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Abstract

California's current budget process fails to accomplish any of the goals a budget should. It does not maintain aggregate fiscal control. The budget fails to achieve allocative efficiency by targeting resources to programs that address the sectors of the state economy that would most benefit from additional resources. In addition, the budget is frequently tardy. A Constitutional Convention could fix these problems.

KEYWORDS: budget, constitutional convention, taxes, policy

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California's Once and Future Budget Crisis: No Country for Old Men . . . Or Young Mothers, Sick Children, or Even Otters

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To solve California's current budget crisis, to avoid repeat fiscal disasters, and to make California's government more effective, we need a constitutional convention to change how California does business. The summit's goals in a nutshell? It would be to trade the establishment of a real spending cap, in return for eliminating the ⅔ requirements for budgets and taxes, as well as to restrict the scope of future ballot initiatives to exclude budget appropriations and revenue restrictions. With such a deal in place, the state would be able to get some additional financing to cover some of the short- and medium-term needs, as it worked out its long-term solvency. So, what are the arguments?

Background

First, it is important to recognize that California doesn't just have a large deficit; it is currently failing to accomplish most of the purposes of an effective budget process. The first goal of a budget is to maintain aggregate fiscal control. Taxes should be sufficient to cover the spending a state does, while also considering current and future macro-economic conditions. Next, an effective budget process enables participants to choose which programs to fund, given that the programs target different sectors of the state economy. The goal is to allocate resources to those programs and projects—choosing among health care, education, the environment, and agriculture—that would most benefit from the resources and offer the greatest benefit for the state (Campos and Pradhan 1996; Schick 1998; Miller, et. al. 2001). Finally, in assessing how well a state accomplishes its budgetary objectives, we might also consider how timely the budget process is in meeting its annual deadline.

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In its budget process, California has failed to accomplish these goals. The first budget goal, to control gross spending should not be a problem—California already has caps on spending—and yet it is. Proposition 4, from 1979, ostensibly limited the growth in spending to equal the previous year's appropriations, as adjusted for changes in the cost of living and population. Later, in 2004, Proposition 58 expanded this authority to require that the legislature may not pass, nor the governor sign a budget bill that authorized expenditures greater than the estimated resources. In addition, California also has a line item veto for the governor. It even has a "special fund for economic uncertainties," and it has a budget stabilization fund. Yet here we are in this budget mess.

Why have none of these measures proved effective? First, citizen budget initiatives authorized new spending. Voters could authorize new spending and new bond measures at any time, which no elected official could alter. Second, the legislature was permitted to spend any surplus funds carried over from previous years. Funds could be moved into the General Fund for spending, rather than into a rainy day fund. Conversely, the legislature could carry over the previous year's deficit, without counting this legacy as a budget year obligation. Finally, budgeteers were able to use gimmicks to satisfy the constitutional balanced budget requirements: in particular, they were able to count borrowing as a way to overcome the pesky differences between revenues and expenditures.

For the second budget goal, how has California done in allocating funding in order to budget for priorities? Not well. To start with, recall two facts about the California budget process. According to the National Association of Stated Budget Officers (2002), California is one of the very few states that require a supermajority for creating a budget and raising taxes. Arkansas and Rhode Island also have such requirements; however, Arkansas has a biennial budget process, so they have an additional year to negotiate. Second, California has something that Rhode Island does not have—a wide open initiative and referendum process. California's form of direct democracy requires that only one subject be included in each initiative, but otherwise there are no restrictions on subject matter.

The consequence is that the legislature does not get to compare and evaluate some budget priorities against others. The voters may use an initiative to require that 40% of the budget be allocated to education and the legislature is unable to adjust that. Or the voters may say that physical fitness, universal preschooling, or stem cell research be funded, and the legislature cannot weigh those needs against others. In addition, any budget must receive a supermajority; this puts a greater premium on status quo spending.

As a result, the legislature is unable to ever achieve the goal of allocative efficiency. Likewise, neither can the voters: even if they were willing to invest the time in fiscal analysis, using the initiative process, they can only judge one budget

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item at a time, so they cannot consider the relative importance of a budget item. Certainly, more funding for after-school care is important, but is it more important than increased healthy family insurance funding? The initiative system does not let voters make that determination.

Moreover, taxes are highly controlled through Proposition 13, and as a result, the mix of taxes is inefficient. Taxes are weighted toward income taxes and those “fees” that might escape the requirements of the ⅔ vote. Moreover, the legislature cannot readily choose to tax business property based on the value of the property. Instead, Prop. 13 requires that even commercial enterprises must be taxed based primarily on their value at the time of the purchase of the property. In general, the mix of taxes is not well balanced to capture the different parts of the economy nor do current taxes compensate for changing economic conditions.

Proposal

To overcome our budget crisis and establish a more effective budget process, all the participants need to make compromises. That means a new constitutional cap on spending; like the existing caps, but without the loopholes. A constitutional convention would create a schedule of annual hard budget caps, decreasing over a 10-year period, to control spending. Funding would be set aside for fiscal emergencies, as well as for debt repayment. The specific final cap might be 20% or 30% of the gross state product. Regardless, what is important is that there be an assurance for the markets and creditors. The hard budget caps build in a stable process and establish funding certainties over the long term.

The two categories of loopholes or gimmicks that undermine budget controls are those that impact expenditures and revenues. To start with, on the expenditure side (see Table 1), the legislature would have to use prior year surpluses for a rainy day fund or to repay prior years’ debt. Only certain programs would be eligible to withdraw funds from the rainy day fund. Other programs would have to rely on supplemental appropriations.

To adjudicate when conflicts emerge, an independent board would act as referee, to review budget proposals to ensure that no gimmicks are used. It might be configured as a panel of retired judges, as proposed in Prop. 77 or it may reflect an appointed bipartisan commission as enacted in Prop. 11 (both used to reform redistricting). Members of the legislature or the governor’s office would be able to challenge legislation and budget proposals, referring contested proposals to the board.

Table 1. Expenditure Gimmicks and Loopholes

Gimmick/Loophole	Problem	Solution
Entitlement program cost projections	Out-year expenses are subject to manipulation; legislative proposals affect timing of obligations; cost estimation is difficult	Instead of auto-pilot program spending, rely on annual and supplemental appropriations and rainy day fund
Delayed payments	Paying vendors and moving payroll expenses to the next fiscal year. Obligations unchanged, only timing of outlays	Require 5 year spending projections, as well as annual projections, to be in balance
Emergency Appropriations	Certain expenses are not counted against the cap.	Do not use any off-budget spending.
Authorizing legislation scoring	Bills that do not appropriate but implicitly increase expected obligations, like required salary increases or overtime pay for state employees	Required balance for 5 year plan and legislative scoring that captures full impacts (reconciliation). For budget year, use across-the-board sequester if outlays exceeds cap.
Cap size determination	Gross state product is based on projections of future economic conditions	For cap target, rely on current year estimates, rather than budget year.
Other potential gimmicks, directed scoring, magic asterisks, etc.	Speculative or partisan legislative drafting and/or scoring, or which seems aimed at avoiding caps	Use of external referee. Point of order to refer budget measure to external panel

Finally, as a way to compensate for any failures to achieve the expenditure target, the program would rely on across-the-board sequesters. This backstop is similar to the way that the federal 1990 Budget Enforcement Act operates.

Note that, for a hard budget cap to operate, voters would not be able to impose new spending on the budget process. In Colorado, a voter initiated constitutional amendment that restricted taxes and spending, the Taxpayer's Bill of Rights (TABOR), became untenable after the combination of a new voter initiative that mandated increased educational funding (Prop. 23) and an economic downturn. As a result, the voters opted to put TABOR "on hold" for five years (New and Slivinski 2005; Roberts and Resnick 2008).

Controlling loopholes on the revenue side—taxes, fees, and receipts—is only relevant as a way to avoid deficit spending (see Table 2). Because there are no limitations on taxes, only on expenditures, there is no encouragement for the legislature to evade a limitation by redefining certain receipts as "fees," rather than "taxes." The legislature's goal would be simply to generate revenues sufficient to cover the planned spending (defined by the cap).

However, the legislature might still avoid imposing taxes or continue to routinely seek new borrowing. The failure to generate sufficient revenues to accommodate the spending plans would automatically trigger revenue enhancements; the nature of which must be determined in advance. These might be fees or taxes, whether sales, income, or a gas tax increase.

While conservatives would be pleased to see government spending limited, there is a price for this concession. In return for an era of smaller government, the ⅔ requirement for budgets and taxation must be eliminated. The current budget process fails to complete a budget in a timely fashion. It lets a minority of the legislature exert far greater influence than their numbers. If the majority is forced to live within tighter constraints, the minority should be willing to let them fund their priorities.

In addition, restrictions on taxation should be dropped. When there are real restrictions on spending, the purpose of taxation is to collect only enough revenue to fund that spending, as well as emergencies and unexpected financial downturns. The legislature needs flexibility to adjust the types of taxes and rates, which the supermajority requirement undoes. Conservatives should not fear that flexibility will result in raising taxes—without the ability to spend additional funds collected, the power to tax is an unappealing authority.

To accomplish the budgeting goal of allocating resources effectively, by viewing the economy in a holistic fashion, voters must also be part of the deal. If resources are limited, the state must be able to compare the needs of different sectors of the state economy and allocate resources where they are most needed. To accomplish this objective, voters cannot be allowed to appropriate funds or otherwise restrict

Table 2. Revenue Gimmicks and Loopholes		
Gimmick/Loophole	**Problem**	**Solution**
Economic projections	Revenues are dependent on economic assumptions; risks from ‘rosy scenario’ or inflated projections	Rely on average of blue-chip economists for projections.
Borrowing as revenue	Frequent use of bond sales as a revenue source	Permitted, except the expenditure cap is not affected
Untenable or unrealistic proposed revenues	Expected savings are unrealistic (e.g., a proposal requires federal approval)	Required to achieve a revenue target to pay for spending and rainy day fund expenses. Review by external referee; failure triggers end-of-year fee or tax increase
Sale of property and lease back	Use of 1 time options with negative long-term implications	Require 5-year revenue projections to reflect cap and rainy-day fund needs

legislators from making spending or revenue choices. According to the National Conference of State Legislatures (2009), 12 states have some form of restrictions on revenue measures and appropriations for initiatives, making this provision the most common initiative constraint, along with the single subject requirement. The California Constitution henceforth would need to restrict the initiative process so that representatives, not voters, determine specific program funding and revenue trade-offs.

Voters would have considerable direct democracy authority remaining. First, should voters want more state spending; they could have the option to increase the aggregate cap. Also, voters would still be able to react to specific nonbudgetary issues or those with a minimal cost, like requiring term limits, establishing new boards or commissions, decriminalizing marijuana, and requiring new laws on animal welfare. Voters would be able to “authorize” specific programs—that is, to indicate a preference for a certain type of program using the initiative process—just without specifying minimum spending levels.

What about a proposal like the three-strike law? While it does not explicitly require a set amount of spending, the financial implications of the legislation were sizable. In general, when voters are able to enact initiatives that commit new spending, the efficacy of expenditure caps will be undermined, as well as the budget's allocative efficiency.

Therefore, initiatives with significant budgetary implications cannot be put into law by the voters' actions. Instead, if passed by the voters, such an initiative would be put before the legislature (somewhat similar to an indirect initiative). The legislature would not have to enact the initiative. However, the failure of the legislature to enact it would require that all candidates explain their actions on the state voter guide for the next general election.

More directly, voters could propose local spending projects. By fixing an unintended consequence of Prop. 13, the convention could help return some authority to local governments. Local communities would be empowered to choose their taxation policies, without seeking the permission of state government for local spending. In response to the Serrano court decision, which restricted local spending, because it increased the disparity in education spending between richer and poorer school districts, local funding used for education (augmenting the current state-based funding) would be subject to a levy that allocated a share of the new spending to less well-off communities.

To avoid a free-for-all, any convention would need to establish clear ground rules that limit eligible reforms to a narrow arena. The convention would be chartered to focus on specific topics, with all other topics of reform excluded from consideration by the convention. For example, participants would not be eligible to introduce elements that impose an outcome; i.e., no debates on immigration, gay marriage, or abortion. Instead, the convention would only consider changes to how California decides on issues; i.e., a focus on reforming the processes of decision making. Therefore, the convention's rules of debate and amendment might include a "germaneness" test, such as is used for the federal government for budget reconciliation (the Byrd Rule).

Conclusion

There are several components of this plan that offer hope that it might work in limiting spending and establishing fiscal stability. First, it focuses controls on the expenditure side, not the revenue side, where prior experience indicates there has been greater success (Elder 1992; Kousser, et al. 2008). It addresses constitutional rules, which have been more effective, rather than relying on statutory measures alone to control spending (New 2001; New and Slivinski 2005). It controls auto-pilot spending and citizen initiatives, which would otherwise undermine spending caps (Ackerman 2009). Finally, it includes safety valves to allow the public to express their desire for particular spending provisions or for increased overall spending.

Republicans should rejoice at this general outcome. They would win a small government future. In return, Democrats get the flexibility to direct spending to where the majority prefer, rather than haggling with a minority of dedicated obstructionists. Budgets might even be passed on time. Taxes would become more flexible—enabling legislators to balance different types of taxes for different economic environments and to set tax rates so as to ensure a balanced budget. And voters would give their representatives the tools and the responsibility to do their jobs, without excessive interference from the initiative process. Voters could vote out of office representatives who fail to perform. They would not rely on initiatives for budgetary decision making. Maybe in giving representatives more responsibility, voters would also find their estimation of state politicians improving.

The goal of this proposal is not smaller government or lower taxes for itself. It is to create a stable state fiscal environment and increase the efficiency of the process. The existing budget process is incoherent, undisciplined, and ineffective. If we really want an improved state budget system, each of the different parties needs to give things up.

When my brother was young, he decided to combine two foods that he enjoyed—scrambled eggs and chocolate—into one dish. Not surprisingly, he got sick. Other people get sick from over-eating. California needs a better process to control what we consume.

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