PIONEER
OPPORTUNITY

How a 2012 income tax hike cost California billions of dollars in economic activity

By Andrew Mikula

WHITE PAPER
No. 224 | February 2021

PIONEER INSTITUTE
PUBLIC POLICY RESEARCH

MISSION

Pioneer Institute develops and communicates dynamic ideas that advance prosperity and a vibrant civic life in Massachusetts and beyond.

Vision

Success for Pioneer is when the citizens of our state and nation prosper and our society thrives because we enjoy world-class options in education, healthcare, transportation and economic opportunity, and when our government is limited, accountable and transparent.

Values

Pioneer believes that America is at its best when our citizenry is well-educated, committed to liberty, personal responsibility, and free enterprise, and both willing and able to test their beliefs based on facts and the free exchange of ideas.

PIONEER
OPPORTUNITY

This paper is a publication of Pioneer Opportunity, which seeks to keep Massachusetts competitive by promoting a healthy business climate, transparent regulation, small business creation in urban areas and sound environmental and development policy. Current initiatives promote market reforms to increase the supply of affordable housing, reduce the cost of doing business, and revitalize urban areas.

PIONEER
EDUCATION

Pioneer Education seeks to increase the education options available to parents and students, drive system-wide reform, and ensure accountability in public education. The Center's work builds on Pioneer's legacy as a recognized leader in the charter public school movement, and as a champion of greater academic rigor in Massachusetts' elementary and secondary schools. Current initiatives promote choice and competition, school-based management, and enhanced academic performance in public schools.

PIONEER
HEALTH

Pioneer Health seeks to refocus the Massachusetts conversation about health care costs away from government-imposed interventions, toward market-based reforms. Current initiatives include driving public discourse on Medicaid; presenting a strong consumer perspective as the state considers a dramatic overhaul of the health care payment process; and supporting thoughtful tort reforms.

PIONEER
TRANSPORTATION

Pioneer Transportation seeks reforms that allow commuters to take full advantage of the coming mobility revolution—with access to a range of affordable and on-demand public and private transportation options, as well as transit-friendly real estate development.

Pioneer Institute is a tax-exempt 501(c)3 organization funded through the donations of individuals, foundations and businesses committed to the principles Pioneer espouses. To ensure its independence, Pioneer does not accept government grants.

Table of Contents

Introduction 4

The Wealthy Take Flight 4

A Corporate Exodus to Match 6

Reductions in Tax Revenue 7

Conclusion 7

Introduction

In the aftermath of the Great Recession of 2007–2009, the State of California faced a series of difficult budget decisions. In state lawmakers' own words, these decisions resulted in some $56 billion in cuts to "education, police and fire protection, healthcare, and other critical state and local services" over the course of four years.[1] Then, in 2012, the same lawmakers reached a dubious conclusion, namely that "raising new tax revenue is an investment in our future that will put California back on track for growth and success."[2] This is the context in which the legislature, and later the state's voters, passed Proposition 30, a momentous tax hike that, among other things, raised the state's highest marginal income tax rate by 3 percentage points.

Proposition 30 has likely stifled business activity in the state, especially among pass-through entities.

Often packaged as a temporary move necessary to avoid $6 billion in additional core service cuts, Proposition 30 has stifled business activity in the state, especially among pass-through entities.[3] The elevated income tax rates were later extended beyond their initial 2018 expiration date to 2030, likely cementing the legislation's detrimental economic effects in place for decades to come.[4]

The Wealthy Take Flight

Research on the migration impacts of California's Proposition 30 was scarce for the first several years after its passage.[5] This is largely due to an absence of administrative "microdata" that would adequately allow researchers to isolate the effect of Proposition 30 from broader macroeconomic trends and changes in the federal tax code. That changed in October 2019, when two NBER economists, Joshua Rauh and Ryan Shyu, found that "For those earning over $5 million, the rate of departures spiked 42%, from 1.5% after the 2011 tax year to 2.125% after the 2012 tax year."[6]

For those earning over $5 million, the rate of departures spiked 42%, from 1.5% after the 2011 tax year to 2.125% after the 2012 tax year.

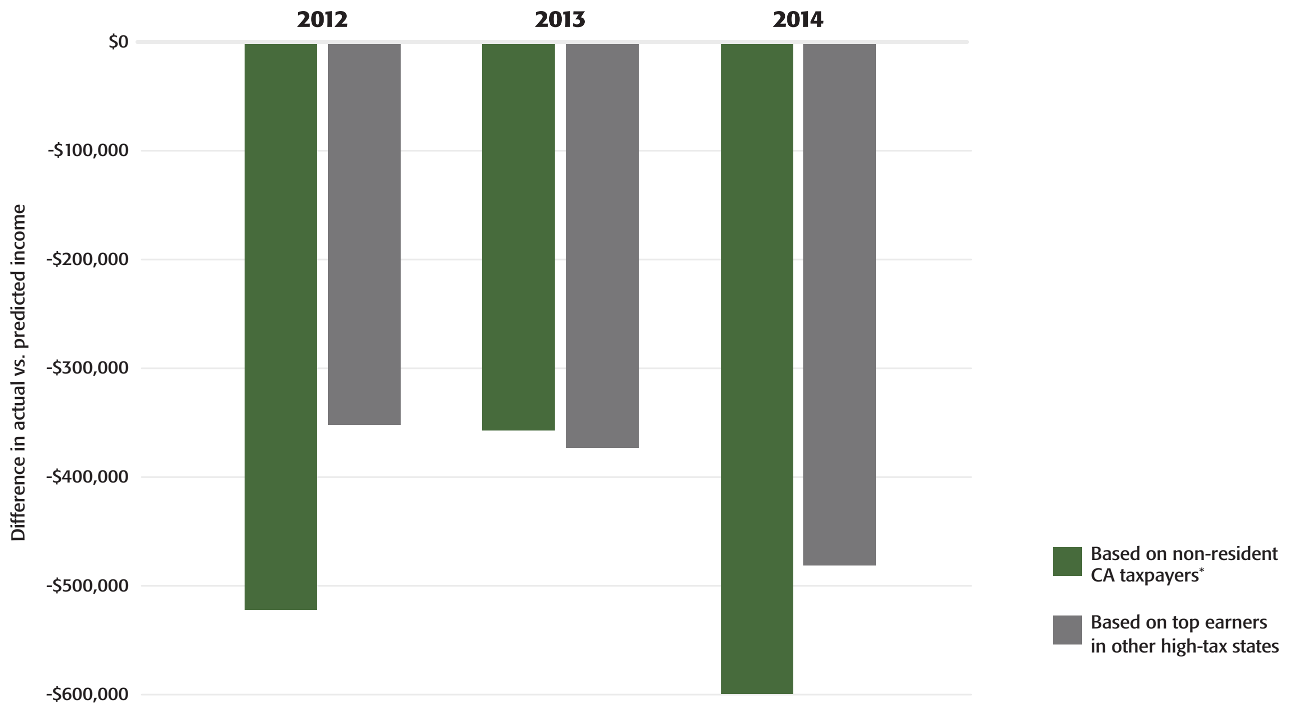
This spike is readily visible among filers who, immediately prior to the passage of Proposition 30, were in California's top income bracket under the new legislation for three straight years. Even more striking, however, is Rauh and Shyu's finding that most of the wealth migration from California after Proposition 30 became law was due to wealthy people reporting less income, not fewer wealthy people paying taxes in California overall. Determining exactly why the wealthy reported less income due to Proposition 30 is beyond the scope of their paper, but it raises the specter of tax avoidance via moving capital assets out-of-state. Other possibilities include how Proposition 30, in the words of Rauh and Shyu, disincentivizes "engaging in wasteful rent-seeking activities" and causes "distortions of productive activity among California's most innovative residents."[7]

Regardless, observed drops in the incomes of wealthy California residents cannot be explained by similar drops in income among analogous residents of other states or non-resident filers. Rauh and Shyu compare tax returns of Californians subject to Proposition 30 to those of affluent filers in other high-tax states as well as those of California taxpayers who do not reside in the state. Regardless of the comparative metric, the average income deficit amounts to hundreds of thousands of dollars in each of the first three years in which Proposition 30 was in effect (see Figure 1). When taking into account that California has nearly 72,500 million-dollar earners, this income deficit amounts to tens of billions of dollars in vanished economic activity.[8]

Rauh and Shyu also find that California's observed wealth flight is both "strongest in the direction of states with zero state taxes" and "concentrated among taxpayers who have filed in the top California bracket three years in a row."[9] These points are related because they both imply that tax savings are a big motivator for changes of residence among the wealthy. Thus, when Californians leave because of high income tax rates, they tend to settle in places with no state income tax at all, states like Florida, Washington, and Texas (see Figure 2). And even within the cohort of California taxpayers paying higher rates under Proposition 30, the wealthiest are the most likely to leave the state. The Tax Cuts and Jobs Act of 2017 has likely exaggerated this trend, given the cap it has placed on state and local income tax deductions, which essentially removes a common work-around for the wealthy in high-tax states.[10]

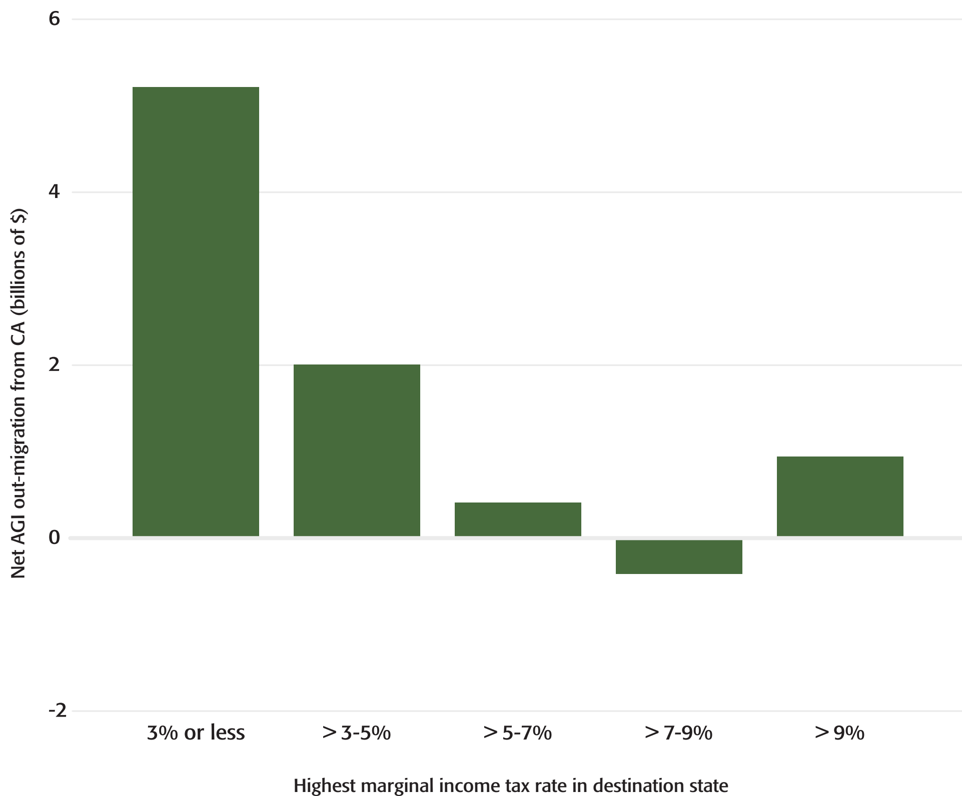
The most consistent high-earners tend to leave at higher rates, and settle in states with no income taxes.

Figure 1: Actual vs. predicted income of top-earning Californians after the passage of Proposition 30[11]



* Rauh and Shyu define non-resident California taxpayers as "taxpayers who do not reside in California, but file California non-resident returns, and who if California residents would have filed in the top California Proposition 30 created bracket from 2009–2011."

Figure 2: Net AGI out-migration from California by top state income tax bracket in destination state, 2018[12]



A Corporate Exodus to Match

It's not just wealthy individuals that have opted to move out of California — it's also the businesses they own. This includes those of billionaire Elon Musk, once California's wealthiest resident. His announcement in December 2020 that he would be moving to Texas was foreshadowed by the construction of a gigantic factory for Tesla, Musk's electric car company, in Austin.[13] Musk also threatened to move his business' headquarters from California to either Texas or Nevada last spring via Twitter, a move that CNBC projected could save him billions of dollars in the long-term.[14]

While Proposition 30 is only a small piece of the puzzle amidst California's harsh regulatory environment (#48 on Cato Institute's regulatory freedom index), the flight of these firms and individuals is illustrative of a long-standing problem that Proposition 30 has perpetuated.[15] It's also hard to argue that high corporate income taxes alone are driving the exodus from California, as Texas, a popular destination for large firms fleeing California, has an even less competitive business tax climate when accounting for gross receipts taxes.[16]

As Elon Musk put it, California "has a forest of redwoods and the little trees can't grow."

Furthermore, income taxes in particular can stifle business activity among pass-through entities such as sole proprietorships, which pay taxes via the personal returns of their owners. As of 2013, sole proprietorships generate some $150 billion in economic activity every quarter in California.[17] While sole proprietorships are by definition small businesses, in the right business climate, many have grown to become major national corporations, including Walmart, J.C. Penney, Marriott, Kinko's, and Ebay, the latter two of which were founded in California.[18] But as Elon Musk put it when discussing the construction of a Tesla factory in Texas, California "has a forest of redwoods and the little trees can't grow."

Meanwhile, various California business groups were notably tepid in their positions on Proposition 30. The California Chamber of Commerce stated that it didn't oppose the legislation "because the measure was supposed to be temporary and the state was in the midst of a dire financial situation."[19] But flash forward to 2016, when the income tax rates under Proposition 30 were slated to be extended in the midst of a booming economy, and the California Chamber of Commerce came out against the measure. Later, state records revealed that the opposition initiative garnered just $3,000 in support, and some observers claimed that would-be individual donors were "afraid of retaliation from organized labor."[20] Rob Lapsley, president of the California Business Roundtable, opined that "business groups didn't think they could beat it," and were also "concerned about alternative tax proposals that would surface if [Proposition 30's extension] failed."[21] As a result, the 2016 ballot measure passed by a 27-point margin, whereas Proposition 30 itself passed by just an 11-point margin.[22]

Reductions in Tax Revenue

Thus, California state coffers became heavily reliant on revenue from wealthy taxpayers. As of 2019, roughly 40% of individual income tax revenue in California comes from filers with taxable income over $1 million.[23]

Behavioral responses of the super-wealthy eroded 45.2% of Proposition 30 tax revenues in its first year, and 60.9% of tax revenues in its second year.

Rauh and Shyu's NBER paper also found that "among top-bracket California taxpayers, outward migration and behavioral responses by stayers together eroded 45.2% of the windfall tax revenues from the reform within the first year and 60.9% within two years."[24] Shortly before the law's passage, the California Legislative Analyst's Office estimated that over 78% of the tax revenue generated from Proposition 30 would come from the top 1% of income earners.[25] This tax setup has left California extremely vulnerable to revenue volatility, tax avoidance efforts, and, more broadly, the whims of a small group of multi-billionaires.

It's worth noting that, for the most part, tax revenues from Proposition 30 have largely exceeded projections in recent years.[26] Possible explanations include high stock market performance, better-than-expected income gains among residents, or any of various poor assumptions made in the state's revenue models. However, this does not undermine the fact that, without the behavioral responses of the wealthy, the California government would be billions of dollars richer.

Ultimately, Proposition 30 was passed to curb the need for further budget cuts in the aftermath of the Great Recession. However, the legislation has contributed to a tax and business environment that only increases the odds that California will face a budget deficit in a given year. Between 2008 and 2009, personal income tax revenue declined by 20.4 percent in California, while sales tax revenue declined by just 9.5 percent.[27] While sales taxes are undeniably regressive, an over-reliance on volatile income taxes often necessitates harsh budget cuts during a recession that hurt the poor the most at the time when they most need core services. Unfortunately, during the 2019–2020 budget cycle, California was slated to get 68.8 percent of general budget revenues from the personal income tax, and just 18.8 percent from sales taxes.[28]

Thus, the passage of Proposition 30 could create the future need for the kind of drastic cuts to social services that it was meant to prevent.

Conclusion

California's Proposition 30 has worsened the state's fiscal and economic situation by encouraging wealth migration, behavioral changes, and tax revenue impacts that undermined the law's original purpose and weakened the state's economic resilience. However, California may have been luckier than most other states should they adopt a similar tax scheme.

Low-income people still suffer from progressive tax policies during recessions, when lower revenues from income taxes and capital gains inevitably lead to core service cuts.

For wealthy individuals, it's relatively difficult to move outside of California while remaining in the same labor market. By contrast, many eastern metropolises span several states, notably New York, Boston, Philadelphia, and Washington, D.C. Thus, wealthy migrants could remain close to their jobs and social circles while still reaping windfall tax benefits.

As for corporations, especially in certain sectors, many of them may be buoyed by the unique start-up culture of, say, Silicon Valley, or the proximity of ancillary business services and venues in a niche industry, like competitive surfing. Many other locations lack the industry specialization necessary to maintain a healthy business climate without competitive tax rates.

It's also the case that, in some states, personal income tax revenues tend to be even more unreliable than those of California. Arizona is an ironic example, given that it just voted to place a 3.5 percent surcharge on its highest income tax bracket in November 2020.[29] From 2008 to 2009, its income tax revenues plunged 24.4 percent, the steepest drop in the country.[30]

Moreover, in the aftermath of COVID-19, it would be highly risky to continue doubling down on the broken tax system that California flaunted with the passage of Proposition 30. California is facing an up to $54.3 billion budget deficit in the 2020–21 cycle, and they have already elected to cut or defer over $11.1 billion in education spending.[31] Perhaps these numbers would have been lower if the state had a more diversified tax base.

While some observers have claimed that state budget deficits after COVID-19 will not be as gaping as first feared, Proposition 30 has prompted disinvestment from wealthy individuals and corporations. Now it's up to California whether they want to repeat the mistakes of the post-Great Recession recovery, or start to build a more sustainable tax system for everyone.

Endnotes

1 California Secretary of State, "Text of Proposed Laws," State of California, 2012, https://vig.cdn.sos.ca.gov/2012/general/pdf/text-proposed-laws-v2.pdf#nameddest=prop30

2 California Secretary of State, "Text of Proposed Laws," State of California, 2012, https://vig.cdn.sos.ca.gov/2012/general/pdf/text-proposed-laws-v2.pdf#nameddest=prop30

3 Xavier Giroud & Josh Rauh, "State Taxation and the Reallocation of Business Activity: Evidence from Establishment-Level Data," The University of Chicago Press, April 9, 2019, https://www.journals.uchicago.edu/doi/pdf/10.1086/701357

4 Dale Kasler, "A tax cut for Californians? Yes, really," The Sacramento Bee, December 30, 2016, https://www.sacbee.com/news/business/article123813839.html

5 California Department of Education, "Proposition 30 Impact to State Aid," State of California, last updated February 18, 2020, https://www.cde.ca.gov/fg/aa/pa/prop30impact12p1.asp

Public Policy Institute of California, "Proposition 30 Archives," 2020, https://www.ppic.org/blog/tag/proposition-30/

6 Joshua Rauh & Ryan J. Shyu, "Behavioral Responses to State Income Taxation of High Earners: Evidence from California," National Bureau of Economic Research, October 2019, https://www.nber.org/papers/w26349

7 Joshua Rauh & Ryan J. Shyu, "Behavioral Responses to State Income Taxation of High Earners: Evidence from California," National Bureau of Economic Research, October 2019, https://www.nber.org/papers/w26349

8 Derek Miller, "States With the Most Million-Dollar Earners," Smart Asset, February 14, 2018, https://smartasset.com/taxes/states-with-the-most-million-dollar-earners

9 Joshua Rauh & Ryan J. Shyu, "Behavioral Responses to State Income Taxation of High Earners: Evidence from California," National Bureau of Economic Research, October 2019, https://www.nber.org/papers/w26349

10 Tax Policy Center Briefing Book, "How did the TCJA change the standard and itemized deductions?" Tax Policy Center, 2018, https://www.taxpolicycenter.org/briefing-book/how-did-tcja-change-standard-deduction-and-itemized-deductions

11 Joshua Rauh & Ryan J. Shyu, "Behavioral Responses to State Income Taxation of High Earners: Evidence from California," National Bureau of Economic Research, October 2019, https://www.nber.org/papers/w26349

12 Morgan Scarboro, "State Individual Income Tax Rates and Brackets for 2018," Tax Foundation, March 5, 2018, https://taxfoundation.org/state-individual-income-tax-rates-brackets-2018/

Michael Walker, "CA IRS State-to-State Migration," Data Made Useful, 2020, https://public.tableau.com/profile/michael.walker#!/vizhome/CA_IRS_StatetoState_Migration/YearlyAGIFlow

13 Sarah Mervosh & Jill Cowan, "'Welcome to Texas!': Musk's California Departure Stokes the States' Rivalry," The New York Times, December 9, 2020, https://www.nytimes.com/2020/12/09/us/elon-musk-texas-california.html

14 Robert Frank, "Elon Musk could save billions in taxes if Tesla moves its headquarters to Nevada or Texas," CNBC LLC., last updated May 12, 2020, https://www.cnbc.com/2020/05/11/elon-musk-could-save-billions-in-taxes-if-tesla-moves-its-headquarters.html

15 William Ruger & Jason Sorens, "Freedom in the 50 States," Cato Institute, 2020, https://www.freedominthe50states.org/regulatory

16 2021 State Business Tax Climate Index, "Corporate Taxes," Tax Foundation, 2020, https://statetaxindex.org/tax/corporate/

17 United States Small Business Administration, "Small Business Profile: California," 2014, https://www.sba.gov/sites/default/files/files/California13(1).pdf

18 Claire Kalia, "What is a Sole Proprietorship?" Kalia Law P.C., May 13, 2014, https://www.kalialawpc.com/2014/05/13/what-is-a-sole-proprietorship/

19 California Chamber of Commerce, "CalChamber Board Takes Positions on Proposed Initiatives," May 23, 2016, https://advocacy.calchamber.com/2016/05/23/calchamber-board-takes-positions-on-proposed-initiatives/

20 Allen Young, "Why big business laid down on Prop 55," Sacramento Business Journal, October 14, 2016, https://www.bizjournals.com/sacramento/news/2016/10/14/why-big-business-laid-down-on-prop-55.html

21 Allen Young, "Why big business laid down on Prop 55," Sacramento Business Journal, October 14, 2016, https://www.bizjournals.com/sacramento/news/2016/10/14/why-big-business-laid-down-on-prop-55.html

22 Ballotpedia, "California Proposition 55, Extension of the Proposition 30 Income Tax Increase (2016)," 2016, https://ballotpedia.org/California_Proposition_55,_Extension_of_the_Proposition_30_Income_Tax_Increase_(2016)

Ballotpedia, "California Proposition 30, Sales and Income Tax Increase (2012)," 2012, https://ballotpedia.org/California_Proposition_30,_Sales_and_Income_Tax_Increase_(2012)

23 Joshua Rauh & Ryan J. Shyu, "Behavioral Responses to State Income Taxation of High Earners: Evidence from California," National Bureau of Economic Research, October 2019, https://www.nber.org/papers/w26349

24 Joshua Rauh & Ryan J. Shyu, "Behavioral Responses to State Income Taxation of High Earners: Evidence from California," National Bureau of Economic Research, October 2019, https://www.nber.org/papers/w26349

25 Joshua Rauh & Ryan J. Shyu, "Behavioral Responses to State Income Taxation of High Earners: Evidence from California," National Bureau of Economic Research, October 2019, https://www.nber.org/papers/w26349

26 California Legislative Analyst's Office, "Hearing Concerning Propositions 30, 31, and 38," State of California, September 24, 2012, https://lao.ca.gov/handouts/state_admin/2012/Propositions_30_31_38_Sept_24_12.pdf

California State Controller, "California Department of Education Audit Report of Education Protection Account Recorded In The State General Fund – July 1, 2012, through June 30, 2015," State of California, August 2016, https://trackprop55.sco.ca.gov/AuditReport/CDE_EPA_AuditReport2012to2015.pdf

27 Mary Murphy, Akshay Iyengar, & Alexandria Zhang, "Tax Revenue Volatility Varies Across States, Revenue Streams," Pew Research Center, August 29, 2018, https://www.pewtrusts.org/en/research-and-analysis/articles/2018/08/29/tax-revenue-volatility-varies-across-states-revenue-streams

28 California Department of Finance, "Governor's Budget Summary – 2019-2020 - Revenue Estimates," State of California, January 10, 2020, http://ebudget.ca.gov/2019-20/pdf/BudgetSummary/RevenueEstimates.pdf

29 Ashlea Ebeling, "Arizona Voters Approve Massive Tax Hike On High Earners, Could Your State Be Next?" Forbes Magazine, November 4, 2020, Massivehttps://www.forbes.com/sites/ashleaebeling/2020/11/04/arizona-voters-approve-massive-tax-hike-on-high-earners-could-your-state-be-next/?sh=175a0ff1f98f

30 Mary Murphy, Akshay Iyengar, & Alexandria Zhang, "Tax Revenue Volatility Varies Across States, Revenue Streams," Pew Research Center, August 29, 2018, https://www.pewtrusts.org/en/research-and-analysis/articles/2018/08/29/tax-revenue-volatility-varies-across-states-revenue-streams

31 California Legislative Analyst's Office, "The 2020-21 Budget: Overview of the California Spending Plan," State of California, October 5, 2020, https://lao.ca.gov/Publications/Report/4263

About the Author

Andrew Mikula is an Economic Research Analyst. Mr. Mikula was previously a Lovett & Ruth Peters Economic Opportunity Fellow at Pioneer Institute and studied economics at Bates College.

Mission

Pioneer Institute develops and communicates dynamic ideas that advance prosperity and a vibrant civic life in Massachusetts and beyond.

Vision

Success for Pioneer is when the citizens of our state and nation prosper and our society thrives because we enjoy world-class options in education, healthcare, transportation and economic opportunity, and when our government is limited, accountable and transparent.

Values

Pioneer believes that America is at its best when our citizenry is well-educated, committed to liberty, personal responsibility, and free enterprise, and both willing and able to test their beliefs based on facts and the free exchange of ideas.

PIONEER INSTITUTE
PUBLIC POLICY RESEARCH

185 Devonshire Street, Suite 1101 Boston MA 02110 617.723.2277
www.pioneerinstitute.org Facebook.com/PioneerInstitute Twitter.com/PioneerBoston