California's State and Local Revenue Structure after Proposition 13: Is Denial an Appropriate Way to Cope?*

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Abstract

The purpose of this paper is to investigate the case of California coping with an alternative sub-national revenue structure that is the result of its 1978 implementation of Proposition 13 and a drastic reduction in reliance on property taxes. It describes changes in state and local revenue reliance for the state and compares California to the United States as a whole. The paper then offers a description of the instability in California's post-Proposition 13 revenue structure. California's policymakers have in part coped with such instability by denying that a structural deficit exists and/or refusing to eliminate it. A review of policy reforms that could alter the boom and bust course of California's fiscal situation over future economic cycles and an "out of the box" idea tied to California's pursuit of greenhouse gas reduction are also offered.

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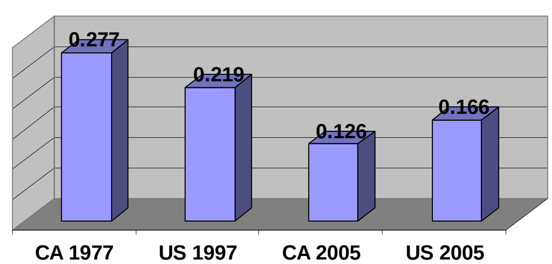
Introduction

California's path on a state and local government revenue structure that is different from that observed in most of the United States began with its June 1978 approval of the Proposition 13 ballot initiative. This initiative placed in California's Constitution the requirement that the *ad valorem* rate of property taxation anywhere in the state not exceed one percent of a property's acquisition value. Acquisition value is set at the time of an arms-length sale and increases annually from the time of sale at a rate that cannot exceed the higher of two percent or inflation. The result of Proposition 13's nearly 60 percent cut in California's local property taxes is illustrated in Figure One. In 1977-78, the last fiscal year before the imposition of Proposition 13, nearly 28 percent of state and local general revenue generated in the state came from property taxation. California's property tax reliance was 26 percent greater than the reliance exhibited in all states in 1977-78.[1] By 2005-06, the most recent fiscal year for which data is available, California's reliance on property taxation as a source of state and local general revenue had fallen to less than 13 percent. This was 24 percent below the property tax reliance occurring throughout the rest of the United States in 2005-06.

Figure One: State and Local Property Taxes as a Fraction of General Revenue



Source: State and Local Finance Data Query System, Urban Institute - Brookings Institute Tax Policy Center, www.taxpolicycenter.org

The purpose of this paper is to describe how California has coped with its chose to reduce its reliance on property taxation. As the title implies, much of the coping has come through a denial of the existence of a structural deficit or a denial of the need to eliminate it. California merits this examination for two reasons: (1) its relative size within the United States (the gross domestic product of California is

[1] In Figures One through Six, and Figure Eleven; a year refers to the fiscal year that begins with the year listed. Thus, 1977 refers to fiscal year 1977-78.

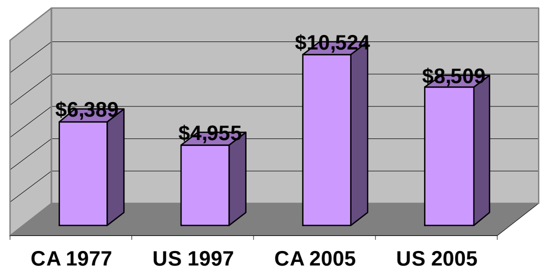
nearly 14 percent of that of the nation, New York's GDP – the next closest – is just 60 percent of California's) and (2) as a cautionary tale to other states that if they adopt California-style revenue reliance, and experience similar economic and demographic changes, they to are likely to experience the fiscal instability described here.

The next section of this paper examines how California's state and local revenue reliance has changed since Proposition 13. In this section, I also describe the sub-national revenue instruments in the state for which reliance has increased and the additional ballot measures that have amended the state's constitution to deal with the repercussions of Proposition 13, *Serrano v. Priest*, and a super-majority budget vote. Section three offers a description of outcomes attributable to California's reduction in property tax reliance. In the fourth section of this paper, I continue with a summary of suggestions that have been offered on how to better deal with California's current fiscal situation and include an "out of the box" idea.

California's State and Local Revenue after Proposition 13

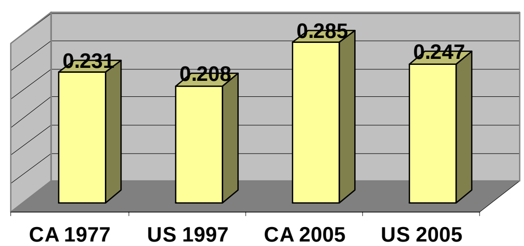
Before looking at some specifics on how California's state and local revenue reliance has changed since Proposition 13, it is appropriate to first look for any changes in overall revenue raised. In Figures Two and Three this is done for real per-capita revenue and for revenue as a percentage of personal income. California's real per-capita state and local revenue increased by nearly $4,000 between 1977-78 and 2005-06, or by about 65 percent. Nevertheless, over the same period, this figure also rose for the entire United States. California's real per-capita state and local revenue was 29 percent above that observed in the entire United States in 1977-78, by 2005-06 it had fallen to 11 percent above the United States. However, California is a relatively affluent state and it is thus appropriate to compare its sub-national revenue to the rest of the country by weighing it by personal income. As shown in Figure Three, at 23 percent of the state's personal income, California's state and local revenue in 1977-78 was 11 percent above the same figure calculated for the rest of the United States. In 2005-06, the percentage difference in revenue as a percent of personal income between California had risen to 15 percent. The amount of state and local revenue in California has increased after the passage of Proposition 13, but so has it in the entire United States. Using personal income terms, in 2005-06 California had further distanced itself from the rest of the United States. Using per-capita terms, California's distance above the rest of the United States had shrunk.

Figure Two: Real Per-Capita State and Local Total Revenue



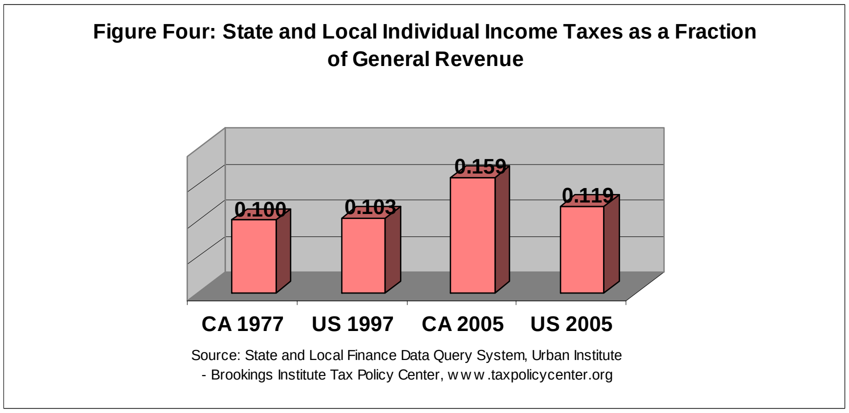
Source: State and Local Finance Data Query System, Urban Institute - Brookings Institute Tax Policy Center, www.taxpolicycenter.org

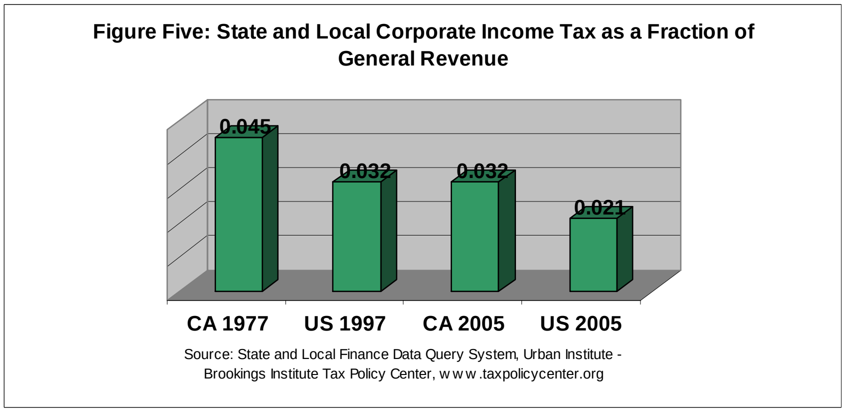
Figure Three: State and Local Total Revenue as a Fraction of Personal Income



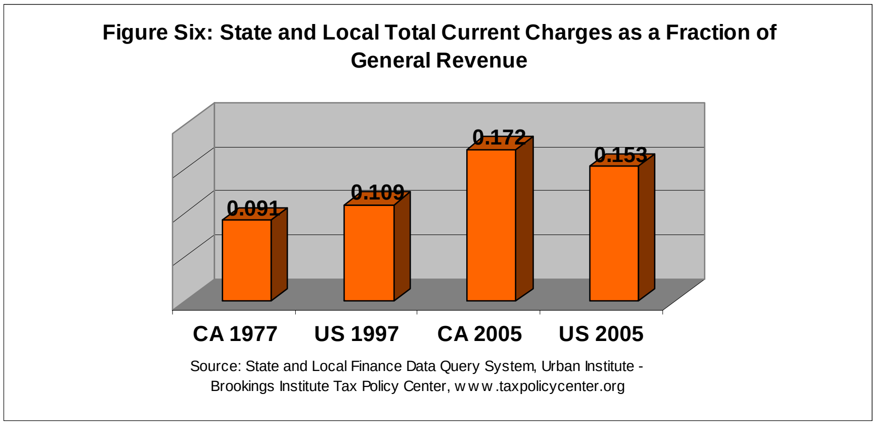
Source: State and Local Finance Data Query System, Urban Institute - Brookings Institute Tax Policy Center, www.taxpolicycenter.org

If California has not significantly reduced the revenue its state and local governments raise, how has it made up for lost property tax revenue? Part of this answer is found in Figures Four through Six. As shown in Figure Four, both California and the entire United States in 1977-78 raised about 10 percent of their state and local revenue from personal income taxes. By 2005-06, California's reliance had increased to 16 percent and the rest of the United States to only 12 percent.





As shown in Figure Five, California's reliance on the corporate income tax had fallen in 2005 to the United States' average in 1997-78, but was still above the country's average in 2005-06. Prior to Proposition 13, California's state and local governments relied on general charges as a source of revenue less than the rest of United States. As Figure Six illustrates, in 2005-06 reliance on this revenue instrument is now greater.



The 1978 passage of Proposition 13 did more than just reduce California's reliance on local property taxation, it added to the state's constitution a two-thirds vote requirement for any changes in state and local taxes within California for the purpose of increasing revenues. In 2007, there were 11 states that required such a supermajority. This requirement is compounded by the fact the California's Constitution has always required a two-thirds vote by the legislature to pass a budget. Only Arkansas and Rhode Island impose similar requirements.

A consideration of California's revenue structure after Proposition 13 would not be complete without a mention of the *Serrano v. Priest* court decisions in 1971 and 1976. California's Supreme Court found the state's reliance on local property taxes to fund local public schools in violation of the equal protection clause in the state constitution. The legislative remedy (AB 65) was a state based funding scheme that intended to equalize general purpose spending by student across the state's school districts by offering financial support to low-spending districts and capping this value for previously high-spending districts. Thirty years later, the results are that over 95 percent of California school districts are within $350 of each in terms of general purpose spending, but California's total per-pupil spending has fallen from being among the top five states before 1977-78, to 33rd in 2004-05 (Education Data Partnership, 2008). Fischel (1989) and others have attributed the separation of local finances from local public school spending that resulted from *Serrano v. Priest* as one causal explanation for voter support of Proposition 13 and the general dislike of taxes it spawned in California.

Super-majority vote requirements, and the anti-tax sentiment generated by *Serrano v. Priest* and Proposition 13, have further encouraged Californians to use the ballot box to make and constrain state and local revenue choices. Table 1 describes the California ballot measures, passed since Proposition 13, that the Legislative Analyst's Office note (LAO, 2006, pp. 14-15) as having major state and local fiscal implications. Further restrictions on the power of local entities beyond Proposition 13 to levy taxes for the provision of local services (Props 62 and 218) make it more likely that state revenue is used to fund previously locally funded services. Requiring the state to devote a 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. 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

MEASURE / ELECTION	Provisions
Proposition 4 **(Gann Amendment)** 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 and weakened over the years through the exemption of certain appropriations. Many believe that it is not now a meaningful constraint.
Proposition 6 June 1982	Prohibits state gift and inheritance taxes
Proposition 62 November 1986	New local general taxes require two-thirds approval of governing body and a majority of local voters.
Proposition 218 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.
Proposition 98 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.
Proposition 99 November 1988	Imposes an additional $0.25 tax on cigarette pack and limits revenue to health-related uses.
Proposition 172 November 1993	Increases state general sales tax by 0.5% and dedicates revenue to public safety programs.
Proposition 10 November 1998	Imposes an additional $0.25 tax on cigarette pack and limits revenue to childhood development programs.
Proposition 42 March 2002	Selective sales taxes collected on gasoline are permanently ear-marked for transportation uses only.
Proposition 49 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.
Proposition 63 November 2004	Imposes a 1% additional tax on personal income earned in the state over $1 million; revenue used to fund mental health services and expected to raise $0.8 billion in FY 2006-07.
Proposition 1A November 2004	After the passage of Proposition 13, local property taxes 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 fund local mandates.

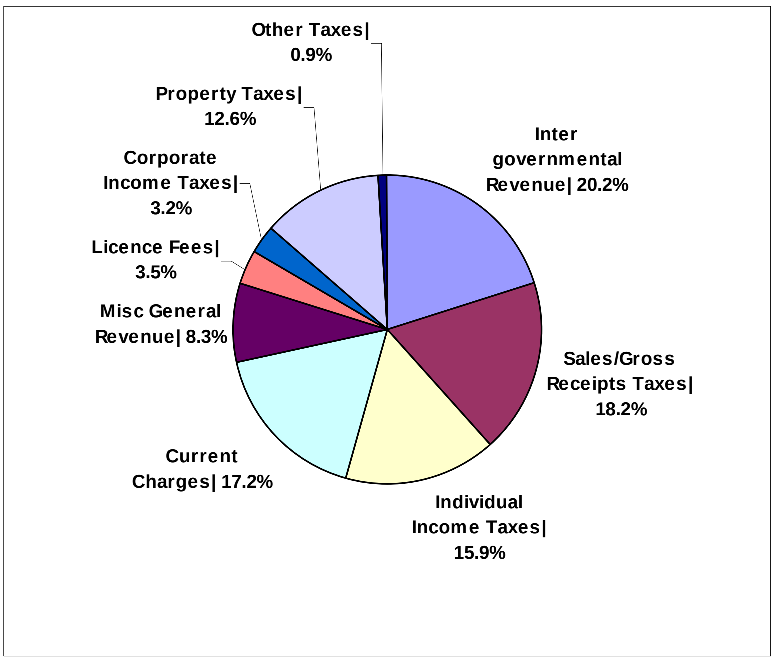
Table 1: California Propositions with Major State-Local Fiscal Implications

county (Prop 1A). In times of statewide fiscal stress, this restriction increases the likelihood that California spends beyond its means to meet its mandated Prop 98 public school funding obligations.

The Legacy of California's Post-Proposition 13 Revenue Structure

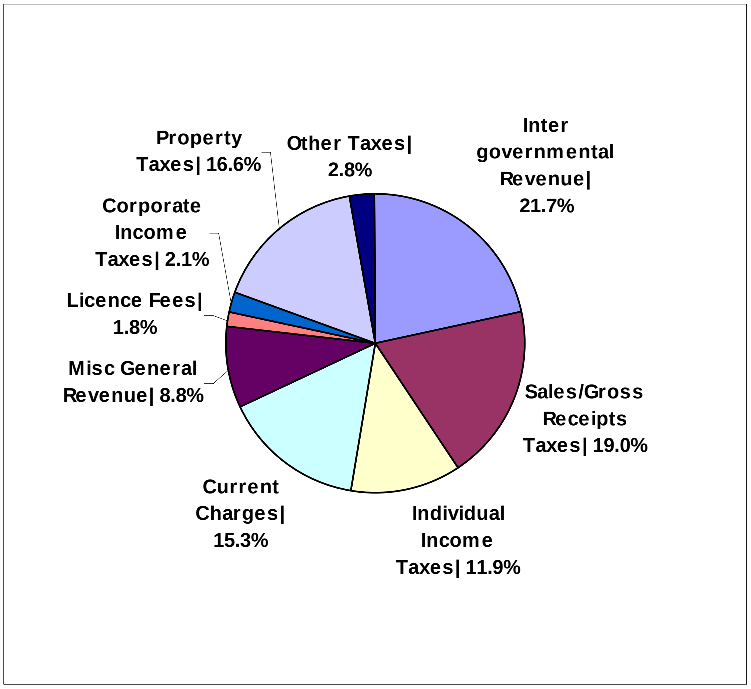
Figures Seven and Eight illustrate how the overall sub-national revenue structure in California is different from the average in all of the United States. Notably, in 2005-06 California generated a smaller proportion of its revenue in property taxes, and greater proportions of its revenue in the forms of individual and corporate income taxes. The result is a greater reliance on revenue sources that are markedly less stable over the business cycle.

Figure Seven: General Fund State and Local Revenue Reliance for State of California, FY 2005-06



Source: State and Local Finance Data Query System, Urban Institute – Brookings Institute Tax Policy Center, www.taxpolicycenter,org .

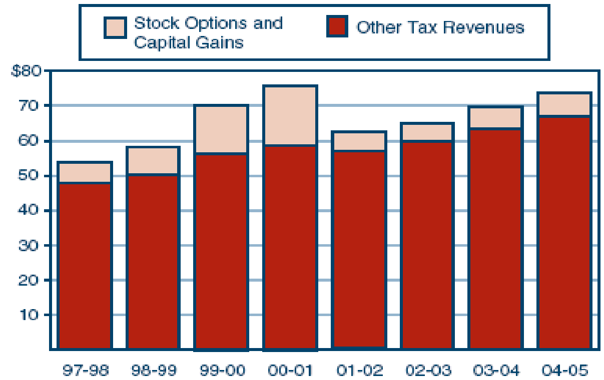
Figure Eight: General Fund State and Local Revenue Reliance for United States, FY 2005-06



Source: State and Local Finance Data Query System, Urban Institute – Brookings Institute Tax Policy Center, www.taxpolicycenter,org .

California's personal income tax is highly progressive. For 2007-08, the upper marginal tax rate of 9.3 percent began at a taxable income of $89,628 for a married household. There is an additional one percent surcharge levied on taxable income greater than a million that is earmarked for the provision of mental health services in the state. For 2007-08, the state's corporate net income tax rate was 8.84 percent, with bank and financial corporations paying 10.84 percent. The California Budget Project (2007, p. 2) notes that the 1.7 percent of corporations with net income greater than a million dollars paid 84 percent of these taxes. The LAO (2006, p. 26) reports that in 2004-05, taxable household incomes above a half million accounted for only one percent of returns, but 39 percent of personal income tax revenue collected in California. These high income tax payers are more likely to record stock options and capital gains as part of their taxable income. As Figure Nine shows, since the realization of these components of taxable income fluctuate widely over the business cycle, so does the revenue collected from all taxes. California's tax revenue during the previous recession declined from $76 billion in 2000-0, to $63 billion in the following fiscal year. This 17 percent loss in 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 2004-05, almost three years after the last recession officially ended, income tax revenues from these two volatile sources were $2 billion less than their peak in 2000-01.

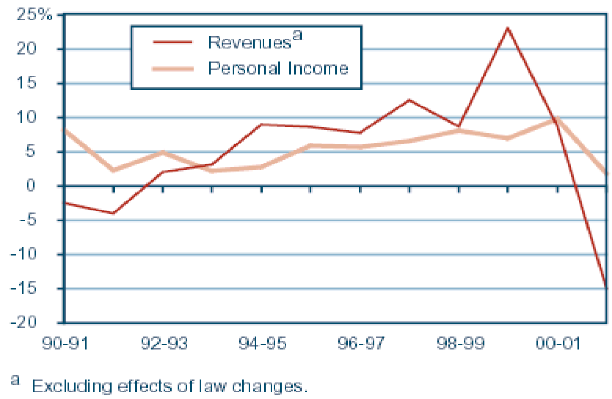
Figure Nine: California Tax Revenue (Billions Real $s) by Fiscal Year



Source: LAO (2004, Table 8), available at http://www.lao.ca.gov/2004/cal_facts/2004_calfacts_toc.htm.

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 Ten. Notice that growth in state revenue is above growth in personal income from 1993-94 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 1993-94 and after 2000-01). Referring ahead to Figure Eleven, these are the same periods when California exhibited negative values for its budget stabilization fund.

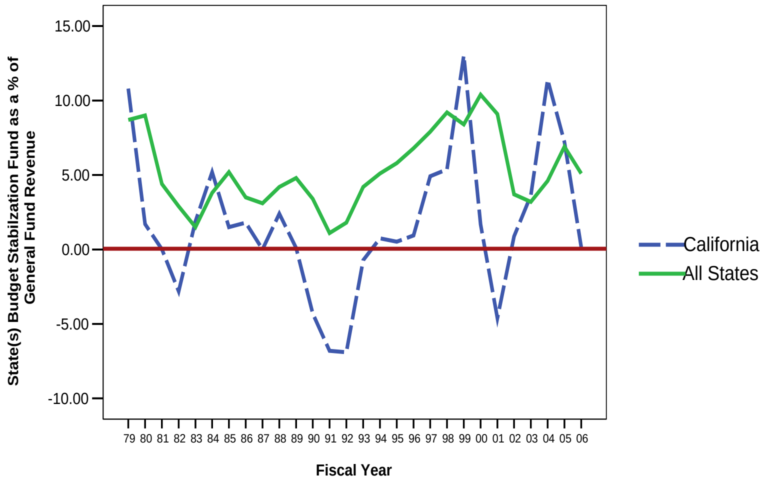
Figure Ten: California Growth in Real General Fund Revenue and Personal Income (Billions $s)



Source: LAO (2002, Table3), *Cal Facts*, http://www.lao.ca.gov/2002/cal_facts/budget.html .

For a given fiscal year, Figure Eleven shows 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.

Figure Eleven: State(s) Budget Stabilization Fund as a Percentage of General Fund Revenue



Sources: California Department of Finance (2006), http://www.dof.ca.gov/Budget/BudgetCharts/chart-b.pdf and NASBO (2005, Table 9), http://www.nasbo.org/Publications/fiscalsurvey/fsfall2005.pdf .

The yo-yo that California's general revenue stream has experienced in this decade is the same as observed in the state from the late 1970s to early 1990s. 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 1982-83, 1991-92 thru 1992-93, and 2000-01) is a persistent period of growth in the state's economy (as occurred between 1994-95 and 2000-01, and 2002-03 to 2006-07). To appreciate this claim, I offer next a summary of California's fiscal experiences over the last decade.

Beginning in the mid-1990s, California's economy boomed along with its "dot-com" industries. 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 and the annual personal income tax revenue collected from these sources doubled to nearly $8 billion (Hill, 2002). In 1998, after campaigning and winning re-election on a platform based on the need to better fund public education, Governor Davis, with the support of the California Legislature, began spending larger portion of these revenue windfalls on education, health, and human service programs. Included 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 of a nearly $4 billion annual cut in vehicle license fees. Many have since questioned whether such ongoing commitments using additional tax revenue that most understood as transitory. But as Tim Gage, then Director of California's Department of Finance 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 period are committed to ongoing expenditures that remain after the loss of the boom period's windfall revenue.

By late 2002, the bottom had fallen out of California's economic boom and revenue from the state's personal income tax fell by nearly 25 percent in that year. The 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 year was $27 billion. These cumulative deficits became the basis for the figure cited by Governor Davis that the 2003 operating deficit for California was $38 billion. In the setting of these immense fiscal problems, Davis ran for reelection in November 2002 and won. However, only months after reelection, 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 allowed such an increase if the governor judges that the state is no longer able to pay its bills. This increase became the major point of contention in the historic recall election that occurred in the same month and swept Governor Schwarzenegger into office.

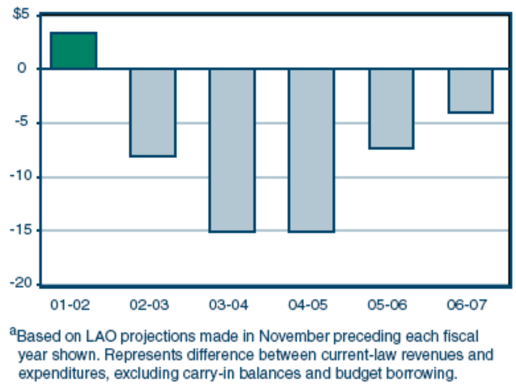
Fulfilling a campaign promise, Schwarzenegger's first act as governor was to repeal the VLF tax increase and place the State of California's budget an additional $3.5 billion in the red. As noted by Zuckerman (2004), Schwarzenegger dealt with this huge budget shortfall by: (1) proposing to seek future voter approval to borrow nearly $11 billion (which was later approved by voters at $15 billion), (2) 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 (largely through an accounting change in Medi-Cal), (3) California State University and University of California tuition increases of nearly 30 percent, (4) state employee layoffs or non-replacements, reductions in judiciary and criminal justice spending, and (5) not fully funding the Proposition 98 guarantee for state funding of K-14 education. The result of these changes, and an unexpected rebound in state tax revenues, allowed California in 2004-05 to report a positive operating balance of over $3 billion and a surplus in its reserve fund of over $9 billion.

Between 2005 and early 2007, the California economy remained strong. The LAO (2006a) reported that state revenues had grown over the past three fiscal years by over $11 billion. Perhaps not surprisingly, the governor and legislature used this additional revenue to further increase the state's spending on K-12 public education and to fund an early pay-off early of debt taken on to cover previous deficits. However, this up tick in the state's economy only served to decrease the operating deficit predicted by the LAO in November of each year. As shown in Figure Eleven, only after the large personal income tax windfalls gained from high capital gain realizations in 2001-02, has this prediction included an expected surplus in the state budget. What this indicates, and what many observers have repeatedly pointed out, is that the changes in California's revenue structure that began with Proposition 13 has resulted in a persistent structural deficit in this century that, despite repeated calls to do otherwise, was not dealt with during the economic recovery the state experienced between 2003 and mid 2007.

A structural deficit for California means that in normal economic times, given the current revenue structure and expected expenditure a commitment, the expectation is for a shortfall in the state's budget.

Observers have pegged this annual structural deficit as in the range of three to eight billion dollars. Even with an annual revenue base of around $100 billion, this is a significant shortfall. The obvious solution to cope with a structural deficit is to either raise revenues or cut expenditures. The political difficulty in implementing the obvious, especially in a state that requires a two-third majority to raise taxes and to approve its annual state budget, comes in the forms of first deciding whether the problem is primarily revenue or expenditure based, and then determining what revenue instruments to increase or what expenditure program to cut. Because of this, many of California's policymakers have decided to cope with its structural deficit by denying that it exists and/or that there is a need for an imminent solution.

Figure Eleven: Projected Operating Surplus/Deficit at Start of Each Budget Cycle (Billions $s)



Source: LAO (2006b), *Cal Facts*, Table 23, http://www.lao.ca.gov/2006/cal_facts/2006_calfacts_budget.htm#budget .

The California Department of Finance predicted the 2007-08 state budget would be around $4 billion in surplus (Governor's Budget, 2008). However, due to an unforeseen rise in oil prices, the sub-prime mortgage crisis, and declines in residential construction and real estate values; by mid 2007 it was apparent that California's economy was slowing and this surplus would not materialize. In November 2007, Governor Schwarzenegger's proposed budget for the upcoming fiscal year identified an expected revenue gap of $14.5 billion for 2007-08. His proposal to deal with it was a 10 percent cut in all state expenditures. Many, including the LAO, thought this simple approach inappropriate. In an unprecedented action, the LAO (2008a) chose to not just offer an analysis of the Governor's proposed budget, but too instead propose their own "alternative budget" that identified $17 billion in possible expenditure cuts – chosen based upon the necessity of service provided and equity considerations – and close to $3 billion in increased revenue through a list of potential reduced tax expenditures to business. Notably, the LAO's alternative budget contained no new taxes or increases in existing tax rates.

After a further weakening of the economy, in February of 2008 the LAO (2008b) raised its prediction of the expected two-year budget shortfall to greater than $16 billion. This prompted California's Legislature to entire into special session and the approval of over $3.3 billion in additional approved, but never issued deficit bonds; and the suspension, delay, and shift of other expenditure programs that yielded an additional $4.2 billion in savings. More than $7 billion of these changes are one time and do nothing to deal with the state's structural deficit.

California's economic situation continued to decline in March and April of 2008. Given the state's heavy reliance on personal income taxes, analysts expected the two-year deficit value to rise. By mid April, many said it was back to an amount similar to what it was before the one-time cuts made in the special session of the legislature. In late April of 2008, Governor Schwarzenegger shocked many by publicly stating that he believed the current two-year deficit figure to be over $20 billion. The exact figure will not be known until after a May revise that accounts for the actual amount of personal and corporate income taxes collected by the state.

A California governor expecting a deficit that is one fifth of the state's own-source revenue brings this story back to 2002 and the state's last recession, when Governor Davis forecast an even greater deficit. In less than 10 years, Californians have rode the fiscal roller coaster of going from boom to bust, back to relative boom, and now heading toward a bust whose trough is not in site. Budget experts, analysts, and observers are well aware of the tendency for California's post-Proposition 13 system of revenue to produce such a pattern and have offered the solutions discussed next.

Ideas on How to Better Cope

The suggestions put forth to reduce the instability currently inherent in balancing the yearly operating budget of California 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 categories, I provide bulleted summaries of some suggested reforms. The items contained in the following lists are from reviews put together by Simmons (2002) and the Institute for Government Studies (2003).

Budget Process Reforms

- *Reduce two-thirds voting requirements*

  Many of the commissions, studies, and individuals that have explored ways to reform California's budget process have come to the conclusion that change is required in it two-thirds vote requirements. The California Constitution Revision Commission in 1996 and the California Citizens Budget Commission in 1998 recommended amending the constitution to 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 in 1995 believed that if two-thirds vote requirements exist for taxes, they should also 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 adjust proposed and current legislation for economic and caseload changes, some have suggested that California move to 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 summary for California in 2008 is nearly 350 pages long and highly technical.[2] 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 LAO, and

[2] The full text of Governor's proposed 2008 budget for California is at http://www.ebudget.ca.gov/pdf/BudgetSummary/FullBudgetSummary.pdf .

Department of Finance, and private organizations like the California Budget Project offer summaries and analyses of the state budget that are easier to digest, the suggestion here is for even more public dissemination of the constraints, trade-offs, and choices necessary in a state budget.[3]

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. 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 improve 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 California is attributable 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 funded by greater reliance on a more stable tax instrument would make the sate'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 California is raising more revenue. Often suggested is a reinstatement of the higher top marginal income tax rates of 10 and 11 percent that existed throughout much of the 1990s. Also proposed is the idea of expanding the state's sales tax base to include services and/or allowing a split role property tax in which business property would move back to market value based assessment.

- *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,

[3] 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/pdfs/2008/080116_govbudget.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 *Eurek* (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). A second is the recent work of Gordon, Alderate, Murphy, and Zhang (2007) at the Public Policy Institute of California.

> California Constitution Revision Commission, and California Business Roundtable all agree and further suggest a significant realignment of state/county public service responsibilities.

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 fiscal situation 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 there 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 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, has raised 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 fund 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.

The political feasibility of enacting the budget process reforms suggested above is currently small. Perhaps the greatest opportunity for major reform of this type occurred on the March 2004 ballot when citizens seemed wiling 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.[4] 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 changes suggested earlier? To assess this possibility, one must first consider 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.

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."

With 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 a viable way of providing California 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

[4] The California Budget Project (2004, p. 5) notes, "[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."

it stands today. One of the last acts of Governor Davis was triggering a provision in the legislation that allowed an increase in the VLF rate back to 2 percent during the time of a state budget "emergency."[5] As the recalled governor found out, voting Californians dislike the visibility and burden of taxing their second most valuable piece of property. Governor Schwarzenegger won the recall election based upon promising to roll back the VLF to 1.3 percent. Thus, while he remains in office, additional revenue is unlikely to come from this source.

A second potential stable revenue source could from maintaining the one-percent *ad valorem* rate of property taxation specified by Proposition 13, but eliminating the acquisition value of assessment for non-residential property. Politicians dismiss such a "split-role" property tax because of the "third-rail" impression they have toward changing anything about Proposition 13. Perhaps promising is a recent bill in the California Assembly to authorize a thorough study of how much revenue such a change would raise.

In addition, there is now documented discussion in California policymaking circles that expanding the state's current 6.25 percent rate of sales taxation to exempted service items needs to be on the table as possible revenue source. A recent study by the State's Board of Equalization places the revenue potential of doing such at close to $2.7 billion. Not all services are being considered, notably not mentioned are legal and medical services, but the suggested base expansion does include automobile repairs and services, entertainment and recreation, household repair and maintenance, and personal services like dry cleaning.

A final way of closing the state's structural deficit through increased revenues would be a reinstatement of the 10 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% rate for those making $260,000 ($520,000), the California Budget Project (2002a) estimates that it would

[5] Later, 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.

have raised $3.5 billion in 2004. But with strong Republican opposition to tax increases, and particularly ones that fall upon the state's highest earners, the supermajority vote requirement make the adoption of this (or a higher VLF, split property tax role, or expanded sales tax base) politically difficult. In addition, if one these were 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.

Governor Schwarzenegger's 2008-09 budget for California included a suggestion for a "Budget Stabilization Act" that would amend the constitution in a manner designed to save excess revenues when they rose above a long-term average rate of growth in order to build up a revenue stabilization fund that could never exceed 10 percent of general fund revenue. Transfers from this fund would go into the state's general fund when growth in general fund revenues falls below a long-run trend. In addition, the proposed act would require that the governor looks at the state's general fund balance three times a year and project whether it is in deficit. If the projected deficit is one percent or less, the governor will then order a reduction in all appropriations by two percent. If the projected deficit exceeds one percent, the reduction in appropriations rises to five percent. Even if additional revenue arises through a tax or fee increase, reform along these lines would prevent the overspending that politics will generate in a surplus year. Thus, the passage of this proposal may offer solace to Republicans who are hesitant to solve the structural deficit through a revenue increase alone. Nevertheless, others (including the LAO) do not approve of Governor's Schwarzenegger's proposal because of the obvious shift it entails in expenditure power to the executive branch.

McNichols and Lav (2008) reports that California is not alone in facing a current budget shortfall for the 2008-09 fiscal year; at least 25 states are in the same situation. As a percent of this fiscal year's expenditure, California's budget gap is expected to be the second largest at 15.4 percent, with Arizona's larger at 17.8; and Florida's at 11, Nevada's at 13.5, New Jersey's at a maximum of 10.6, and Rhode Island's at 11.2 percent. The usual solutions of expenditure cuts and/or tax increases are always problematic during an economic recession and the use of a reserve fund to fill gaps during an economic downturn makes sense. The problem is that many states do not possess a significant reserve to fill the expected gap. In the final section of this paper, I explore a possible revenue option that could be used by California, or any state using cap and trade to reduce greenhouse gas emissions, to raise revenue to create such a reserve.

An "Out of the Box" Revenue Idea

In July of 2005, Governor Schwarzenegger signed Executive Order S-3-05 that declared climate change a reality and emphatically stated that it was time for California, the 12th largest emitter (in terms of government-based entities) of greenhouses gases (GHGs) in the world, to take action to reduce these emissions. The executive order directed the state by 2010 to reduce GHG emissions to 2000 levels; by 2020 to reduce GHG emissions to 1990 levels, and by 2050 to reduce GHG emissions to 80 percent below 1990 levels. In September of 2006, the Governor Schwarzenegger proceeded to sign the Global Warming Solutions Act (AB 32) that codified the GHG reduction targets previously specified in EOS-3-05 into law and required, by the start of 2009, mandatory reporting rules for significant sources of greenhouse gases and a specific plan to achieve the required GHC emissions through regulations, market mechanisms, and/or other actions. AB 32 also required the creation of an Economic and Technology Advancement Advisory Committee (ETAAC) to advise California's Air Resource Board on the specific implementation of the law. In late February of 2008, in anticipation of the year-end deadline imposed by AB 32 for an implementation plan, the ETAAC (2008) released its final report. The recommendations of the Market Advisory Committee of the ETAAC are contained in Chapter 9 of this report.

Policy analysts remain divided on whether cap and trade or carbon taxes are the better policy instruments to achieve a desired reduction in GHGs (see Green, Hayward, and Hassett, 2007; or EconoSpeak, 2007). Basically the tradeoff between the two comes down to greater certainty in the amount of GHGs reduced, and less certainty in the cost of companies complying with this reduction, when choosing a cap and trade system as opposed to a carbon tax. The ETAAC's Market Advisory Committee came out in favor of a system of cap and trade as the "best" solution to reduce GHGs in California.

An important item to consider in designing a cap and trade system for California is how to price the initial allocation of CHG allowances. The choices are: (1) free allocations of GHG allowances based on historical emission level, (2) free allocations based on previous economic output, or (3) revenue generating allowance auctions. The ETAAC report concluded that some level of auctioning is preferred for the clear and early price signal it will send on a unit of GHG emission under the specified cap. Furthermore, they recommend that productive and appropriate uses of these auction revenues include making direct investments in low carbon technologies, allocating dollars to California universities for research and development surrounding GHG reduction, and investment in technologies that could improve air quality in low income neighborhoods disproportionately affected by the trade portion of the program (an important objective explicit in AB 32). Most importantly for the purpose of this paper, the ETAAC's Market Advisory Committee recommends that the "California Air Resources Board may wish to convene an advisory group involving persons with budgetary experience and a wide knowledge of energy, environmental, tax and budgetary policy, and including representatives of both the Department of Finance and Legislature, to prepare a study outlining several sensible options for recycling revenues to businesses or individuals" (p. 56).

My "out of the box" suggestion is that California employ only a system of cap and trade to reach its stringent GHG goals, that initial allocations be fully auctioned off, and a portion of the earned revenue be used to establish a rainy-day fund that is built up to a maximum of a pre-determined percentage of the state's general fund expenditure (say 10 percent). Additional auction revenues reduce the rates of existing distortionary taxes only after this rainy-day fund is established. Rules for drawing done this fund could be the same as those proposed by Governor Schwarzenegger in his Budget Stabilization Act.

An anticipated difficulty in this suggestion is that California Courts are very likely to interpret auction revenues as a fee, and based upon the earlier Sinclair Paint Decision require a nexus between the purpose of the fee and the use of its corresponding revenues.[6] As pointed out by the advocacy group

[6] "When is a Fee Really a Tax?," an article in *Alert*, a newsletter put out by the California Business Chamber of Commerce, offers a good summary of this interpretation. Available at

"Carbon Share: Because the sky belongs to all of us," what has been auctioned off is publicly owned California air.[7] A nexus possibly exists if the revenue from selling this public good supplements the state's general fund revenue with the intention of providing public goods and services that confer public benefits to the same who owned the state's air. If this argument does not pass legal muster, the auction revenues are from a tax and a two-thirds vote of the California Legislature would be required for their use for any purpose not related to further GHG reduction.

The revenue raised from the proposed auction depends negatively on the number of GHG units available for auction and if it is an annual auction to price GHGs emitted in the upcoming year (as opposed to one-time auction that sells the right to emit GHGs forever). An annual auction best suits California's desire to reduce over time the allowed GHCs emitted annually, and its desire for companies to invest in the latest GHG reduction technologies, as. If this is the case, a yearly revenue estimate for California in 2007 dollars ranges from $2 to $8 billion a year depending on a price per ton between $5 and $20.[8] A reasonable expectation must be that even if such a plan was used in California (or any other state), the auction revenue gained from it would only last as long as a similar cap and trade plan was not adopted at the federal level. At the time of a federal plan, California would need to abandon its own and become part of that. In the meantime, this out of the box idea would yield the double dividend of getting California closer to the GHG reductions required by AB 32 and establishing an initial rainy day fund that may be substantial enough to offset the fiscal cyclicality built into California's current revenue reliance. Like in the proposed Budget Stabilization Act, state revenue growth over a long-term trend would need to replenish this fund once the California GHG auctions went away.

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http://www.lumberassociation.org/Weekly%20E-Update/CalChamber_TaxvFee_Article_2-15-08.pdf .

[7] The Carbon Share website can be found at www.carbonshare.org .

[8] See www.carbonshare.org/june22event.htm .

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