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WORKING PAPER NO. 03-287

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By

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Working Paper Number 03-287

ANATOMY OF THE CALIFORNIA FISCAL CRISIS: FACTS AND FIGURES DO MATTER

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September 22, 2003

Anatomy of the California Fiscal Crisis: Facts and Figures Do Matter

This issue paper is intended to set out the facts and figures of California's fiscal problem and to present some suggestions for closing the fiscal gap. The California recall campaign now underway has become a political dog fight with remarkably little attempt to understand the nature of California's fiscal problem or to propose reasonable solutions to this problem. Remarkably, one of the leading candidates even stated that the public does not care about "facts and figures."

California's Economy: A Little Better Than the United States, With a Strong Central Valley Economy

Several leading candidates speak about the weak economic performance of California and California's losing jobs to other states. In fact, California's economy is doing slightly better than the rest of the country, with Southern California and the Central Valley outperforming the nation by a substantial margin. As Table I shows, California has lost 284,000 jobs, or 1.9% of its workforce, since early 2001, while the United States has lost 2.8 million jobs, or 2.1% of payroll employment, since its peak employment. The unemployment rate has risen from 4.8% in California to 6.6%, a rise of 1.8 percentage points. At the same time, the national unemployment rate has risen from 4.2% to 6.1%, a rise of 1.9 percentage points. In fact, **California has almost exactly mirrored the national economic performance since 2000.**

On a regional basis, **the Central Valley has posted strong job growth throughout the national jobs recession, while Southern California has lost only 0.9% of its jobs since California's peak employment in early 2001, compared with a 2.1% job loss for the nation.**

As Table II shows, the San Francisco Bay Area has accounted for nearly all the job loss in California during the recession. These losses represent sharp cutbacks from the 1996 to 2001 high-tech, Internet, venture capital, IPO, Y2K boom, which was clearly a gold rush that turned into fool's gold. Our 2001 paper entitled, "Gold Rush or Fool's Gold" clearly foretold the collapse of this boom, for which we were roundly criticized at the time.

Examining the jobs data, it is difficult to conclude that California's economic problems are caused by state government policies. If those problems were caused by state policies, we would not see the divergence between Southern California and the Central Valley on the one hand, and Northern California on the other. The relative strength of Southern California and the burst technology bubble in Northern California

believe the assertions that state policies are primarily responsible for the state's economic problems.

It is highly likely that California's energy crisis and costs, a very expensive workmen's compensation system, and a bureaucratic regulatory system in a number of areas could have slowed job growth and encouraged some jobs to move to neighboring states. **California public policy clearly can do better**, and a more pro-business environment could clearly lead to an even more successful California economy. We strongly support these initiatives, including the recently signed workmen's compensation bill.

California's economy is nevertheless in better shape than the national economy. Both the U.S. and the California economies face the huge challenge of global competition from China, India and other low cost labor environments. However, California with its large immigrant labor force and its strategic location is in the best position to deal with this global challenge.

Fiscal Problems: Temporary Revenue but Permanent Expenditures

Like almost all accidents, there are several contributory causes to California's fiscal accident. First, the economy is one, but only one, cause of California's fiscal problems. Second, the NASDAQ bubble and the IPO and venture capital boom and collapse produced an unsustainable surge in capital gains and stock options tax revenue during the boom. Third, expenditures increased rapidly in response to that surge in revenue. Fourth, a deeply embedded voter preference for income- and sales-related taxes over property-related taxes have caused California to rely more heavily on highly cyclical components of tax revenue.

The Jobs Issue: A Straw Man

The first cause, the economy, is cited by many candidates and pundits as the only problem. California is exporting jobs to other states, they say. If this is true, then on balance California's employment growth should have slowed relative to the nation's during the period of deteriorating fiscal balances. In fact, California's job growth has moved in lock step with the nation's for many years, and during the recent downturn in jobs, California has done marginally better than the nation, as indicated in detail in the previous section. If anything, California has gained advantage over the nation during the period of its intense fiscal crisis. **The jobs data simply do not bear out the main contentions of the long list of those who would fix California's budget.**

Table I: California and United States Change in Payroll Employment (000)

	Peak	Trough	Absolute	%
	Mar-01	Aug-03	Change	Change
California				
Total Nonfarm	14,725.3	14,441.6	-283.7	-1.9%
Goods Producing	2,660.6	2,382.6	-278.0	-10.4%
Natural Resources and Mining	26.3	23.7	-2.6	-9.9%
Construction	779.7	785.2	5.5	0.7%
Manufacturing	1,854.6	1,573.7	-280.9	-15.1%
Service Providing	12,064.7	12,059.0	-5.7	0.0%
Trade, Transportation and Utilities	2,769.8	2,725.7	-44.1	-1.6%
Information	589.7	471.1	-118.6	-20.1%
Financial Activities	833.3	865.8	32.5	3.9%
Professional and Business Services	2,238.2	2,110.8	-127.4	-5.7%
Educational and Health Services	1,427.9	1,529.8	101.9	7.1%
Leisure and Hospitality	1,364.1	1,416.5	52.4	3.8%
Other Services	497.5	500.9	3.4	0.7%
Government	2,344.2	2,438.4	94.2	4.0%
	Peak	Trough	Absolute	%
	Feb-01	Aug-03	Change	Change
United States				
Total Nonfarm	132,560	129,761	-2,799	-2.1%
Goods Producing	24,478	21,977	-2,501	-10.2%
Natural Resources and Mining	605	566	-39	-6.4%
Construction	6,841	6,822	-19	-0.3%
Manufacturing	17,032	14,589	-2,443	-14.3%
Service Providing	108,082	107,784	-298	-0.3%
Trade, Transportation and Utilities	26,264	25,183	-1,081	-4.1%
Information	3,714	3,259	-455	-12.3%
Financial Activities	7,774	7,974	200	2.6%
Professional and Business Services	16,800	16,024	-776	-4.6%
Educational and Health Services	15,416	16,525	1,109	7.2%
Leisure and Hospitality	12,003	12,052	49	0.4%
Other Services	5,197	5,310	113	2.2%
Government	20,914	21,457	543	2.6%

Sources: California EDD, US BLS.

Table II: MSA Change in Nonagricultural Payroll Employment (000)

	Peak	Trough	Absolute	%
	Mar-01	Aug-03	Change	Change
Metropolitan Area				
Los Angeles	4,115.4	4,000.1	-115.3	-2.8%
Orange County	1,422.6	1,405.6	-17.0	-1.2%
San Diego	1,215.1	1,231.6	16.5	1.4%
Riverside	1,023.2	1,074.4	51.2	5.0%
Ventura	279.9	273.1	-6.9	-2.5%
Total Major Southern CA Markets	8,056.2	7,984.8	-71.4	-0.9%
Sacramento	727.9	739.1	11.2	1.5%
Fresno	303.6	317.6	14.0	4.6%
Bakersfield	201.0	206.2	5.2	2.6%
Stockton	190.7	193.2	2.5	1.3%
Modesto	148.9	150.4	1.5	1.0%
Total Major Central Valley Markets	1,572.1	1,606.5	34.4	2.2%
San Francisco	1,089.6	966.8	-122.8	-11.3%
Oakland	1,068.3	1,040.0	-28.2	-2.6%
San Jose	1,045.6	862.2	-183.5	-17.5%
Total Major Bay Area Markets	3,203.5	2,869.0	-334.5	-10.4%
Santa Rosa	190.7	183.6	-7.1	-3.7%
Vallejo	177.4	182.2	4.7	2.7%
Santa Barbara	166.5	164.6	-1.9	-1.1%
Salinas	131.9	130.0	-1.9	-1.5%
Total Other Major Markets	666.5	660.4	-6.1	-0.9%
Total Major Markets Excl. Bay Area	10,294.9	10,251.7	-43.2	-0.4%

Sources: California EDD, seasonally adjusted by RCG (X-11).

The major cause of California's fiscal crisis was that the NASDAQ bubble and IPO and venture capital boom of the late 1990s produced an unsustainable rise in tax revenue. Table III shows the details of California's revenue by category from 1995 to 2003, with a projection for 2004. The personal income tax revenue demonstrates sharp volatility, primarily because of a surge and then a decline in tax revenue from capital gains and stock options.

Revenue from capital gains and stock options taxes combined for an average of \$3 billion to \$4 billion annually during the mid-1990s, rose to \$7.5 billion in 1998, \$14.7 billion in 1999 and finally \$17.9 billion in 2000. As the stock market bubble burst, these revenues dropped to \$6.1 billion in 2001 and \$5.0 billion in 2002, with a slight increase to \$5.3 billion in 2003. **If we use \$5 billion per year as the baseline number, the state generated a cumulative revenue windfall of more than \$26 billion since 1998 because of the unsustainable stock market bubble.** See Figure I for the history of the major revenue sources.

In contrast, the sales and use tax rose steadily with a slowdown but no decline during the 2001 to 2002 recession. Corporate taxes were flat, with a small increase in 2000 and 2001 and a small decline in 2002 and 2003.

Spending: Sharp Spending Growth Geared to an Unsustainable Revenue Base

Spending adjusted upward as state elected officials (both executive and legislative) treated the windfall as permanent. The revenue windfall was spent in 2000, as state spending increased 15% in that year, and the state budget still showed a \$3.5 billion surplus. By 2001, revenues were beginning to drop but spending rose another 13%, pushing the budget into a \$2.4 billion deficit. See Figure II for the history of the major expenditure categories.

Note that our data include only the General Fund, excluding Special Funds expenditures. This method provides us with the most accurate picture of California's current fiscal health because special fund revenues are earmarked.

Table IV shows detailed state government expenditures by broad expenditure category. A comparison of 1999 expenditure with 2001 expenditure shows that spending on K-12 education rose \$5.6 billion; health expenditures rose \$2.5 billion; higher education spending rose \$1.8 billion; criminal justice (prisons, etc.) rose \$1.3 billion; general government expenditures rose

\$4.8 billion; and other expenditures, such as transportation and environmental protection, rose \$3.3 billion. The general government category includes the legislature, the Franchise Tax Board, the Board of Equalization, the Department of Finance and other state agencies. Except for general government and transportation and environment spending, the recipients of the windfall in revenues were the state's students and its poor and needy citizens.

Unfortunately, state spending in 2002 and 2003 remained at these new, high levels based on the revenue expectation of 1999 through 2001. But this spending was not matched by tax revenues, which began to shrink in 2001 because of the bursting stock market bubble. Thus, the cumulative state budget deficit of approximately \$30 billion resulted. In short, the surge in temporary revenue in 1999 and 2000 was built into the budget and then spent in 2000 to 2003.

Several additional items have exacerbated this revenue gap. The expenditures associated with the energy crisis were initially passed through the state budget and amortized through the use of energy bonds. Also, some state taxes and fees were cut. State income taxes were cut in 1995, reducing the top tax bracket from 11% to 9%, resulting in an estimated state revenue loss of \$2.7 billion during the current fiscal year. The car license tax was reduced from 2.0% to 0.65% in 1998, producing a revenue loss of \$3.8 billion in 2003, and a cumulative \$11.9 billion since 1998.

If all spending categories were kept at their trend rate of growth, in line with the state's GSP growth, then we can account for \$24.3 billion in expenditures that should not have been made since 1998. During the last two years, the deviation of actual state expenditures from an historically precedented baseline of about 8% annual growth is a cumulative \$9.6 billion.

During the past two years, the spending increases (in excess of a trend baseline), the income tax cut, and the vehicle license fee cut amount to about \$23.6 billion of the cumulative \$30 billion deficit. The balance has resulted from revenue declines. Note that the largest one-year revenue decline occurred during the fiscal year ended in June 2002 (more than a year ago). During that one-year period alone, personal income tax revenue declined \$12 billion.

Structural Issues: Propositions 13 and 98 Create a Permanent Imbalance

Although the immediate crisis resulted from cyclical causes (the surge in spending and drop in tax revenues due to tax cuts and reductions in revenue from capital gains and stock options gains), several structural issues also fundamentally undermined

Figure I: California Revenue by Category

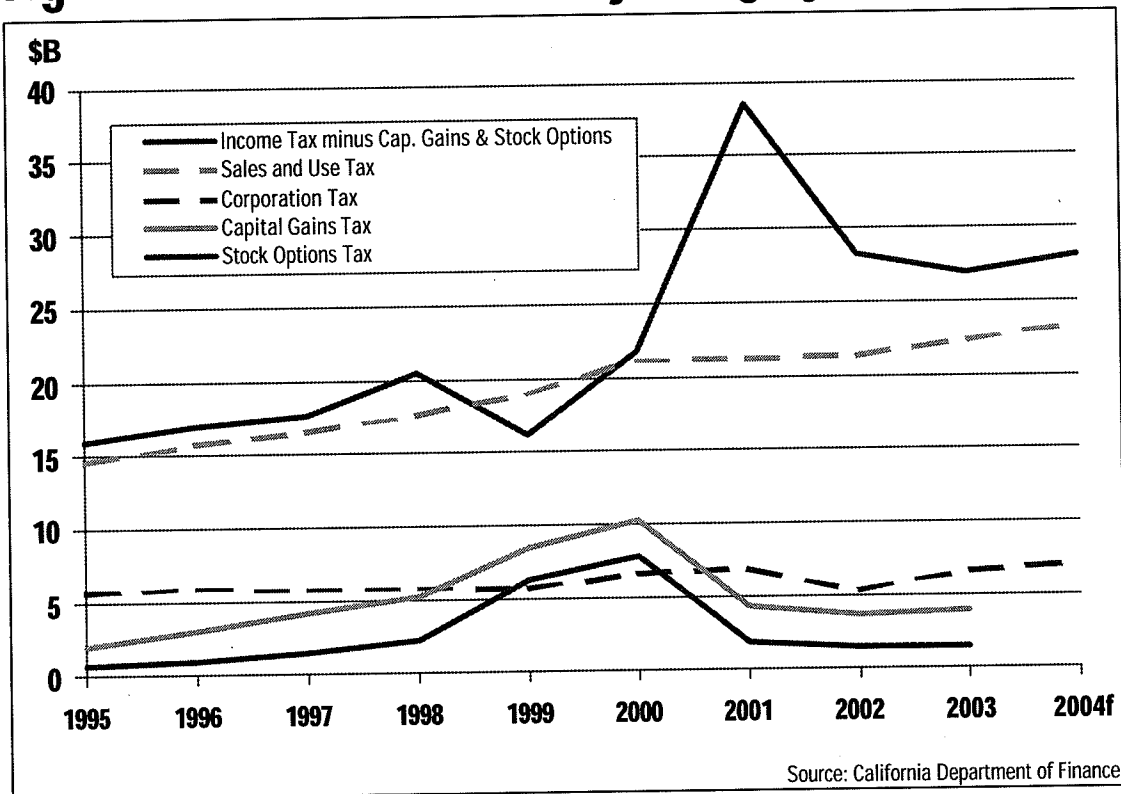


Table III: California Revenue by Category, 1995-2004f (\$B)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004f
Sales and Use Tax	14.6	15.8	16.6	17.6	19.0	21.1	21.3	21.4	22.4	23.5
% change		7.7%	5.2%	6.1%	7.8%	11.5%	0.8%	0.5%	4.7%	4.9%
Personal Income Tax	18.5	20.9	23.3	27.9	30.9	39.6	44.6	33.0	32.1	33.5
% change		12.8%	11.5%	20.0%	10.6%	28.1%	12.7%	-26.0%	-2.7%	4.4%
Capital Gains Tax	1.9	3.0	4.2	5.2	8.4	10.3	4.3	3.6	3.9	-
% change		58.3%	38.9%	24.4%	61.2%	22.6%	-57.9%	-16.7%	7.5%	-
Stock Options Tax	0.7	1.0	1.4	2.3	6.3	7.7	1.8	1.4	1.4	-
% change		38.0%	39.4%	68.4%	173.4%	21.4%	-76.5%	-25.0%	0.0%	-
Corporation Tax	5.7	5.9	5.8	5.8	5.7	6.6	6.9	5.3	6.7	7.1
% change		2.7%	-1.3%	0.9%	-1.9%	16.0%	3.9%	-23.2%	26.4%	6.0%
Other	2.1	2.3	2.3	2.5	2.6	2.7	2.9	3.0	3.0	2.7
% change		8.7%	-0.2%	8.0%	4.4%	1.9%	7.1%	3.9%	0.5%	-9.4%
TOTAL General Fund (major sources)	38.8	42.5	45.6	51.3	55.6	67.4	72.8	59.7	61.2	64.1
% change		9.4%	7.4%	12.5%	8.2%	21.2%	8.1%	-18.0%	2.5%	4.7%
TOTAL General Fund (all sources)	41.0	44.8	48.0	53.9	58.2	70.0	75.7	62.7	64.2	66.8
% change		9.4%	7.0%	12.3%	8.1%	20.3%	8.1%	-17.2%	2.4%	4.1%

Source: California Department of Finance

Figure II: California Expenditure by Category

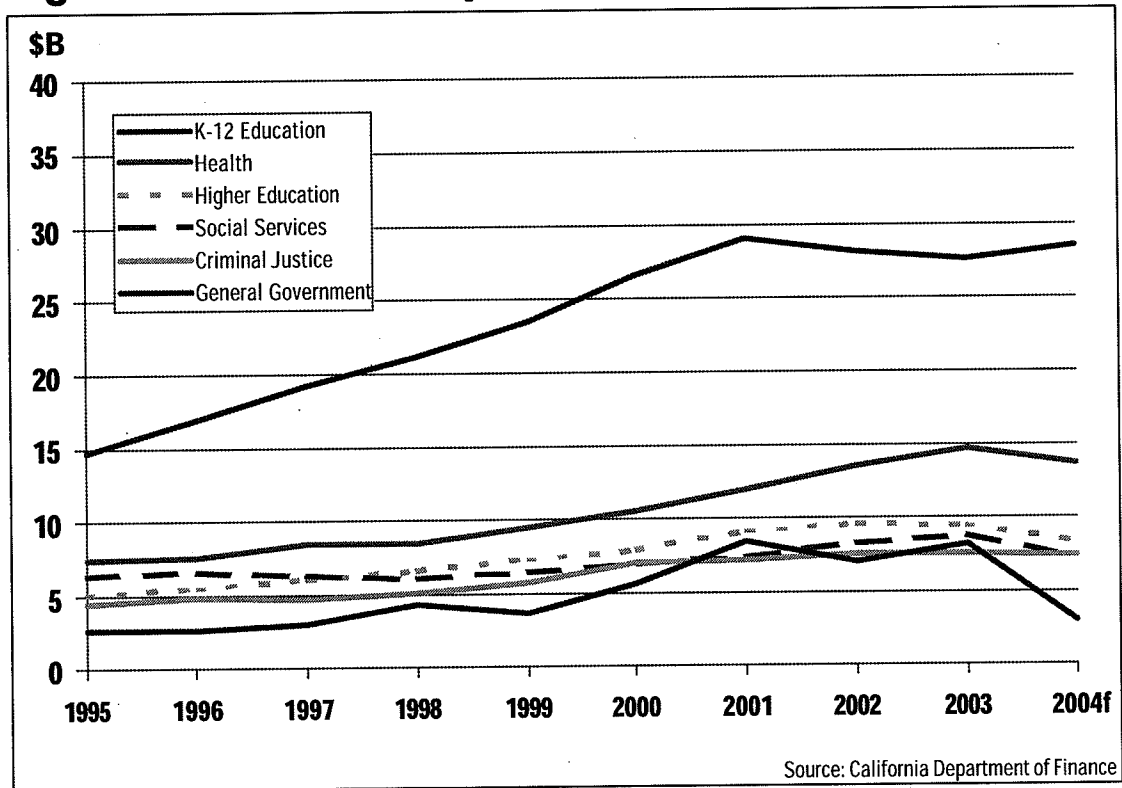


Table IV: California Expenditure by Category, 1995-2004f (\$B)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004f
K-12 Education	14.7	16.9	19.2	21.1	23.4	26.6	29.0	28.2	27.7	28.5
% change		15.2%	13.7%	9.8%	10.6%	13.7%	9.1%	-2.8%	-1.8%	2.9%
Health	7.5	7.6	8.4	8.4	9.5	10.5	12.0	13.5	14.6	13.7
% change		1.1%	10.5%	0.1%	13.0%	10.1%	14.4%	12.5%	8.1%	-6.2%
Higher Education	5.1	5.5	6.2	6.6	7.4	8.0	9.2	9.7	9.5	8.3
% change		8.5%	12.0%	7.2%	12.6%	8.4%	14.3%	5.4%	-2.1%	-12.6%
Criminal Justice	4.5	4.8	4.7	5.1	5.8	7.0	7.1	7.6	7.6	7.5
% change		8.6%	-2.0%	6.6%	14.5%	21.6%	1.0%	7.0%	0.0%	-1.3%
Social Services	6.4	6.6	6.4	6.2	6.5	7.0	7.5	8.3	8.8	7.4
% change		3.5%	-3.2%	-3.4%	5.4%	7.7%	6.9%	10.7%	6.0%	-15.9%
General Government	2.7	2.7	3.0	4.4	3.6	5.6	8.4	7.0	8.2	3.0
% change		-0.7%	9.1%	47.7%	-17.6%	55.1%	49.4%	-16.7%	17.1%	-63.4%
Other	1.1	0.8	0.8	0.9	1.0	1.1	4.4	2.1	1.6	2.4
% change		-25.3%	6.3%	3.5%	16.2%	8.0%	303.0%	-51.7%	-26.9%	52.3%
TOTAL General Fund (major categories)	40.9	44.6	48.2	52.0	56.8	65.4	73.7	74.6	76.5	68.1
% change		9.0%	8.2%	7.8%	9.3%	15.1%	12.6%	1.3%	2.5%	-11.0%
TOTAL General Fund (all categories)	42.0	45.4	49.1	52.9	57.8	66.5	78.1	76.8	78.1	70.4
% change		8.2%	8.1%	7.7%	9.4%	15.0%	17.4%	-1.7%	1.7%	-9.8%

Source: California Department of Finance

California's fiscal position. The main issue concerns Proposition 13, passed in 1978, which limits the tax revenue that can be raised from residential and commercial real estate—the predominant source of revenue for local expenditures on education in the rest of the United States.

As a result of Proposition 13's passage in 1978, **the state has been forced to rely increasingly on more volatile general revenue sources (income, corporation and sales taxes)** to support state expenditure, including public education. See Table V for more details. In addition, Proposition 98, passed in 1998, virtually locks in the proportion of the state budget spent on K-12 education based on a formula tied to the base year, inflation and the growth in student enrollment.

These two voter-initiated propositions set up the structural basis that underlies the state fiscal crisis: a greater reliance on cyclically volatile revenue sources (income, corporation and sales taxes) than on the cyclically more stable property tax; and, at the same time, virtually locking in the largest proportion of the state budget, that part devoted to K-12 education. Other major portions of the budget are also locked in statutorily.

Government Employment: California Compares Favorably

There is a general perception that Californians are not only over-taxed, but that they also have too many government employees. Table VI shows that while state government employment has grown rapidly during the past three years, **California is still on the low end of state employees per capita**. Only Florida and Pennsylvania, among the nation's ten largest states, have fewer employees per capita than California.

Tax Burden and Tax Structure: California's Tax Rate is in the Middle Among Large States

Contrary to popular perception, the tax burden in California has fallen dramatically since the 1978 passage of Proposition 13. State and local taxes as a share of gross state product have

Table V: Property Tax as a Percentage of Total Tax, 2000

State	Property Tax as a % of Total Tax	Other Tax as a % of Total Tax	Total Tax (\$M)
California	25.6%	74.4%	\$113,176
Other Large States			
New York	39.5%	60.5%	\$69,030
Texas	43.9%	56.1%	\$49,111
Florida	37.7%	62.3%	\$40,047
Illinois	40.6%	59.4%	\$38,436
Pennsylvania	32.3%	67.7%	\$33,224
Ohio	33.7%	66.3%	\$29,713
New Jersey	46.7%	53.3%	\$34,109
Michigan	30.6%	69.4%	\$32,855
Georgia	32.1%	67.9%	\$20,012
United States	33.2%	66.8%	\$810,811
Nearby States			
Nevada	29.40%	70.60%	\$5,319
Oregon	33.40%	66.60%	\$8,953
Arizona	34.30%	65.70%	\$12,414
Colorado	36.60%	63.40%	\$11,224
Washington	31.80%	68.20%	\$18,492

Sources: US Census Bureau, US Department of Commerce, BEA

dropped from 10.2% in 1978 to 8.5% in 2000. Of the ten largest states, five have total tax rates lower than California's, and four have total tax rates equal to or greater than California's. As Table VII shows, California's tax burden is about the same as New York's, Florida's and Illinois', but much lower than New Jersey's and Michigan's.

However, California's tax burden is slightly higher than that of four out of five neighboring states that are considered its economic rivals. But those states are small, with the cumulative tax revenue for all five states totaling less than one-half of the California total. Many of those states, with a smaller and more homogeneous population base, just do

not have the same issues and problems faced by the state government in California. We think a better comparison is with the other large states.

The dramatic shift in California's tax structure since 1978 is shown in Figure III. California derived 17.3% of its revenue from personal income taxes in 1978 but derives 40% of its revenue from that source today. In contrast, property taxes account for only 30% of revenue today, versus 59% in 1978, pre-Proposition 13. As Table VIII shows, personal income tax revenue grew at more than 10% per year during the last 25 years, while property taxes grew at 3.4% annually, far below the nominal gain in California's GSP, or the market valuation of its real estate.

How Balance Could Have Occurred

Suppose that a mechanism were in place to produce a "planning revenue" estimate by subtracting from actual revenue the excess of capital gains and options revenue (over \$5 billion). Suppose further that this planning revenue discipline had been sufficient to restrain spending growth in the 1999 to 2003 period to its historic rate of 8.3% (1995 to 1999). Then the cumulative deficit would have been \$7.2 billion at the end of the fiscal year ended in June 2003.

If in addition the vehicle license fee (VLF) decline enacted in 1998 had been immediately reversed, the cumulative incremental revenue from the VLF would have been \$11.9 billion. These

Table VI: State Government Employment Per Capita, 21 Ten Largest States in Terms of Gross State Product

State	Gov't Empl. (000s)	Gov't Empl. per 1M Residents	CAGR, 1999-2002
Florida	208.5	12.5	0.2%
Pennsylvania	160.2	13.0	2.9%
California	472.0	13.4	3.3%
Illinois	168.9	13.4	0.9%
New York	267.0	13.9	1.0%
Ohio	164.1	14.4	0.0%
Texas	341.2	15.7	1.6%
New Jersey	140.7	16.4	1.8%
Michigan	172.5	17.2	0.7%
Georgia	152.1	17.8	0.2%

Sources: Department of Labor, US Census Bureau

Table VII: Total Tax as a Percentage of Gross State Product (GSP), 2000

State	Total Tax (\$M)	GSP (\$M)	Total Tax as % of GSP
California	\$113,176	\$1,330,025	8.5%
Other Large States			
Michigan	\$32,854,531	\$323,717	10.1%
New Jersey	\$34,109,394	\$357,453	9.5%
New York	\$69,030,166	\$798,382	8.6%
Florida	\$40,047,378	\$471,623	8.5%
Pennsylvania	\$33,223,962	\$399,488	8.3%
Illinois	\$38,436,359	\$466,312	8.2%
Ohio	\$29,713,257	\$370,617	8.0%
Georgia	\$20,011,679	\$295,539	6.8%
Texas	\$49,111,004	\$738,270	6.7%
<i>United States</i>	<i>\$810,811,234</i>	<i>\$9,891,187</i>	<i>8.2%</i>
Nearby States			
Washington	\$18,492,439	\$218,095	8.5%
Arizona	\$12,413,796	\$153,469	8.1%
Oregon	\$8,952,990	\$121,383	7.4%
Nevada	\$5,318,524	\$75,533	7.0%
Colorado	\$11,223,558	\$169,341	6.6%

Sources: US Census Bureau, US Department of Commerce, BEA

Figure III: California State Revenue, 1978 versus 2000

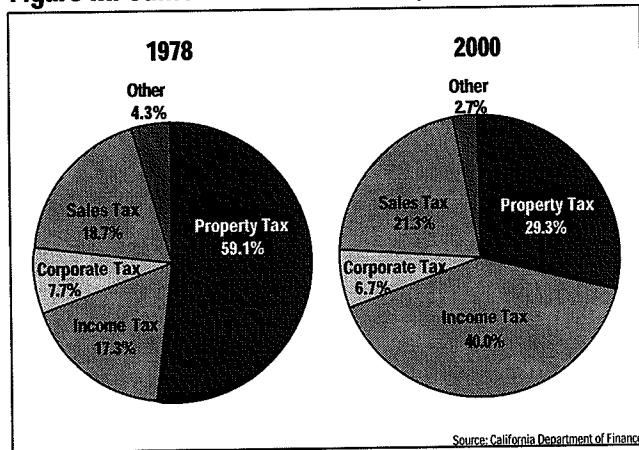


Table VIII: California Revenue by Category, 1978 versus 2000

	\$B (current)			As % of total tax		As % of pers. income		As % of GSP	
	1978	2000	CAGR	1978	2000	1978	2000	1978	2000
Income Tax	4.7	39.6	10.2%	17.3%	40.0%	2.1%	3.9%	1.8%	2.9%
Corporate Tax	2.1	6.6	5.4%	7.7%	6.7%	0.9%	0.7%	0.8%	0.5%
Sales/Use Tax	5.0	21.1	6.7%	18.7%	21.3%	2.3%	2.1%	1.9%	1.6%
Other Tax	1.2	2.7	3.8%	4.3%	2.7%	0.5%	0.3%	0.4%	0.2%
Total Non-Property Tax	13.0	70.0	8.0%	48.1%	70.7%	5.9%	6.9%	4.9%	5.2%
Property Tax	14.0	29.0	3.4%	51.9%	29.3%	6.4%	2.9%	5.3%	2.2%
TOTAL	26.9	99.0	6.1%	100.0%	100.0%	12.3%	9.8%	10.2%	7.4%

Source: California Department of Finance

three elements, a planning revenue mechanism, restraint on spending to its historic growth as a result of the planning revenue mechanism, and a repeal of the VLF fee decline, would have resulted in a \$4.7 billion surplus. Spending growth of 8.3% is not a draconian rate in any event. The state should have been able to meet the education, health, justice and other needs of its citizens with spending increases in the 8.3% per year range. And, given the actual revenue that came in, together with what would have come in with the repealed VLF cut, the budget would now be in surplus.

Conclusions

1. Among large states, California does not stand out as a particularly high tax state. In fact the total state and local tax burden in California has fallen sharply since the enactment of Proposition 13 in 1978.

2. Among large states, California does not have a heavy burden of state employees per capita.

3. California's economy overall is doing marginally better than the US economy. California's economy is not the poor performer compared with the rest of the country that some would have us believe. The fact is, the entire nation is not performing very well.

4. In fact, after mirroring the US economy for many years, California's economy during the period in which the budget crisis developed actually performed marginally better than the nation's. This result is inconsistent with the story that California's jobs picture has worsened relative to the United States, and is the main, or only, cause of the budget problems.

5. California's tax and regulatory environment is not the primary cause of its economic problems. Although workmen's compensation and other pro-business reforms are important to enhance California's attractiveness to employers, the fact that California's employment growth moves nearly in lock step with the nation's belies the claims that tax and regulatory policies in the state are damaging the state's employment prospects.

6. California's fiscal problems have a cyclical and a structural component. From a cyclical standpoint, there was a strong upswing in tax revenues during the high tech Internet boom, which could not be sustained. However, rather than treating these revenues as temporary, state officials treated them as permanent, using them to support increased expenditures or to finance tax and fee cuts.

7. The structural problem is related to Proposition 13, which shifted state and local tax revenue away from property

taxes toward more cyclically volatile income, corporation and sales taxes. In addition, Proposition 98 virtually locked in the largest single chunk of state spending, K-12 education.

8. We propose the following policy prescriptions to deal with California's budget problems in the future.

At the present time, the only way to address the current budget deficit is to increase taxes or decrease expenditure growth, recognizing that much of the expenditure side of the budget is determined statutorily. The one time boom in receipts from capital gain taxes and stock option taxes is not going to reoccur. There is no other choice but to rightsize California government either through boosting revenue or cutting expenditure growth.

If one-time revenue gains appear in the future, they should be regarded as temporary and spent on capital projects, or saved in a "rainy day fund," or given back to tax payers as a one-time tax rebate--not a permanent cut in the tax rate.

The state budget should be constructed on a "normalized" revenue base that corrects for large swings in capital gains revenue, both positive and negative, to help match stable expenditure streams with more volatile revenue streams. This procedure would help to prevent gearing expenditures to ephemeral revenue sources.

In the longer term, Proposition 13 should be updated. One simple fix might be to change the annual allowed maximum increase in assessed value to, say, 5% per year from 2% per year. Another possibility would be a different treatment of commercial and residential real estate. A complete relook at Proposition 13 would be essential from both an equity and a revenue standpoint.

However, if Californians do not wish to tamper with Proposition 13, then the state should build a "rainy day fund" of \$5 billion to \$10 billion. This fund could be used to even out the revenue flows from the highly cyclical tax base that has resulted as an unintended consequence of Proposition 13.

Wrongly blaming the economy, high tax rates, or too large a government will not solve the real budget issues facing California. Those criticisms of California simply do not stand up under close scrutiny of the facts and figures. It will take some imagination on the part of our elected officials to correctly diagnose the problems, the outlines of which are set forth here, and then to design detailed measures akin to those proposed here to deal with the real issues.