

*I bet you're wondering how I knew
About your plans to make me blue
With some other guy you knew before.
"Heard it through the Grapevine"
—Marvin Gaye*

Chapter 8

The California Story: Karl Marx vs. Adam Smith

California has many policy success stories. From rolling back and capping property taxes via Proposition 13, to the Gann spending limit, indexing the personal income tax for inflation, and repealing the state estate tax, California has often been the pro-growth policy leader of the U.S. But, then there are periods like today. First, a little history.

California was one of the many states that adopted both a sales and an income tax during the Great Depression. And this perverted thinking of raising taxes during bad times has persisted to this very day. California's implementation of sales and income taxes was the primary enabler that fostered the explosive growth of California's government. Progressive personal and corporate income taxes are the necessary policy precursors to empower big government. The California state sales tax took effect in 1933 at a rate of 2.5 percent and its state income tax began in 1935.

California's income tax had a difficult birth. Although voters decisively rejected in 1932 Proposition 9 that would have required the Legislature to adopt an income tax to fund schools, among other things, the Legislature approved a proposal (AB 2429) for an income tax in 1933. However, the bill was vetoed by Governor James "Sunny Jim" Rolph.

Due to the transfer of a considerable amount of state taxes to counties in 1935, the Joint Committee on Revenue and Taxation urged the Legislature to adopt an income tax. The proposal, introduced by Assemblyman Ford Chatters from the San Joaquin Valley as AB 1182, was subjected to numerous amendments drawn by University of California Professor Roger J. Traynor (who later became chief justice of the California Supreme Court).

As passed and signed into law (Statutes of 1935, Chapter 329) by Governor Frank Merriam, the bill was modeled after the federal income tax (as embodied in the Federal Revenue Act of 1934) and had rates of 1 percent of the first \$5,000 of net income up to 15 percent on net income in excess of \$250,000 (approximately one-fourth of federal rates). Definitions of taxable income differed somewhat with federal law, however. Net income generally included wages, profits, and gains.¹

Exhibit 33

California Historical Tax Rates, Selected Taxes (where applicable, rates are top marginal rates)

Year	Personal Income	Corporate Income	State Sales & Use	Combined State & Local Sales & Use	Insurance	Estate	Vehicle License Fee (VLF)	Gasoline	Cigarette	Beer	Distilled Spirits
1970	10.00%	7.00%	4.00%	5.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1971	10.00%	7.00%	4.00%	5.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1972	10.00%	7.60%	3.75%	5.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1973	11.00%	7.60%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1974	11.00%	9.00%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1975	11.00%	9.00%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1976	11.00%	9.00%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1977	11.00%	9.00%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1978	11.00%	9.00%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1979	11.00%	9.00%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1980	11.00%	9.60%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1981	11.00%	9.60%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1982	11.00%	9.60%	4.75%	6.00%	2.35%	24.00%	2.00%	\$0.07	\$0.10	\$0.04	\$2.00
1983	11.00%	9.60%	4.75%	6.00%	2.33%	16.00%	2.00%	\$0.09	\$0.10	\$0.04	\$2.00
1984	11.00%	9.60%	4.75%	6.00%	2.33%	16.00%	2.00%	\$0.09	\$0.10	\$0.04	\$2.00
1985	11.00%	9.60%	4.75%	6.00%	2.33%	16.00%	2.00%	\$0.09	\$0.10	\$0.04	\$2.00
1986	11.00%	9.60%	4.75%	6.00%	2.35%	16.00%	2.00%	\$0.09	\$0.10	\$0.04	\$2.00
1987	11.00%	9.60%	4.75%	6.00%	2.35%	16.00%	2.00%	\$0.09	\$0.10	\$0.04	\$2.00
1988	9.30%	9.30%	4.75%	6.00%	2.35%	16.00%	2.00%	\$0.09	\$0.10	\$0.04	\$2.00
1989	9.30%	9.30%	4.75%	6.00%	2.35%	16.00%	2.00%	\$0.09	\$0.35	\$0.04	\$2.00
1990	9.30%	9.30%	5.00%	6.25%	2.35%	16.00%	2.00%	\$0.09	\$0.35	\$0.04	\$2.00

Year	Personal Income	Corporate Income	State Sales & Use	Combined State & Local Sales & Use	Insurance	Estate	Vehicle License Fee (VLF)	Gasoline	Cigarette	Beer	Distilled Spirits
1991	9.30%	9.30%	6.00%	7.25%	2.35%	16.00%	2.00%	\$0.15	\$0.35	\$0.04	\$2.00
1992	11.00%	9.30%	6.00%	7.25%	2.35%	16.00%	2.04%	\$0.16	\$0.35	\$0.20	\$3.30
1993	11.00%	9.30%	6.00%	7.25%	2.35%	16.00%	2.00%	\$0.17	\$0.35	\$0.20	\$3.30
1994	11.00%	9.30%	6.00%	7.25%	2.35%	16.00%	2.00%	\$0.18	\$0.35	\$0.20	\$3.30
1995	11.00%	9.30%	6.00%	7.25%	2.35%	16.00%	2.00%	\$0.18	\$0.37	\$0.20	\$3.30
1996	9.30%	9.30%	6.00%	7.25%	2.35%	16.00%	2.00%	\$0.18	\$0.37	\$0.20	\$3.30
1997	9.30%	8.84%	6.00%	7.25%	2.35%	16.00%	2.00%	\$0.18	\$0.37	\$0.20	\$3.30
1998	9.30%	8.84%	6.00%	7.25%	2.35%	16.00%	2.00%	\$0.18	\$0.37	\$0.20	\$3.30
1999	9.30%	8.84%	6.00%	7.25%	2.35%	16.00%	1.50%	\$0.18	\$0.87	\$0.20	\$3.30
2000	9.30%	8.84%	6.00%	7.25%	2.35%	16.00%	1.30%	\$0.18	\$0.87	\$0.20	\$3.30
2001	9.30%	8.84%	5.75%	7.00%	2.35%	16.00%	0.65%	\$0.18	\$0.87	\$0.20	\$3.30
2002	9.30%	8.84%	6.00%	7.25%	2.35%	16.00%	0.65%	\$0.18	\$0.87	\$0.20	\$3.30
2003	9.30%	8.84%	6.00%	7.25%	2.35%	16.00%	0.65%	\$0.18	\$0.87	\$0.20	\$3.30
2004	9.30%	8.84%	6.25%	7.25%	2.35%	16.00%	0.65%	\$0.18	\$0.87	\$0.20	\$3.30
2005	10.30%	8.84%	6.25%	7.25%	2.35%	0.00%	0.65%	\$0.18	\$0.87	\$0.20	\$3.30
2006	10.30%	8.84%	6.25%	7.25%	2.35%	0.00%	0.65%	\$0.18	\$0.87	\$0.20	\$3.30
2007	10.30%	8.84%	6.25%	7.25%	2.35%	0.00%	0.65%	\$0.18	\$0.87	\$0.20	\$3.30
2008	10.30%	8.84%	6.25%	7.25%	2.35%	0.00%	0.65%	\$0.18	\$0.87	\$0.20	\$3.30
2009	10.55%	8.84%	7.25%	8.25%	2.35%	0.00%	1.15%	\$0.18	\$0.87	\$0.20	\$3.30
2010	10.55%	8.84%	7.25%	8.25%	2.35%	0.00%	1.15%	\$0.35	\$0.87	\$0.20	\$3.30
2011	10.30%	8.84%	6.25%	7.25%	2.35%	0.00%	1.15%	\$0.35	\$0.87	\$0.20	\$3.30

Base/measure: Personal income: taxable income; Corporate income: net income; Retail sales and use: receipts from sales or lease of taxable items; Insurance: gross premiums; Estate: taxable federal estate; VLF: market value; Gasoline: gallon; Cigarette: package; Beer: gallon; Spirits: gallon.
Source: California Governor's Budget Summary (various editions), California State Board of Equalization

California's original personal income tax was steeply progressive and extraordinarily anti-growth. And, so it is again today. California's economy currently struggles with a steeply progressive and exceptionally high personal income tax rate system and a high corporate income tax rate—both of which were seen to be associated with low growth from our cross state analyses. Additionally, the operations of California's state and local government bureaucracy are rife with misaligned incentive structures, not to mention that the legislature is completely dysfunctional. All of these obstacles combine to create the anti-growth policy environment that is now plaguing the state.

Righting California's economy requires an understanding of how California's current anti-growth policies are altering the incentives to work, save, and invest in the state. It is the universal applicability of the theory of incentives across all states (and nations) that explains why even in California economic policies matter.

Earlier chapters provided the theory linking changes in economic policies to changes in economic outcomes. Chapter 3 looked at all of the states while Chapter 7 focused on California's housing

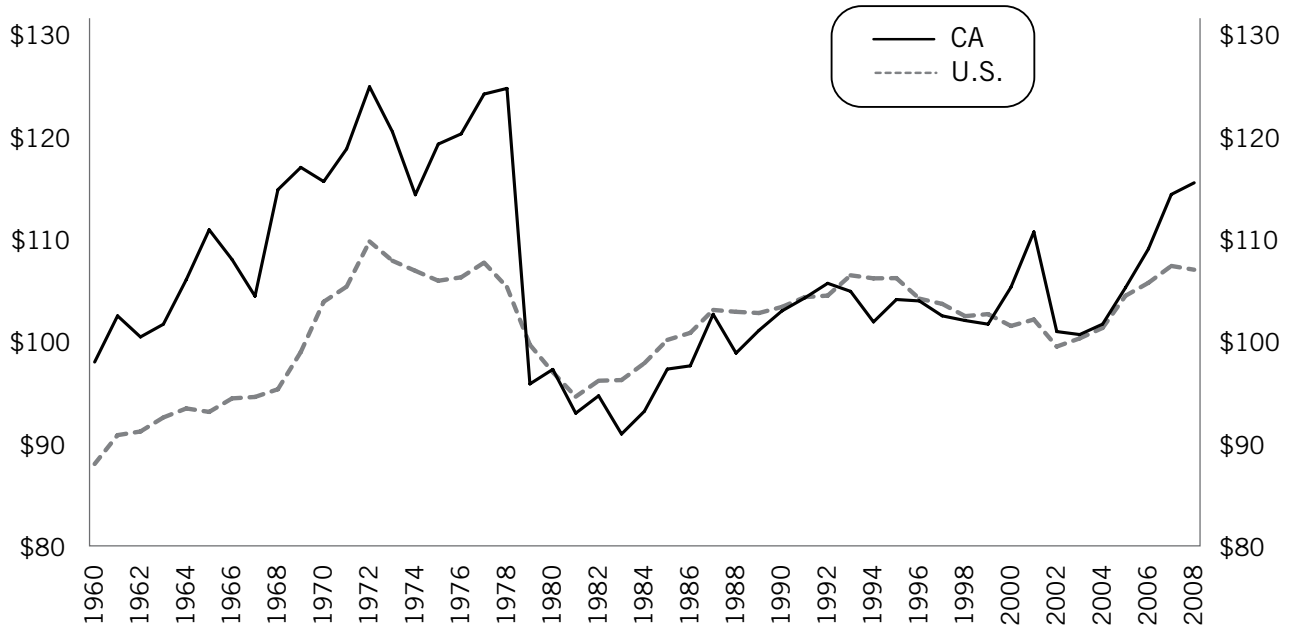
Righting California's economy requires an understanding of how California's current anti-growth policies are altering the incentives to work, save, and invest in the state.

market. As illustrated in our review of all 50 states, there is a strong correlation between sound pro-growth economic policies and robust economic outcomes. California's own history illustrates the same strong correlation between sound economics and prosperity. Although macroeconomists lament the fact that they have no truly controlled experiments to use to isolate the effects of different fiscal policies, the case of California comes pretty close to fitting the bill. This chapter provides a brief review of California's economic history, emphasizing the key policy changes and subsequent economic results to illustrate that California's economic prosperity is also linked to the economic policies that it implements.

California's political and economic swings from Karl Marx to Adam Smith become apparent when we compare the total tax burden (total state and local tax receipts divided by the state's personal income) in California to the total state and local tax burden in the U.S. When California's state and local tax burden was low, California prospered by just about any measure you would like to pick. And when California's state and local tax burden was high, the opposite held true as well. The present circumstances of California's economy are yet more proof of the principle that bad results follow bad policies. Exhibit 34 compares California's tax burden to the U.S. tax burden from 1960 through 2010. An inspection of Exhibit 34 shows that we should focus our review on several key periods.

Exhibit 34

Tax Burden for California and U.S. State and Local Tax Revenues per \$1,000 of Personal Income



Source: Bureau of Economic Analysis, U.S. Census Bureau

The first period encompasses the 1960s on through the mid 1970s. At the outset, California's tax burden was substantially higher than the nation's tax burden and as this period progressed, California's already heavy tax burden continued to increase, rising even further above the also-rising U.S. average. Then, seemingly in a blink of an eye in the late 1970s, California's tax burden dropped dramatically back to the U.S. average where it remained for a number of years—the second period. The third period begins during the late 1980s and early 1990s, when California's previous lower-than average tax burden grew again, returning California up to the U.S. average. The fourth period began in the late 1990s and lasted through the early 2000s when the tax burden once again fell back below the U.S. average. Finally, the last period began in the mid-2000s when California's tax burden surged higher than the national average for all state and local governments and has continued to the present. Exceptionally observant readers will connect these periods with the changing economic outcomes presented in Chapter 7.

But the one problem we have identified as universal has plagued California throughout all of these periods: California's steeply progressive corporate and personal income tax system. If we had to sum up the booms and busts of California's volatile history, two words would suffice: *progressive taxes*. California's progressive income tax accentuates California's economic and tax revenue volatility. The higher California's top personal income tax rate, the greater California's volatility has been. Due to the pivotal role the progressive income tax has played in California's economic history, it is useful to first review California's progressive income tax problem.

Progressive Taxes Are Driving California Progressively Broke

Our story outline runs as follows: politicians in Sacramento inevitably paint themselves into a corner. 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 high income earners. Yet since government spending is much easier to expand than it is to contract, the revenue shortfalls lead to massive deficits.

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.

To close the budget deficit gap, the “solution” all too often is to hike taxes even more, which in turn serves to further discourage employment and output—and hence reduces the tax base. Because of the dynamic effects (as illustrated by the Laffer Curve), the tax hikes don't raise as much revenue as predicted, and thus budget deficits persist and continue to disappoint. At the same time, welfare rolls and other support programs expand right along with rising unemployment. The downward spiral is only arrested when the public is finally fed up and demands drastic tax relief. Yet old habits die hard; the vicious cycle resumes once again in a few years when the public has forgotten the lesson. But at each new cycle the

tax and spending problems ratchet up further and further. California today may just be testing how far this vicious cycle can go.

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 mandatory education spending levels regardless of need or student performance, personal income tax increases, increases in the gas tax, increases in the sales tax, and a disemboweling of the Gann spending limit (Proposition 111)—all horrible!

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. Those who argue that California’s government is more liberal than its electorate miss the point: big government is a byproduct of a progressive tax code.

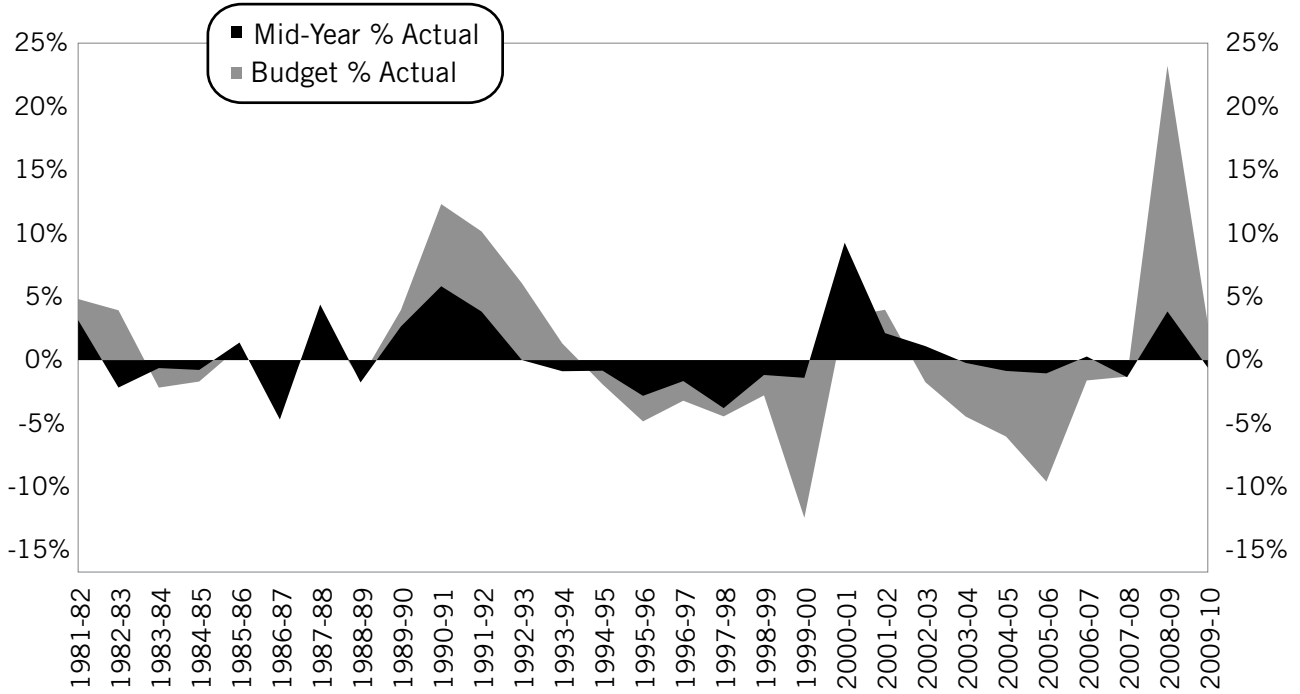
Progressive tax codes lead to a plethora of specific fees and taxes, many of which don’t even raise enough revenue to pay for the costs of their collection. It’s a shame, but true. It’s always tough (but not impossible) to raise the big taxes—especially with the Proposition 13 mandated two-thirds majority 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 turn to less visible taxes, often disguised as fees. As a result, we have literally thousands of taxes and fees at the state and local level here in California. While it may be impossible to compile a complete list of all state and local taxes and fees levied, you can surely get a flavor of what Californians face by reviewing Appendix A.

The volatility created by California’s progressive tax system also makes it difficult to forecast revenues for the state. Exhibit 35 illustrates California’s budgeting record. Whether it was during the actual budget process (about 12 months before the end of the fiscal year) or during the mid-year review (about six months before the end of the fiscal year), California’s progressive income tax system has led to massive overestimates of general fund revenues during difficult economic times and massive underestimates of general fund revenues during periods of strong economic growth. To partially explain these gigantic goofs, in Exhibit 36 we show the shocking “V”-shape pattern of California revenue from the tax on personal income. The surges and drops in tax revenue from personal income’s share of total General Fund revenues correspond with the persistent underestimating and overestimating of revenues.

California’s progressive income tax system has led to massive overestimates of general fund revenues during difficult economic times and massive underestimates of general fund revenues during periods of strong economic growth.

Exhibit 35

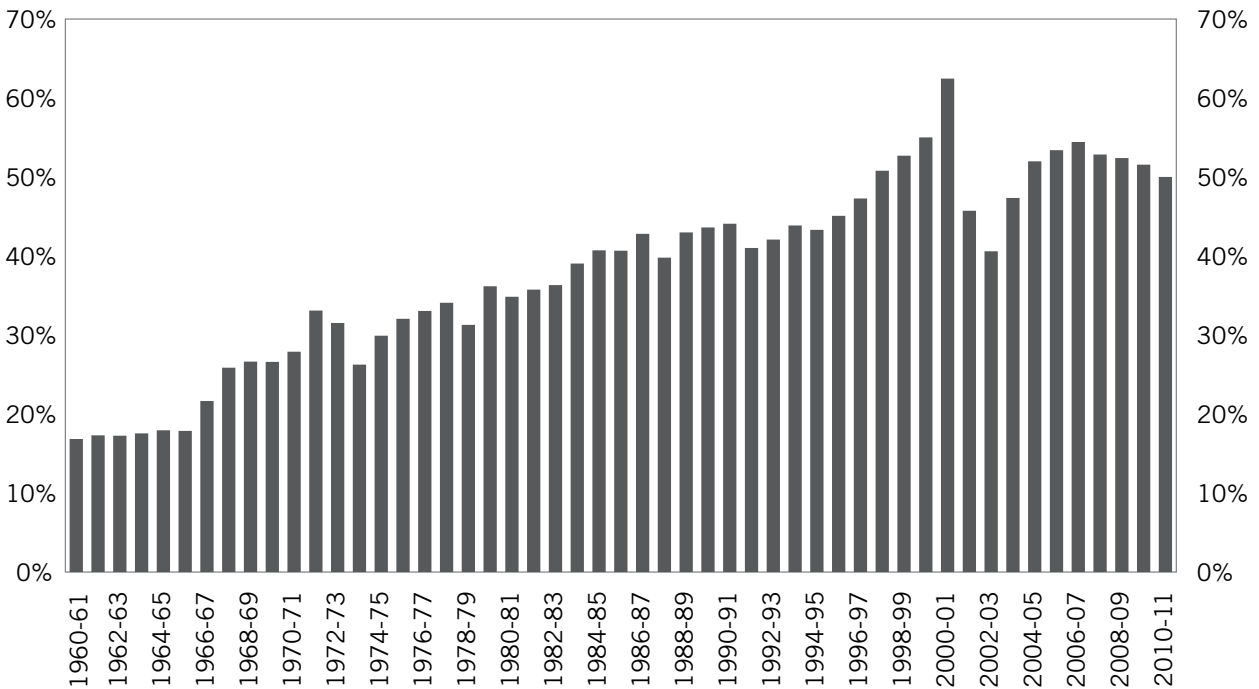
California General Fund Revenue (and Transfers): Forecast as a Percent Above or Below Actual



Source: California Department of Finance

Exhibit 36

California Revenue from Personal Income Taxes as a Percent of General Fund Revenue FY1980-81 through FY2010-11



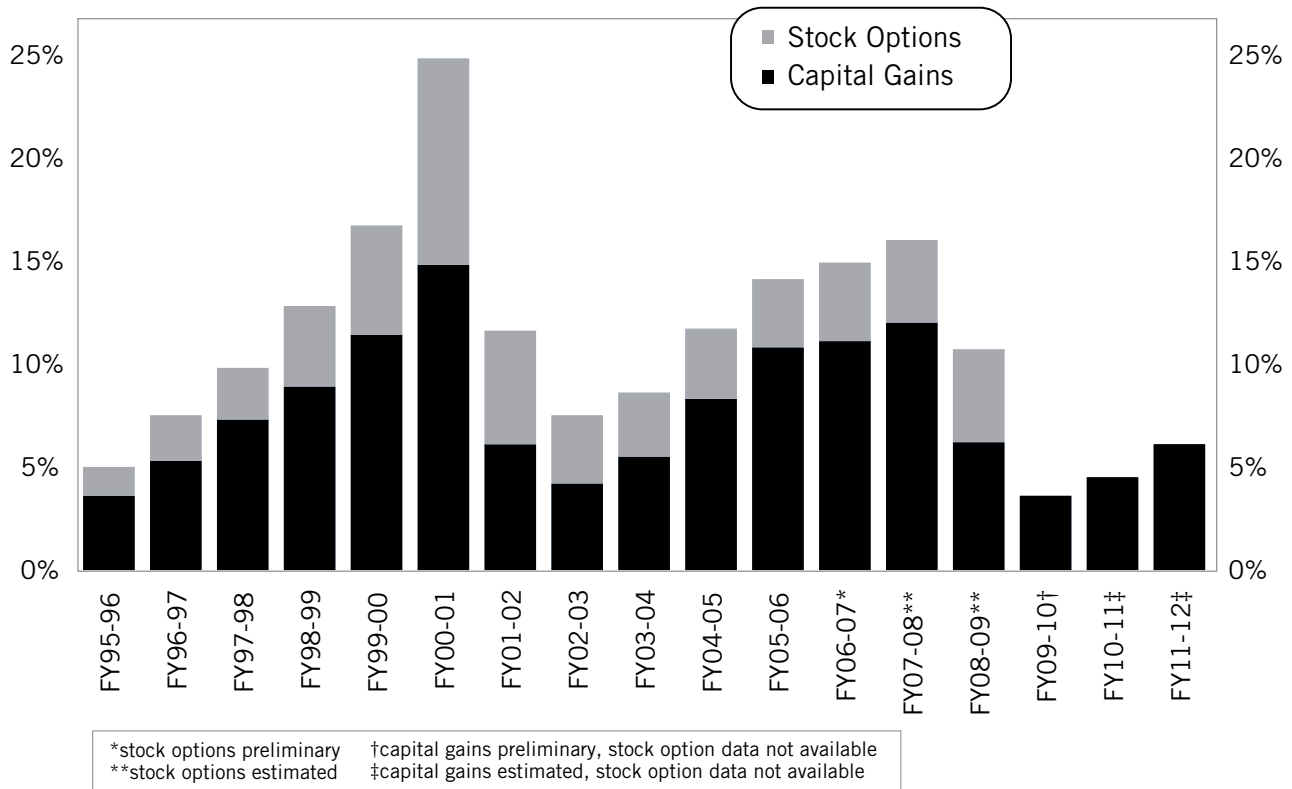
Source: California Legislative Analyst's Office

To drive home the point, consider this: the number of reported millionaires in California dropped from 44,000 in 2000 to 29,000 in 2002. And yet those original 44,000 millionaires contributed \$15 billion to the state treasury in 2000, meaning that the richest 0.15 percent of the population contributed roughly 20 percent of the total income tax revenues. The last thing in the world California should ever want to do is drive these people away or to enact policies that make them poor. Make no mistake, there really are productive individuals who have moved out of California.

In fact, if we digress a little bit more, not only are millionaires important, but two components of their income are inordinately important...taxes collected on realized capital gains and exercised stock options. These two sources of tax revenue as a share of general fund revenues are plotted in the chart below. Just look at 2000. A full 24.8 percent, almost one-fourth of all general fund revenues came from these two sources alone. It is inconceivable yet true nonetheless that almost one-fourth of all general fund revenues come from taxes collected on exercised stock options and realized capital gains. Talk about a messed up system. And you wonder why tax revenues in California are so volatile?

Exhibit 37

California Revenue from Stock Options and Capital Gains as a Percent of General Fund Revenue FY1995-06 through FY2011-12 (estimated)



Source: California Governor's Budget Summary, various years

The policy mess in Sacramento cannot be solved without addressing California's steeply progressive income tax that encourages budget boom and bust. The Golden State applies a top marginal income tax rate of 10.3 percent, one of the highest on earnings of any state, according to the Tax Foundation. And the 10.3 percent (as of September 2011) applies to capital gains as well as ordinary income. Because federal tax deduction for state income tax payments are a preferred item on the Alternative Minimum Tax (AMT), a rising share of those who pay the 10.3 percent rate are now hit by the federal AMT. About one-third of California's income tax is no longer deductible on the federal tax return. State taxation without federal tax deductibility is one more reason for taxpayers to flee the state.

Just to mention in passing, the current 10.3 percent highest marginal tax rate was 10.55 percent last year until the surcharge lapsed. The powers that be couldn't get the surcharge renewed, although God knows they tried.

Our quick lesson leads to the obvious conclusion: If California wants to balance its budget and revitalize its economy, the progressivity of the income tax system needs to be either diminished or greatly reduced and the tax rates need to be slashed, not increased. In my opinion, relying on the vigilance of the voters to “guard the guardians” is naïve. If you don’t believe me just look again at Appendix A, a partial selection of California’s State, County and City Taxes and Fees. A more promising approach is to completely revamp California’s tax code, replacing it with a single tax rate on two flat tax bases of personal income and business value added. By reducing the highest marginal tax rates, such a reform would immediately energize the state’s most productive individuals, as well as attract more talent from outside its borders. Beyond the boost to average incomes and growth, the switch to a low rate flat tax would also allow California to reduce its overall tax burden and the volatility of its tax revenue stream. But, we will discuss this in more detail later.

Now that we’ve summed up the problems with California’s steeply progressive income tax, we next offer a punctuated chronology of some of the major events in California’s history to better understand how we got into our current fix, and to underscore our claim that pro-growth policies are the only solution. California truly is a state of exaggerated policy swings moving from Karl Marx to Adam Smith and back again in a blink of an eye.

The Gipper as Governor: Don’t Let Reagan Be Reagan

From the early 1960s to the early 1970s, California, along with the aggregate of all states, increased taxes as a share of personal income by enormous amounts, see Exhibit 34. From 1960 to 1972, California increased total state and local tax receipts as a share of personal income from 10 percent to 12.7 percent, as shown in Exhibit 34. In the vernacular, that percentage increase in California’s total tax burden is not “chopped liver” by any stretch of the imagination. During that same time period the sum of all states raised their tax burden from 8.9 percent to 11.1 percent. California was right at the forefront of the lemmings as they marched over the cliff. Edmund G. (Pat) Brown was governor during the 1960 to 1967 period, followed by Ronald Reagan. For those of you who weren’t around back then, Pat Brown was current Governor Jerry Brown’s father. I remember Pat Brown most for his editorial comment responding to my support for Prop. 13: if he were a Communist he would support Prop. 13. There you go!

To keep everything in its proper perspective, the 1960s and early 1970s were the eras of the “Go-Go” sixties, followed by the Johnson/Nixon melt-down. The mid-1970s was a period of massive tax indigestion following the tax binge. The U.S. economy was weak everywhere, but was especially bad in California.

For the country as a whole, the period 1966 through 1982 was the period when America was governed by whom I like to refer to as the four stooges...Johnson, Nixon, Ford, and Carter; the largest assemblage of bipartisan ignorance ever put on planet earth.

The stock market is probably the perfect metric to give you a flavor of just how bad that period was. In early February 1966, following President Kennedy’s tax cuts and other Kennedy Administration

supply side measures, the Dow Jones Industrial Average hit an intraday high of 1000. About 16½ years later in August of 1982, the Dow Jones Industrial Average hit a low of 777. That corresponds to a nominal decline of 22.3 percent in the value of America's capital stock in 16½ years.

But from early 1966 to August 1982, the U.S. price level trebled so the change in the real inflation adjusted value of the Dow Jones Industrial Average went from 1000 in February 1966 to 235 in August of 1982. That is a 76.5 percent decline in 16½ years, or slightly over a 7 percent annual average compounded decline. That really is a bear market.

From 1960 until 1978, California's tax burden and the aggregate tax burden of all states moved in lock step, with California always having a much higher tax burden. From 1960 through 1977, California remained one of the very highest taxed states in the nation—a dubious honor to be sure. In 1977, for example, California ranked as the third highest taxed state in the nation. In 1960, California had been way up there on the tax charts too. But prior to the end of the 1960s, even though California's taxes were relatively very high, they had been rising sharply from a much lower base (see Exhibit 34).

From the standpoint of how a state's economy performs, both the state's absolute tax burden and its relative tax burden should be important. Using an admittedly extreme hypothetical illustration to make our point, if California's state tax burden were twice that of other states', and yet amounted to only two pennies of tax per \$1,000 of income, the relative tax burden should have only a minimal impact on how well California's economy should perform. The absolute tax burden would be so small as to dilute the relative tax effect.

In the very early 1960s California's relative tax burden was quite high, but its absolute tax burden was much less than it was in the mid-1970s. As a result of a lower absolute tax burden, California's relative tax burden should have weighed less heavily on California's economy in the early 1960s than in the mid-1970s. However, consistently increasing taxes from a low tax burden will eventually lead to a large tax burden. And, while no one appreciates President Ronald Reagan (1967-1975) more than we do, a sharply rising tax burden is what happened during his watch by the late 1960s and early 1970s.

If not the very best president ever, Ronald Reagan was surely one of the best presidents in our nation's history. In fact, in our view, Reagan's only modern challenger for greatness was John F. Kennedy. But part of Reagan's greatness was his humanity, humility, and ability to learn from his mistakes—of which he made several while serving as governor of California. Although some of Reagan's critics may bitterly point to the “Bloody Thursday” shooting at UC Berkeley or his enthusiasm for capital punishment, Reagan was in many respects a Hollywood liberal on social issues. In our view, Governor Reagan's critical mistake came when he hiked the highest tax rates on personal and on corporate income, as well as on capital gains. The top marginal rate on personal income and capital gains went from 9.3 percent to 11 percent by 1974, and the top marginal tax rate on corporate income was 9 percent by 1974. Yikes!

The savior for California in the early to mid 1960s was the pro-growth U.S. policies of the Kennedy Administration at the federal level. Kennedy not only cut tax rates like mad, but he also put in the investment tax credit, shortened lives for depreciable assets, and pushed the Kennedy Round

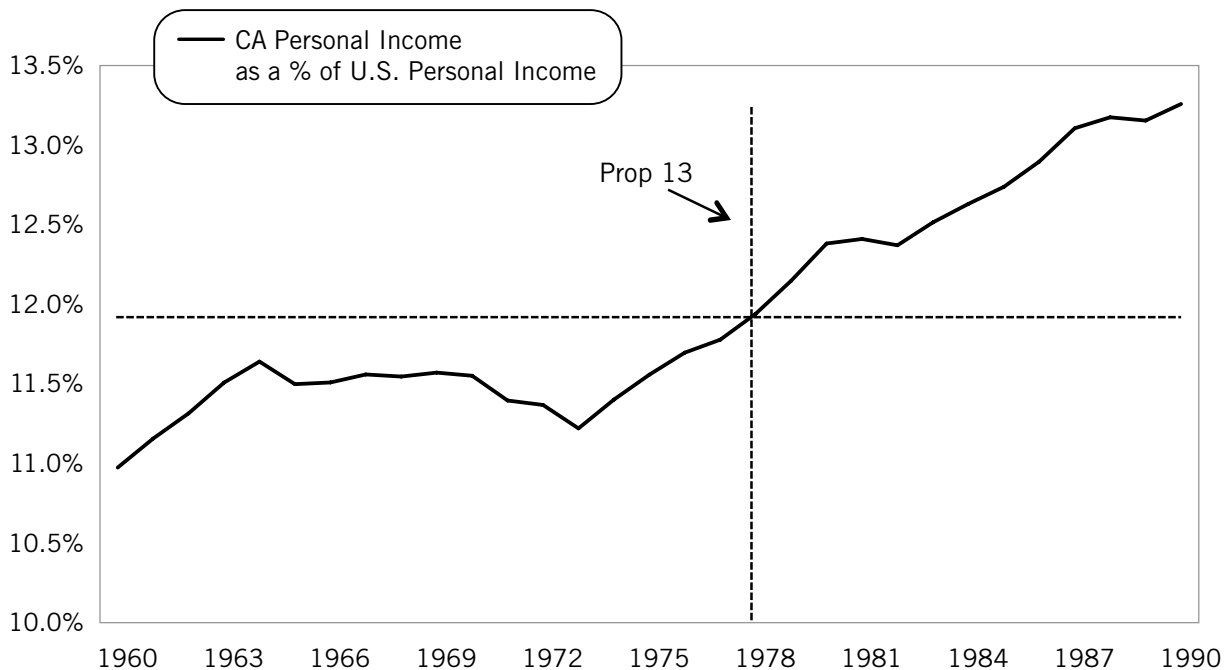
tariff cuts into a reality. As a result, U.S. growth was enormous and the period was called the “Go-Go” sixties. California benefitted from U.S. growth. But once U.S. growth was gone, so was California.

During the late 1960s through the mid-1970s, the reader will recall, California’s economy underperformed. Four of the variables we have tracked as measures of economic well-being are relative personal income growth, relative population growth, relative employment growth and housing values. Throughout our historical review we will bring in California’s performance in these areas to connect the policies implemented to the economic outcomes created. During Reagan’s period as Governor neither the policies nor the economic outcomes were desirable.

Exhibits 38–41 illustrate California’s share of U.S. personal income, U.S. population, U.S. employment and California’s housing values. As the reader can clearly see, California’s economic performance in light of its rising relative tax burden and higher marginal tax rates was awful. While California’s share of the national economy was growing in the early part of the 1960s, from the mid-1960s through the mid-1970s the growth in California’s economy relative to the U.S. economy came to a halt. The same story holds true for California’s share of national employment, population, and home values.

Exhibit 38

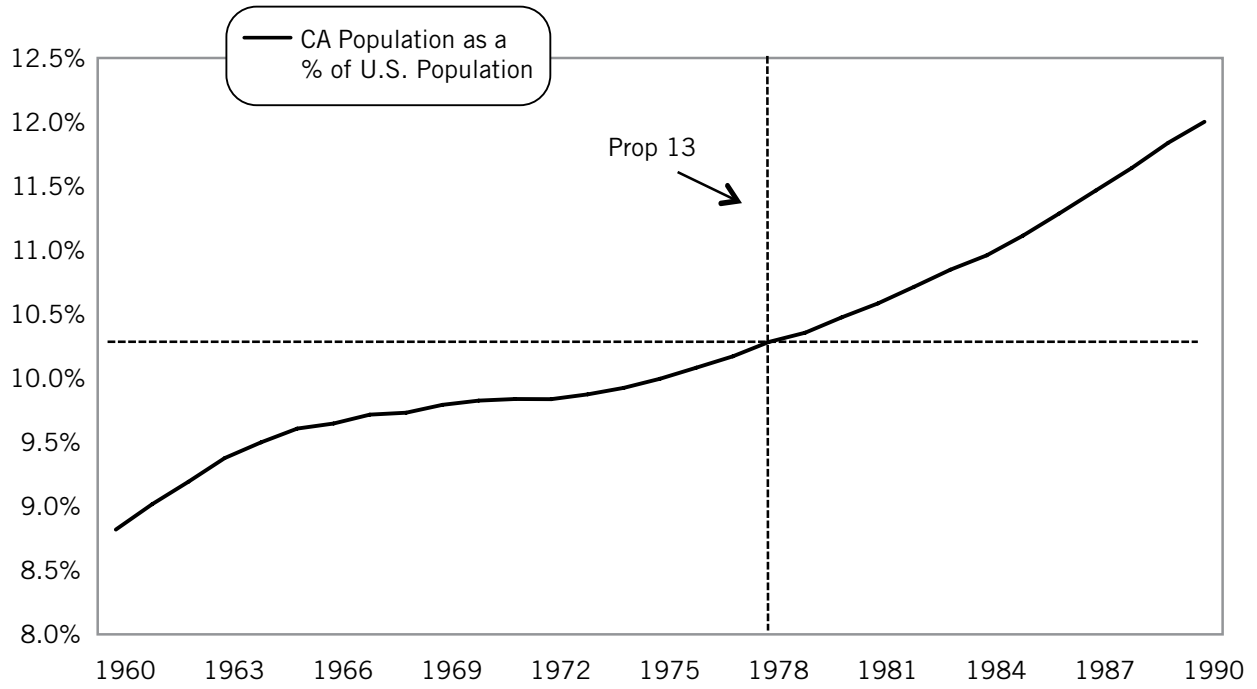
California’s Share of U.S. Personal Income, 1960–1990



Source: Bureau of Economic Analysis

Exhibit 39

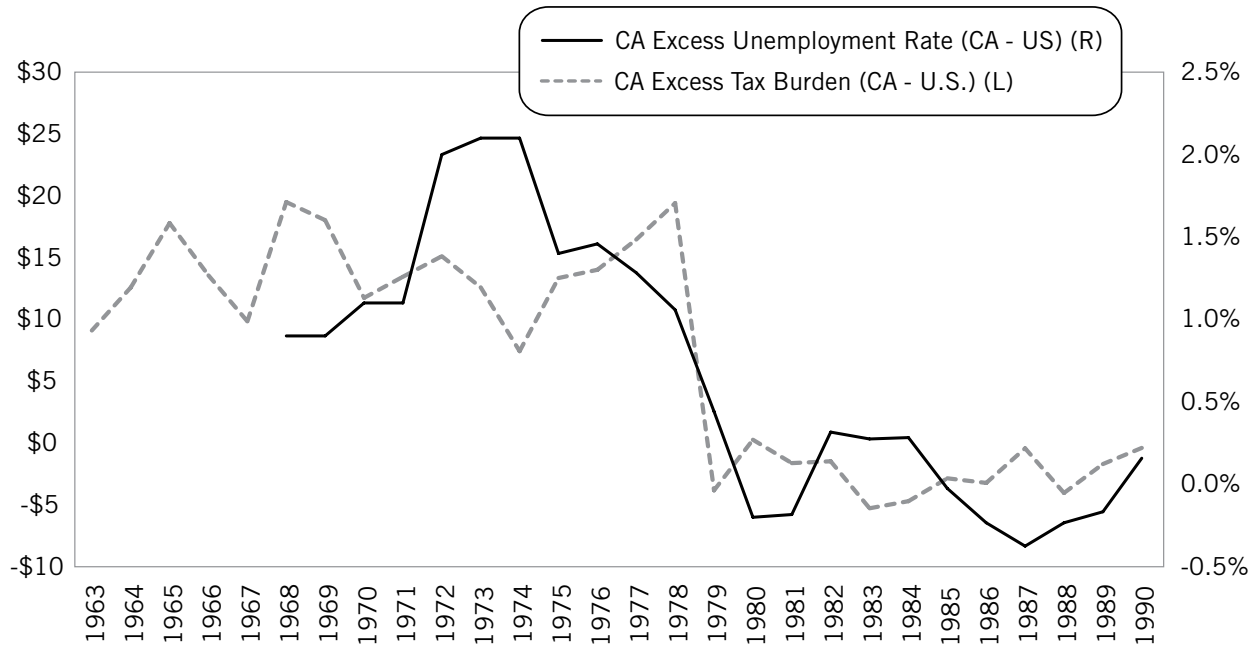
California's Share of U.S. Population, 1960–1990



Source: U.S. Census Bureau

Exhibit 40

Excess State and Local Tax Burden vs. Excess Unemployment California vs. U.S., 1963–1990

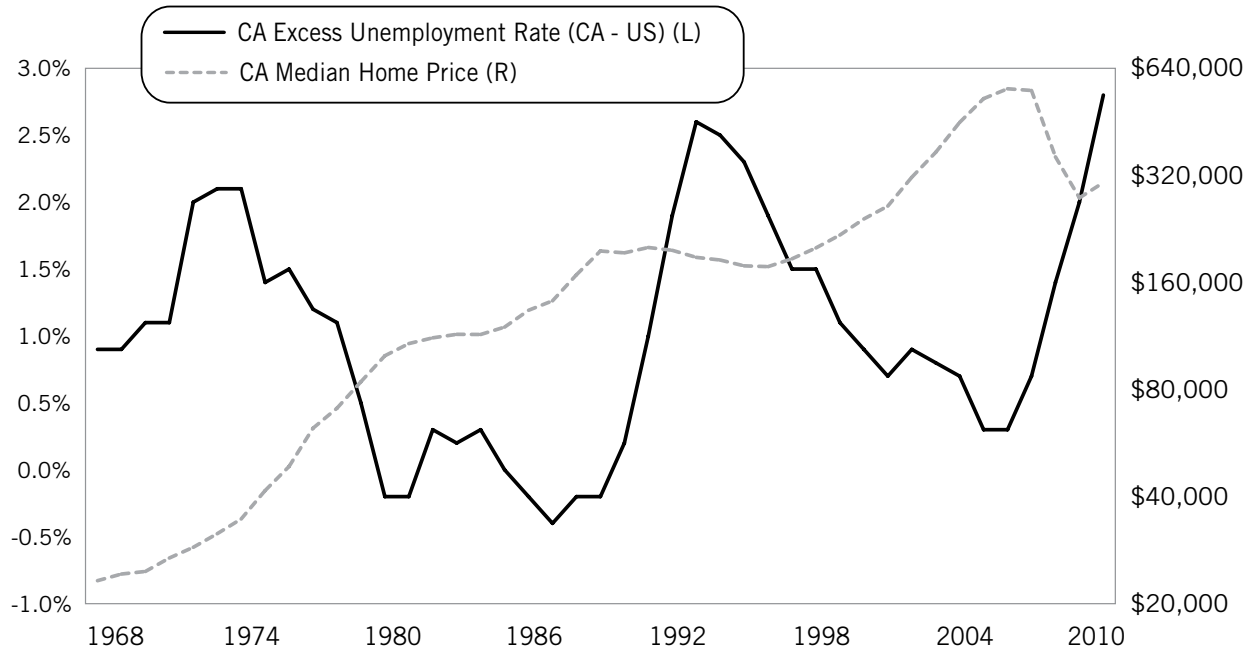


Source: U.S. Census Bureau *Statistical Abstract*, various editions; Bureau of Labor Statistics; Bureau of Economic Analysis

At the macroeconomic level, the changes in the economic variables that lead to downturns in the real estate market can be used to forecast when the downturn in the real estate market will occur. Population growth fell during the late 1960s through the mid-1970s and was followed by downturns in the real estate market.

Exhibit 41

California Excess Unemployment vs. California Median Home Prices, 1968–1997



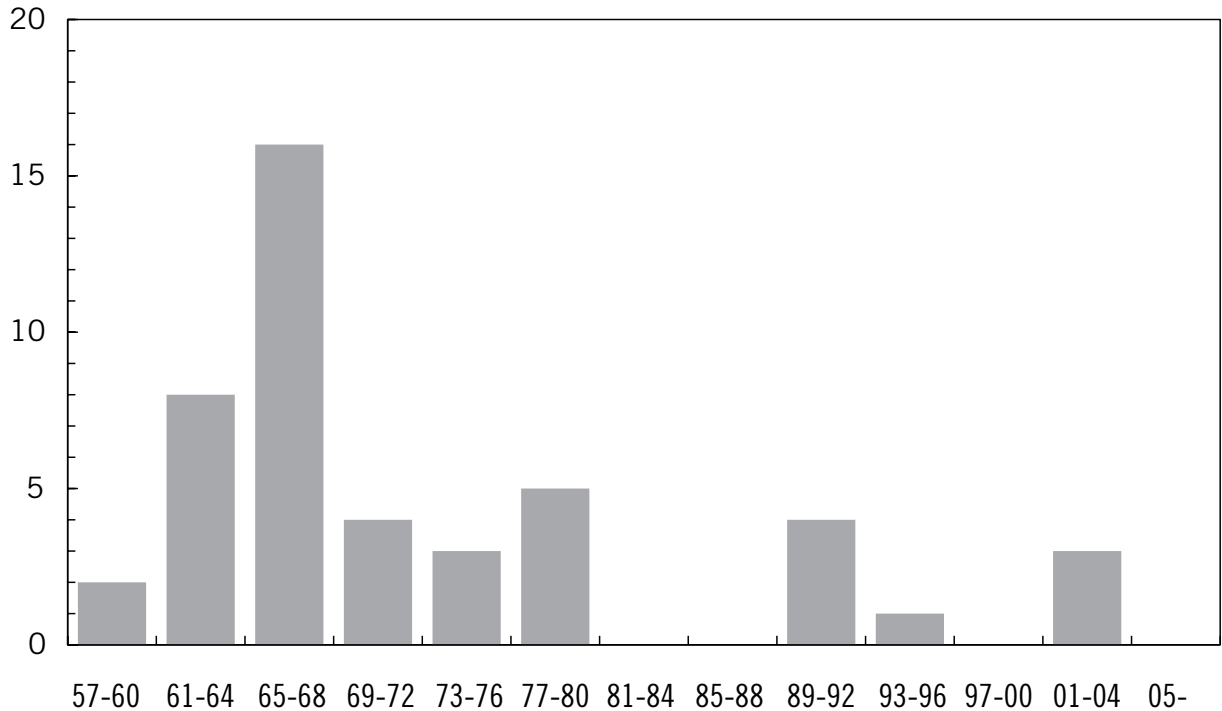
Source: U.S. Census Bureau Statistical Abstract, various editions; Bureau of Labor Statistics; California Association of Realtors

It was not just the economy that was troubled throughout the 1970s. Racial tensions, like the rest of the country, were also plaguing California during this time. They boiled over in 1965 in the Watts Riot that raged in Los Angeles for five days.

We often forget just how racially disruptive the U.S. society had been prior to President Reagan taking office. When I joined the University of Chicago faculty, you wouldn't believe how bad the riots were in the South Side of Chicago surrounding the assassination of Martin Luther King. Teenage members of the Black P. Stone Nation gang literally stopped cars to check for incendiary material as those cars entered their South Side Chicago gang territory. There was no police presence and as a result of gang inspections, no buildings were burnt in their territory. It was scary. California was no different.

Exhibit 42

Number of Major Race Riots by Administration, (four-year periods to the present)



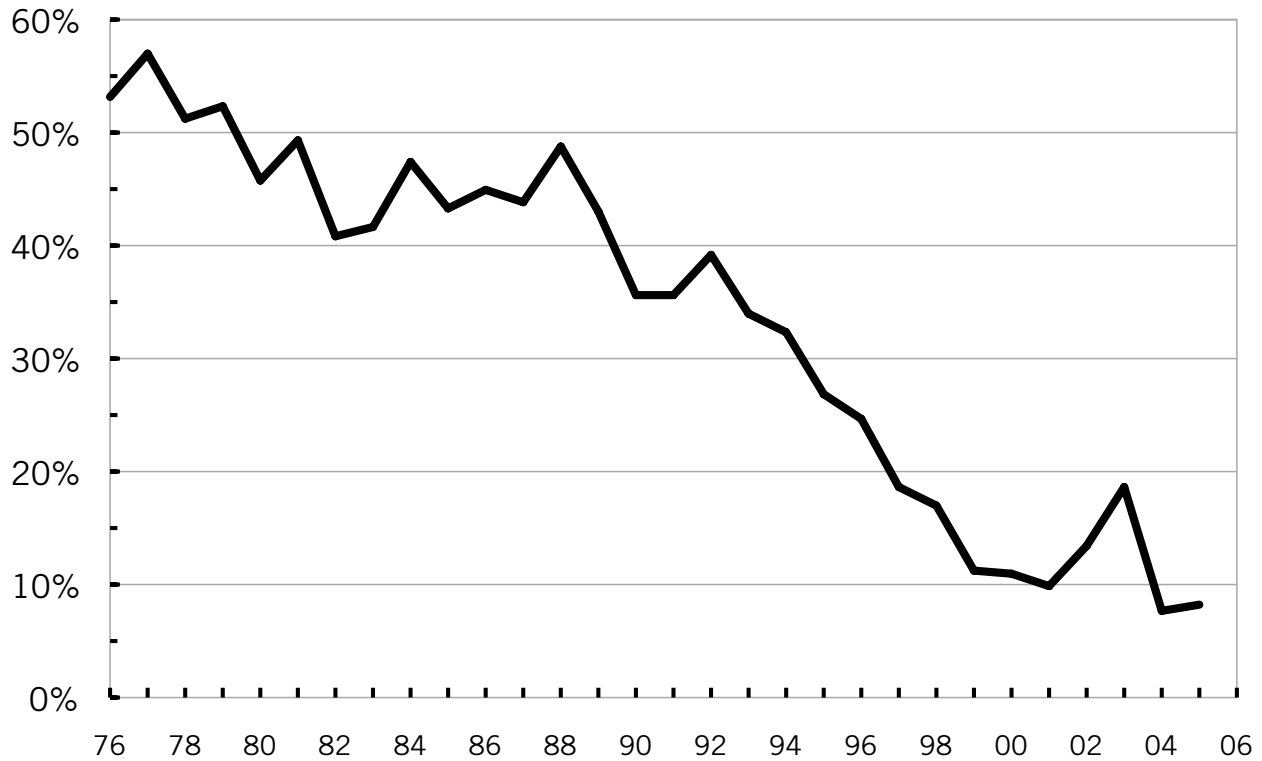
Source: The Encyclopedia of American Facts and Dates, 10th edition.
Past published research paper. Supplemented by wikipedia.com and other web sources.

And then there was pollution. Pollution was a real problem for California. It was not that long ago that a charcoal gray postcard with the caption: “Los Angeles on a clear day” was an accurate reflection of the problem facing California. The Mayor of Azusa was reputed to have claimed that “he doesn’t trust air that he can’t see.”

Smog in Los Angeles has been documented as far back as 1943. In fact some have it that the inversions that cause pollution occurred in the Los Angeles basin before man inhabited the area. Being downstream from a herd of buffalo was pretty gross. But the problem of pollution grew along with California’s population throughout the 1950s and 1960s, peaking in the late 1960s. I personally vividly remember driving down from Stanford to visit my cousins in Anaheim in 1964. I was driving on the 10 Freeway in what seemed like a dense opaque yellow-green fog. I believe that on that day there was a 100-plus car pile-up on the 10 Freeway. Pollution levels remained high throughout the 1970s but were on a steady downward path to their significantly lower levels today.

Exhibit 43

Percentage of Days Per Year in Violation of Federal Air Quality Standards in the Los Angeles Area (South Coast Air Basin)
Annual through 2005



Source: South Coast Air Basin data from the South Coast AQMD.

Throughout this period California began implementing what could be considered the most stringent environmental regulations in the country. California's laws and regulations also were at the forefront of pushing new products—such as the catalytic converter, which reduces emissions from automobiles. Pollution levels did fall dramatically throughout the 1970s and 1980s. These regulations were amazingly helpful as shown in Exhibit 43.

These same regulations, pushed way too far in later years, are at the root of later economic crises and California's current uncompetitive regulatory environment. As discussed in the next chapter, the roots of California's electricity crisis during the early 2000s can be traced back to some of these energy regulations. These regulations have also come at a great cost to Californians working and investing in the state. For example, a study commissioned by the state legislature and published by Varshney and Tootelian (2009) found that California's overall regulatory burden (both environmental and other

regulations) costs “\$493.0 billion which is almost five times the state’s general fund budget, and almost a third of the state’s gross product. The cost of regulation results in an employment loss of 3.8 million jobs which is a tenth of the state’s population.”²

While racial tensions and pollution undoubtedly have many causes and must be addressed from a multi-faceted approach, ensuring a vibrant economy is clearly a key to racial harmony and a clean environment. Putting first things first, it is crucial that federal, state, and local governments establish an environment in which the economy can flourish. It is only when there is a prosperous economy that important problems such as pollution and racial tensions can be solved in a just and permanent manner. The policies of the 1970s were creating just the opposite affect.

Then came Proposition 13.

*Hiding up in the mountains
Laying low in the canyons...
Their funky exile.
“Los Angelenos”
—Billy Joel*

Chapter 9

A Man’s Home Is His Castle: The Legacy of Prop. 13

In 1978, a force that had been building strength for several years finally brought huge and dramatic change to the California economy. Proposition 13 is an event that earned the moniker “the tax revolt heard round the world.” Proposition 13 was made law thirty years ago, June 6, 1978. On that day America was jolted by the political equivalent of a sonic boom. Political analysts often argue when the modern-day conservative movement in America was officially launched. Some say that it was Barry Goldwater’s campaign in 1964. Others, say it was the election of Ronald Reagan in November 1980. In our view, modern day supply-side economics had its origins when Proposition 13 was passed. We believe that a strong case can be made that the conservative, tax-cutting tide began in 1978 when almost 60 percent of California’s voters declared thumbs up on Howard Jarvis’s and Paul Gann’s brainchild.

This was arguably the greatest tax revolt since the Boston Tea Party and the Whiskey Rebellion. And do you remember when we postulated California as being the nation’s trend setter? Well, the spirit of Proposition 13 was rapidly exported to the rest of the country. Within five years of Prop. 13’s passage, nearly half the states strapped a similar straitjacket on politicians’ tax raising capabilities by cutting income or property taxes, or both. In many ways, Prop. 13 presaged the improbable presidential election of Ronald Reagan, who sailed into the White House on the crest of a national anti-tax wave by promising a supply-side 30 percent income tax cut for one and all. I can personally assure you that had Prop. 13 not passed, Ronald Reagan would have been a very different president. Once again, the old maxim was proven true: as goes California, so goes the nation.

Two patriots led this tax revolt: Paul Gann and Howard Jarvis, men described by the *Los Angeles Times* as “the chief spokesmen for this expanding group of angry and disgruntled taxpayers across the state who believe they are paying too much for the cost of government.” And that was the essence of the Proposition 13 revolt: after a decade-long voracious expansion in the size of the Great Society welfare state, along with years of double-digit inflation that escalated tax burdens through bracket

creep and soaring asset values while erasing family purchasing power, Americans no longer believed that government was giving them anywhere near their money's worth. In the 1970s, real family tax payments rose at almost twice the pace of real family income. In California, uncapped property tax assessments were driving thousands of residents out of their homes—particularly seniors with fixed incomes who had little capacity to pay the double-digit tax rate increases on their homes.

Almost everyone of consequence in both political parties (even Reagan was originally skeptical) and almost every organized interest group in the state condemned Proposition 13 as reckless. Joel Fox, the longtime director of the Howard Jarvis Taxpayers Association writes in his book entitled, *The Legend of Proposition 13*: “Surprising to many, was that big business stood opposed. Businesses not only lent their names to the “NO on 13” campaign, they helped finance it.”¹ The opponents of Prop. 13 warned voters of the doom that awaited the state if Proposition 13 passed: on June 6, 1978, San Francisco's schools and libraries would be closed; 2,500 Los Angeles policemen would be laid off; prisoners would be released into the streets for lack of funds; and 450,000 jobs would be lost in the state according to the UCLA Business School. If those claims seem familiar, UCLA's business school released a similarly shrill and preposterous prediction on the impact of President George Bush's tax cut.

On a very personal level, my godfather, Justin Dart strongly supported Proposition 13 but was outvoted by his colleagues on the Business Roundtable and therefore, by the Roundtable's rule of speaking with one voice, was forced to oppose Prop. 13 officially. Secretly however, he had his fingers crossed hoping it would pass and was egging me on all the time.

Few listened to the hysteria. Taxes were so suffocating in California that even firefighters in Los Angeles voted 2 to 1 in favor of Prop. 13.

In June 1978, Proposition 13 (commonly called the Jarvis/Gann initiative) roiled the entrenched political establishment. Proposition 13 was a constitutional amendment that:

- Set property taxes not to exceed 1 percent of the property's fair market value;
- Allowed the base value to grow no more than 2 percent per year unless the property changed hands; and,
- Required that all new or increased special taxes at the local level receive a two-thirds vote of the electorate and that any new or increased special taxes at the local level receive a two-thirds vote at the electorate and that any new or increased tax at the state level receive a two-thirds vote of each house.

Proposition 13 won in a landslide.

Following on Proposition 13's heels were ballot measures and legislation including an elimination of the state's inheritance tax, indexing of the state's income tax, and the elimination of the state's business inventory tax. In 1979 Proposition 4 (the Gann spending limit initiative) passed, locking the tax gains into place by requiring:

- Spending to grow no faster than the sum of population growth and inflation; and
- All surplus revenues to be returned to the taxpayers.

Contrary to the protestations of the critics, Prop. 13 ushered in a second California gold rush in the decade following its enactment. In the 10 years after the passage of Prop. 13, incomes in California grew 50 percent faster than the nation as a whole, and jobs grew at twice the pace. During the 1980s and 1990s, the high tech sector in Silicon Valley ignited the greatest burst of technological progress anywhere at any time in history.

Other states had their own Prop. 13 which also worked and surprisingly were frequently supported by Democrats. Just read the quotes from Steve Moore’s paper “Timber! State Tax Rates Continue to Fall,” Laffer Associates, May 29, 1997:

An income tax cut is the single most important step we can take to make Maryland more competitive and create more jobs.

—Democratic Governor Parris Glendening

Even when the final and deepest phase of New York’s income tax cut is implemented this year, the state’s resurgent economy appears likely to generate more income tax revenue under Gov. George Pataki than it ever did under former Gov. Mario Cuomo.

—Empire Foundation Report, April 1997

In 1964, while a first year student at the Stanford Business School, I had my first job in California as a night watchman at Shockley Transistor at 1801 Page Mill Road in Palo Alto. It was a hoot, but unfortunately I was so young and ignorant that I hadn’t realized who the people were who passed by my desk. William Shockley received the Nobel Prize in Physics for his discovery of the germanium transistor when he had worked at the Bell Labs. A number of the other applied physicists there formed Texas Instruments. You could literally touch the high tech revolution. I still have and use in my office the first generation HP calculator which was given to my boss George Shultz (then director of the Office of Management and Budget) by Deputy Secretary of Defense David Packard in 1971. George gave it to me.

If the modern conservative view of Ronald Reagan is a bit fuzzy when it comes to his early years as governor, the same holds true in reverse for Jerry Brown. Now admittedly, Brown was a bit of an odd bird in social settings, but even so he was a great governor. People forget just how unpopular Proposition 13 was amongst the “elite”—we use the term lightly—before the public overwhelmingly

In the 10 years after the passage of Prop. 13, incomes in California grew 50 percent faster than the nation as a whole, and jobs grew at twice the pace.

approved it in June of 1978. As we've said, Californians were treated to all sorts of terrifying predictions of what would happen under the tax cuts and limitations of Prop. 13. In fact, noted leftist economist John Kenneth Galbraith sent me a toy fire engine to replace the real fire engines that my support for Prop. 13 would ostensibly eliminate. Ken Galbraith always stayed in character as an elongated wind instrument.

Amid the dire forecasts of financial catastrophe, Jerry Brown saw to it that the state assessor sent out tax notices the week before the election, indicating a five-fold increase in property taxes. Brown then said he had a much larger budget surplus than people had originally thought. The point, of course, was to disarm the critics who said Prop. 13 was fiscally irresponsible. With a much larger surplus, the argument that schools, libraries, and firehouses would be closed and masses of police and fireman would be laid off sounded pretty hollow.

In 1976 I was quite recognizable to the public since I had been the TV presence voicing opposition to the Cesar Chavez movement. I had also become well known for my involvement in Reagan's presidential race. Later, I also became known for all sorts of issues including Proposition 13. On the very evening when Prop. 13 passed, Jerry Brown and his chief of staff Gray Davis invited me (an outspoken proponent of the measure) to Sacramento where they held discussions over the course of three days. As a humorous illustration of Governor Brown's social awkwardness, on the way to a joint press conference, Governor Brown remarked, "Professor Laffer, I do hope you don't take this opportunity to dump all over me." His awkwardness was only exceeded by his good governance. Governor Brown made sure Prop. 13 would be implemented correctly. He was great as governor and became one of my lifelong friends. And to be quite serious, Jerry Brown wasn't a fair weather supporter of good economics.

While drumming up support for Prop. 13, I wrote a pamphlet for the United Organization of Taxpayers in March 1978—10 weeks before the vote. I predicted that the static revenue forecasts overstated the losses to the state treasury from Prop. 13 because of supply-side effects:

Property tax revenues will fall by less than [the static forecast of] \$7 billion because property values will rise and new construction activity will expand. Both of these effects will expand the tax base, and thus lead to less property tax revenue loss. In the out-years, property tax receipts will fall by far less than \$7 billion annually. Take, for example, a \$100,000 home, paying taxes of 3.5 percent of market. Taxes would be \$3,500 per year without Jarvis. If Jarvis passes, the tax rate would fall to 1 percent of market, but tax receipts would be greater than \$1,000. Using a discount rate of 10 percent, the approximate receipts would initially be \$1,250, reflecting a rise in the market value of the house to \$125,000.

In short order, the higher values of homes would encourage more new construction and an enlarged property base. As this process progressed, total property values would rise by far more than the 25 percent of the example.

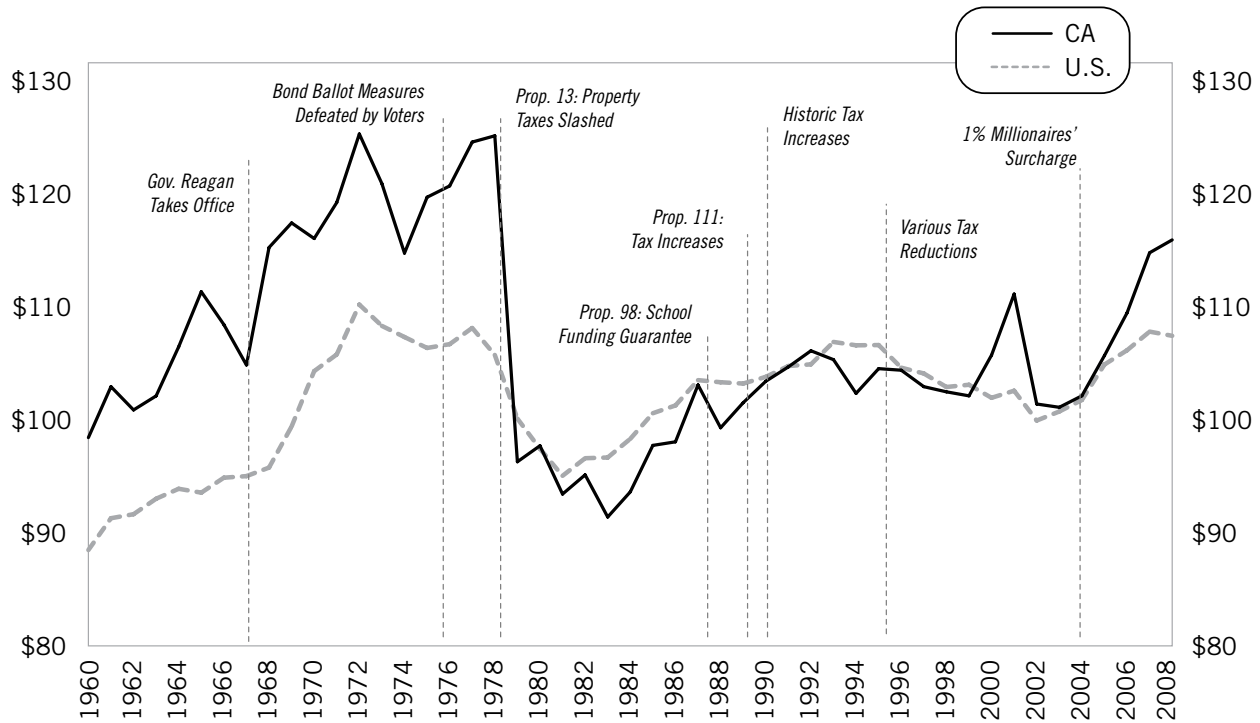
Tax revenues elsewhere would expand absolutely. Social welfare mandated spending would fall. With property taxes lower, businesses will expand their activities within the State. This expansion will create new jobs, more investment, and higher real wages. Sales, incomes, and other forms of activity will expand. Sales taxes, income taxes, etc., all will rise. In addition, State outlays for social welfare will fall (unemployment compensation, rent subsidies, medical, etc.).

Tax revenues in future years will be reduced by less or, quite conceivably, even expanded as a result of Jarvis-Gann. When combined with the healthier economic base and, as a direct consequence, less social welfare expenditures, the State should shortly be back in a surplus condition.²

Indeed, history vindicated my supply-side analysis. This is clearly captured in Exhibit 44, which is Exhibit 34 reproduced for the era prior to and following Proposition 13. These figures show that the tremendous tax cut for Californians led to a substantial economic recovery relative to the rest of the nation. Exhibit 44 shows just how dramatic Proposition 13 et al has been to California's relative tax burden and how this tax burden remained low throughout the "roaring" 1980s. It was amazing! While Proposition 13 and all of the other pro-growth policies of that era did occur in and around 1978, a lot of political build-up had been apparent in California well before 1978. Without Proposition 13, there would not have been the Reagan tax revolt and Margaret Thatcher surely would not have been the Margaret Thatcher we know and love.

Exhibit 44

State and Local Tax Burden Per \$1,000 of Personal Income California vs. U.S.



Source: Bureau of Economic Analysis, U.S. Census Bureau

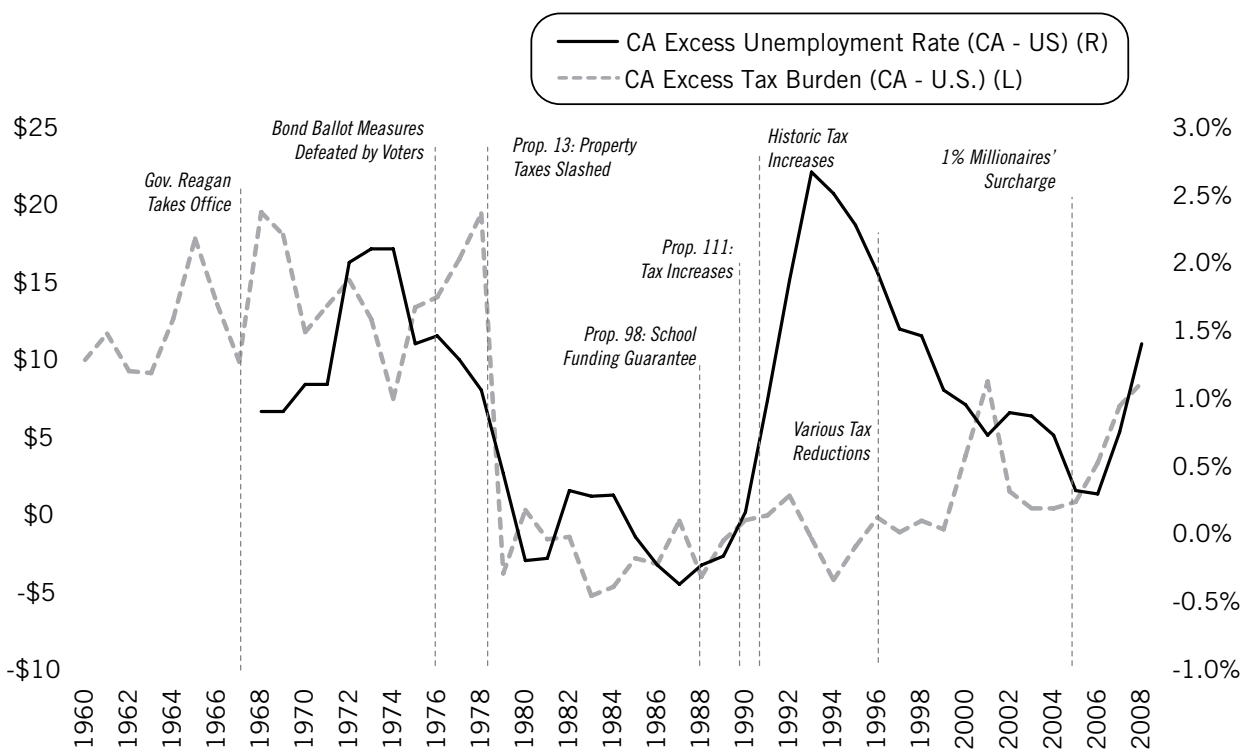
In Exhibit 45, California's tax burden is directly related to the State of California's economic well-being. Exhibit 45 plots California's tax burden against the state's excess unemployment over the period 1960 through 2009. As charts of this genre go, this is a good fit. It is worth a brief tangent to review this relationship as this vacillation between good and bad economic policies is at the center of California's vacillating economic fortunes—a theme we return to again and again throughout this chapter.

With the implementation of Proposition 13, and its significant reduction in California's tax burden relative to the U.S., there was a corresponding reduction in the rate of unemployment in California relative to the U.S. California's lower relative unemployment rate persists until the historic tax increases of the mid-1990s. It is important to note that despite the higher tax rates, California failed to realize significantly higher tax revenues. Consequently, the actual tax burden from the tax increases is much higher than the burden as shown in Exhibit 45. And, as to be expected by now, once California lowered its tax burden in the late 1990s, its relative economic performance compared to

the nation once again soared—measured here by the relative unemployment rate. The final period in Exhibit 45 shows that as California once again turned to tax increases to solve its budget problems, the economic consequences depressed relative economic growth. Simply put, over the broad sweep of time, California’s excess unemployment is definitely correlated with California’s tax burden. When one realizes just how little is included in this analysis, the relationship is much more impressive.

Exhibit 45

Excess State and Local Tax Burden vs. Excess Unemployment
California vs. U.S.



Source: U.S. Census Bureau Statistical Abstract, various editions; Bureau of Labor Statistics; Bureau of Economic Analysis

Returning to our post-Prop 13 story, the fiscal outcome also played out just as predicted. Proposition 13 passed on June 6, 1978, one month prior to the end of FY1978. State and local property tax revenues fell \$5 billion, from \$11 billion in FY1978 to \$6 billion in FY1979, far short of the static revenue loss forecast of \$7 billion. In addition, this drop was largely offset by higher revenues in every other major tax category. Total state and local total tax revenues fell by only \$1.1 billion that first year. Obviously, tax revenues other than those from property taxes rose by \$3.9 billion. That \$3.9 billion increase is on a tax base of a little more than \$25 billion. Not bad!

Looking at the bigger picture, the combined state and local tax burden per \$1,000 of personal income fell from \$124.57 in FY1978 to \$94.93 in FY1982, a 24 percent reduction. Yet in spite of the precipitous fall in the state's average tax rate, state and local revenues did not fall proportionately. In fact, total tax revenue grew by 19 percent from \$27.4 billion in FY1978 to \$32.5 billion in FY1982. The tax base expanded by more than enough to offset the reduction in tax rates. "Neener neener neener," is all I have to say to you of little faith.

Economic expansion and higher property values led to healthy property tax growth over the following years, and by FY1985 property tax collections were back to their FY1978 \$11 billion level. What this means is nothing short of astounding. Property tax rates were reduced by over 65 percent and yet in seven short years the property tax base rose by enough to fully offset the cut in tax rates and leave tax revenues unchanged. The disruptive shortage of funds so widely anticipated never materialized.

For Californians, Prop. 13's legacy has been to save the average homeowner in California tens of thousands of dollars in property tax payments over the past 25 years.

During the interim while property taxes were catching back up, Governor Brown, in yet another major pro-growth positive move, made sure local governments—who rely heavily on property taxes—were "made whole" by a state subvention of revenues program. In other words, the state transferred tax monies the state had collected to the cities, counties, and local districts impacted by Prop. 13. Governor Brown proved himself to be a governor's governor. And yes he was a Democrat. But not like those today. He believed in jobs, economic growth, and prosperity.

Turning our attention to spending, total state and local direct general expenditures were not slashed between FY1978 and FY1979 as skeptics had predicted; in fact, expenditures increased 1.6 percent from \$36.9 billion to \$37.5 billion over this period. Even better, spending on police and fire services increased 3.7 percent in FY1979. So much for a shortage of fire trucks, Dr. Galbraith! The tax reduction which had invigorated the state's economy so profoundly did not impose any significant reduction in government services.

Political aversion to heavy taxes went hand in hand with a desire to tighten the reins on spending. In November 1979, Proposition 4 placed a constitutional limit on state and local government spending. This limit, as we mentioned earlier, commonly referred to as the Gann limit, allowed spending to increase each year based on 1) the statewide population growth, and 2) inflation as measured by the percentage growth in the U.S. CPI or in California per capita personal income. Certain appropriations were not subject to the Gann spending limit, including the costs of retiring voter-approved bonds and the costs of bonds in existence when Proposition 4 was enacted. Exceptions to the limit also included appropriations required by the federal government and court mandates as well as unrestricted funds transferred to local governments or schools. In the early 1980s, Propositions 6 and 7 passed, which repealed the inheritance tax and made full indexation of the income tax permanent.

The state's balanced budgets during this period reflect the remarkable success of combining lower tax rates and increased output, employment and production with restrained spending.

For Californians, Prop. 13's legacy has been to save the average homeowner in California tens of thousands of dollars in property tax payments over the past 25 years. This is tax money that was returned to homeowners and would have fueled an even more rapid escalation in California's state and local public bureaucracies if those dollars had been sent to Sacramento and city halls. Californians intuitively understand why Proposition 13 is good for all of California as well as homeowners. That is why every major poll from 1978 to today has confirmed that a large majority of residents in California for the last 30 years continuously say that they would still vote for Prop. 13 again if it were on the ballot.

Taxpayers nationwide also owe a debt of gratitude to Howard Jarvis and Paul Gann. They helped reverse the economically disabling era of unrestrained over-taxation, over-spending, and over-regulation of government at all levels in America that dragged the nation into a malaise at the end of the 1970s. Just as important, they taught us all an enduring civics lesson that we should never forget: in America you really can fight city hall. And judging from California's wobbly performance of late, the indifference, and not so benign neglect of the political class in the state, it may be high time for another revolt heard round the world in the Golden State.