Expert Analysis

Calif. Proposes A Job-Killing Tax On Talent

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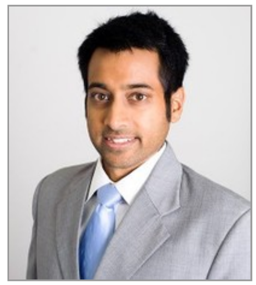
Korok Ray

Law360, New York (July 7, 2014, 10:26 AM EDT) -- Next session, the California state legislature plans to raise corporate taxes on companies with high CEO pay. A similar bill passed a California Senate committee on May 23, but died when the Senate failed to pass it with 19 votes in favor and 17 votes against (a two-thirds majority was required for the bill to become law). The proposed bill would increase taxes on companies that pay executives more than 100 times average worker pay. Legislators justify the proposal on inequality grounds: the tax would "level the playing field" by compressing the wage distribution.
The motives behind the legislation mirror a similar initiative at the federal level, where the U.S. Securities and Exchange Commission proposes that in order to implement Dodd-Frank all companies should disclose the ratio of CEO pay to average worker pay. California's legislation is much more aggressive and would directly tax companies with high CEO pay.

The bill aims to amend the California Revenue and Taxation Code by altering the flat corporate tax rate of 8.84 percent to a sliding scale. The proposed bracket ranges from a tax rate of 7 percent for a compensation ratio of 1, to a 13 percent tax for a compensation ratio of over 400. Publicly held corporations with a nearly equal pay ratio will still receive a 7 percent tax on net income, compared with a national average state corporate tax rate of 6.6 percent. This will discourage firm of all sizes from locating in California. The bill inhibits not only the largest businesses, but all business.

This law represents a fundamental misunderstanding of how labor markets work. I find that companies use performance-based pay to attract talent. Firms compete with one another for labor, and the best workers will select the best firms. This is true for both factory workers and executives. Employees within the firm do not compete against each other, but rather compete in an external labor market. Comparing the pay of the executive against the average worker is meaningless — what matters is one executive's pay against the pay of another executive. Compensation is set in the marketplace, not in an internal comparison.

Just as companies compete for talent, states compete with firms through their tax rates. California has already lost major corporations to other states. For example, the large mutual fund manager, Dimensional Fund Advisers, moved from Los Angeles to Austin, Texas. More recently, Toyota moved its headquarters from Torrance, California, to Plano, Texas. Additionally, Occidental Petroleum, Comcast, Waste Connections, Campbell Soup in Sacramento, Vision Service Plan, Chevron, Facebook, eBay, LegalZoom, Apple, Paypal, Yelp, Maxwell Technologies and Tesla have either partly or entirely relocated to other states, notably Texas, Oregon and Arizona. This migration has occurred before the passage of SB 1372. Competition for business across states is real and this carries the legitimate risk that corporations will leave California.

If more corporations leave the state, the long-term economic damage to California will vastly exceed any possible gain from this tax change. Supporters of the proposed legislation avow the bill would force "companies to put less money into the hands of their CEOs and more into the hands of average employees." However, the average worker pay will become zero, since the firm will no longer be located in California.

When Toyota relocated its headquarters from California to Texas, executives maintained their salaries — they simply received payments in another, lower-tax state. But the vast majority of workers employed by Toyota in California lost their salaries entirely, because they did not move 1,500 miles to Plano.

According to the Tax Foundation, the bill would disproportionately hurt retail chains. Gap, headquartered in San Francisco, employs many workers in entry-level positions. Gap focuses its business model on a large number of customer service employees, which reduces the level of median worker compensation, and thus increases the compensation ratio and Gap's applicable tax rate as proposed by SB 1372.

Indeed, the current proposed structure rewards firms that pay their CEOs at lower levels and do not hire entry-level workers. This will only attract unproductive firms to the state and reduce opportunities for new entrants. If a firm paid all of its employees the same, the productivity of that firm would sink, because no one of significant talent would choose to work there.

The bill contains another misguided provision, a penalty for corporations that shift to hiring contract employees. This prevents firms from contracting out low-wage work in order to compress the wage distribution. The bill would raise the applicable tax rate by 50 percent for firms that decrease domestic full-time employees by 10 percent and increase contracted and foreign full-time employees by a specified amount. If a publicly held corporation has a compensation ratio over 400 and decreases full-time employment in the United States, the firm would be taxed 63 percent of its annual net income, where as a corporation with a nearly equal compensation ratio, but decreased domestic employment, would still be taxed 57 percent each year.

Contract employees serve as key assets to firms. When a firm does not require full-time work, or is unsure about future business trends, contract employees can supply the firm with desired services, reducing costs and raising productivity. Forcing firms that hire contract labor to pay a penalty would similarly discourage efficient firms from locating in California.

Opponents of SB1372, such as Governor Jerry Brown and 22 California-based companies, have branded the bill a "job killer," and they are correct. The amendment to Section 23151 of the California Revenue and Taxation Code will push companies out of California, increase unemployment, and further deteriorate the state's economy.

California is in an enormous engine of economic growth — policies should keep it competitive, not drive away business.

—By Korok Ray, George Washington University

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