California's Budget Stress and Proposition 13

Tracy Gordon
School of Public Policy
University of Maryland, College Park

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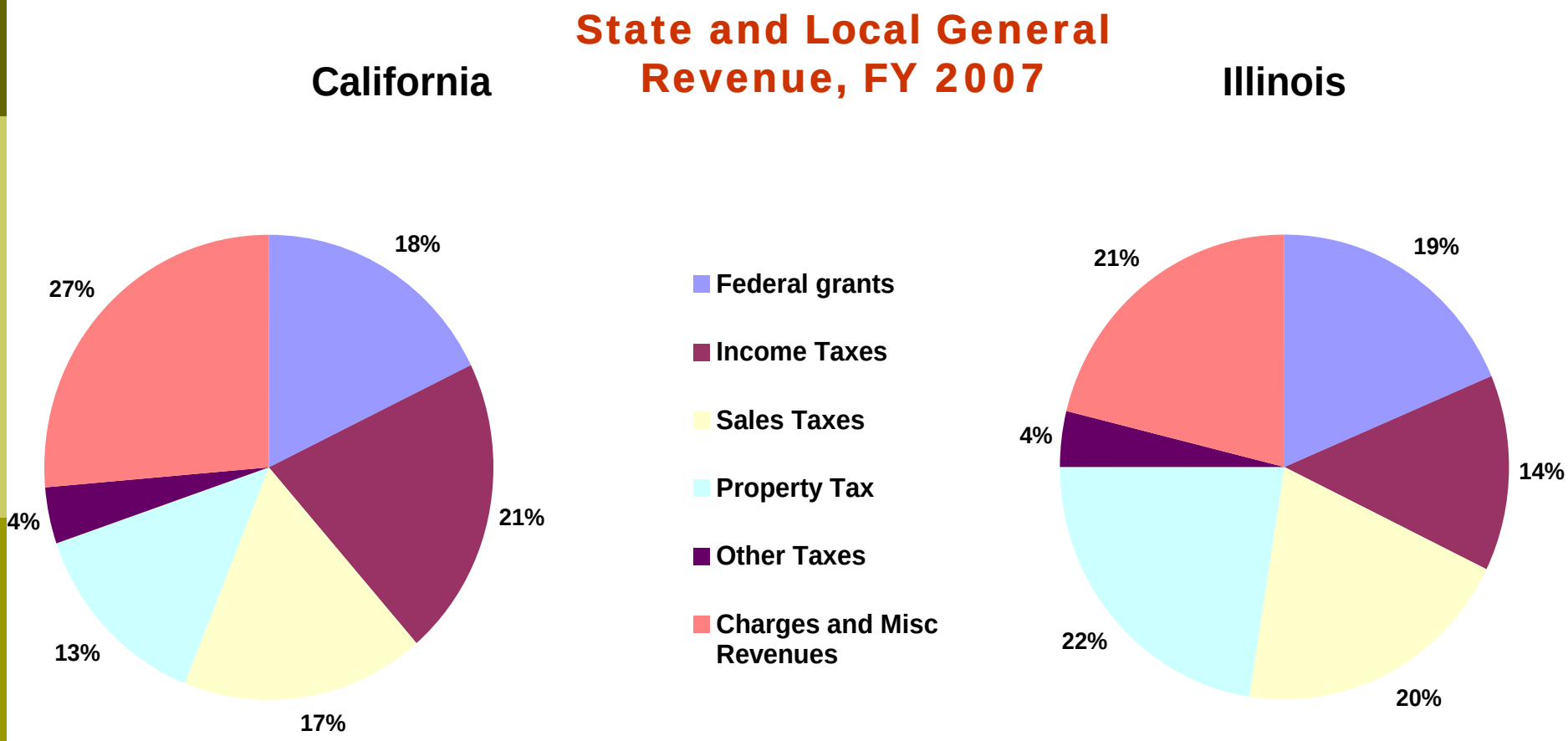
Outline

- *California's budget turmoil*
- The role of fiscal institutions
- Directions for reform

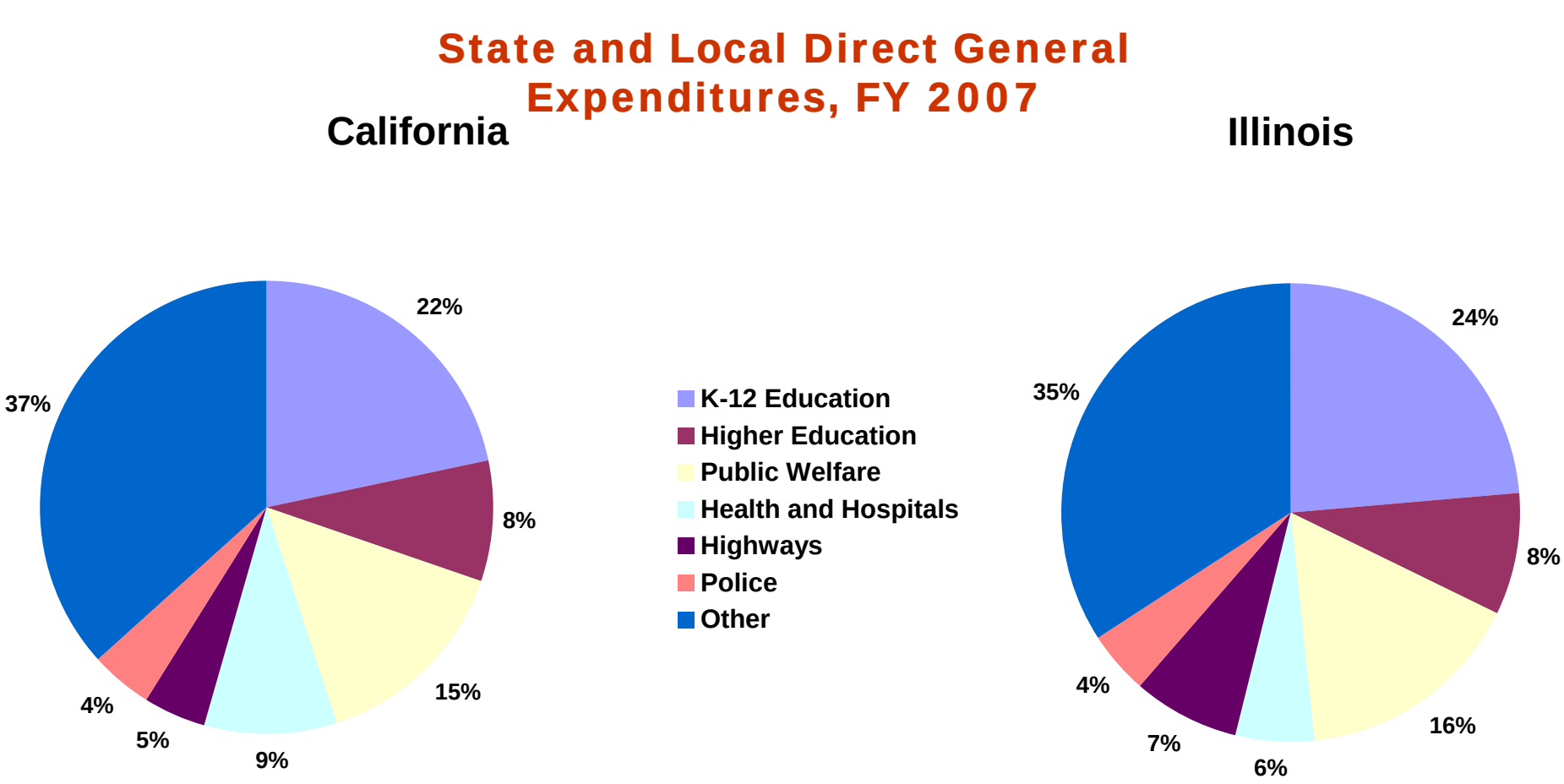
Background on California's Finances: Where the Money Comes From



Source: Census of Governments, Urban-Brookings Tax Policy Center, 2010.

Background on California's Finances: Where the Money Goes

State and Local Direct General Expenditures, FY 2007



Source: Census of Governments, Urban-Brookings Tax Policy Center, 2010.

California's Current Budget Problem

Figure INT-02

Changes in the Budget Gap

(Dollars in Billions)

Budget Shortfall Projected in the 2010-11 Governor's Budget	-$19.9
Special Session Approved Solutions	1.4
Achieved Federal Funds	0.7
Revenue Decline	-0.6
Cost Increases	-0.5
Increase in Reserve	-0.2
Total Budget Solutions Proposed	-$19.1

Source: Governor's Budget, May Revision 2010.

Governor's Proposed Solutions

Spending cuts	$12.2 billion
Federal funds	$ 3.4 billion
Borrowing and fund shifts	$ 2.6 billion
Revenues	$ 0.9 billion

Spending cuts include elimination of CalWORKs (TANF), child care subsidies

Also, 5% reductions in salaries, payroll, and state pension contributions

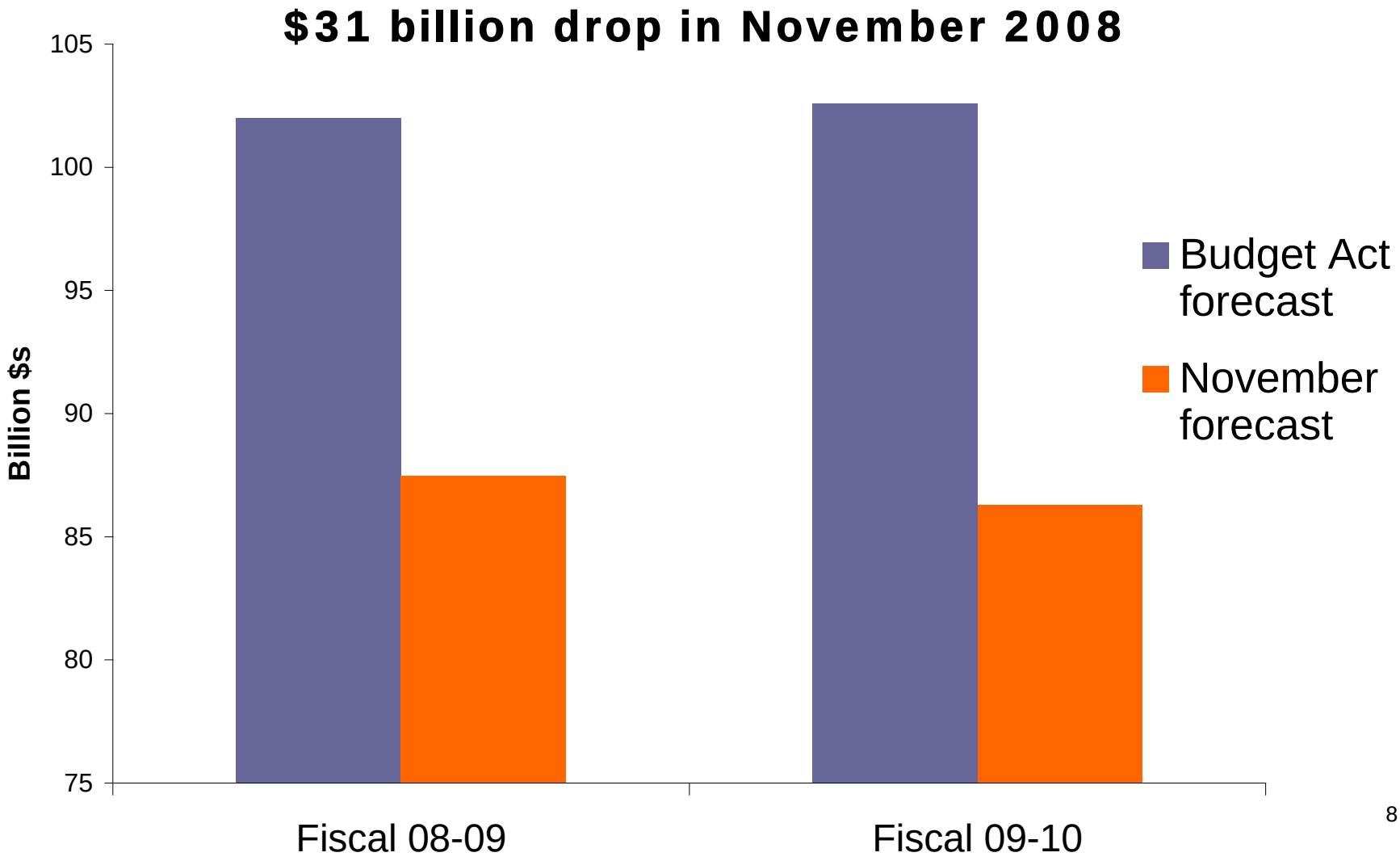
Sources: Governor's Budget, May Revision 2010; Legislative Analyst's Office, Overview of the May Revision, 2010.

How Did This Happen? California Was Hit Hard by The Recession

	Employment growth		Unemployment rate	
	California	U.S.	California	U.S.
2008 (actual)	-1.1%	-0.4%	7.2%	5.8%
2009 (estimated)	-4.5%	-3.8%	11.7%	9.2%
2010 (forecast)	-1.2%	-0.7%	12.1%	10.0%
2011 (forecast)	1.5%	1.9%	11.3%	9.4%
2012 (forecast)	2.3%	2.5%	10.2%	8.5%

Source: Public Policy Institute of California, Legislative Analyst's Office.

Revenues Plunged Below Forecast

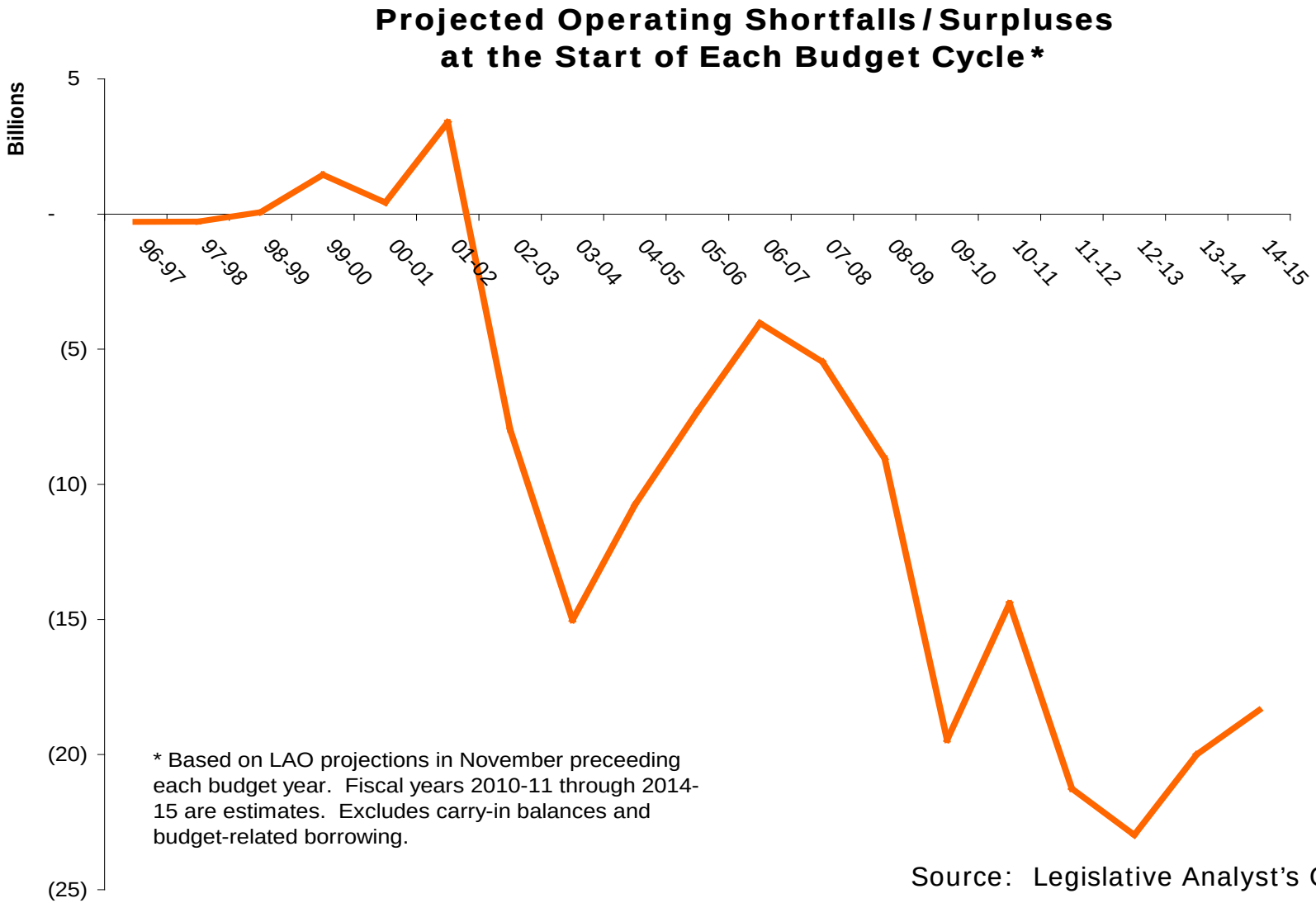


Source: Department of Finance, December 2008.

Lawmakers Had to Find $60 Billion in Solutions Last Year


Justin Sullivan / Getty Images

California Has Long Faced Budget Shortfalls…



* Based on LAO projections in November preceeding each budget year. Fiscal years 2010-11 through 2014-15 are estimates. Excludes carry-in balances and budget-related borrowing.

Source: Legislative Analyst's Office, 2009.

… And It Faces Significant Future Liabilities

- Budget-related borrowing $ 35 billion
- Long term debt outstanding $ 70 billion
- Unfunded retiree obligations >$130 billion

Source: Legislative Analyst's Office, 2009.

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What Accounts for California's Recurring Budget Woes?

- Among the usual suspects:
  - 2/3 vote requirements
  - "Locked in" budget
  - Narrow and volatile revenue base
  - "Something for nothing" mentality
  - Legislative term limits
  - Political polarization

How much due to Prop 13?

What Is Proposition 13?

- Adopted in 1978, the “People's Initiative to Limit Property Taxation” (Article XIIIA of the California Constitution):
  - Capped property tax rates at 1%
  - Rolled back assessed values to 1975 levels
  - Mandated that assessed values could not increase by more than 2% per year unless a property was sold
  - Required 2/3 of state legislature to approve new taxes and majority of local voters for new “special” taxes
  - Charged state with allocating property taxes among local governments within a county

Where Did It Come From?

- General antipathy toward property tax
- Rising real estate values
- School finance equalization decisions
- Accumulating state budget surpluses
- Scandals and intervening events
  - From 1965 to 1978, 2 assessors went to prison, 1 committed suicide, and 1 resigned while under investigation
  - LA County mailed large property tax bills right before the election

What Did It Do? In Near Term…

- Cut local property taxes in half
- Increased reliance on user charges (including developer impact fees)
- Increased reliance on state aid, including AB 8 “bailout” (1979):
  - Shifted property taxes from schools to local governments according to pre-Prop 13 shares
  - Transferred some county programs to state
  - Backfilled school losses with general revenues

In the Longer Term…

- Centralization of education finance
  - Expenditures per pupil are about average ($7,747 in CA vs. $8,294 in US-CA in FY 04)
  - But, costs are higher (2nd highest school salaries in nation at $58,143 in FY 04)
  - Result is lower staff per pupil compared to other states (about 70% of US-CA average)
  - Private school enrollments went up
  - Student achievement lags rest of nation

In the Longer Term…

- Rise of ballot box budgeting

Measure/Election	Major Provisions
Proposition 13/ June 1978	• Limits general property tax rates to 1 percent, limits increases in assessed value after a property is bought or constructed. • Makes Legislature responsible for dividing property tax among local entities. • Requires two-thirds vote for Legislature to increase taxes, and two-thirds voter approval of new local special taxes.
Proposition 4/ November 1979	• Generally limits spending by the state and local entities to prior-year amount, adjusted for population growth and inflation (now per capita personal income growth). • Requires state to reimburse locals for mandated costs.
Proposition 6/ June 1982	• Prohibits state gift and inheritance taxes.
Proposition 7/ June 1982	• Requires indexing of state personal income tax brackets for inflation.
Proposition 37/ November 1984	• Creates state lottery and allots revenue to education. • Places prohibition of casino gambling in State Constitution.
Proposition 62/ November 1986	• Requires approval of new local general taxes by two-thirds of the governing body and a majority of local voters (excludes charter cities).
Proposition 98/ November 1988	• Establishes minimum state funding guarantee for K-12 schools and community colleges.
Proposition 99/ November 1988	• Imposes a 25 cent per pack surtax on cigarettes and a comparable surtax on other tobacco products, and limits use of surtax revenue, primarily to augment health-related programs.
Proposition 162/ November 1992	• Limits the Legislature's authority over PERS and other public retirement systems, including their administrative costs and actuarial assumptions.
Proposition 163/ November 1992	• Repealed "snack tax" and prohibits future sales tax on food items, including candy, snacks, and bottled water.

Measure/Election	Major Provisions
Proposition 172/ November 1993	• Imposes half-cent sales tax and dedicates the revenue to local public safety programs.
Proposition 218/ November 1996	• Limits authority of local governments to impose taxes and property-related assessments, fees, and charges. • Requires majority of voters to approve increases in all general taxes, and reiterates that two-thirds must approve special taxes.
Proposition 10/ November 1998	• Imposes a 50 cent per pack surtax on cigarettes, and higher surtax on other tobacco products. • Limits use of revenues, primarily to augment early childhood development programs.
Proposition 39/ November 2000	• Allows 55 percent of voters to approve local general obligation bonds for school facilities.
Proposition 42/ March 2002	• Permanently directs to transportation purposes sales taxes on gasoline previously deposited in the General Fund. • Authorizes state to retain gasoline sales taxes in General Fund when state faces fiscal difficulties.
Proposition 49/ November 2002	• Requires that the state fund after-school programs at a specified funding level.
Proposition 57/ March 2004	• Authorizes $15 billion in bonds to fund budgetary obligations and retire the state's 2002-03 deficit.
Proposition 58/ March 2004	• Requires a balanced budget, restricts borrowing, and mandates creation of a reserve fund.
Proposition 1A/ November 2004	• Restricts state's ability to reduce local government revenues from the property tax, sales tax, and vehicle license fee.
Proposition 63/ November 2004	• Imposes an additional 1 percent tax on incomes of $1 million and over to fund mental health services.
Proposition 1A/ November 2006	• Limits state's ability to retain gasoline sales taxes in General Fund and constitutionally requires repayment of past-year loans to transportation.

Source: Legislative Analyst's Office, 2006.

In the Longer Term…

- Warped state-local fiscal relationship
  - 1992-1993: Education Revenue Augmentation Fund shifted some property taxes back to schools (partly offset by Prop 172 funds for public safety)
  - 1998: State cut Vehicle License Fee (VLF) and backfilled revenue losses to local governments
  - 2003: State raised VLF, but did not take effect for several months ($1.3 billion backfill gap later repaid)
  - 2004: Prop 57 "triple flip" reduced sales taxes for local governments, replaced with ERAF funds, gave schools general revenue. Prop 1A prohibited further changes unless under certain conditions and repaid with interest.
  - 2006: Prop 1A restricted shifts from transportation fund

Major tensions and unclear accountability

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What to Do? Renewed Attention to Fiscal Institutions

- "Maybe Process is the Problem…"
  - Tax and expenditure limits (TELs)
  - Supermajority requirements
  - Balanced budget rules
  - Enhanced executive budget authority
- Proposals in California to:
  - Lower budget vote requirement
  - Enact multi year budgeting, PAYGO, and performance measurement
  - Limit use of one-time revenues

Do Fiscal Rules Work?

- Mixed empirical evidence
- Studies often fail to consider variation in institution goals and design
- Also, how to identify causal relationship:
  - When institutions don't vary over time?
  - When they do vary, but for a reason?

Lessons Going Forward

- Prop 13 remains enormously popular
  - More than half of likely voters want to keep it
  - Recent tax reform commission (COTCE) considered and rejected reform (e.g., split roll)
- Voters will continue to have their say
  - Use ballot for sensible reforms
  - Remember there are no easy answers