Strangled in the Crib

Jobs and Regulation in California

Joseph Farah and Mike Antonucci

"Do you want to make money?" a Northern California accountant asks his clients seeking to set up new businesses. Without waiting for an answer, he suggests they consider incorporating in Nevada. Why? Because the cost of doing business in California is considerably higher than in neighboring states. California's top personal income tax rate is 11 percent, compared to 7 percent for Arizona. Both California and Arizona have 9.3 corporate tax rates. Nevada has no personal income or corporate taxes. But perhaps worse than California's taxes are the regulations it imposes on businesses, some of the most draconian in the country.

The result has been a deep destructive, and long-lasting recession that has seriously tarnished the economic luster of the Golden State, driven out thousands of existing businesses and, perhaps most importantly, stopped dead in their tracks an untold number of potential business start-ups and expansions.

Studies of the effects of regulations often focus on aggregates, for example, the dollar value of lost Gross Domestic Product, the costs added to goods by transportation regulations, or the limits on credit availability from banking regulations.

But it is useful also to take an entrepreneurs' eye view of the difficulties they confront as they try to find their way through the regulatory maze and to overcome the regulatory obstacles in his or her path. Anecdotal evidence helps convey a realistic appreciation of what businesses actually face in a state. And it is these types of stories that one businessman hears from another when he or she asks about the local business climate, stories that influence decisions on where to open an enterprise. It is thus useful for policymakers and scholars to understand regulatory conditions from this perspective.

The Job Hemorrhage

California's unemployment rate is around 10 percent, well above the 6 percent average for the rest of the country. The state lost between 600,000 and 800,000 jobs between 1990 and 1993. And, according to a 1994 report by Pacific Gas & Electric of California, most of these job losses are the result of structural changes—not

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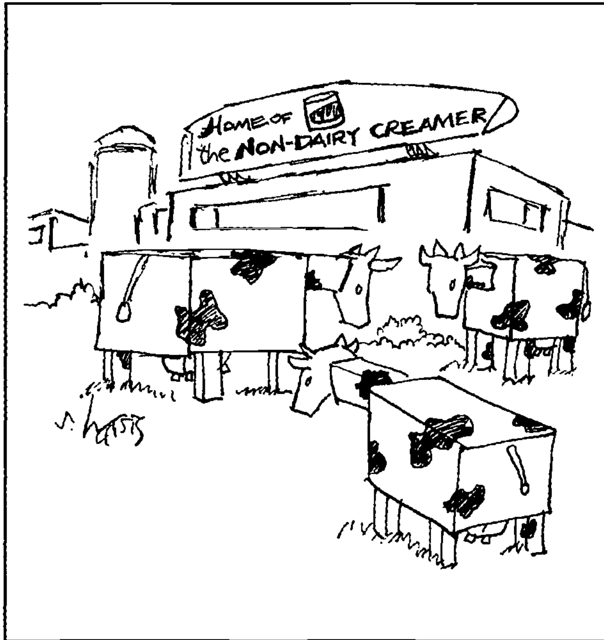

cyclical—and are therefore not coming back.

The manufacturing sector has been the most severely affected. Some industries, for example, shipbuilding, machinery and petroleum, have experienced job losses of between 10 percent and 30 percent over the past decade. Over 700 manufacturing facilities have moved or expanded outside of California since 1987, taking nearly 100,000 manufacturing jobs with them.

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Neighboring states are experiencing solid economic growth at the expense of California whose businesses and would-be entrepreneurs are leaving the state in droves. Earlier this year, the California Business Roundtable found that 41 percent of California companies now plan to expand outside the state. Another 14 percent, including a quarter of all manufacturers, plan to relocate altogether.

In many cases, the regulatory costs of doing business in California are the major cause of business flight. For example:

- The Zero Corporation moved 2 manufacturing facilities to Utah in 1991. Vice Chairman Howard Hill said this move meant a 50 percent reduction in health-care costs, a 60 percent reduction in worker's compensation costs, a 40 percent reduction in utility costs, and an elimination of legal consulting costs. "The relationships that manufacturing companies have with the EPA, AQMD, EEOC, OFCCP, Cal OSHA, worker's compensation, water control, and other agencies is nearly totally one-sided and extremely bureaucratic," he said.
- Indicative of the problems was the 1990 decision by California-based Applied Materials to built a $100 million facility in Austin, Texas. It was a difficult decision for CEO James C. Morgan to make. His wife, Rebecca Morgan, was at the time a state senator. "The attitude of state and local government toward industry is pathetic," Mr. Morgan explained.

A Federal Reserve Board study conducted earlier this year found California lagging well behind the rest of the nation economically. While 12 percent of the nation's population resides in that state, about 30 percent of the nation's job losses occurred there. The loss of industry has been so dramatic that state tax revenue actually fell in 1992 despite passage of the largest state tax increase in American history during the previous year.

Causing Business Flight

Interestingly—but perhaps not surprisingly—some of the most intensive research on California business flight has been done not by government but by a private utility company fearful of losing some of its best customers. Southern California Edison, the electric supplier serving 50,000 square miles of southern and central California, devoted more than 2 years to studying why businesses were leaving the state—interviewing owners and managers, compiling data, and issuing a report that has been widely circulated among business leaders and government officials. Edison has even trained 500 of its own field personnel to discuss future plans with customers to head off possible out-of-state moves.

What the utility found is deep discontent with the business climate in California focused principally on increasing costs due to worker's

compensation and health requirements, anti-business attitudes by regional agencies and local governments, complex environmental restrictions, and fear of greater regulatory controls. "Southern California just isn't a good place to do business anymore for manufacturers," one food processing company official told Edison's researchers.

Of the 31 business managers interviewed, most said they would have preferred to stay in California. According to Edison's report on the business climate:

> Only after encountering community resistance or regulatory delays did many of the firms consider expanding their search to alternate sites inside and outside Southern California. Such encounters usually prompted an expanded review of the negative conditions associated with operating in the region. This review generally reinforced the decision to relocate.

Most companies gave more than one reason for relocating. But overwhelmingly the two major reasons cited were the cost of doing business and difficulty in complying with government regulations. Internal business reasons, quality-of-life factors and other reasons accounted for much less than half of the flight.

But even those businesses that have chosen to stay in California are fearful about the future and deeply concerned about the anti-business climate and the regulatory chokehold on the state. Barry R. Sedlick, Edison's manager for business retention, says many companies considering a more are reluctant to let government officials know about their plans.

"Frankly, we find the companies that are staying here are often fearful of recriminations," Sedlick said.

Another recent study of industry migration sponsored jointly by five public and private California utilities, including Southern California Edison, found that between 1987 and 1992, California lost 708 manufacturing plants and 107,000 jobs due to relocations. Mexico captured 21 percent of the facilities, with neighboring states claiming most of the rest. Of those that left, 87 percent cited California's business climate as the principal reason.

Since 1989, 233,000 manufacturing jobs have left the state. That is one reason the cost of taking a U-Haul vehicle out of California is 4 times higher than the cost of bringing one in. The effect of this flight is having an impact on employer-employee relations in the state as well.

"One by one I have watched businesses both large and small leave this county," said John L. Salem, a mechanic who recently decided to leave California for upstate New York. "Some went out of business when the recession hit, others simply moved to other states that were more business-friendly. When these businesses left, hard-working people left with them. It's hard to ask my employer for a raise when all his customers are leaving."

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A Problem Defying Simplification

How difficult is it to deal with the regulatory web in California? One company, Touchstone Environmental Inc. in Oakland, has prepared a "simplified guide" to help businesses comply with state environmental regulations. This simplified guide is a 2-volume, 1,200-page report costing $266. The introduction to the report states that,

> Environmental compliance in California is a very complex process—an uncomfortable blend of science and law, of engineering and economics, of federal, state, and local requirements. The rules are complicated, frequently overlapping, and rapidly changing. Firms large and small encounter grave difficulty in determining what to do: goals, objectives, techniques, priorities. In the face of this conclusion, they cannot successfully allocate their available resources of people, money and technology. Their attempts to comply are typically ad hoc, sporadic, and too late.

Even a 1993 *Guide to Doing Business in California*, published by the Business, Transportation, and Housing Agency, designed to encourage business starts, cannot hide the

bureaucratic morass an entrepreneur must wade through:

> Cities are authorized to impose a tax in addition to a license fee. Because of the difference in ordinances, local officials need to be contacted to determine the costs and types of businesses that are required to be licensed in the local jurisdiction. Note: most jurisdictions require license for each location. Local ordinances may require a business to have other permits in lieu of, or in addition to, a business license, such as zoning permits, entertainment permits and health permits. . . . Some business and vocations must also obtain a state license, registration or permit such as a Sales/Use Tax Permit issued by the Board of Equalization. Firms with employees must show proof of workers' compensation coverage and register with the California Employment Development Department and Internal Revenue Service for payroll taxes. Other state licenses are generally limited to occupations requiring extensive training, or where public safety or health is involved, or consumer fraud is a problem.

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Fees and Red Tape

The costs of fees and delays in the permitting process are major problems faced by businesses starting up or expanding in California. The Office of Small Business in the California Department of Commerce, for example, in 1992 estimated that it costs between $45,000 and $90,000 annually for each of the 67,000 Los Angeles basin small businesses to comply with regulations. Red tape and fees constitute much of that cost.

How does this red tape actually affect businesses? Typical examples include:

- Officials of the Great American Food Stock Company needed a new facility for their growing business. If they stayed in their home city of San Diego, they could expect to pay $40,000 for a building permit and wait 18 months or more for a review of their plans. Instead, they decided to build their new facility in Rio Rancho, New Mexico, where the same building permit cost $2,250 and took all of 4 days to obtain.
- In 1991, Target Department Stores applied simultaneously for approval of 2 nearly identical 500,000-square-foot distribution centers—one in Pueblo, Colorado, and the other outside of Los Angeles. The Colorado facility was completed and operating before construction was even permitted to begin in California.
- In 1992, Lockheed Corporation decided to compare the number of regulatory agencies it had to deal with for plants in Sunnyvale, California, and Austin, Texas. Lockheed's analysis found that in Austin, the city building department essentially offered one-stop shopping, and fulfilled all of the requirements and paperwork of the other city, county, and state agencies. But in Sunnyvale, Lockheed was forced to deal with 16 separate city agencies, 12 county-regional offices, and seven different state bureaucracies.
- Rohr Industries experienced so much difficulty in getting a permit for a new manufacturing plant that it gave up and moved to Arkansas. The permit that would have cost $750,000 in California cost only $750 in Arkansas.
- The loss of aerospace jobs in California is not due only to defense cutbacks and the recession. One aerospace aluminum manufacturing company, which employed 750 Californians, spent 10 months and $360,000 on permit fees for a new plant. Faced with even stricter regional air quality standards, the company, like so many others, moved to Nevada.

The tough regulatory climate in California is even claiming some non-traditional employers as victims. Last spring, World Vision U.S., with 525 employees, announced it was packing up and moving to Seattle within a year thanks, in part, to government regulations, including a mandatory ride-share program that costs the organization as much as $100,000 a year.

"It's not that (the mandate) is going to break

anyone's back, but when you put all these things together, the arithmetic goes in the wrong direction," explained Robert A. Seiple, president of World Vision. "When you put what our costs are here relative to other states, it makes California look bad."

Peter Morrison, a demographer for Rand Corporation, said the announcement illustrates "how certain footloose industries that don't need to be tied to a certain location are picking up and leaving." Just 2 days after World Vision's announcement, another major for-profit company, Thrifty Drug Stores, said it was moving its corporate headquarters from Los Angeles to Oregon. Los Angeles Mayor Richard Riordan tried to intercede in the decision and offered to do "anything" to keep 899 jobs and a $40 million payroll in town. But officials of the company said the decision was final.

Most smaller companies that leave the state, however, never get wooed by city, county, or state officials. One durables manufacturer interviewed as part of the Edison study said: "In fact, this is the first time anyone has even asked us why we're moving out."

Sometimes the red tape and regulations that can drive businesses out of state are simply silly. An example:

• The Gillette Company was sued and fined for leaving a warning off the label of one of its products—a tiny bottle of typing correction fluid with a label too small to fit the state warning.

An Environment Free of Businesses

Entrepreneurs seeking to start or expand businesses in California have been hit particularly hard by environmental regulations. For example:

• Fox Studios wanted to expand on its Century City property but residents sued on environmental grounds and blocked the project. The local planning committee presented Fox with 500 "mitigating conditions" that had to be met for approval. One of these was a requirement that Fox hire a full-time fossil expert to search the construction site for bones. Fox took the committee's demands under advisement, and immediately opened negotiations with Texas.

• California businesses had been required to perform a self-inspection of their facilities, using a state-developed check-list, to document contamination and clean-up needs. The deadline for filing results was to be January 1, 1995. Yet as of this writing, in August, 1994, the State Department of Toxic Substances Control had yet even to adopt an approved checklist for businesses to use, forcing legislators to approve a bill deleting the deadline date.

Air quality regulatory agencies are among the worst offenders when it comes to choking off business activity and driving up costs. The Southern California Air Quality Management District, an unelected agency with sweeping powers, has estimated that its regulations would cost about $3 billion a year. But one independent analysis, in 1991 by Resources for the Future, placed the costs at $10 billion, while another, in 1992 by the National Economic Research Association, estimates the cost to be $12 billion.

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Researchers with the National Economic Research Association and Resources for the Future found that Air Quality Management officials had decided some regulations had no costs at all. When asked how its staffers had arrived at those conclusions, district officials explained that they did not want to use "arbitrary" figures. So they arbitrarily picked zero as the cost.

An example of the results of the agency's policies:

• A Southern California furniture manufacturer, Panel Concepts, wanted to move its operations to a smaller plant in the area. But the South Coast Air Quality Management District would not permit the company to transfer its existing permits to the new site. Finally, the company packed up and moved to North Carolina.

The Perils of Risk-Reduction

In its April 23, 1992 report, the California Council on Competitiveness stated that, "Regulations should be based on good scientific and socioeconomic analysis to ensure that the public's money is being spent efficiently. The

benefit of environmental regulation is achieved at a cost. For regulators to make informed decisions about proposed regulations, they must understand and balance these impacts and benefits." Yet California's environmental laws still generally fail to take account of costs and benefits. Evidence of this is documented in a report of the Office of Small Business of the California's Department of Commerce, which found that government regulations in the state often are designed to eliminate all risk to health—an impossible and costly goal.

Take the example of water safety. The Association of California Water Agencies says that regulatory requirements on radon, a naturally occurring radionuclide that in high doses can cause health problems, will cost California water suppliers about $3.7 billion in capital costs and hundreds of millions of dollars a year in operating costs. And what results will be achieved? Available statistics show no actual deaths attributable to radon poisoning. Some environmental activists claim as many as 8 lives will be saved in California each year due to such regulations, or $462.5 million for each hypothetical life saved.

These policymakers fail to understand that state agencies do not create any marketable good or service when they use taxpayer's money and regulatory policy to promote green industries.

In 1994, after studying the issue, California Environmental Protection Agency (Cal-EPA) Secretary James Strock recommended that public opinion be taken into account when determining environmental risks. Some believe this step could reduce the demand for "zero tolerance" of environmental risks.

Riding Down Businesses

The state's policy to promote car pools to reduce automobile emissions is another example of failing to take account of regulatory costs to business. The "trip reduction mandates" of the South Coast Air Quality Management District force employers to develop and enforce employee car-pool plans.

The cost effectiveness of this approach first might be questioned. For example, if a number of employees ride in the largest car, it may be the worst-polluting vehicle. Because that bigger, perhaps older, smog-producing auto is now forced to drive to various locations to pick up employees at their homes—and, thus, run more miles than it would have previously—the result might be more pollution, not less. In other words, while the air-quality boards have decided that forcing car-pooling is a good thing, they have not determined exactly what the benefits of such a program are.

Car pool rules still mean that employers will spend millions of dollars devising and implementing plans, and seeking board approval for them. And there is no limit on what the air-quality boards can charge businesses through fines and fees to fund their operations. One hospital, Kaiser Permanente in Los Angeles, that failed to submit its ride-share plan on time, was fined nearly $1 million.

The adverse effects of California's car pool rules do not end simply with fines and wasted time for businesses. Currently the state courts are trying to determine if injuries sustained by a worker while participating in a ride-share program are covered under workers' compensation laws. The legal reasoning is that workers are participating in "a company-sponsored alternative commute program" and thus employers are liable for any injuries that may occur during the commute.

Curiously, some policymakers see these regulations that harm businesses as a positive thing, creating a climate suited for "reinventing" the state's economic base. Assembly Democrat Tom Bates and Mayor Loni Hancock of Berkeley call for a new "green" economy: "An economy of stewardship will put California in a position of leadership in developing programs and products needed for global survival. . . . We can create new markets by direct government purchase of recycled and environmentally sound products."

To restore the state's growth, economists Stephen Levy and Robert K. Arnold of the Center for Continuing Study of the California Economy in Palo Alto recommend "boosting [public] investment in education, infrastructure, research and development, and new technology, [and] improving the quality of life in the state by relieving traffic congestion, high housing prices,

and pollution."

These policymakers fail to understand that state agencies do not create any marketable good or service when they use taxpayer's money and regulatory policy to promote green industries. In fact, they destroy wealth and penalize productive activities.

Few Reforms in Sight

Last year, it seemed California's elected officials had finally heard the wake-up call. Both Democrats and Republicans in the state legislature talked about reforming the regulatory process in an attempt to improve the state's business climate. There were modest legislative efforts to reform the state's worker's compensation system, to create tax breaks for manufacturers, to streamline regulatory operations, and to cut some steps from environmental reviews.

But, so far, judging from the lack of improved performance by the California economy, it may have been just too little, too late. "These reforms do not match the expectations that were raised by the Competitiveness Council and the 1993 Economic Summit," Gov. Pete Wilson announced after the 1993 legislative session. "It is imperative that the Legislature revisit this issue early next year."

Even though California's economic problems persist, there is a strange resistance to further reform. "It's usually prudent to let the new laws settle and then re-evaluate, rather than tinker year after year," explained Senate President Pro Tem Bill Lockyer. "In a society that is very, very diverse, there is a sound argument for making changes gradually. The business community just won enormous victories. They have to realize those victories meant a defeat for somebody else."

In some cases, elected officials simply react in an ad hoc way to business flight with legislation designed to deal with the threat of individual corporations leaving. Taco Bell, for instance, has been discussing relocating its corporate headquarters to Texas. In reaction, Assembly Speaker Willie Brown introduced AB 1313, better known as the "Taco Bell Bill," to provide a 6 percent tax credit to the company for investments in California headquarters. But even this limited response to a particular case was defeated in committee.

Now Senator Lockyer is talking about the possibility of creating a state commission that would allocate tax breaks to specific companies to keep them in California or lure them from other states. What the legislative leaders have categorically failed to address, however, is how you encourage new businesses to start up in the state.

Conclusion

California's regulatory regime is a principal cause of the state's job loss and the absence of new job creation. State policymakers might rationalize that any given regulation places only a small burden on the entrepreneur. Or they might claim that some vaguely defined social good will result that more than offsets the small inconveniences of the regulation.

But the costs and destructive effects often are large by any standard. In any case, the cumulative costs in time and money of California's regulations are barriers too high for many businessmen to surmount. The only jobs created by these regulations are in the other states, by businesses fleeing the Sunshine state. California policymakers have to date failed to deal effectively with the regulatory crisis and thus have a difficult economic road ahead.

Selected Readings

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