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State legislators consider increasing income taxes on the wealthy

California's tax rate is the nation's highest, but budget woes are prompting proposals to raise it further. Tax foes say it could backfire by driving businesses and top earners out of the state.

By Evan Halper

SACRAMENTO — California has long had a reputation for soaking the rich, claiming a particularly large slice of their earnings to feed its growing government. Now, legislative Democrats want to push it further.

Their plan to balance the state budget would raise the wealthiest Californians' income taxes — already the highest in the nation — to a level not seen anywhere in the country in years. After years of income taxes steadily dropping elsewhere, California would raise the effective rate on those earning at least \$1 million to 12%, more than twice the rate in most other states that have income taxes.

Although legislative leaders are weighing a plan to balance the budget in part by raiding transportation funds and local government accounts, many Democrats are still rallying around an income-tax increase as the best way to bring the budget into balance over the long term.

Economists and money managers, though, are wondering whether California would be returning to this well one time too many. There is, they say, a point at which the cash infusion is outweighed by damage done to the economy: Entrepreneurs get driven away. Profits get stowed in tax shelters. Companies shelve plans for expansion.

“The more a tax sticks out like a sore thumb, the more taxpayers will look for ways to avoid it,” said Robert Ward, deputy director of the Nelson

A. Rockefeller Institute of Government in Albany, N.Y. California's income tax on its highest earners “would be a significantly higher rate than in any other state.” Rhode Island's is the next highest, at 9.9%.

Robert Brown is well aware of that. The 72-year-old small-business owner from Thousand Oaks isn't a million-dollar earner, but his income is in the high six figures, and the state tax on it would jump from 9.3% to 11% under the Democratic plan. He's considering bolting.

“These people have no concept that when you raise taxes, you drive people away,” he said. “Quite a number of my good friends have moved — to New Mexico, to Arizona, to North Carolina. We are thinking about doing the same.”

Proponents of tax hikes, though, say there is no evidence that meaningful numbers of high earners follow through on threats to leave. The number of wealthy Californians continued to swell after the last tax hike targeted at the rich, a 1% surcharge on income above \$1 million that was approved by voters in 2004, according to the California Budget Project, a think tank that advocates for low-income Californians. And a study by the Public Policy Institute of California concluded that the state's job growth typically keeps pace with the national average.

People need not move away to avoid a tax increase. Those who handle money for the wealthy are already working on strategies.

“There are a lot of legitimate alternatives,” said Jeff Fishman, a Century City money manager for the wealthy.

The options are as simple as giving a business an out-of-state address or as complex as setting up a pension fund for oneself with tax-free contributions.

socking away money in tax-free bonds is another option.

Nicholas Stonnington, a money manager in Los Angeles, said Californians could establish residence elsewhere just before they cash in a stock windfall or make millions on the sale of a business. “I know of people who have moved or are planning to move based on significant transactions they expect to have,” he said. “People come up with ways to avoid paying taxes they view as excessive or unfair.”

Democrats defend the tax-hike idea, saying the alternative would be thousands of teacher layoffs, hundreds of thousands of children and elderly Californians going without healthcare, cuts in public safety and other steep reductions in government services. Public opinion surveys show Californians don’t want those cuts.

Moreover, supporters argue, the increases would echo a move made under Republican Gov. Pete Wilson during the budget crisis of the 1990s. The rates being proposed now — minus the 1% surcharge on top earners — temporarily went into effect in 1991, they say.

Senate Budget Committee Chairwoman Denise Moreno Ducheny (D-San Diego) described the proposal as “just rolling back tax cuts that have been made since 1997.”

“The only way to get ourselves back from the cliff is to acknowledge the need for all of us as a community to pay for those things we want done,” she said.

But the 1991 example cuts both ways. Much of the money the state was expecting to generate from that tax hike didn’t materialize. Projections showed it would bring in \$1.2 billion. Collections fell hundreds of millions of dollars short. To this day, Democrats and Republicans in Sacramento argue about whether that shortfall resulted from the rich moving their

money elsewhere or from broader economic issues — the state was entering a major recession at the time.

Some economists warn the state not to bank on the \$5.6 billion that tax officials project can be raised with this year’s proposed hike.

“You sometimes get a lot less than you expect,” said Bill Fox, director of the Center for Business and Economic Research at the University of Tennessee and an expert on state taxation.

Denise Bustamante, a tax director at Deloitte Tax LLC, said she doubted an increase would prompt many wealthy Californians to move. “But it will make businesses thinking of coming here re-think it,” she said.

Small businesses typically file their taxes under the personal income tax rules instead of paying the corporate tax. According to the California Taxpayers’ Assn., that means half the state’s businesses would be affected by the proposed hike.

The Small Business and Entrepreneurship Council, a national trade group, and the Tax Foundation, a nonpartisan think tank based in Washington, D.C., say the state’s tax system is among the least business-friendly in the country. Both groups ranked California in the bottom four. Only New Jersey fared worse in both studies.

Patrick Fleenor, chief economist at the foundation, said many companies had been willing to endure tough circumstances for the privilege of doing business in California.

“But what is often missed is the firm that would have popped up in L.A. but is instead popping up outside Las Vegas,” he said. “People on the cusp of moving to California or leaving California would certainly be affected by this.”