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TESTIMONY

ERASE ARTIFICIAL BARRIERS: FOCUS ON ENTREPRENEURSHIP

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California Senate Governance and Finance Committee

Chairwoman Wolk, Vice Chair Huff, and members of the Committee:

Thank you for inviting me to testify on policy alternatives to California's Enterprise Zone (EZ) program. Last year, I provided written testimony to the Committee on the effectiveness of the EZ program based on the extensive literature evaluating zone performance.

The EZ program has not had the impact on local economic development envisioned by those who designed the program. Where results have been achieved, they have been small relative to the cost borne by the state. However, the broad goals of the EZ— to encourage economic development and socially-beneficial entrepreneurship—can be met without direct intervention or a loss of revenue.

In fact, there is much work ahead for California policy makers to accomplish the goals articulated by EZ policy. The toolkit available to policy makers is limited but powerful. It includes California's tax structure, fiscal regime, and regulatory environment. In the coming months and years, these must be reformed through the application of general principles of neutrality, stability, sustainability, and transparency. By establishing predictable and stable rules based on pro-growth policies, California will signal to residents and investors that the state is a place where individuals, businesses, and communities can thrive.

I will touch on each of these areas an offer more specific suggestions. I will conclude my testimony with some general thoughts on economic development.

TAXATION

California's tax system is in need of reform. Consistently ranked as a state with the nation's highest income, corporate, and sales taxes, California's taxpayers face the highest marginal tax rate on income, with a top bracket of 10.55 percent on those earning over $1,000,000. Many small businesses are taxed under the individual code (partnerships, sole proprietorships, and LLCs). Effectively, this high rate makes it difficult for small businesses to expand, hire, and create jobs.

California's sales tax at 8.25 percent is riddled with exemptions resulting in a tax that is inefficient and distortionary. As the Tax Foundation notes, while California's sales tax has a high rate, its collections are relatively low.[1] In FY 2007 California's collections lagged behind 12 other states. The sales tax's narrow base applies to just 34.7 percent of goods and services, compared to a national median of 43.6 percent.[2] The Tax Foundation further estimates that if California were to broaden the base of the sales tax to include all goods and services, while still exempting business-to-business transactions, the rate could drop between 7.25 percent and 5.8 percent without a loss in revenue.[3]

The elimination of the EZ is a step towards greater neutrality in California's tax code. However, it must be recognized that the credits are considered valuable by those businesses currently claiming them, in part because of California's high rates of taxation on small business owners through the personal income tax and the high rate of taxation on corporations.

To encourage economic development of all types—small businesses, individual entrepreneurship, and corporate expansion

[1] Joseph Henchman, "A Golden Opportunity: California's Budget Crisis Offers a Chance to Fix a Broken Tax System" *Fiscal Fact* no. 170, May 18 2009, http://www.taxfoundation.org/research/show/24712.html.
[2] John L. Mikesell, "State Retail Sales Tax Burdens, Reliance and Breadth in Fiscal 2003," *State Tax Notes* 125 (July 2004).
[3] Henchman, "A Golden Opportunity."

and job creation—California lawmakers should continue to apply these principles to the state's tax system: broaden the base, lower the rate, and strive for greater neutrality by eliminating exemptions and incentives. This will transform California's tax system into one that is less complex, more transparent to taxpayers and businesses, non-discriminatory, and one that is pro-growth. It will also have the benefit of reducing volatility in revenue collections and increasing fiscal stability for the state.

LASTING SPENDING REFORM

California's spending has outpaced growth in inflation and population over a two-decade period. Since 1991, spending grew at an average of 5.91 percent annually, while population plus inflation grew by 4.38 percent annually.[4] This has driven the size of the state's continuing budget gaps. In addition to ongoing yearly gaps, California must contend with the significant promises it has made to public sector workers in the form of pensions and benefits. Undertaking reform to the pension system is necessary to stabilize the state's fiscal future and to ensure commitments are met. That means reform must begin now and include ending the defined benefit plan and switching new hires to a defined contribution plan. This policy move will also send a powerful signal that California is pursuing structural fiscal reforms in order to reduce its long-term debt, and the risk that this presents to taxpayers, and to meet its commitments to workers who have earned rights to their benefits.

DECENTRALIZATION

The passage of Proposition 13 in California in 1978 achieved a short-term policy goal of keeping taxes low on the local level. But as economic theory would predict, the long-term outcome of Proposition 13 was to leave localities more dependent on state revenues to support local services. Without the ability to raise taxes to support schools and other local services, localities in California have turned to other sources to fund spending, including increased local sales taxes; the "fiscalization of land-use policy" and "sales-tax farming" to attract businesses with high sales-tax receipts, eroding family-owned businesses; an increased reliance on government fees; the rise in special assessment districts; and also the underfunding of city pensions. All of these are outcome that result from local governments attempting to circumvent the limits imposed by Proposition 13.[5] In addition, Proposition 13 increased local reliance on state revenues, contributing to the state's current fiscal problems. Transfers from a higher level of government to a subsidiary level may induce greater spending on the local level by softening the hard budget constraint facing local government. In other words, localities spend beyond what they can support in own-source revenue, contributing to poor fiscal discipline on the local level.

Currently, Governor Brown is considering how to undo the centralization that occurred as a result of Prop 13. This is an important reform that if properly implemented will help put the state on more stable fiscal footing. Activities that can be performed on the local level should be left to localities. This approach has several benefits. First, fiscal decentralization ties revenues more directly to the activities being funded, contributing to transparency and making it easier for local residents to evaluate the effectiveness of spending. This in turn promotes greater community involvement on the local level and thus greater policy flexibility and variety for both local government, as well as greater fiscal stability for the state government.

REGULATORY ENVIRONMENT

Currently, a bipartisan effort is underway to introduce regulatory reform to the state of California. The effort to establish a process to review and analyze regulations' economic impact and effectiveness is an essential step towards weighing the costs and benefits of regulations on the state's economy. In a 2010 report, the Institute for Policy Integrity states that "California's Office of Administrative Law—praised as one of the nation's first, most active, and independent review entities—runs a review process that frustrates many agencies."[6] In practice, economic analysis is not employed in the preparation of impact statements with cost estimates, which are "prepared by first making a preliminary, 'not particularly scientific' estimate and then relying on regulated industries to critique and refine the estimate during the public comment period."[7] While improving the assessment of regulations may be difficult given the current fiscal pressure in the state, a gradual process of implementing a more rigorous review of regulations will have long-term benefits for the state's improving the quality of regulation.[8]

Encouraging economic development and socially beneficial entrepreneurship requires policies that tackle the structural

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[4] Adam B. Summers, "California's Spending by the Numbers: A Historic Looks at State Spending from Governor Pete Wilson to Governor Arnold Schwarzenegger," Reason Foundation, February 2009, http://reason.org/files/a2ec7caccc5d660e870c4a21526ef5f8.pdf.
[5] Colin H. McCubbins and Mathew D. McCubbins, "Proposition 13 and the California Shell Game" (Center in Law, Economics and Organization, Research Paper Series and Legal Studies Research Paper Series, University of Southern California Law School, 2009).
[6] Jason A. Schwartz, *52 Experiments with Regulatory Review: The Political and Economic Inputs into State Rulemaking* (New York, NY: NYU Institute for Policy Integrity, November 16, 2010).
[7] Ibid, 171.
[8] See also, Robert N. Stavins and Todd Schatzki, "Comments on the Little Hoover Commission's Study of Regulatory Review in California," http://www.lhc.ca.gov/studies/activestudies/regulatoryreform/Stavins.Schatzki%20testimony.pdf.

weaknesses in California's tax system, fiscal institutions, and regulatory environment. California is moving in the right direction on all of these fronts. Applying the principles of broad-base, lower-rate taxation will lead to a more pro-growth economic climate for investors, entrepreneurs, and individuals. Addressing the structural problems with California's budget will require a commitment to pension reform, arguably one of the most pressing factors to affect California's long-term fiscal prospects. Addressing the fiscal imbalances created by Proposition 13 through the promotion of greater decentralization is an important step towards improving the state's finances, as well as granting more autonomy to local units of government. Lastly, California can send a powerful signal by committing to improvement of its regulatory review process.

The rules of the game matter deeply. Ultimately, it is this framework that determines the amount and kinds of entrepreneurship that occur in society. The goal of public policy should be to promote variety and innovation by setting rules that are neutral, clear, reduce uncertainty, are easy to administer and evaluate, and are predictable for residents and the state. These rules should be based on the principles discussed above. Economic development is ultimately a local phenomenon that depends on the institutional setting and is based on promoting the greatest amount of flexibility to allow individuals to take risks, to innovate, and to flourish.

By instituting such reforms, the state can achieve the goals that it is trying to reach today: greater fiscal stability, improved quality of life, and economic prosperity.