

# FISCAL RESEARCH CENTER

## THE “ROLLER COASTER” OF CALIFORNIA STATE BUDGETING AFTER PROPOSITION 13

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FRC Report No. 131  
July 2006



ANDREW YOUNG SCHOOL  
OF POLICY STUDIES

# **The “Roller Coaster” of California State Budgeting After Proposition 13**

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## **Acknowledgments**

This report was prepared at the request of the Fiscal Research Center and was presented at a conference on intergovernmental relations and fiscal conditions sponsored by the Fiscal Research Center.

The paper is one of three papers that the Fiscal Research Center asked experts from other states to prepare. This paper focuses on California, the other two papers consider Pennsylvania and Florida. Each paper addresses the state’s fiscal condition, exploring the factors that explain the conditions and the likely future trends. The objective was to learn more about the fiscal conditions in these other states and how the states have or haven’t dealt with the situation. We hope that by considering the fiscal conditions that other state governments have faced perhaps Georgia can learn something from the experiences of those states.

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## I. Introduction

The National Association of State Budget Officers (NASBO, 2005, p. ix) open their recent edition of *The Fiscal Survey of States* with the statement that “[s]tate fiscal conditions rebounded noticeably in fiscal 2005.” This nationwide recovery was characterized by a marked improvement in revenues that allowed states to restore much of the funding to programs that were severely cut in the nationwide recession that began in 2001. State budget officers also report that general fund expenditures across all states are expected to grow by 6.3 percent in fiscal year (FY) 2006-07, which is just below the 6.4 percent average recorded over the last 28 years.<sup>1</sup> In FY 2005-06 all states reported an expected \$38.5 billion end-of-year surplus that is equivalent to 6.9 percent of all expected general fund expenditures.<sup>2</sup> However, as shown in Figure 1, this nationwide average masks important differences in how well some states have recovered from the last downturn. More than one-third of the states are expected to display year-end reserves that are less than 4.9 percent.

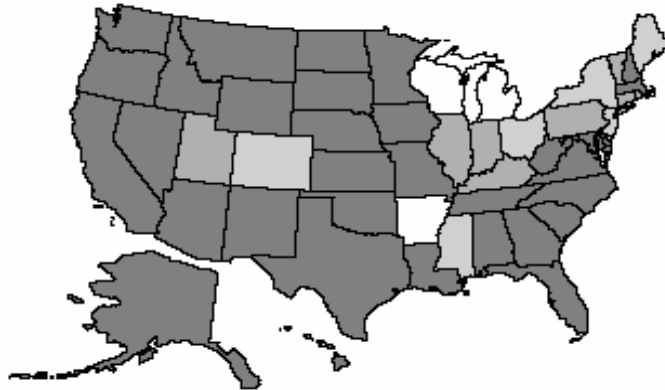
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<sup>1</sup> General fund expenditures are from general revenue sources that comprise all state revenue except that classified as liquor store, utility, or insurance trust revenue. General revenue is classified by four main categories: taxes, intergovernmental revenue, current charges, and miscellaneous general revenue. For details see <http://www.census.gov/govs/www/class.html>.

<sup>2</sup> As defined by NASBO (2005, p. 11), the end-of-year surplus for a state includes both an ending balance between general fund revenue and expenditures and any amount accumulated in a budget stabilization (rainy-day) fund.

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**FIGURE 1. EXPECTED YEAR-END STATE GOVERNMENTS RESERVES AS A PERCENT OF EXPENDITURES, FY 2005-06**



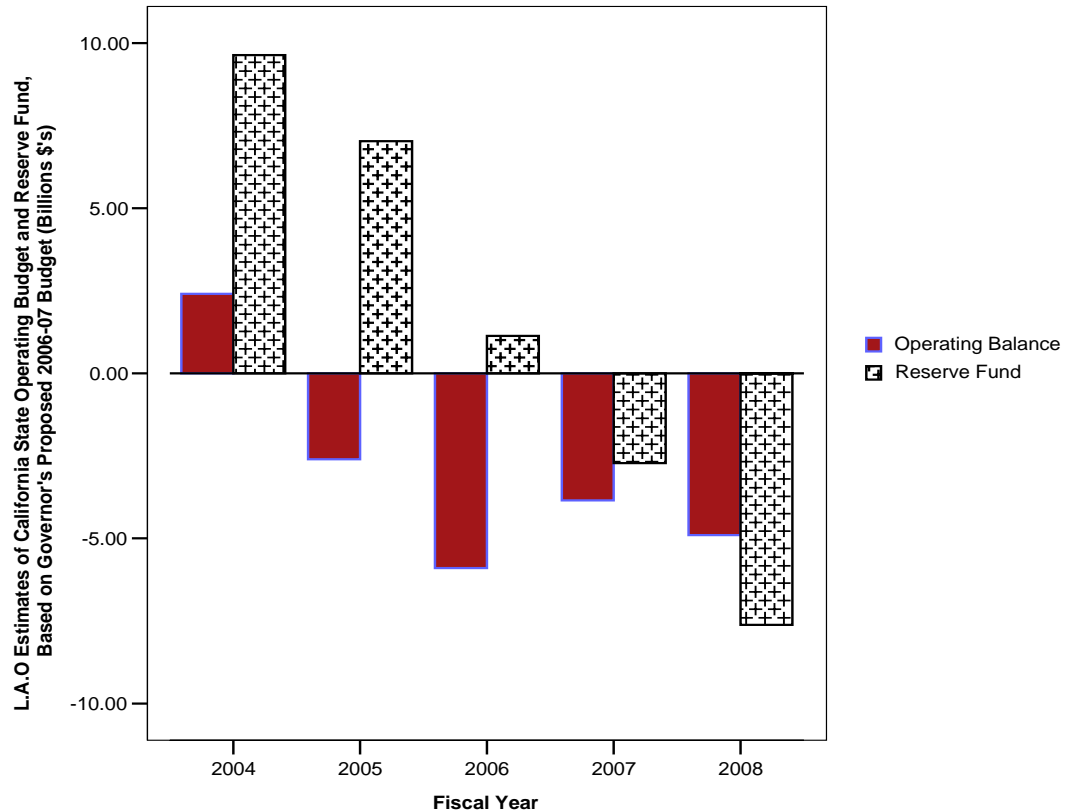
Black – 5.0% or more (33 states)  
Dark Gray – 3.0 to 4.9% (8 states)  
Light Gray – 1.0 to 2.9% (6 states)  
White – Less than 1.0% (3 states)

Source: National Association of State Budget Officers (2005), Figure 4, p. 16.

Based upon only Figure 1, the State of California looks in relatively good fiscal shape. The California Legislative Analyst's Office (LAO) in February of 2006 reported the State's expected reserve at the end of FY 2005-06 to be \$6.5 billion, or 7.2 percent of general fund expenditures. However, this positive reserve is not due to the State spending less than it takes in. In FY 2005-06 California is expected to run an operating deficit of \$2.6 billion. It will finance this with a reserve from the previous year of \$9.1 billion. This reserve, which amounts to 11.4 percent of state government expenditure in FY 2004-05, is attributed to unexpected increases in state personal income, corporate income, and sales taxes revenue; the proceeds of a state tax amnesty program, and \$10.4 billion raised through deficit-financing bonds issued in FY 2003-04. But as Figure 2 illustrates, because the pattern of State deficits is expected to continue, both California's yearly operating balance and reserve fund is predicted to go negative after FY 2006-07.

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FIGURE 2. ESTIMATES OF FUTURE CALIFORNIA STATE BUDGET OUTCOMES



Data source: Legislative Analyst’s Office (2006).

In an article titled “State Budgets: Bliss or Blues,” Eckl (2005) expects a future of unsustainable state budgets in the United States to be more the rule than the exception. On a scale of one to ten (with ten being her assessment of a state most at risk for exhibiting factors expected to contribute to future structural state budget deficits), she only awards Minnesota, Nebraska, New Jersey, North Dakota, Vermont, and Wisconsin a score below a five. California is rated a seven, and there are 18 states thought to be at even greater risk. Eckl’s (p. 24) conclusion on future state budget trends is that “cutting spending, raising taxes – or both – will become painful realities.”

Using California as a case study, the purpose of this paper is to investigate the factors that have produced the ominous budget outlook characterized by Figure 2. I do this first by examining budget patterns for the State of California to see if there is

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any evidence that they differ from what has been observed for states as a whole. Sections 3 through 7 are then used to describe some of the specific circumstances in California – constitutional restrictions, revenue reliance, demographics, future concerns, and public opinion – that are responsible for the previous patterns observed, and future patterns expected in California state government expenditures and revenue. Finally, Section 8 concludes with a description of how the State’s budget fared during the last business cycle and suggested policy reforms that could help alter the expected course of California’s budget outcomes over such future cycles.

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### **II. California State Budget Patterns Compared to All States**

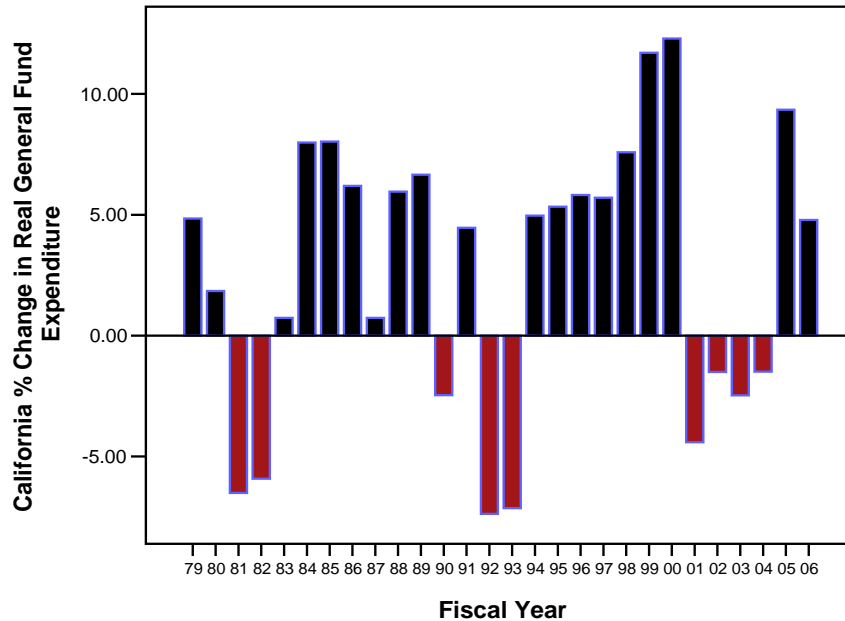
Historical data on state budgeting outcomes in California are next compared to the same measures calculated for all states in the country. The specific measures of comparison are restricted to ones collected annually by NASBO for all states. FY 1979-80 is chosen as a starting point because it is the first full fiscal year following the implementation of Proposition 13. Though Proposition 13 is simple in its tenants (a maximum rate of statewide property taxation at one percent, property value assessments rolled back to 1975 levels and allowed to increase a maximum of two percent per year unless sold, new “special” taxes require a two-thirds approval by voters, and property tax revenue is to be distributed among local governments “according to law”), it is now widely believed to have produced a legacy of further “unintended consequences” on California’s system of state-local public finances (Chapman, 1998). Data offered throughout this paper for FY 2005-07 must be considered preliminary, while data for FY 2006-07 and beyond are estimates from state budget officers.

Figure 3 presents the percentage change in real general fund expenditure for the State of California from the previous fiscal year. Notice that in the early parts of the 1980s, 1990s, and 2000s this real growth rate was negative. Also notice the consistent growth rates between five and 13 percent that occurred from FY 1994-94 to FY 2001-02. A comparison to Figure 4, which includes the same percentage change in real general fund expenditure for all states, shows that the pattern observed in California is unusual in at least a few aspects. States as a whole saw no negative growth rates in real expenditures during the early 1990s and also did not enjoy the consistent 5 percent plus growth rates in the remainder of the 1990s that California did. Expectations for FYs 2005-06 and 2006-07 also point toward higher growth rates in real expenditures in California than in the states as a whole.

California chooses to increase its spending at a higher (lower) rate than all states during boom (bust) years in the State’s economy. Later I will argue this is driven in large part by the highly pro-cyclical sources of revenue that it primarily relies on.

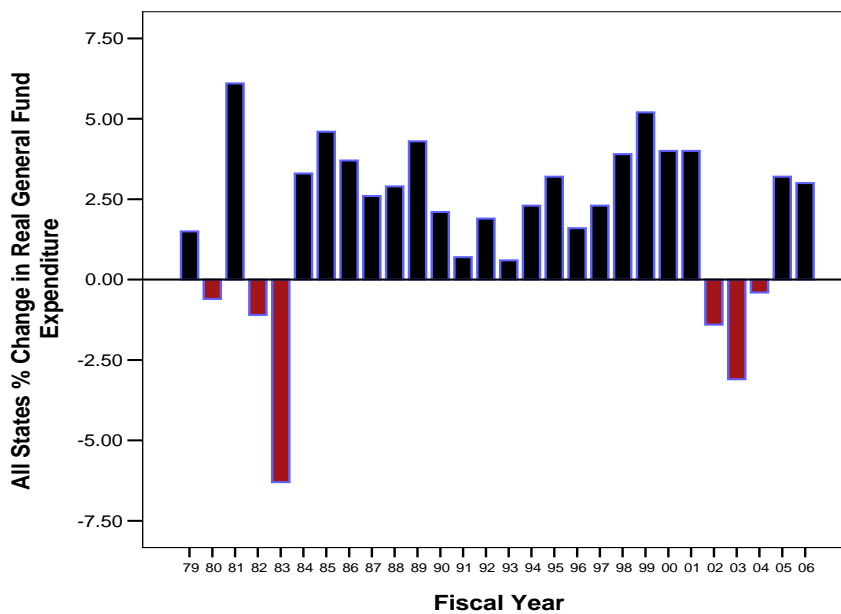
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FIGURE 3. CALIFORNIA % CHANGE IN REAL GENERAL FUND EXPENDITURE



Data Source: California Department of Finance (2006).

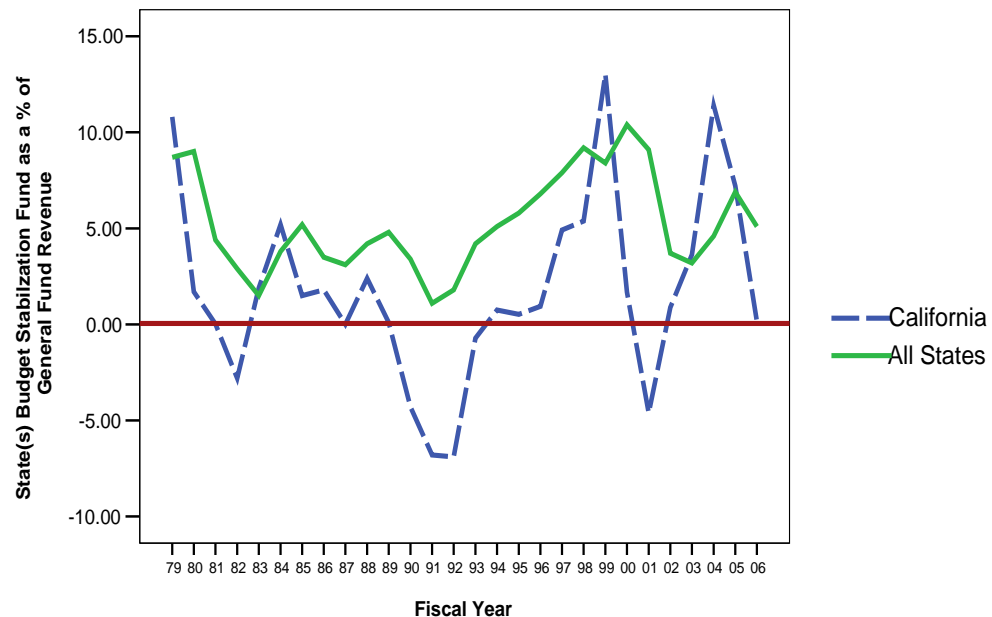
FIGURE 4. ALL STATES % CHANGE IN REAL GENERAL FUND EXPENDITURES



Data Source: National Association of State Budget Officers (2005), Table 2, p. 3.

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**FIGURE 5. STATE(S) BUDGET STABILIZATION FUND AS A % OF GENERAL FUND REVENUE**



Data Sources: California Department of Finance (2006); and NASBO (2005), Table 9, p. 14.

Figure 5 shows for a given fiscal year the ratio of the budget stabilization fund to general fund expenditures for both California (dashed line) and aggregated for all states (solid line). When these measures fall below the middle line, the yearly operating budget has gone negative enough that the budget stabilization fund cannot cover it and it also turns negative. Notice that deficits of this magnitude are not all that unusual in California, while they have never occurred in the aggregate measure calculated for all states.

The fiscal yo-yo that California's state budget has experienced in this decade is not all that different than what was observed in the State from the late 1970s to early 1990s. It appears that the only thing that spares California's state budgets from an operating deficit large enough to cause the budget stabilization fund to turn negative (as occurred in FYs 1982-83, 1991-92 thru 1992-93, and 2000-01) is a persistent period of growth in the State's economy (as occurred between 1994 and 2000).

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The remainder of this paper turns to an examination of explanations for the past and expected future budget outcomes for the State of California. The State merits this examination for two reasons: (1) its relative size within the United States (the gross domestic product of California is nearly 14 percent of that of the nation, New York’s GDP – the next closest – is 60 percent of California’s) and (2) as a warning to other states that if they adopt California-style fiscal reform, and experience similar economic and demographic changes, they too are more likely to experience, as shown in Figure 5, the “Californication” of their state’s budget cycles.<sup>3</sup> The explanation first examined is the fiscal restrictions imbedded in California’s 1879 state constitution and the interconnected chain of additional restrictions placed in California’s constitution after, and to a large part because of, the passage of Proposition 13.

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<sup>3</sup> My apologies to the Red Hot Chili Peppers for stealing the title of their album.

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### **III. Fiscal Restrictions in California’s Constitution**

The only states that require a super-majority for the annual passage of a state budget are Arkansas, California, and Rhode Island. The two-thirds supermajority requirement in California dates back to the populist constitution it adopted in 1879. Since the passage of Proposition 13 in 1978, a two-thirds majority has also been required in the State for any “changes in state taxes enacted for the purpose of increasing revenues;” however, legislative actions that decrease state tax revenues can be enacted with only a simple majority (California Budget Project, 2004). In 2006 there were 11 states that required a two-thirds majority to pass any form of tax increase. In the spring of 2006 the political composition of the California Senate was 63 percent Democrat, while the California Assembly was 75 percent Democrat. Thus, Democrats must gain the support of some Republicans to annually pass the state budget and/or to raise state taxes. California’s Constitution also requires that all state general obligation bonds receive support from two-thirds of both houses of the legislature and majority support from voters. Interesting to note is that it was not until FY 2004-05, and the passage of Proposition 58 which accompanied the unprecedented voter-approval of \$15 billion in state deficit reduction bonds (Proposition 57), that California’s Constitution required its Legislature to send its Governor a budget where general fund appropriation for the next fiscal year matched estimated general fund revenues and transfers from a budget stabilization account.

Table 1 describes the California ballot measures, passed since Proposition 13, that are noted by the LAO (2004, pp. 14-15) as having major state-local fiscal implications. They are offered here as evidence of further factors that have placed the State’s annual operating budget in the roller coaster situation earlier illustrated in Figures 3 and 5. With the exception of the Gann Amendment, an argument can be made that each of the constitutional amendments listed in Table 1 have served in some way to make it more difficult for California to balance its annual operating budget.

Further restrictions on the power of local entities to levy taxes for the provision of local services (Props 62 and 218) make it more likely that state revenue be used to fund previously locally funded services. Requiring the state to devote a

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**TABLE 1. CALIFORNIA PROPOSITIONS WITH MAJOR STATE-LOCAL FISCAL IMPLICATIONS**

<b>Measure/ Election</b>	<b>Provisions</b>
<b>Proposition 4 (Gann Amendment)</b> November 1979	Limits spending by state and local governments to prior-year amount adjusted for population growth and per-capita income. If exceeded, state must return surplus to taxpayers in two years. Only reached in 1987. Weakened over the years through the exemption of certain appropriations. Many believe that it is not now a meaningful constraint.
<b>Proposition 62</b> November 1986	New local general taxes require two-thirds approval of governing body and a majority of local voters.
<b>Proposition 218</b> November 1996	Further limits authority of local governments to impose taxes, assessments and fees. Two-thirds of voters must approve any new local non-general taxes.
<b>Proposition 98</b> November 1988	Guarantees a minimum level of state general fund revenues be devoted to funding K-14 public education. Guaranteed amount is calculated based upon greater of three tests: (1) % received equal to % received in FY 86-87 (approx. 40%), (2) as much as received previous year adjusted for enrollment, or (3) same as “(2)” except growth factor is equal to growth in per-capita general fund revenues plus ½%. Intended to act as a floor, in practice worked as a ceiling typical equal to 40 – 45% of state’s general fund revenue going to K-14.
<b>Proposition 99</b> November 1988	Imposes an additional \$0.25 tax on cigarette pack and limits revenue to health-related uses.
<b>Proposition 172</b> November 1993	Increases state general sales tax by 0.5% and dedicates revenue to public safety programs.
<b>Proposition 10</b> November 1998	Imposes an additional \$0.25 tax on cigarette pack and limits revenue to childhood development programs.
<b>Proposition 42</b> March 2002	Selective sales taxes collected on gasoline are permanently earmarked for transportation uses only.
<b>Proposition 49</b> November 2002	Increases state grants to public K-12 schools for before and after school programs. No additional funding source prescribed. Currently close to \$0.5 billion of state spending devoted to it.

*Table 1 continues next page...*

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**TABLE 1 (CONTINUED). CALIFORNIA PROPOSITIONS WITH MAJOR STATE-LOCAL FISCAL IMPLICATIONS**

<b>Measure / Election</b>	<b>Provisions</b>
<b>Proposition 63</b> November 2004	Imposes a 1% additional tax on personal income earned in the state over \$1 million. Revenue is used to fund mental health services. Expected to raise \$0.8 billion in FY 2006-07.
<b>Proposition 1A</b> November 2004	After the passage of Proposition 13, local property taxes were paid to California counties and the state had the constitutional right to distribute those revenues to cities and school districts in the county, and the county government in a manner they chose. During times of statewide fiscal stress, this often resulted in the state reducing payments to counties and cities and shifting them to school districts to meet constitutionally-imposed Proposition 98 funding requirements. This constitutional amendment freezes the current allocation in a county in place unless the Governor declares a fiscal emergency and agrees to repay imposed transfers after three years. Also requires the State to fully fund local mandates.

minimum amount of general fund expenditure to K-14 education (Prop 98) reduces what is available for other needed state expenditures. Raising state taxes, but then directing them to only one category of expenditure (as in Props 99, 172, 10, 42, 49, and 63) makes it difficult to exercise the budget flexibility needed to reallocate existing revenues when spending priorities change. And finally, California’s Constitution now prohibits the State from shifting property tax revenue from the county and city governments in a county to the school districts in the county (Prop 1A). In times of statewide fiscal stress, this restriction increases the likelihood that the State will have to spend beyond its means to meet its mandated Prop 98 public school funding obligations.

California allocates a significant portion of its state budget to local assistance. In FY 2001-02 the State devoted 40.4 percent of all state expenditure to intergovernmental expenditure to local governments.<sup>4</sup> A comparable figure, calculated for all states in the United States was 28.4 percent. This development is a result of the *Serrano v. Priest* school finance decisions (that declared the difference in

<sup>4</sup> Data to calculate drawn from Census of Local Governments (2002).

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base revenue limits per pupil in California’s public schools need be less than \$350 per student in 2005 dollars), Proposition 13, and the propositions described in Table 1. California’s continuing assumption of state responsibility for funding things that are provided locally, and were once funded locally, is a clear reason for the difficulty observed in balancing the State’s operating budget. The next section looks to the State’s revenue reliance for another.

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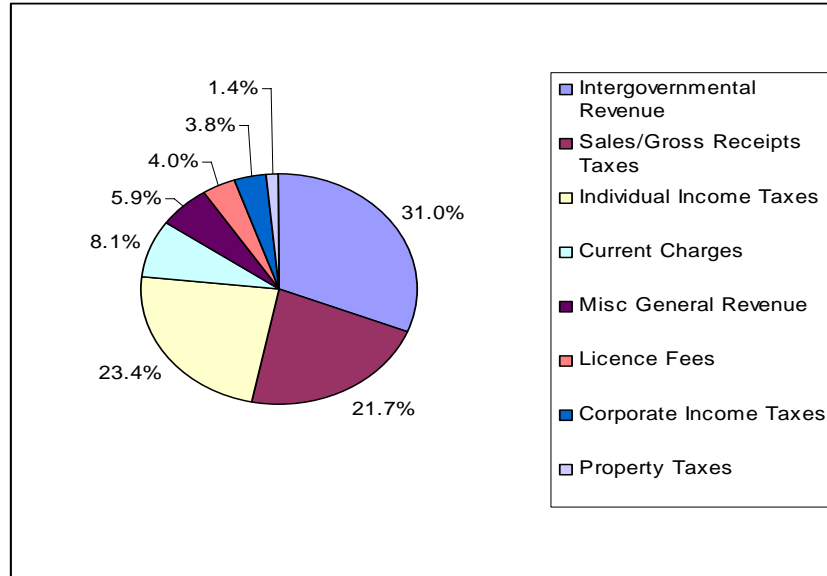
### **IV. State Revenue Reliance**

In comparison to other states, there are important differences in the way that California raises revenue. Some of these differences can be pointed to as reasons the State has experienced wider fluctuating and less predictable revenue streams. As shown in Figures 6 and 7, California relies on individual income taxes, sales/gross receipts taxes, and corporate income taxes to a greater extent than all states. While these two sources accounted for about 19 percent of all aggregate state revenue in FY 2001-02, they accounted for nearly 26 percent of all California’s revenue. This is a concern because these forms of tax revenue exhibit greater instability over the business cycle. The structure of California’s individual income tax makes this instability particular acute.

California’s individual (personal) income tax is one of the most progressive in the country. In 2005, a single person (married couple) making over \$41,476 (\$82,952) in taxable income owed 9.3 percent of every additional taxable dollar to the State. As reported by the LAO (2004, p. 26), taxpayers with taxable incomes over a half-million dollars account for only a half percent of all California’s income tax returns, but a whopping 30 percent of income tax liabilities. Furthermore, the State draws about half of its personal income tax revenue from households reporting above \$200,000 in taxable income. These high income tax payers are more likely to record stock options and capital gains as part of their taxable income. As Figure 8 shows, since the realization of these components of taxable income fluctuate widely over the business cycle, so does the revenue California collects from all taxes. During the last recession, California tax revenue declined from \$76 billion in 2000-01 to \$63 billion in the following fiscal year. This 17 percent loss in general fund tax revenue was almost entirely composed of a loss in personal income tax revenue due to a reduction in realized stock options and capital gains. Even in FY 2004-05, almost three years after the last recession officially ended, income tax revenues from these two volatile sources were still \$2 billion less than their peak in FY 2000-01.

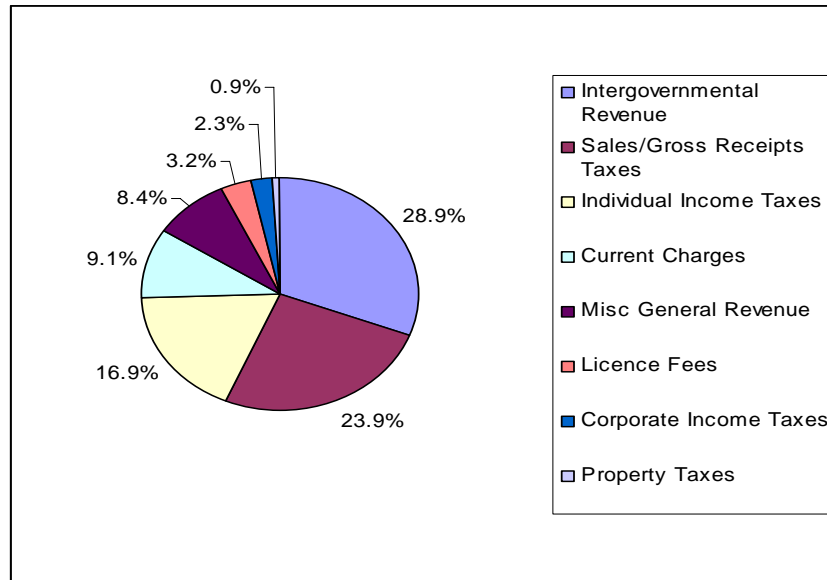
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**FIGURE 6. GENERAL FUND REVENUE RELIANCE FOR STATE OF CALIFORNIA, FY 2001-02**



Data Source: Census of Governments (2002).

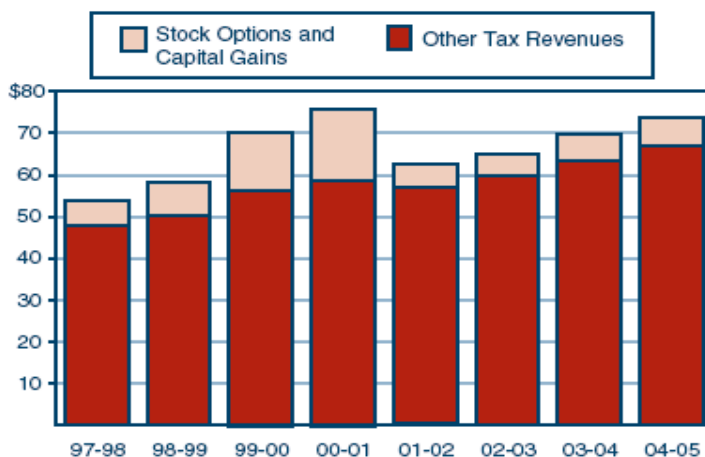
**FIGURE 7. GENERAL FUND REVENUE RELIANCE FOR ALL STATES, FY 2001-02**



Data Source: Census of Governments (2002).

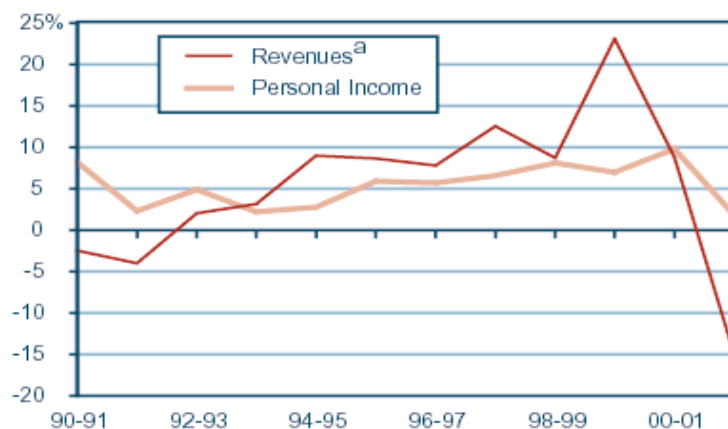
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**FIGURE 8. CALIFORNIA TAX REVENUE (BILLIONS \$\$) BY FISCAL YEAR**



Source: LAO (2004), *Cal Facts: California's Economy and Budget in Perspective* Table 8); available at [http://www.lao.ca.gov/2004/cal\\_facts/2004\\_calfacts\\_toc.htm](http://www.lao.ca.gov/2004/cal_facts/2004_calfacts_toc.htm).

**FIGURE 9. CALIFORNIA GROWTH IN GENERAL FUND REVENUE AND PERSONAL INCOME (BILLIONS \$)**



<sup>a</sup> Excluding effects of law changes.

Source: LAO (2002), *Cal Facts: California's Economy and Budget in Perspective* Table 3); [http://www.lao.ca.gov/2002/cal\\_facts/budget.html](http://www.lao.ca.gov/2002/cal_facts/budget.html).

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The variability of tax revenue from stock options and capital gains, as a driver of California’s yearly operating deficits, finds further support through the observed relationship between the changes in State revenue and personal income drawn in Figure 9. Notice that growth in State revenue tracks above growth in personal income from FYs 1933-04 to 2000-01. It is only when the growth in personal income is on a general downward trend, and stock options and capital gains less likely to be realized, that growth in revenues falls below growth in personal income (i.e., before FY 1993-94 and after FY 2000-01). Referring back to Figure 5, these are also the same periods when California exhibited negative values for its budget stabilization fund.

The historical instability observed in the State of California’s fiscal situation may have also been related to variations in previous spending patterns. In addition, projected demographic trends could make the State’s future fiscal instability even worse. I turn to a review of these issues next.

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### **V. Previous Spending and Future Demographics**

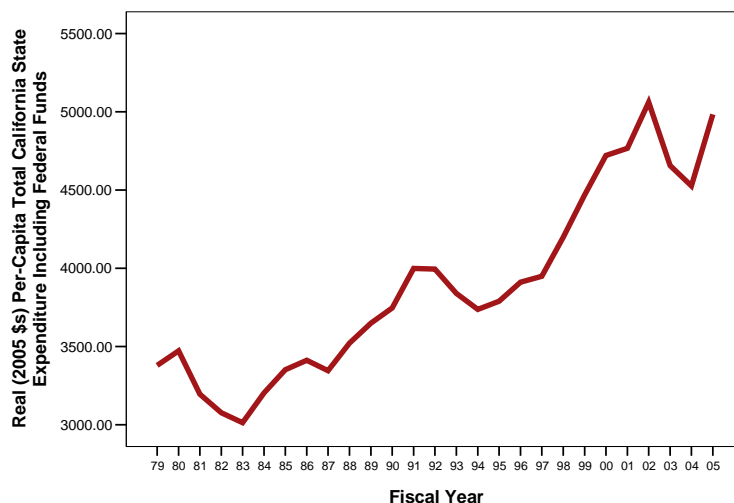
Has the fiscal instability in California’s state budget been caused at all by upward spending pressure upon the state since Proposition 13? Earlier there was some evidence of this offered in Figure 3 where the percentage change in California’s real general fund expenditure rose in most years, and at a rate that was higher than that calculated for all states as a whole. Though, one could argue that these trends may have been caused by population increases in the State being greater than the rest of the country. Figure 10 dismisses the idea that real spending growth in California has only been due to population increases. With a few dips after the recessions of the early 1980s, 90s, and 2000’s, real (2005 \$s) per-capita spending in the State has risen sharply from about \$3,500 in 1979 to nearly \$5,000 in 2005 (comparable figures for all states are \$2,190 in 1979 and \$4,897 in 2002).

As detailed in Figure 11, California currently spends 62 percent of its general fund budget on K-12 and higher education, and corrections. Most observers consider this portion of the budget untouchable due to the Proposition 98 funding guarantee for primary and secondary public education, the State’s historical commitment to its “Master Plan” of offering an accessible higher education to all, and public attitudes that support correctional spending. Of the remaining 38 percent of general fund expenditures, 31 percent is devoted to health and human service spending. As noted in Fisher (2006, p.12), for states as whole in FY 2001-02, education and correction expenditures made up 36 percent of general expenditure, while health and human service spending accounted for 27 percent. California’s expenditure patterns and commitments are quite different than observed for all states as a whole. This difference could lend itself to further fiscal instability given the demographic and related income trends predicted for California.

Throughout the period under observation, the haves and the have-nots in California have been growing farther apart than in the rest of the United States. Figure 12 demonstrates this occurrence well. Notice that the percentage change in family income for the bottom 10<sup>th</sup> percentile grew at a much slower rate than for the top 10<sup>th</sup> percentile. Though this divergence has occurred throughout the United States, the figure shows that it was more pronounced in California.

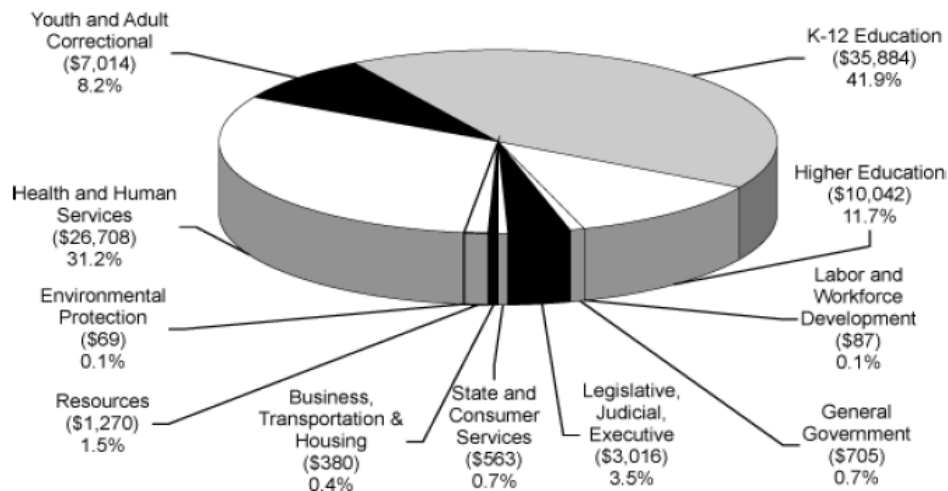
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**FIGURE 10. REAL (2005 \$) PER-CAPITA TOTAL CALIFORNIA STATE EXPENDITURE**



Data Source: California Department of Finance (2006).

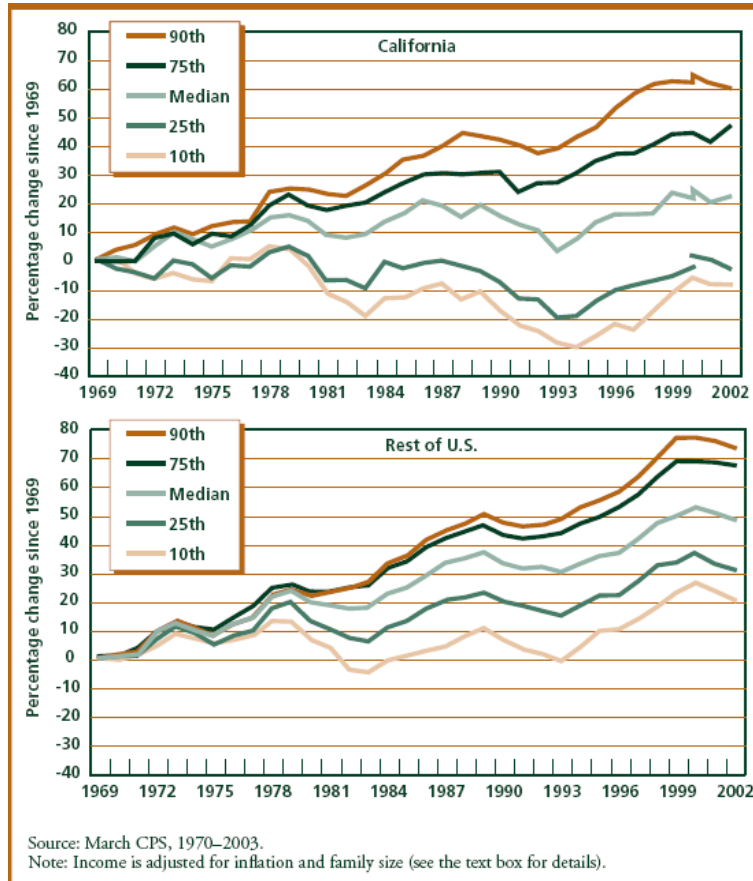
**FIGURE 11. FY 2005-06 CALIFORNIA GENERAL FUND EXPENDITURES (MILLIONS \$)**



Source: Public Policy Institute of California (January 2005), *Just the Facts: California's State Budget*; [http://www.ppic.org/content/pubs/jtf/JTF\\_BudgetJTF.pdf](http://www.ppic.org/content/pubs/jtf/JTF_BudgetJTF.pdf).

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FIGURE 12. FAMILY INCOME CHANGE RELATIVE TO 1969



Source: Reed (2004), Figure 1, p. 5,

A likely cause of the greater divergence in income growth in California is the large increase in the number of foreign-born residents that the State has experienced in the last three decades. According to PPIC (2002), the State’s foreign-born population totaled 1.8 million (7.6 percent of its total) in 1970, but by 2000 it had reached 8.9 million (26.1 percent of its total). In 2002, the poverty rate among California’s immigrants was 18 percent, while native-born residents experienced a significantly lower rate of 12 percent poverty. Much of this divergence in poverty incidence is traceable to differences in educational achievement that exist between immigrants and the native born. The rate of non-completion of high school among California’s immigrants over age 25 was 42 percent in 2002 (as compared to only 12

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percent for the native born), while only 23 percent of these immigrants had completed college (as compared to 29 percent for the native born).

Thus, some of the State of California’s fiscal instability can be attributed to budgetary commitments that are different than other states and a growing underclass that has pushed the percentage of general fund expenditures devoted to health and human service activity to 36 percent as compared to the 27 percent that all states devote. Projections indicate that these fiscal pressures are unlikely to abate. The next section describes other possible future occurrences that, if they occur, are likely to put present even further challenges to the State’s fiscal situation.

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### **VI. Other Concerns on the Horizon**

State budget analyses for the United States as a whole (Eckl, 2005), and for California in particular (LAO, 2006), contain caveats of further concerns on the horizon that could make existing warnings of doom for state budgets even worse. Here I report upon the ones mentioned specifically for California.

In California, as in most states, budget analysts worry over the continuing demands placed upon the statewide primary and secondary public education by the growing accountability movement and the Federal “No Child-Left-Behind” Act. Regarding this policy concern, California faces the additional demands of a larger and more difficult to educate immigrant population and the State Legislature’s requirement that in 2006 high school seniors pass an exit exam in order to receive a high school diploma (than in 2005 nearly a quarter failed). In addition, if the nationwide movement for greater adequacy in K-12 public school funding catches hold in the State, required expenditure in this area could rise by as much as one-third (Conley, 2006). This is a fiscal catastrophe in the making for a state that devotes over 40 percent of its annual general fund budget to K-12 education spending.

Eckl (2005, p. 25) points to Medicaid (or Medi-Cal as it is called in California) as the fastest growing single category of state spending. Across all states it is budgeted to grow over 8 percent in the next fiscal year. In California, Medi-Cal spending from the State’s general fund is expected to total \$12.9 billion in the current fiscal year. This is just over 14 percent of total general fund expenditure. But this is only 38 percent of public expenditure on medical services for California’s low-income residents, the remaining portions come from the federal government (55 percent) and other state and local revenue sources (7 percent). As noted by the California Health Care Foundation (2006), Medi-Cal expenditures in the State over the last decade increased by nearly 75 percent due to enrollment growth and rising costs per beneficiary. In the future, this category of spending poses even greater fiscal concerns to California for a few reasons: the increasing number of beneficiaries using it, the high percentage of funding it receives from the federal government, and President Bush’s plan to reduce federal spending on Medicaid grants to states as part of his deficit reduction plans.

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Related to Medi-Cal spending, rising health care costs in general could also spell trouble for balancing California’s future operating budgets. According to (Benson, 2006), the State currently pays about \$1 billion a year to cover health care premiums for current retirees. But analysts at the LAO estimate that this will not be enough to cover future unfunded liabilities that will fall somewhere between \$40 and \$70 billion. Subsequently, the LAO has suggested that the State begin putting aside an additional \$1 billion a year to meet these obligations. In a related development, the LAO (2006) estimates that the state funded retirement systems for public employees (PERS) and public K-14 teachers (STRS) face future unfunded liabilities of about \$24 billion. There have been some increases to the contribution rates made by public employers to account for this, but not nearly enough. If the State contribution to STRS were adjusted up enough to cover its projected future shortfall, the added annual costs would be an additional \$1 billion. California Assemblyman Keith Richman called these developments a potential “bombshell for state and local finance” (Benson, 2006). The California Legislature and Governor are likely to face increasing pressure to deal with these bombshells because the Government Accounting Standards Board, through ruling 45, has just required that all state governments (and local governments with expenditures greater than \$100 million) begin better tracking and reporting to the public on the actuarial amount of funding required to meet the future projected health care and pension costs of its retirees.

The LAO’s (2006) analysis of the most recent California budget notes two other possible developments that would alter their budget forecast if they came to fruition. The first is the outcome of three different court cases that the State is currently appealing. If all three are ultimately lost, the liability to California’s general fund could be as high as \$1.5 billion. Of likely greater concern for the potential size of the of the State’s structural operating deficit is whether the California economy and the tax revenues it generates continues to expand at the moderate pace that the budget forecast assumes. The risks of this not happening are tied to a rise in energy costs and/or a pronounced slowdown in California’s real estate and construction markets. The LAO estimates that such a deceleration of the State’s economy could result in as much as a \$4 billion reduction in annual state revenue.

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Though, as shown earlier, such a change is not unusual when the State enters an economic downturn.

Before examining suggestions that have been put forth to improve California’s budget situation, the next section considers the current opinions of the State’s citizens on the issue.

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### **VII. Opinions on State Budget Reform**

In its ongoing surveys, the Public Policy Institute of California have regularly asked a random sample of Californians their opinion on the State’s fiscal condition. Based upon a January 2006 survey, 61 percent of residents believed that the State’s budget situation presented a big problem for the people of California, while an additional 30 percent considered it somewhat of a problem (Baldassare, 2006). From the same survey, a majority of adult Californians (72 percent) believed that the State’s budget situation had stayed the same or even gotten worse in the last two years. In an earlier survey conducted in May 2005, only 7 percent of residents thought it okay for the state to run a budget deficit, while a plurality of 43 percent thought the State’s budget gap needs to be dealt with a mix of spending decreases and tax increases (Baldassare and Hoene, 2005).

Returning to the results of the January 2006 survey, residents were asked to be specific in their belief regarding what areas the State should spend less money on. Majorities of residents (respectively 66 percent, 55 percent, 59 percent, and 51 percent) thought more – not less – money needed to be spent on K-12 public education, health and human services, roads/infrastructure, and universities. Only for the category of corrections did less than a majority favor no spending increase (39 percent felt the same should be spent and 33 percent felt less). In this same survey, when residents were asked what taxes they favored to alleviate California’s structural deficit, the only favorable majority responses derived were 66 percent preferring an increase in the top personal income tax bracket and 70 percent preferring an increased cigarette tax. Realizing that respondents in these type of surveys naturally gravitate toward a “free lunch” perspective, the PPIC survey explicitly asked residents whether they would rather pay higher taxes and have a state government that provides more services, or pay less taxes and get less services. Higher taxes and services prevailed at 56 percent, with 36 percent choosing the alternative, and 8 percent not knowing how to respond.

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In the PPIC survey conducted in January 2006, California residents were also asked to choose among the public policy issues of education, state budget, immigration, economy, health care, crime, and roads, as to which should be of the single most concern for the Governor and Legislature in 2006. Second to only education which received 26 percent support, the state budget garnered 17 percent. In further support of populist concern over state fiscal matters, 83 percent of the State’s residents thought that some of the recent surge in state income tax revenues should be used to reduce the amount of state debt.

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### **VIII. California’s Last Business Cycle and Suggestions for Budget Reform**

Before I conclude the paper with the suggested reforms to California’s budget process and fiscal structure that have been put forth by a variety of past commissions and experts, and offer my own commentary on their political feasibility, let me first take you through a brief synopsis of what went on during the State’s last boom-to-bust-to-boom period.

#### **California’s Last Business Cycle**

From the mid-1990s onward, California’s economy boomed along with its “dot-coms.” There was \$50 billion in taxable income from exercised stock options and realized capital gains in the State in 1996. By 2000 these had quadrupled to \$200 billion. The tax revenue collected by California from these sources equivalently soared from \$4 billion, to nearly \$8 billion (Hill, 2002). In 1998, after campaigning and winning on a platform of the need to better fund public education, Governor Davis, with the support of the Legislature, began a policy of spending larger portion of these revenue windfalls on education, health, and human service programs. Included among the state expenditure increases were: (1) K-12 teacher salary increases, (2) K-3 class size reduction (which began in 1996 and continues to offer \$800 per student annually to districts that reduce these level class sizes to 20 per teacher), (3) additional spending in the State’s higher education systems to forestall fee increases, (4) covering county trial court expenses which were previously funded locally, and (5) a tax expenditure in the form a nearly \$4 billion annual cut in vehicle license fees. Many have since questioned whether such ongoing commitments should have been made with additional tax revenue that most understood as transitory. But as Tim Gage, Director of California’s Department of Finance at the time points out, the choice was motivated by the politics of the situation, “[t]he fundamental driver is simply, you’ve got constituents and it’s nice to do things for them” (Murray, 2006). This logic is truly the reason why highly pro-cyclical state revenue sources put a state on fiscal roller coaster. Revenue surpluses in a boom

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period are committed to ongoing expenditures that remain after the boom period's revenue windfall dissipates.

By late 2002 it was obvious that the bottom had fallen out of California's economic boom. Revenue from the state's personal income tax fell by nearly 25 percent in FY 2001-02. The FY 2002-03 operating budget for the state ended up \$11 billion in the red, and because there were no specific plans to cut spending or increase revenues by any significant amount, the projected deficit for the following fiscal year was projected to be \$27 billion. These cumulative deficits became the basis for the figure cited by then Governor Davis that the FY 2003-04 operating deficit for California was \$38 billion. Within the setting of these immense fiscal problems, Davis ran for reelection in November 2002 and won. Though, only months after being reelected, his popularity plummeted as he faced the prospect of crafting a state budget to deal with a deficit projected to be nearly one-third of that year's operating budget. In October 2003 Governor Davis directed the Department of Finance to institute an increase in California's vehicle license fees (VLF) through a “trigger” present in earlier legislation that had lowered it, that allowed such an increase if the State had reached a point that it was no longer able to pay its bills. This tax increase became a point a point of contention in the historic recall election that occurred in the same month and swept current Governor Schwarzenegger into office.

Fulfilling a campaign promise, one of Schwarzenegger's first acts as governor was to repeal the VLF tax increase and place the State budget an additional \$3.5 billion in the red. As noted by Zuckerman (2004), Schwarzenegger dealt with the huge budget shortfall by proposing to seek future voter approval to borrow nearly \$11 billion (which was later approved by voters at \$15 billion), instituting loans and borrowing from state funds that amounted to about \$5.5 billion, and state program changes that led to \$9.2 billion in savings (an accounting change in Medi-Cal, California State University and University of California tuition increases of nearly 30 percent, state employee layoffs or non-replacements, reductions in judiciary and criminal justice spending, and not fully funding the Proposition 98 guarantee for state funding of K-12 education). The result of these changes, and an unexpected rebound in state tax revenues, were what allowed the State in FY 2004-05 to again enjoy a

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positive operating balance of over \$3 billion (as noted earlier in Figure 2) and a surplus in its reserve fund of over \$9 billion.

In less than 10 years, Californians rode the fiscal roller coaster of going from boom to bust and back to relative boom. Budget experts, analysts, and observers are well aware of the tendency for California’s system of state budgeting and finances to produce such a pattern and have offered the solutions discussed next.

### **Suggested Reforms to California’s State Budget Process and Finances**

The suggestions put forth to reduce the instability currently inherent in balancing the yearly operating budget of California state government can be broken down into two categories. The first is reforms targeted at changes in the institutions and rules surrounding the budget process itself. The second deals with altering the way California raises revenue for its state and local governments. For each of these two categories I offer a bulleted summary of the major reforms that have been suggested. The first list is of budget process reforms. The items contained in it are drawn from reviews put together by Simmons (2002) and the Institute for Government Studies (2003).

#### **Budget Process Reforms**

- *Reduce two-thirds voting requirements*

To one extent or another, many of the commissions, studies, and individuals that have explored ways to reform the State’s budget process have come to the conclusion that its two-thirds vote requirements needs be changed. The California Constitution Revision Commission in 1996 and the California Citizens Budget Commission in 1998 recommended amending the Constitution to only require a simple majority to enact a budget. The California Commission on Tax Policy in the New Economy in 2003 concluded that the vote threshold for approval of local special taxes be reduced to 55 percent. The California Budget Project in 1999 (whose purpose is to represent the well-being of low and middle income Californians) suggested the elimination of all super majority vote requirements across the state, while the California Business Roundtable in 1995 favored the elimination of a super-majority vote requirement for the passage of a state budget, but not for new taxes. The League of Women Voters of California

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in 1995 believed that if two-thirds vote requirements are kept for taxes, they should also be required for the approval of tax expenditures.

- *Create greater fiscal discipline*

Previous observers believe that greater discipline could be instilled in the budget process through a better accounting of, and public information campaign on, the magnitude of tax expenditures by the state, a loosening of revenue and spending restrictions currently locked in California’s Constitution, a curtailment on future propositions, and the establishment of a truly “reasonable and necessary” prudent state budget reserve fund that is required by the Constitution. For instance, the Speaker’s Commission on the California Initiative Process in 1992, the California Constitution Revision Commission, and the California Business Roundtable all suggested that voter approved propositions be subject to allowed modification by the legislature after various periods to remedy the unintended fiscal consequences wrought by their simple majority passage.

- *Move to multi-year budgeting*

With the hope of allowing policymakers more time to evaluate program effectiveness and to appropriately adjust proposed and current legislation for economic and caseload changes, the State should move to some form of multi-year budgeting. The California Citizens Budget Commission suggested a three-year perspective, while the Little Hoover Commission in 1995, the California Business Roundtable, and the California League of Women Voters have recommended a two year budget cycle.

- *Improve the public’s and legislator’s understanding of the budget*

Governor Schwarzenegger’s proposed budget for California in FY 2006-07 is nearly 1300 pages long and highly technical.<sup>5</sup> Previous observers of the State’s budget process contend that a budget described in this form does not promote public, or even legislative, scrutiny of spending choices, economic forecasts, and program performance. Though state organizations like the Legislative Analyst’s Office and Department of Finance, and private organizations like the California Budget Project offer summaries and analyses of the state budget that are easier to

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<sup>5</sup> The full text of Governor’s proposed 2006-07 budget for California is at <http://www.dof.ca.gov/Budget/Budget2006-07/GovernorsBudget2006-07/GovernorsBudget2006-07.htm>.

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digest, the suggestion here is for even more public dissemination of the constraints, trade-offs, and choices necessary in a state budget.<sup>6</sup>

The next list of suggested reforms to improve the outcome observed in California state budgeting relate to changing the way that general fund revenue is raised at the state level. Since state finances are so closely tied to local finances in post-Proposition 13 California, some of have also suggested that the only way to truly improve state budget outcomes are reforms to the entire system of state and local finance.

### Revenue Reliance Reforms

- *Increase state revenue reliance on tax bases more stable over the business cycle*

As the previous discussion has made clear, much of the fiscal strife experienced by the State of California can be attributed to approximately a quarter of California’s general fund revenue coming from personal income taxes, the high top marginal income rate, the large percentage of households that fall into the top bracket and contribute a large percentage of the income tax revenue raised, and the variability of this revenue due to much of it being in the form of stock options and capital gains. So any reduction in reliance on this tax instrument, that is funded by greater reliance on a more stable tax instrument, would make the State’s general revenue flow more predictable and less prone to generating negative operating balances during an economic downturn. Obvious suggestions to do this have been raising the vehicle license fee, raising or instituting other fees/charges, expanding the general sales tax base to include services, and/or instituting a statewide property tax.

- *Raise more state revenue*

If it is not politically possible to raise a more stable stream of general fund revenue in California, some have suggested that a reasonable alternative to reducing the reoccurring pattern of operating deficits in the State is just raising more revenue. Often suggested is a reinstatement of the higher top marginal

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<sup>6</sup> The LAO’s, California Department of Finance’s, and California Budget Project’s descriptions of the proposed state budget can respectively be found at <http://www.lao.ca.gov/main.aspx?type=3&CatID=10>, <http://www.ebudget.ca.gov/BudgetSummary/BSS/BSS.html>, [http://www.cbp.org/2006/0603\\_bwatch.pdf](http://www.cbp.org/2006/0603_bwatch.pdf). An example of one way that tradeoffs inherent to crafting a state budget are being shared with the public is a computer based simulation called *Eureka!* (created by the Center for California Studies at Sacramento State University) that asks the user to craft a balanced California state budget using real-world data ([http://www.csus.edu/calst/civic\\_education/eureka.html](http://www.csus.edu/calst/civic_education/eureka.html)).

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income tax rates of 10 percent and 11 percent that existed throughout much of the 1990s.

- *Reduce local government reliance on state revenue by shifting to greater local tax reliance*

Nearly every commission and expert that have studied California’s overall system of financing state and local government have come to the conclusion that it is in need of major reform. The California Citizens Budget Commission concluded that local governments need greater fiscal independence. The California Governance Consensus Project in 2002, California Budget Project, California Constitution Revision Commission, and California Business Roundtable all agree and further suggest a significant realignment of state/county public service responsibilities.

### **The Political Feasibility of Suggested Budget and Revenue Reliance Reforms**

Any of the previously suggested reforms, if adopted in California, would likely offer some relief to the boom-bust tendency exhibited in the State’s budget after Proposition 13. Objective analyses based in the disciplines of political science and/or public administration broadly support the budget process reforms described above, while the same forms of analyses based in the economics of public finance throw their support (to various degrees) behind the suggested reforms to California’s revenue reliance. But the reality in California is that the policy reforms suggested by these analyses would require amending the Constitution and hence approval by a majority of voters. Thus it is essential that the political feasibility of these reforms be assessed to determine their real-world viability as a solution. It is for this reason that I next turn to the results of recent elections that featured initiatives that contained some of the elements of reform just suggested.

Californians were asked in March of 2004 to vote on Proposition 56 which would have enacted many of the budget process reforms suggested above (budget and budget-related tax and appropriation bills enacted by a 55 percent legislative majority rather than two-thirds vote currently required, budget summary in state ballot pamphlet, and 25 percent of certain state revenue increases deposited into reserve fund). Only about a third of voters approved of this budget reform package and it

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failed. What passed on this same ballot, by respective margins of 63 percent and 71 percent, were Propositions 57 and 58. If the second proposition also passed, the first proposition allowed the issue of up to fifteen billion dollars in general obligation bonds to pay off the accumulated general fund deficit. The second proposition required the enactment of a balanced general fund budget (which previously was never a constitutional requirement) and a formula for calculating yearly deposits into a budget reserve that was smaller in magnitude and less binding than what proposed in Proposition 56. The passage of Proposition 58 was a movement in the right direction of the suggested budget process reforms, but most experts would have preferred the passage of Proposition 56.

Since March 2004, there has only been one initiative on California's statewide ballot whose roots are in satisfying the budget process reforms suggested above; while there have been two whose end results are likely to be quite the opposite. Proposition 1A, which barely gained majority support on the November 2004 ballot, is likely to raise the State's level of fiscal stress by constitutionally prohibiting: (1) unfunded mandates by the state to local governments, (2) any reduction of the one percent statewide sales tax that goes to the local government site of a sale, and (3) the future shift of property tax revenues raised in a county from the county and local governments in the county, to state funded public K-12 schools in the county. On the same ballot in November 2004, the voter's continued their favored path of locking into California's Constitution the earmarking of specific revenue streams. With an approval rate of 54 percent, Proposition 63 constitutionally requires that the revenue (about \$800 million in FY 2006-07) from an additional 1 percent tax on taxable personal income above \$1 million be dedicated to funding the expansion of mental health services and programs. Alternatively, Proposition 76 which failed with a 62 percent majority in November 2005 would have limited state spending to the prior year's level plus three previous years' average revenue growth, reduced the degree that Proposition 98 binds the state's funding of K-14 public education to a specific percentage of general fund expenditure, and under specified “fiscal emergencies” allowed the governor to reduce budget appropriations within a fiscal year.

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Californians’ continued interest in ballot-box-budgeting will again be tested in June 2006. Proposition 82 (Preschool for All Act) would allow a new tax of 1.7 percent on the incomes of individuals above \$400,000 and of couple above \$800,000. The act would raise an estimated \$2.3 billion and offer all Californians the right to enroll their children in a private or district provided pre-school program that was subject to state regulation.

No matter what recent public opinion polls indicate, the political feasibility of enacting the budget process reforms suggested above is currently very small to non-existent. Perhaps the greatest opportunity for major reform of this type occurred on the March 2004 ballot when citizens seemed where willing to listen to Governor Schwarzenegger (whose job approval rating was above 60 percent) for suggestions on how to get the State out of its fiscal crisis. First to qualify for this ballot was the citizen-initiated Proposition 56 that contained the widely suggested reduction of the two-thirds legislative vote requirement for approval of a state budget and new taxes to the smaller supermajority of 55 percent. Propositions 57 (\$15 billion in deficit bonds) and 58 (which gave the impression of achieving budget process reform) were placed on the same ballot by the Legislature. This forced Schwarzenegger to choose between endorsing the stricter Proposition 56, or Proposition 57 that many in his Republican Party favored because of the populist view that the two-thirds vote requirements hold state government spending and taxes down in California.<sup>7</sup> He chose to endorse Proposition 57 (which helped convince some Republicans to endorse the deficit bond proposal that he needed to make his fiscal recovery plan work) and remained mute on Proposition 56. Perhaps if he chose otherwise, California voters would have followed their “Governator” and the State would have gotten the reduction in the two-thirds vote requirement that many experts point to as the cornerstone of true budget process reform.

What about the current political feasibility of instituting any of the revenue reliance reforms suggested earlier? To assess this possibility, one must first consider

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<sup>7</sup> The California Budget Project (2004, p. 5) notes that “[t]here is very little research on the impact of supermajority vote requirements on state fiscal policymaking. The research that is available suggests that supermajority vote requirements may serve to increase, rather than decrease, spending and do not necessarily result in lower taxes.”

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that the California’s Constitution still requires a two-thirds vote of both houses of the Legislature to pass any increase in state taxes. Given that Democrats do not possess this majority, and Republicans in California remain strongly opposed to any new taxes (even if tied to a tax decrease in a current tax instrument), the option of steadying California’s revenue stream through greater reliance on more stable taxes is limited. With only the downside that it is likely a regressive tax (see California Budget Project, 2002b), the choice of raising the vehicle license fee (VLF) tax back to its historic rate of 2 percent seems the most viable way of providing the State with a more stable revenue structure. In 1998 the California Legislature lowered this tax from 2 percent of the market value of the vehicle – where it had been for most of the 60 years it was in place in State – to 1.5 percent. Subsequent legislation in 2000 lowered it to the 1.3 percent where it stands today. One of the last acts of Governor Davis was triggering a provision in the legislation that allowed a rollback in the VLF rate back to 2 percent during the time of a state budget “emergency.”<sup>8</sup> But as the recalled governor found out, voting Californians dislike the visibility and burden of taxing their second most valuable piece of property. Perhaps in a time of relative fiscal stability, as is now, a VLF tax increase could be made more acceptable to the public if an offsetting reduction in state personal income or general sales taxation was packaged with it.

Some have also suggested that a partial solution to the State’s budget problems requires a recognition that the main problem is that a structural imbalance exists between what it costs to provide what Californians want from state government and the revenues currently collected. A way of closing this imbalance, and what Democrats often propose, is a reinstatement of the 10 percent and 11 percent upper rates of marginal income taxation that were last used by Republican Governor Pete Wilson to counteract budget shortfalls during the early 1990s. If a 10 percent rate was added for single (married) taxpayers making \$130,000 (\$260,000) in 2002 dollars, and an 11 percent rate for those making \$260,000 (\$520,000), the California Budget Project (2002a) estimates that it would have raised \$3.5 billion in FY 2004-

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<sup>8</sup> Later, the new Governor Schwarzenegger would argue that the State’s budget situation had not reached the required degree of emergency that the legislation intended before the VLF tax increase could be put in place.

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05. But with strong Republican opposition to tax increases, and particularly ones that fall upon the State’s highest earners, the supermajority vote requirement again make its adoption politically difficult. In addition, if this was the only fiscal reform adopted, an argument could be made that it could make the see-sawing of the State’s operating deficits worse if the surpluses it generated in good years produces even greater commitments to on-going spending that cannot be met in the bad years. Perhaps a solution is to legislate that such a personal income tax increase only occurs when the California budget displays a yearly operating deficit.

The revenue reliance reform favored by many academics and policy analysts, but still disliked by a majority of California’s voting populous, is a reduction in government dependence on state revenue by shifting to greater local tax reliance. This would be best achieved through a loosening of the Proposition 13 restriction that property taxation in the state never exceeds 1 percent. Unfortunately, the current populist support for such a proposal is nearly non-existent. Political folklore in the State widely recognizes Proposition 13 as the “third rail” of California politics: touch it as a politician and your political life dies. (Or as Governor Schwarzenegger is paraphrased as telling his elder political advisor Warren Buffet: “Mention changing it one more time and you will do 500 pushups.”)

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### IX. Conclusion

This paper has offered evidence on the variability of California’s operating budget over the business cycle and how this variability is unlikely to cease unless budget process and/or revenue reliance reforms are adopted. Of the reforms favored by analysts, I conclude that a reduction in the two-thirds vote requirement to pass a state budget and raise state taxes, and/or an increase in the vehicle license fee rate are likely to be the most acceptable reforms to Californians. But as I have also argued, my suggested changes are not likely to occur anytime soon in California. In the current race to elect a California governor in November 2006, only one Democrat, former State Treasurer Phil Angelides is attempting to make a necessary solution to the State’s structural budget deficit a campaign issue. Angelides’ solution is the less than ideal increase in the top marginal personal income tax rates. But at the same time, he is advocating that a significant portion of additional revenue from this state tax increase fund and increase in K-14 public education spending. The state budget concerns described here cannot be solved by increasing the reliance on a highly pro-cyclical revenue instrument and the proposing to spend a significant portion of the additional revenue in the form of on-going expenditures. Alternatively, Democrat contender, former State Controller Steve Westley and existing Republican Governor Arnold Schwarzenegger are following the “safe” campaign strategy of publicly saying that the State has a budget problem, but staying away from real specifics on how to solve it.

Not wanting to end on such a pessimistic note, I finish by pointing out what Ellwood and Sprague (1995, p. 344) include in their review as a possible reason for what is wrong with California’s budget process: **NOTHING**.

“The supposed failures of the process have more to do with the poor performance of the California economy and with the particular partisan divisions of the State than with the specific provisions and political institutions in the California economy.”

As recent attempts at policy reforms have demonstrated, maybe just ending the State’s poor economic performance and eliminating its political divides would be easier to accomplish than reducing a legislative vote requirement to pass a state

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budget that is higher than what 94 percent of the other states follow and/or increasing a tax on the value of automobiles that would result in the average Californian paying less than \$200 more per automobile?

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**Publisher(s):** Fiscal Research Center of the Andrew Young School of Policy Studies

**Author(s):** Robert Wassmer

**Date Published:** 2006-07-01

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**Subject(s):** Community and Economic Development; Government Reform