Mitchell's Musings 2-10-2014: Business Climate: Not Open and Shut

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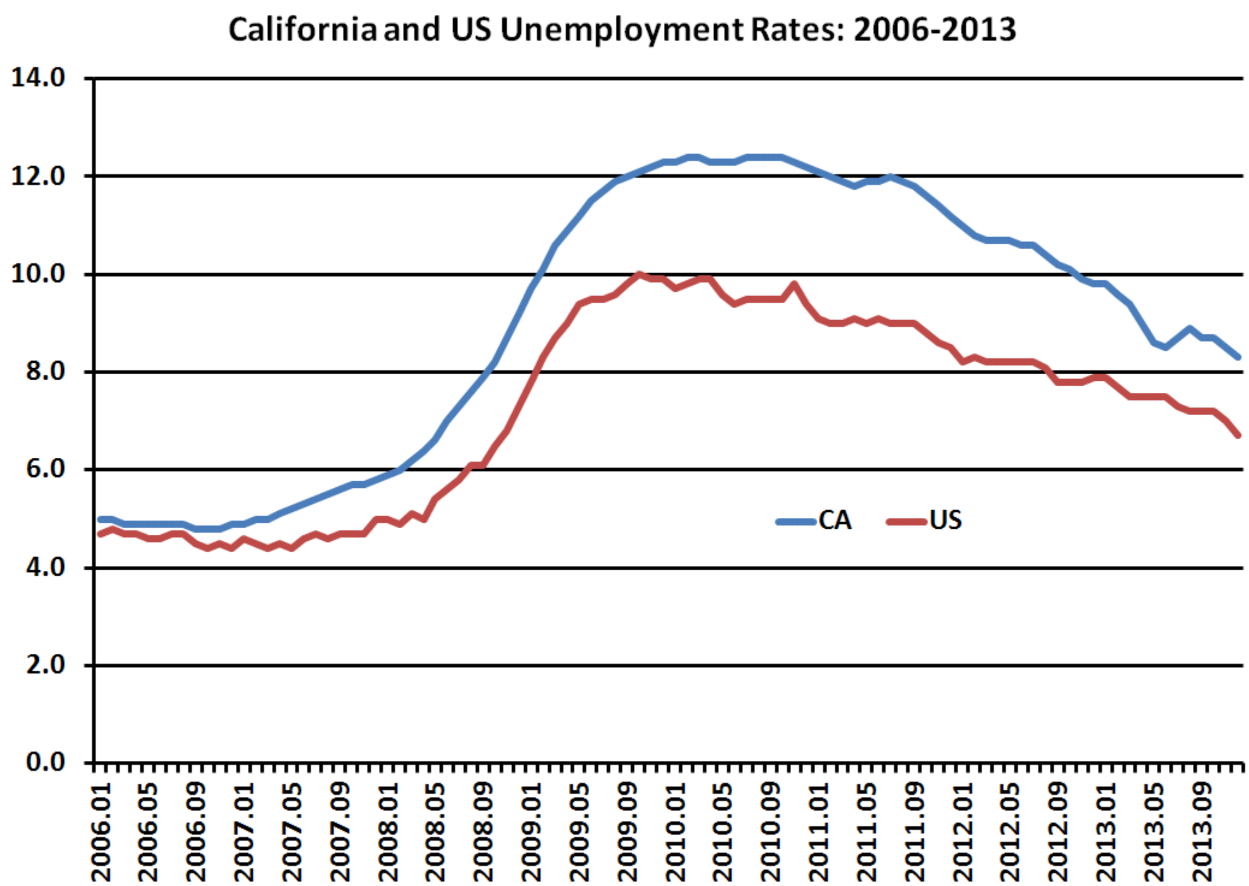
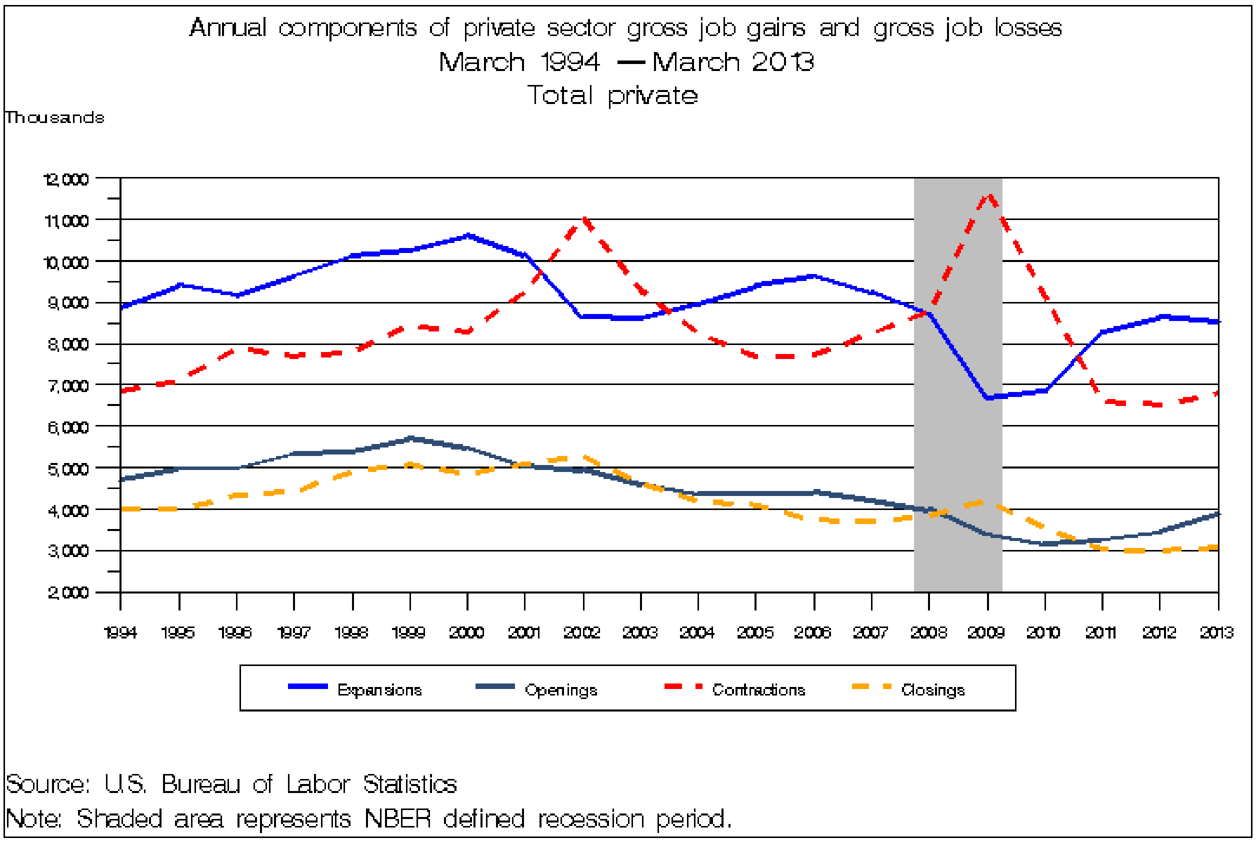
An ongoing issue in California has been the business climate. Specifically, there is a charge that businesses are leaving or shutting down because of a poor business climate. Similarly, it is argued that new businesses are deterred from opening due to that poor climate.

It is true that California's unemployment rate – one measure of the job market – has been higher in California during and since the Great Recession than in the U.S. as a whole. But in 2006, before the contraction began, the U.S. and California rates were about the same as can be seen on the chart below. Could the business climate have shifted dramatically at the start of the Great Recession in late 2007? No major laws or regulations in California went into effect in that period, making a sudden climate shift implausible. A more plausible story has to do with the fact that a disproportionate share of the housing bubble/bust and flaky mortgage/financial fiasco was located in California. During the boom, housing and funny mortgages helped power the economy. But during the bust there were big layoffs in the construction and financial sectors. The decline in house values also produced a negative wealth effects on homeowners, reducing consumption/retail, and other sectors.



In fact, it could be argued that, when the impact of the Great Recession is factored in, *lack* of appropriate regulation by the state of its real estate and financial sectors harmed the state. Perhaps the boom/bust in housing would have been less severe. Perhaps some of those flaky mortgages would not have been written.[1]

The U.S. Bureau of Labor Statistics makes available series on inflow to - and outflows from - employment. As can be seen on the chart below for private employment in the U.S. as a whole, the inflows come from existing establishments that add job and new establishments that open and hire. The outflows come from existing establishments that reduce jobs and establishments that close and lay off. Let's focus on the lower lines on the chart that refer to job changes in establishments opening (crudely, new businesses) and establishments closing (crudely, businesses failing).[2]

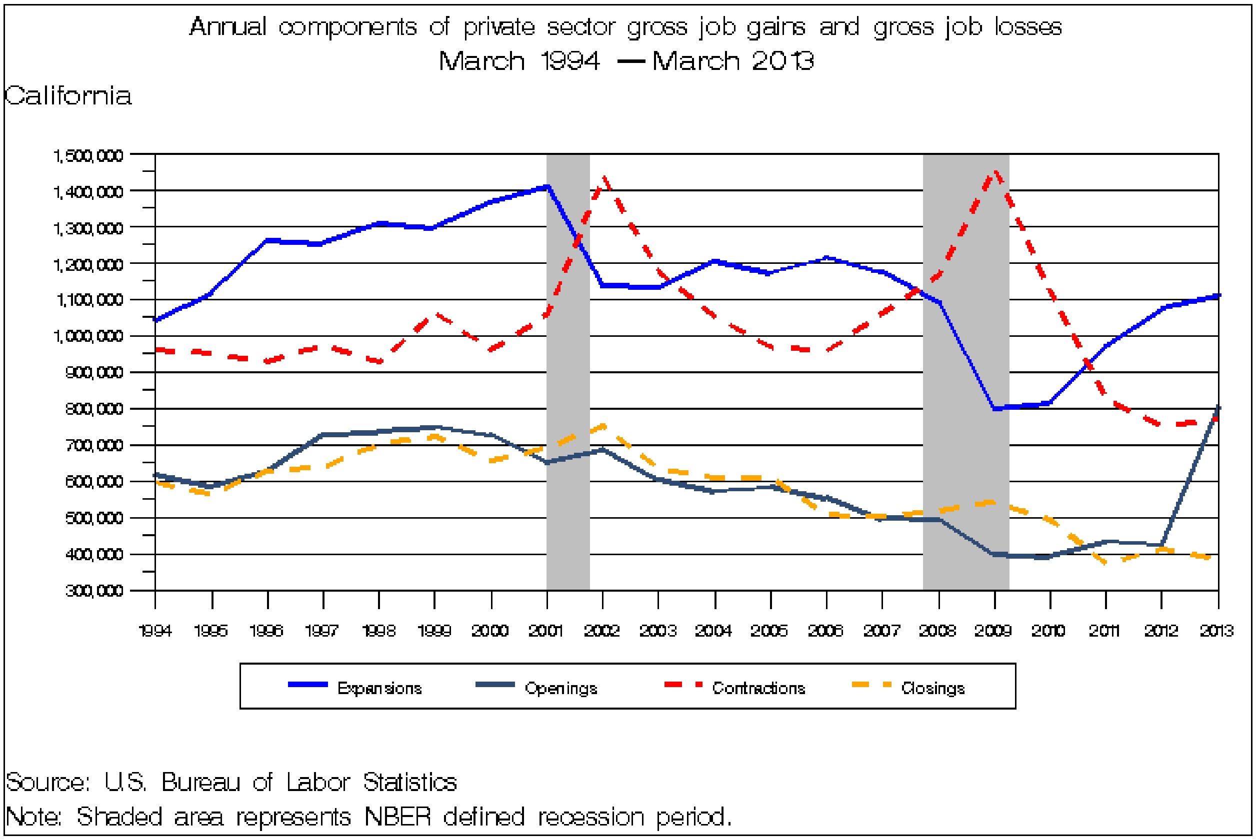


Source: http://www.bls.gov/bdm/bdmann.htm

[1] The sad tale of Countrywide Financial Corporation, a mortgage firm headquartered in California, can be found in Connie Bruck, "Angelo's Ashes: The man who became the face of the financial crisis," *New Yorker*, June 29, 2009. http://www.ritholtz.com/blog/wp-content/uploads/2009/06/man-with-a-tan-6-29-09.pdf

[2] An establishment can be part of a larger business. It is difficult to define exactly what a "business" is, since some businesses are subsidiaries of others, some are franchises, and some are wholly independent enterprises. But the two series come as close as possible to the idea of businesses coming into existence and businesses folding.

If we focus on the lower two lines on the chart on the previous page, we see that during good times, new jobs at opening businesses exceed job loss at closing businesses. During bad times (early 2000s, Great Recession), the reverse occurs.



In general terms, California shows the same pattern on its lower two lines, as might be expected. (See the chart above.) But between 2012 and 2013, there is a big uptick in jobs in new businesses opening and hiring. The jump could be a fluke, of course. But the timing is surprising. In that period, California's governor, Jerry Brown, engaged in a long and ultimately successful campaign to raise state taxes via a ballot initiative. Both sales and income taxes were to be raised on a temporary basis in response to an ongoing state budget crisis he inherited from his predecessor, Arnold Schwarzenegger, who inherited it in turn from Governor Gray Davis after a recall election in 2003.

Noteworthy is the fact that although the increase in the sales tax was small, the income tax increase was concentrated at the highest brackets. Much of the added revenue came from the income tax. In short, it was the kind of increase that is supposed to be bad for business climate. Of course, there is a lot more to be said here. As noted, the uptick could be some kind of statistical fluke. But you can be sure that if a downtick had occurred, you would be hearing about how it proved that tax increases worsened the business climate and caused the business closures.

During the campaign, it might be noted, the business community was not the major source of opposition. Some business organizations supported the governor, in fact. Perhaps they felt that having the state in an ongoing fiscal crisis, period after period, was more upsetting to the business climate than providing more revenue to move away from the kinds of instability that regular budget crises produced.

California is not out of the woods. While currently, the “structural” budget deficit is now said to be a thing of the past, such projections are based on continuous, linear growth. No downturns in the economy are predicted. But if past history is any guide, there will someday be another downturn. The state’s heavy reliance on the income tax (roughly six out of ten dollars flowing into the state’s general fund), and the income tax’s heavy reliance on its top brackets, makes the California revenue base volatile. Those in the upper brackets receive (or don’t receive) taxable capital gains which reflect the ups and downs of financial markets. A downturn could easily return the state budget to crisis.

There are many issues on the policy menu for California that could help or hinder the state’s long-term economic health. For example, states with major energy sectors relative to their economies are the ones tending to do well in the post-Great Recession era. In absolute terms, California has a significant oil sector. The state’s decision on so-called “fracking” technology could enlarge that sector but with environmental costs. Housing costs are high in much of California but the state’s transportation infrastructure is overloaded with its current population. Commuting from lower cost areas to higher cost areas is difficult. An employment boom, to the extent it relied on increased population, is limited ultimately by that capacity constraint.

It is unclear at this point how the state will respond to such challenges. The one thing that can be said is that the relation between taxes and business climate is not an open and shut matter. If that’s true in California, it is likely to be so elsewhere.