

TAX THAT MAN BEHIND THE TREE

PROPOSITION 82: ANOTHER CALIFORNIA TAX THE RICH PLAN

By Joel Fox¹

Less than two years after California ballot measure Proposition 63 increased the personal income tax rate on taxable incomes over \$1 million from 9.3% to 10.3% to pay for mental health programs, another initiative is bearing down on California's upper-end taxpayers. Following the late Senator Russell Long's dictum, "Don't tax me, don't tax thee, tax that man behind the tree," Proposition 82, the "Pre-School for All" initiative, proposes to increase top marginal personal income tax rates by 1.7 percentage points to promote a universal pre-school system in the state. This would result in California having the highest top marginal personal income tax rate in the nation.

In the June 2006 state primary election, the voters of California will get their say on Prop 82, the only initiative on the ballot placed there by citizen petition. If successful, this measure, sponsored by Hollywood actor/director Rob Reiner, would wreak havoc on the California economy while shortchanging other programs funded by the state general fund, including K-12 education. It is hard to fathom an initiative more potentially destructive to California's economy than this one.

And I wouldn't count on any opposition to Prop 82 to arise from Sacramento. Governor Schwarzenegger has been disturbingly silent on the issue, and while Democratic Senate leader Don Perata has recently withdrawn his support of the initiative because of flaws in the plan he feels "are fatal," he cites the fact that the plan is not means-tested as the biggest of these flaws.²

June 6th: D-Day

This coming June 6th is the 62nd anniversary of D-Day; it is also the 28th anniversary of the passage of Proposition 13, the seminal tax revolt measure in California. This 6th of June will also be a day of decision and a test of how the tax revolt is holding in California.

Under 1978's Proposition 13, a two-thirds vote is required to increase taxes in the legislature. However, Proposition 13 was silent on statewide tax increases presented to the people. Thus, tax increase advocates often take their measures directly to the people because a simple majority vote by the voters passes the tax.

Proposition 82 is following this path. It proposes to create a free, voluntary pre-school for all four year olds in California. The entitlement program would begin in the 2010-11 school year, although, if passed, taxes would begin being collected in 2007 and early implementation of the pre-school plan would be allowed for low performing schools.³ Once the program is fully implemented, Pre-School for All will require:

- A minimum three-hour per day instructional program offered at least 180 days each year;
- A curriculum based on state pre-school learning standards and guidelines and aligned to the state's academic standards for kindergarten through third grade; and
- Classes of no more than 20 children taught by at least one credentialed teacher and one instructional aide.

The Pre-School for All program will be under the supervision of the elected state superintendent of public instruction and operated by each county Office of Education. Ironically, the county Offices of Education have been considered redundant organizations by many and were even tagged for elimination under Governor Schwarzenegger's California Performance Review Committee.⁴

¹ Joel Fox is president of the Small Business Action Committee and is the co-chairman of the No on Proposition 82 Committee.

² Daniel Weintraub, "A Change of Mind About Preschool," *Sacramento Bee*, March 3, 2006.

³ Legislative Analyst letter to Attorney General Bill Lockyer, July 28, 2005.

⁴ California Performance Review, ETV05 Regionalize K-12 Education Infrastructure, Recommendation A.

The 34-page Pre-School for All initiative spells out in detail many of the requirements for the program, including ensuring that teachers in pre-school receive salaries comparable to the county's K-12 teachers; that teachers hold a new early learning teacher's credential; and that all Pre-School for All employees have a right to union representation and collective bargaining.

To pay for this new entitlement, Prop 82 would raise the marginal personal income tax rate by 1.7 percentage points from 9.3% to 11% on individuals making \$400,000 a year and couples earning \$800,000 a year. That's an 18% tax increase on each dollar earned above and beyond the floor of this bracket. The new top marginal personal income tax rate—paid by those with incomes over \$1 million thanks to the state's "millionaires surtax"—would increase from 10.3% to 12%. This top marginal personal income tax rate of 12% would be the highest in the nation.⁵

The Legislative Analyst's Office ("the Analyst") projects that the tax increase would produce \$2.4 billion per year by 2010-11 when the measure is fully implemented, although she notes that tax revenue from this high-end earner group is highly variable. The money can only be used for pre-school and cannot be moved by the governor or legislator for any other purpose, including K-12 education.

Prop 82 is another initiative which will earmark money for a specific program and thereby tie up the budget, something that critics have been complaining about for some time.⁶ The Analyst projects that enough revenue will be collected to provide each student up to \$8,000 a year for a three hour program, about 75% of what each K-12 student costs for a full day's program.

What will California taxpayers get for the cost? Using information from a RAND study on pre-school, proponents of Prop 82 claim that for every \$1 invested in pre-school, society will benefit by \$2.62 as a result of fewer school dropouts and less crime as the children mature. The RAND conclusions were based on a study focused on a group of African American students from Chicago who were followed over a couple of decades.

The circumstances are different in California from the earlier studied group. In addition, former California Legislative Analyst William Hamm's consulting firm, LECG, took a look at the RAND study and pointed out that RAND estimates that about 78,000 additional students will attend pre-school if Proposition 82 is passed. However, Hamm points out that according to the RAND figures, four out of five pre-school students subsidized by the taxpayers are already attending pre-school anyway. He goes on to report that RAND indicated that three out of four high-risk participants in a Proposition 82-type program would have attended pre-school even without the program.⁷

Therefore, this expensive pre-school for all proposition will not greatly benefit high-risk children. Hamm notes that funding for high-risk students amounts to less than 9% of the money being raised by the initiative.⁸ Nearly 75% of the revenue will go to either students who would have attended private pre-school or to increased costs for children already attending public schools.⁹

Tax that Man Behind the Tree

The question is not whether pre-school brings benefits to society but whether the state can afford a new \$2.4 billion bureaucracy while K-12 education is found wanting. Frankly, \$2.4 billion could hire 69,000 more teachers or buy 1.2 million computers. Yet, this money will only increase pre-school participation by a small fraction.

The Analyst says that about 66% of current four-year-olds attend some type of "nursery school," of which slightly less than half are enrolled in privately run programs.¹⁰ Based on information from other states, the Analyst predicts that when Prop 82 is fully implemented, 70% of the four year olds will attend pre-school.¹¹

The personal income tax is the lifeblood of California's general fund, producing 53% of the revenue to the fund.¹² However, in 2003 only 11.5% of California's income taxpayers paid 76% of the income tax.¹³ To break the personal income tax figures

⁵This assumes that the New York and New York City temporary personal income tax rate increases are allowed to expire as scheduled as of 1/1/06. If they are allowed to expire, New York City's top marginal personal income tax rate will fall from 12.15% to 10.50%.

⁶"Earmarking Budget into Concrete," by Joel Fox, *Los Angeles Times*, November 2, 1990.

⁷Proposition 82—The Preschool for All Act, Evaluation of the Program's Design by William Hamm and Ronald Schmidt, LECG, Inc., March 2006 p. 8.

⁸Ibid, p. 4.

⁹Presentation by LECG to the Silicon Valley Leadership Group, February 2, 2006.

¹⁰Op cit Legislative Analyst letter to Attorney General July 28, 2005.

¹¹Ibid.

¹²"Tax Impact of Reiner Initiative," California Taxpayers Association 2006.

¹³Op cit Hamm and Schmidt, Likely Impact of Proposition 82, p. ii.

down even further, less than one-half of one percent of California's income tax payers would be subject to the Prop 82 tax increase. However, this small group contributes 33% of the general fund revenues.¹⁴ Targeting the top income taxpayers would disrupt this important revenue stream.

Tax increases on high-end earners produce quite different effects than expected. Laffer Associates' research has for years demonstrated that rich people are mobile and can move to low- or no-income tax states like Nevada, Washington or Texas to escape excessive taxation.¹⁵ *The Wall Street Journal* pointed out that in 2005 California lost 239,416 native-born Americans to other states.¹⁶ *The Journal* suggested one of the biggest reasons people are leaving California is because of California's tax system.¹⁷

Other options for high-end taxpayers to protect their money include shifting investments from taxable to tax-exempt or tax-deferred instruments; deferring compensation; increasing contributions to tax deferral plans like 401-Ks; and substituting taxable salary and wages for tax-exempt or tax-deferred compensation like more generous health benefits or stock options. California's highly progressive tax structure encourages this type of behavior and virtually guarantees a volatile revenue stream.

This type of activity will have a detrimental effect on the state's general fund. Hamm and Schmidt estimated that a 1% reduction in after-tax income causes the highest income taxpayers to reduce their taxable income by 1.5% to 2.5%.¹⁸

The impact of this action from high-end taxpayers will put a hole in the state's general fund. Hamm and Schmidt report: "Our analysis indicates that Proposition 82's 1.7% tax surcharge would reduce General Fund revenues by \$618 million in 2007, and by \$1.1 billion in 2011—the first year in which the measure's preschool program would be fully implemented."¹⁹

Interestingly, because the K-12 program relies so heavily on the general fund, the Hamm/Schmidt estimate means that K-12 could see cuts in expected revenue, perhaps \$450 million by the 2011-12 budget year.²⁰

There is no inflation clause built into Proposition 82. This means as more and more taxpayers reach the \$400,000/\$800,000 taxable figures they will be ensnared in the tax trap.

Furthermore, this tax scheme could hurt California's economy in other ways. As many as 80% of California businesses pay taxes through the personal income tax using sub-S corporations and sole proprietorships. What will these entrepreneurs do as their tax burden continues to climb? The wide-open spaces of Nevada and Texas may look better and better.

Government will compete with private business for pre-school children and many current pre-schools run by lower and middle class people who don't have the credentials required by Prop 82 may have to close up shop and lose their jobs.

Other methods for delivering pre-school services have proved successful at a smaller cost. Private money in Kern County funds a program called Ready-to-Start, a four to five week summer session that costs about \$350 a student and shows promising results.

Ad Controversy

The Yes on Proposition 82 campaign has become embroiled in a controversy over use of taxpayer dollars to promote the Pre-school for All idea.

During the final weeks of qualifying what would become Prop 82 for the ballot in December 2005 and January 2006, a state agency, First Five Commission, spent \$23 million on a media campaign promoting the value of pre-school for four-year-olds. The First Five Commission, so named because it is supposed to support advantageous programs to help children in the first five years of their life, is a creation of Reiner, the man behind Prop 82. Reiner supported an initiative in 1998, Proposition

¹⁴Ibid p. 8.

¹⁵Papers on this topic include: Arthur B. Laffer and Jeffrey Thomson, "The Only Answer: A California Flat Tax," Laffer Associates, October 2, 2003; Arthur B. Laffer and Jeffrey Thomson, "California: The Journey Begins," Laffer Associates, January 27, 2004; Laffer State Competitive Environment, current edition.

¹⁶This figure is from the U.S. Census Bureau. The Demographic Research Unit of the California Department of Finance, using a different methodology of calculating net domestic migration, also reports a net outflow, but of a smaller magnitude.

¹⁷"Meathead Economics," *Wall Street Journal*, February 28, 2006.

¹⁸Op cit Hamm and Schmidt , Likely Impact of Proposition 82, p. 25.

¹⁹Ibid p. 28.

²⁰Ibid p. 30.

10, which raised cigarette taxes 50-cents per pack to fund the First Five Commission. After the election, Governor Gray Davis appointed Reiner as commission chairman.

While First Five claims its media campaign was scheduled well before the submission of the Pre-school for All initiative, and also that Reiner in his position as chairman did not take part in voting for the media effort, questions have been raised about the appropriate use of taxpayer money in advocating an initiative effort.

The legislature's Joint Legislative Audit Committee voted 11-0 to order the Bureau of State Audits to look into First Five's spending. At the same time, the Attorney General's office, citing a conflict since it represents the commission, has asked the Sacramento District Attorney to look into a request from a state senator to see if the advertising money was used appropriately. Reiner has taken a leave of absence from the commission and welcomed the audit. Both Reiner and the First Five board claim they have done nothing wrong.²¹

What Will the Voters Do?

The first poll taken on Proposition 82 in January 2006 showed support for the idea (Table 1).

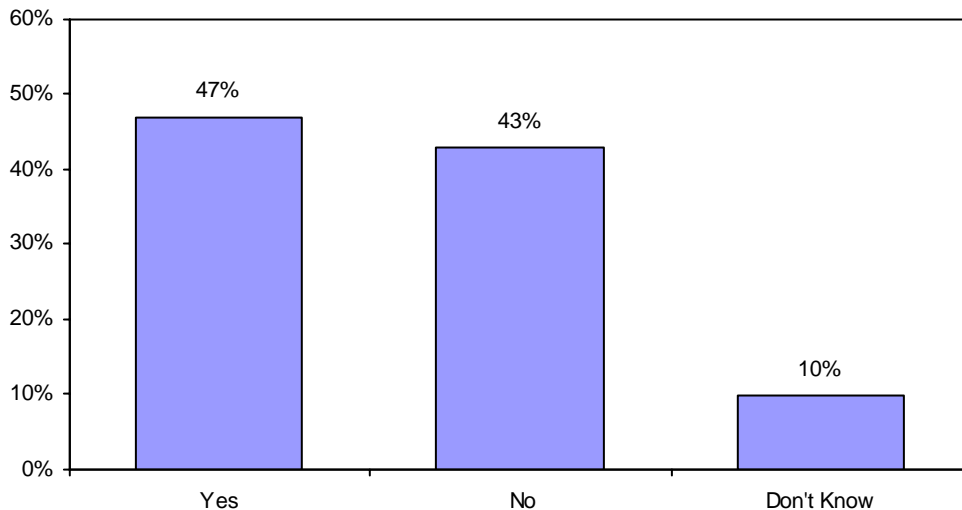
**Table 1
Support for Proposition 82, January 2006**

		All Adults	Party			Likely Voters
			Dem	Rep	Ind	
How about increasing taxes by 1.7 percent on individual incomes above \$400,000 dollars annually, and \$800,000 dollars for couples, to pay for voluntary public preschool for all 4-year old children?	Yes	66%	77%	49%	66%	63%
	No	31	20	49	32	35
	Don't Know	3	3	2	2	2

Source: Public Policy Institute of California, January 2006 Survey

However, the way the question was asked would undoubtedly elicit a positive response. Numbers have dropped in subsequent polls. In its late February 2006 poll, Datamar Surveys, which claims to poll over 2,000 voters who have participated in the last two elections, showed Proposition 82 in trouble, leading only by a few percentage points (Figure 1).

**Figure 1
Support for Proposition 82, January 2006**



Source: Datamar Surveys

The statewide Field Poll, which measured 507 likely voters in March, showed Proposition 82 ahead, but losing steam when voters learn more about the measure (Table 2).

²¹Dan Morain, "Panel Run by Reiner to be Audited," *Los Angeles Times*, March 9, 2006.

Table 2
Voter Preferences About Proposition 82
 (among likely voters)

	Would vote...		
	Yes	No	Undecided
Total statewide	55%	34	11
<u>Party</u>			
Democrat	73%	16	11
Republican	36%	50	14
Non-partisans/others	53%	43	4
<u>Political ideology</u>			
Conservative	38%	50	12
Moderate	56%	32	12
Liberal	74%	15	11
<u>Gender</u>			
Male	52%	38	10
Female	58%	30	12
<u>Race/ethnicity</u>			
White (non-Hispanic)	53%	35	12
Latino*	62%	30	8
Other*	64%	27	9
<u>Prior awareness of Prop. 82</u>			
Yes, had heard of it	53%	40	7
No, not aware	57%	30	13

* Small sample size

Source: The Field Poll, March 7, 2006

Conclusion

Proposition 63, which raised taxes on million dollar incomes 1% to pay for mental health programs, enjoyed 70% support before the 2004 election. A late opposition campaign buying a small amount of radio ads succeeded in cutting the margin of support down to 53% on Election Day.

The opposition campaign to Prop 82 has begun earlier and is better organized than the No on Prop. 63 campaign. If a serious fundraising effort is accomplished, Prop. 82 could very well be defeated.