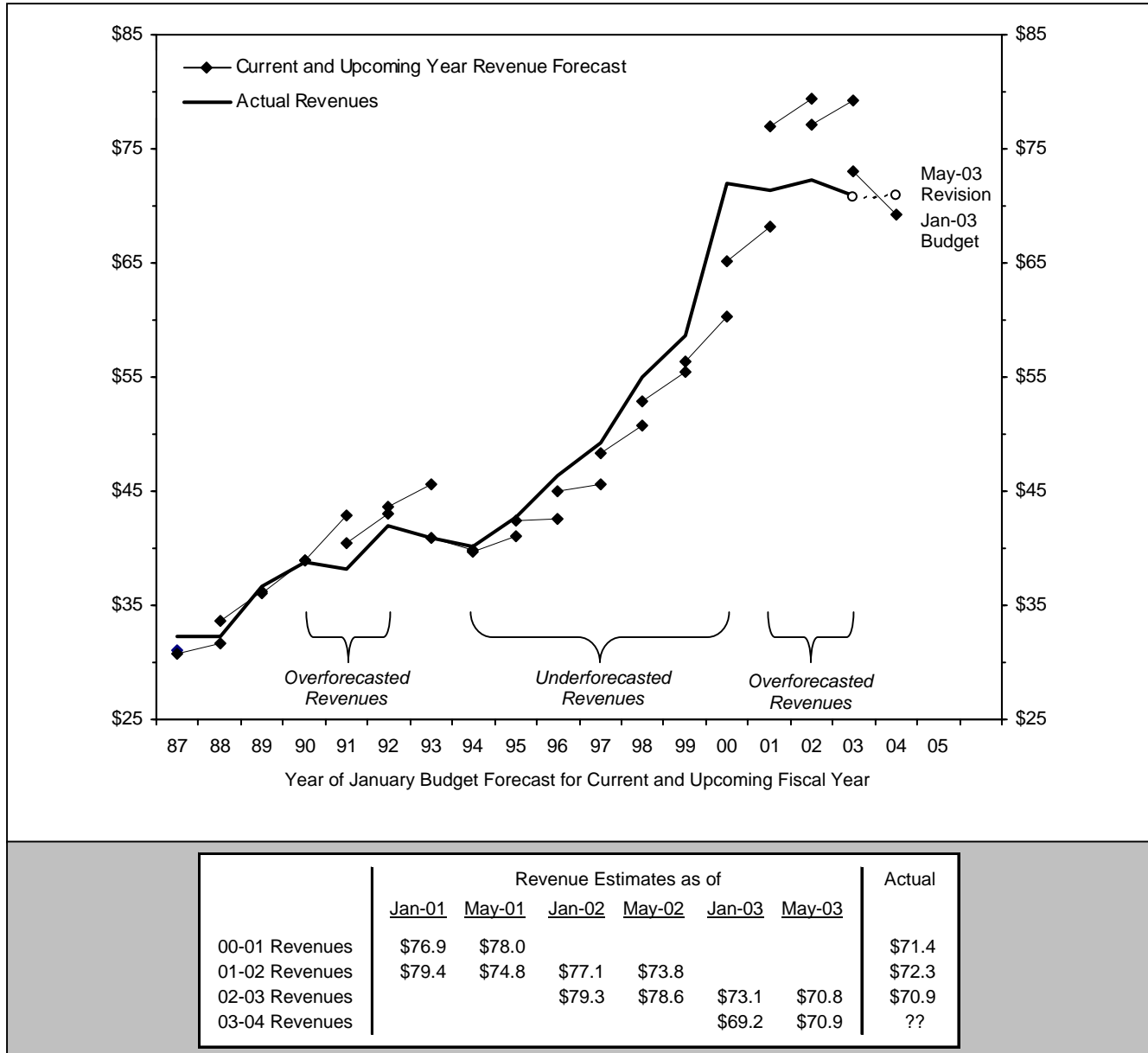


**Figure 3
Yr/Yr Growth in California Per Capita
Total Expenditures
(fiscal year)**



Another rather insidious factor in the growth of spending results from the budgeting process. Because of the state's volatile revenues, California has a longstanding and successful budgetary tradition of overstating projected revenues during times of crisis in order to get higher spending approved by the legislature. Then, when revenues fall far short of projections (surprise!) the politicians turn to taxes to make up the difference. Figure 4 demonstrates this effect by showing current year (6 month) and budget year (18-month) revenue forecasts taken from each year's January budget proposal compared to actual revenues collected.

Figure 4
California General Fund Revenue (Plus Transfers): Forecast vs. Actual
 (in \$billions)



Progressive tax codes lead to a plethora of specific fees and taxes, many of which don't even raise enough revenue to pay for the costs of their collection. It's a crime, but true. It's always tough (but not impossible) to raise the big taxes—especially with the two-thirds majority vote requirement to raise taxes in California—but less visible taxes often can be snuck in under the tent late at night. During downturns, when legislators want to raise taxes for fiscal reasons, they often turn to less visible taxes. As a result, we have literally thousands of taxes and fees at the state and local level here in California (while it's impossible to compile a list of all of them, to get a flavor of what Californians face see Table A-1 in the appendix).

For example, attempts to raise sales, income and cigarette excise taxes may have failed, but last year tax loss carryforwards were suspended for two years and the current budget allowed the Manufacturers' Investment Credit to expire (\$400 million annually) and tacked on an estimated \$1 billion in various new fees—and that isn't even counting the \$4 billion executive act

to increase the vehicle license fee. Yet these smaller taxes and fees often fail to make the headlines. As written in the parable, we Californians die the death from a thousand cuts. The only difference between the parable and today's California is that we in California also get strangled, shot and kicked to death. The flourishing of all these taxes and fees can be attributed directly to the steeply progressive tax codes of California.

Taxation and Fairness—"Power Up the U-Haul"

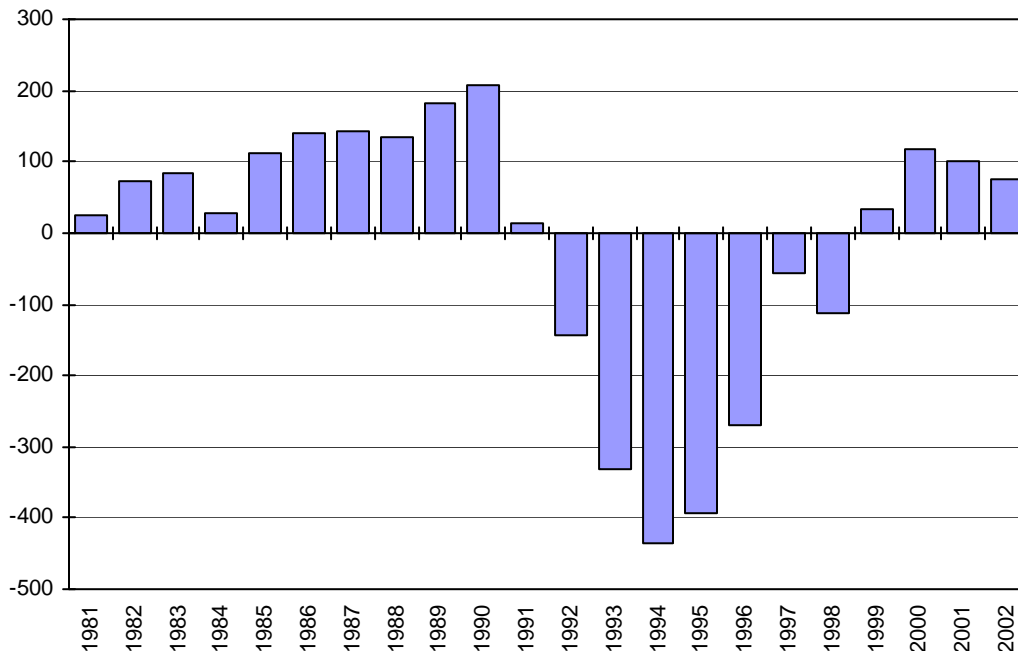
California's highest corporate income tax rate is 8.84% (28% above the national average of 6.9%); its highest personal income tax rate stands at 9.3% (fourth highest in the nation behind Montana, Rhode Island and Vermont); its top tax rate on capital gains is also 9.3%. And had the Democrats had their way with the FY2004 budget, the latter two would now stand at 11%. In addition to these sky-high rates, Californians face tax rates among the highest in the nation in almost every other major tax category, including a top state and local sales tax of 8.50% (11th highest in the nation) and a cigarette excise tax of \$0.87 per pack (19th highest in the nation). Both of these taxes also narrowly escaped having their rates raised in last year's budget negotiations. Property tax rates are exceptionally low primarily because of Proposition 13, which was passed in 1978.

Because you have such a highly progressive tax structure in the state of California, the most successful and productive of the state's residents and businesses are the ones who are taxed the most on the margin. And they are the ones who make the decision whether to locate in California or, if they are already here, whether or not to stay.

With this in mind, juxtapose our high tax rates with the fact that there are nine states in the U.S. without a state personal income tax at all—including the biggies of Florida and Texas, in addition to California's neighbors, Nevada and Washington—and you can see why California once again is facing the very serious prospect of a brain drain. Just this past year my son took our family business and left California for Tennessee, a state with no income tax. It is a wonder that we have any entrepreneurs or venture capitalists in our state.

Primarily due to Pete Wilson's huge tax increases in California in 1990 and 1991 and more tax-friendly climates in neighboring states, Census Bureau data show that California went from importing a net of 207,000 people from other states in 1990 to losing 435,000 people in 1994 alone (Figure 5). And now we're back at square one because of progressive taxes. The consequences of these population inflows and outflows and their potential effects on state revenues should not be ignored. Considering that the wealthiest 3.1% of California's population pays 61.7% of the state's personal income taxes—by far the state's most important source of revenue—California can ill afford to tax the wealthy to the point where they choose to leave the state.¹ These wealthy residents, many of whom are baby boomers approaching retirement age, are mobile and could decide to become ex-Californians in a heartbeat.

Figure 5
California: Domestic Migration, 1981-2002
(in thousands of people)



Source: Demographic Research Unit, California Department of Finance

¹ California Franchise Tax Board, "2000 Annual Report."

This same logic applies to the state's businesses as well. One of the major costs of a business is the tax bill it has to pay. If you raise taxes on businesses, especially during bad economic times, the cost of doing business rises *pari passu*. These businesses then raise their heads and look around, and it won't take long for them to realize that most states have a more business-friendly environment than does California. In fact, there is nary a state with as high a corporate income tax rate within 2,500 miles of California.

The Supply-Side Version of Robin Hood

And don't for a moment think that our highly progressive tax structure here in California helps the poor, the minorities, or the disenfranchised—it doesn't. Just on an intuitive level, it should be self-evident that if a government taxes people who work and pays people who don't work, there will be more people who don't work and fewer people who do work. The more workers are taxed and the more non-workers are paid, the more people there will be who don't work. It's as straightforward as 1-2-3.

The important question to address, and one critical to California and the U.S., is what is the best way to help the poor? All of us understand the importance of helping those who really do have difficulty helping themselves. The question is not whether you want to help the poor. The question is, how can you, literally, make the poor better off?

If the rich are taxed and the money is given to the poor, do not be surprised if there are a lot of poor people and very few rich people. People respond to incentives. Whether it fits with your view of what the world should be or not, it is the way the world works. If you make an activity less attractive, people will do less of it. If you make an activity more attractive, people will do more of it. Taxes make an activity less attractive and subsidies make an activity more attractive.

I'd like to retell the story of Robin Hood, only here the supply-side version of the story of Robin Hood. If you'll remember the story, it begins with Robin and his band of merry men in the English town on Nottingham. They would wake up in the morning and don their light green leisure suits and go zipping off into the Sherwood Forest, where they would wait for hapless travellers by the trans-forest throughway hiding in amongst the trees.

If a rich merchant came by—and by rich I mean a super richie (this guy didn't have a silver spoon in his mouth, he had a golden goblet down his throat)—Robin would stop him, chat with him for a few minutes and then take everything the guy had. He'd make the guy run naked back into the forest. But before you feel sorry for the guy, remember he is so rich that by the time he gets back to his castle there will be lots of other golden goblets, lots of other jewels and wealth. He'll be just fine, none the worse for the wear.

If a prosperous merchant came through the forest, one who was just rich but not super rich, Robin would take almost everything the guy had, but not quite everything. If a normal, everyday average businessman came through the forest, Robin would take just a moderate chunk of what the man had. And if a poor merchant came through the forest, one who could barely make it, Robin would just take a little token from that guy.

In the vernacular of our modern day society, Robin had a progressive stealing structure from the merchants who came through the forest. You recognize the model, don't you? Doesn't it sound like the California government to you?

At the end of the day, Robin and his men would take their contraband and go back into Nottingham where they'd wander the streets. If they found someone who was down-and-out and had absolutely nothing, Robin would stop him and say, "Hi, my name's Robin Hood. I'm your local redistributionist agent around here and I'd just like to tell you how much I love you." And then Robin would give the destitute man a whole pile of goodies.

When Robin and his men found another person whom we'd call "working poor," with an income around \$10,000 a year at about minimum wage, they would give him a smaller bundle of goodies than they gave to the guy who had nothing. And if Robin Hood found some normal, everyday average citizen walking around the streets of Nottingham, Robin would give the man a small token equivalent to our modern day tax rebate. Robin would add, "You and your wife go out to dinner and the wine's on me." If Robin happened to bump into a rich person, he might just rip him off.

Once again using today's words, the more a person makes the less Robin gives him, and the less a person makes the more he gives him. You follow the model: he stole from the rich and gave to the poor. The richer you were the more he'd steal from you, the poorer you were the more he'd give you. This is the story of Robin Hood.

Now, put on your supply-side economics hat and imagine for a moment that you are a merchant back in the ancient days of Nottingham: **HOW LONG WOULD IT TAKE YOU TO LEARN NOT TO GO THROUGH THE FOREST?** Those merchants who couldn't afford armed guards would have to go around the forest in order to trade with the neighbouring villages. The route around the forest is a lot longer and full of rocks, bumps, logs, holes, etc.—it was far more costly doing commerce when you're travelling around the forest rather than going through the forest.

Those merchants who could afford armed guards (and by the way, today we call these armed guards lawyers, accountants and lobbyists) would go through the forest and Robin couldn't rip them off. And believe me when I tell you that those armed guards were as expensive then as they are today. So at the end of the second day, Robin Hood had no contraband whatsoever to give to the poor. All he had succeeded in doing was driving up the cost of doing business, which meant the poor had to pay higher prices and were literally worse off. By stealing from the rich and by giving to the poor, Robin Hood made the poor worse off.

And so it is in California as I write this paper. The poor, who rely on the state for their sustenance, are having their benefits cut to the bone; because of our state's business-unfriendly policies, our unemployment rate is higher than the national average; because of our bad governance, we have one of the worst K-12 education systems in the nation. I could go on and on, but the point is simple enough. Our progressive tax structure is not benefiting the truly needy.

Let me put the theorem to you precisely (and I could prove it to you mathematically if need be): By trying to redistribute income, government never, ever succeeds in redistributing income. But what government does accomplish when it tries to redistribute income is the destruction of the volume of income. Government cannot change the distribution of income with taxes but it always lowers the volume of income with taxes. As we look across the world at the progressive tax structure of California and other economies, it's amazing how the distribution of income, if anything, is made worse. And that's where we are today.

To me the best form of welfare is still a good, high paying job. There is no alternative to economic growth.

Ending the Crisis Cycle

If California ever wishes to break out of its fiscal crisis cycle it must redress the progressivity of its tax codes, pure and simple. Spending controls by themselves won't work. You can't expect politicians to set aside and then not spend a rainy day fund of \$75 billion or more. And for sure they won't pass billions of unspent dollars on to their term-limited successors. It just ain't going to happen. No sooner was the Gann spending limit actually effective than Proposition 111 passed, rendering it totally ineffectual. The best form of spending control is the simplest form of spending control: don't give government the extra money during good times and don't shortchange essential programs during tough times. The case for a flat tax is nowhere more compelling than it is in California today.

My preferred flat tax structure would encompass all local taxes as well as state taxes. Today that number is somewhere around \$120 billion with some \$70 billion needed for the state's general fund, \$20 billion for state special funds and \$30 billion for local government. "Sin taxes" should be excluded from consideration as part of a flat tax because their purpose is more to alter behavior than it is to raise revenues. Fines for speeding, disturbing the peace and illegal parking, along with court ordered payments and taxes on alcohol, tobacco and firearms, are classic sin taxes and really do make sense. But other than these sin taxes, every state and local tax should be abolished. And I do mean abolished.

The new governor—or Gray Davis if he survives—should heed the warning of the recall and get rid of all sales taxes state and local, all income taxes business and personal, all payroll taxes, all property taxes commercial and residential, all excise taxes, and all those other taxes that boggle the mind both by their numbers and their inanity. Everything other than sin taxes should have "Hasta La Vista, Baby" shouted at them.

In their stead California should enact two single rate flat taxes, one placed on business net sales and one on personal unadjusted gross income. A company's net sales tax base would simply be total sales less purchases from other companies, i.e., net sales. No other deductions should be allowed, period.

Businesses would as a result expense 100% of all capital purchases because capital is purchased from other companies which have already paid the taxes. No double taxation. There would never be an issue of loss carryforwards or other such complications. Every company would pay its share of the tax burden based upon its use of California's precious natural resources. The distortions inherent in our current tax codes that discriminate against successful companies by taxing profits, and by the process of elimination subsidize inefficient companies, would be gone, gone, gone. The only issue for businesses might be some transition considerations resulting from the existing tax codes, but these are really not of any great import.

For individuals, no income should be exempt from taxation just because that income is below a certain threshold. In other words, the first \$30,000 of income should be taxed at the same rate as every other \$30,000 of income. Maybe I missed something in Econ 1, but I have never understood the benefit of a tax deduction to someone with no income. Deductions don't help the truly poor, they just require offsetting higher tax rates where those tax rates do the most damage.

For individuals the tax base would be total income minus deductions for home mortgage interest expense, charitable contributions and rent on one's primary residence (if the taxpayer is not a homeowner). Interest deductibility is the right thing

to do from the standpoint of economics as well as from the standpoint of politics. If interest income is taxable then interest expense must be deductible. The rationale for deducting charitable contributions is self-evident. Rent on one's primary residence should also be deductible as long as homeowners aren't required to pay tax on the imputed rental value of their homes. While there are other complications for gamblers, independent contractors, transfer payments, government output, etc., these don't materially affect the principal. Both the business tax base and the personal tax base are each approximately equal to gross state product.

With California gross state product averaging some \$1.35 trillion per year over the last five years and total state and local tax revenues less sin tax revenues averaging \$120 billion per year over five years, to match revenues over time, without presuming a supply-side or Laffer Curve effect, the tax rate on business net sales and on personal unadjusted gross income would be somewhere in the range of 5.85% and 6.00%. For more on my California flat rate tax, including detailed revenue data and tax rate calculations, please see my two recent papers on this topic.² Most individuals wouldn't even have to file a tax return as long as they received all of their income from accredited employers who withheld. All personal taxes would be deductible on federal tax returns, thus providing additional benefit to California taxpayers. But most of all there would be no state income taxes, no state and local sales taxes, no property taxes, no state gas taxes and no state payroll taxes, none, none, none.

Conclusion

Can you imagine the dynamics of California in competition with other states? California's tax revenues would fluctuate mildly, right in line with the state's personal income. The incessant urge of government to overspend would be a thing of the past and the incentives to flee the state for more friendly shores would vanish. We truly would be the Golden State. And who knows, maybe someone in Washington, D.C. would pay notice.

²Arthur B. Laffer, "A Flat Rate Tax for California State and Local Governments," Laffer Associates, April 28, 2003; Arthur B. Laffer, "Will Gray Davis Survive?" Laffer Associates, August 6, 2003.

APPENDIX

Table A-1
A Partial Selection of California's State, County and City Taxes and Fees

abandoned vehicle fees	fish and game violation fines	penalties on traffic violations
activity fee	foreign corporation fees	penalty assessments
additional assessments on fish and game fines	franchises tax	penalty assessments on fish and game fines
admission tax	garbage truck inspection fees	personal income tax
aircraft jet fuel tax	general fees – Secretary of State	phone booth permits
alcoholic beverage taxes and fees	general fish and game licenses tags permits	phone, california high cost fund-A (CHCF-A)
animal licenses	general fish and game taxes	phone, california high cost fund-B (CHCF-B)
animal shelter fees and charges	generator fee	phone, california relay svc. and comm. d.f. surcharge (DDTP)
architecture public building fees	genetic disease testing fees	phone, california teleconnect fund surcharge (CTF)
ballast water management fee	golf course fees	phone, city and county utility taxes
beverage container redemption fees	guardianship fees	phone, emergency telephone users surcharge tax
breast cancer research cigarette stamp tax	hazardous material fees	phone, rate surcharge
building construction filing fees	hazardous waste control fees	phone, rate surcharge
business license tax	health and dental fees	phone, service provider number portability
cable, city cable fee	highway carrier uniform business license tax	phone, state regulatory fee (PUCURA)
cable, franchise fee	horse racing (parimutuel) license fees	phone, universal lifeline telephone service surcharge (ULTS)
California children and families first cig. stamp tax	industrial homework fees	plan checking fees
California State University Fees	insurance company examination fees	private rail car tax
California tire fee	insurance company license fees and penalties	private railroad car tax
candidate filing fees	insurance department fees, general	proceeds from estates of deceased persons
childhood lead poisoning prevention fee	insurance department fees, Prop. 103	public administrator fees
cigarette and tobacco products surtax	insurance fraud assessment, auto	public safety fund sales tax
cigarette tax	insurance fraud assessment, general	quarterly public utility commission fees
city and county sales tax	insurance fraud assessment, workers comp.	real property transfer tax
construction permits	insurance gross premium tax	recording fees
corporation tax	integrated waste management fee	renewal fees
county clerk – miscellaneous fees	interest, penalties, and delinquent taxes	retail sales and use tax
county transportation tax	interstate user tax	retail sales and use tax-realignment
court fees	library fines and fees	revenue – abandoned property
court filing fees and surcharges	liquor license fee	sale of real and personal property
delinquent fees	local revenue fund state sales tax	sales of documents
disposal fee	marriage licenses	secured and unsecured property tax
district transactions and use tax	motor vehicle fuel tax (diesel)	sewer service charges and connection fees
division of real estate examination fees	motor vehicle fuel tax (gasoline)	solid waste collection
division of real estate license fees	motor vehicle license (in-lieu) fees	special district taxes
domestic corporation fees	motor vehicle registration	state beach and park service fees
duck stamps	museum hall and art commission fees	state disaster relief tax
eating places licenses	natural gas surcharge	state energy surcharge
electric, CA public benefit fee	new motor vehicle dealer license fee	state tax
electric, city tax	notary public license fees	street and curb permits
electric, franchise fee	occupational lead poisoning prevention fee	street sweeping fee
electric, state regulatory fee	off-highway vehicle fees	subdivision filing fees
electric, underground surcharge	oil spill response fee	teacher credential fees
electric, user utility fee (UUT)	oil spill response, prevention, and admin. fees	teacher examination fees
electrical energy surcharge	open space cancellation fee	telecommunications tax
elevator and boiler inspection fees	other property tax	timber yield tax
employer's payroll tax	other regulatory fees	towing fees
employment agency filing fees	other regulatory licenses and permits	traffic violations
employment agency license fees	other regulatory taxes	trailer coach license (in-lieu) fees
engineering fees, inspection, and others	opera and civic auditorium fees	transient lodging tax
environmental fee	parental fees	underground storage tank maintenance fee
estate, inheritance and gift tax	parking lot revenues	uninsured motorist fees
explosive permit fees	parking permits	voter approved indebtedness property tax
facility free and tiered permit fees	parking violations	waste water system maintenance
farmers market and ag. commission fees	parks and recreation fees	water service charges
filing financing statements	pay patients board charges	water, high elevation charge
fines and forfeitures	penalties and interest on personal income tax	water, special facility charge
fingerprint ID card fees	penalties on public utility commission quarterly fee	zoning and subdivision fees