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A Blueprint for Rebuilding California's Antiquated Fiscal Structure

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As we brace ourselves for the next round of salary reductions, furloughs, layoffs, service cuts, and benefit reductions in California, we look to the federal government and its stimulus funds to end the recession and turn our economy around. Our chronic budget deficits, however,

will not magically disappear as employment and incomes rise. As John Decker explains, California budget deficits are forecast to continue long after the recession ends. Even as tax revenues begin to grow, expenditure growth will continue to outpace them. These structural deficits are the result of tax and expenditure policies that have evolved over the last 20 years and the solution or prescription for recovery is going to require structural change.

Decker begins by describing the process of approving a state budget beginning with the governor's budget proposal released in January through to final passage of the budget bill; often well past the constitutionally set June 15 deadline. While the state constitution details the division of responsibility between the governor and legislature, most procedural aspects are determined informally by legislative customs believed to facilitate negotiation and minimize conflict.

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The annual budget cycle begins with the release of the governor's budget proposal in January. The first phase of review occurs from March to mid-May as the budget committees of each house appoint subcommittees that conduct reviews including public forums on the impact of the governor's proposed budget. In May, the governor is required by statute to provide a "May Revision" that contains revised revenue forecasts. Before the end of May subcommittee recommendations are considered by the full budget committee in each house and an amended budget bill is approved. The Assembly and Senate each submit their amended budget bills to the conference committee consisting of three members from each house that then negotiate with the governor's representative on a compromise bill that must be approved by a two-thirds majority in both houses and signed by the governor by June 15.

As Decker reports, the legislature has not passed a budget before the June 15 deadline since 1984, and only four budgets since 1991 have passed before the start of the fiscal year. He points out that the process may be a contributing factor as the bipartisan conference committee has only two weeks to develop an acceptable compromise.

With respect to the broader task of managing state finances, Decker argues that the budget is a very limited tool. The budget bill provides a list of appropriations but cannot be used to set policy. In fact, the state constitution prohibits the budget bill from containing statutory provi-

sions. Instead, these are included in trailer bills, which are not subject to the same level of review or scrutiny, and hence can lead to unintended consequences and poor fiscal policy.

The legislative budget process also limits the legislature's impact on fiscal policy. Budget deliberations are based on the governor's budget proposal and hence are reactionary. In addition, the subcommittee review that takes place from March 1 through the end of May involves no collaboration, so minority party members have no influence and the resulting document does not reflect bipartisan interests. Finally, after the subcommittees submit their proposals to the conference committee, it has only two weeks to develop an acceptable compromise.

The electorate plays a role in determining state and local fiscal policy via the initiative process. Decker provides a summary of the fiscal propositions approved by voters since California's landmark tax limitation measure, Proposition 13, passed in 1978. This process, however, cannot possibly deal with the myriad of complex fiscal issues that must be addressed, so the legislative and executive branches must resolve most aspects of fiscal policy outside the context of the state budget. In 2007–08, Decker reports, only 69% of the \$103 billion state budget was appropriated through the Budget Act, 23% was appropriated by statutory law, and the remainder by constitutional provisions or other means.

In Chapters 3 and 4 Decker reviews the pattern of state revenues and expenditures over the 10-year period from 1998–99 through 2007–08. On the revenue side, he provides an overview of the 2008 tax structure and traces its evolution since 1991, beginning with Governor Wilson's \$6.1 billion tax increase that was part of the negotiated 1991 budget deal. Income, sales, vehicle license, cigarette, and alcohol taxes were all increased, but 40% of these were temporary increases that expired in the mid 1990s. By 1996–97, only \$1.3 billion of additional taxes from 1991 were still ongoing, and they had been fully offset by 2003 by subsequent tax reductions.

California's largest revenue source is the personal income tax, providing 40% of state revenue. Subject to one of the most progressive income taxes in the country, Californians with incomes less than \$30,000 (56.3 percent of all taxpayers) pay less than 1% of income taxes while those with incomes of \$100,000 or more (13.6% of all taxpayers) pay 83% of income taxes. This makes the income tax a very volatile revenue source, as was evidenced in 2001 when wealthy taxpayers suffered large income losses, causing income tax revenues to plummet.

The sales tax is the state's second largest revenue source (24.5% of total revenue in 2008). Decker points out that this revenue source has been declining in importance as a result of the shift in consumption patterns from taxable goods to untaxed services. He reports that Cali-

fornian's devoted 65% of their consumption spending to taxable goods in 1945 and only 45% to services, but the shares had reversed by 2002.

After the tax cuts of 1991, the legislature struggled to balance a budget that was running large chronic deficits. Rapid growth in investment income in the late 1990s allowed the legislature to cut taxes by about \$16 billion, half of which was reduced car taxes. The remainder of the tax cuts went mostly to corporations via rate reductions and the Manufacturer's Investment Credit, and to families with dependents via increased dependent deductions from personal income taxes. Despite these cuts, income tax revenues grew almost 18% per year between 1996 and 2000. Since 2000 income tax revenues have been very volatile, falling by \$11.6 billion in 2001–02 when the capital gains boom ended.

On the expenditure side, Decker reports that general fund spending increased from \$58.8 billion in 1998–99 to almost \$104 billion in 2007–08, an average annual increase of roughly 5.9%. In 2007–08, the majority was spent on K-14 education (\$36.2 billion) followed by health and human services (\$29.4 billion), corrections (\$9.7 billion), and higher education (\$6.8) billion. Over the 10-year period, corrections was the fastest growing spending category (average annual rate of 11.2%), more than twice the rate of growth in either K-14 (4.3%) or higher education (4.8%). Medi-Cal spending increased at an average annual

rate of 8.1%, and debt service increased at a rate of 6.8% per year over the same period.

These established patterns of revenues and expenditures together with the complexity of the state budget and its development through consensus contribute to the difficulties of eliminating budget deficits. As Decker points out, most of the legislature's budget-balancing methods avoid the hard choices of cutting expenditures and/or raising taxes. Instead, they shift the cost to future taxpayers in the form of higher debt or off-budget gimmicks such as accelerating tax collections, deferring payments, borrowing from special funds, shifting local revenues, or changing accounting practices.

From 1996–97 to 1999–2000, state general fund revenues grew at an average annual rate of 13.4% fueled by the boom in capital gains. Even though expenditures grew at a more modest 10.6% over this period, the state's baseline spending increased through the expansion of existing programs and the addition of new ones. Tax payments on capital gains fell dramatically in 2001 while spending continued at high levels as no one anticipated the sudden drop in revenues. Even after the revenue decline became apparent, the legislature was unable to make the necessary adjustments to spending. California expenditures have exceeded revenues every year since 2000. State treasurer Bill Lockyer forecasts that state expenditures will exceed revenues by approximately 4% over the next 20 years

even assuming recovery to full employment and that by 2027–28 general fund revenues will fall short of operating expenditures and debt service by \$14.6 billion.

What is the solution to California's structural deficits? While many point the finger at our super-majority voting requirement for passage of a budget bill, Decker's research has found no statistical link between voting requirements and fiscal outcomes. Of five studies cited, two establish no link, two suggest that super majority requirements have reduced taxes, and one reports that the requirements have led to increased taxes.

Decker argues that the legislature needs to better exercise its fiscal authority through various institutional and procedural reforms. He recommends strengthening both fiscal management mechanisms and the policy and appropriations committees. He also suggests that budget outcomes could be improved by improving revenue and expenditure forecasts, establishing budget priorities, legislative consulting with the governor prior to his January budget proposal, and reducing the subcommittee review period, moving to an Oct. 1 fiscal year start date, and posting budget assessments and reviews.

While Decker is probably right that these changes will improve the budget process and result in better fiscal policy, we must recognize that our current state and local fiscal system is out of sync with economic reality. Given the current system, future revenues will be insufficient to

meet the growing demand for government services. The principal causes of the imbalance are both demographic and economic including more elderly, fewer children, and more immigrants as well as a growing service sector and increased globalization.

Income will eventually grow again leading to increased service demand, but the composition of income and consumer spending will change so as to erode the primary tax bases of state and local governments. Transfer payments to the elderly and other labor income in the form of employer contributions to pensions, workmen's compensation, and health insurance, most of which are nontaxable, will grow faster than taxable income. The growing elderly population will spend a larger proportion of income on health and other services that are exempt from most state and local sales taxes.

Technological advances pose several challenges for state and local revenue systems. New digital and online products and services are being developed that are not currently included in the sales tax base in most states. The most likely effect is erosion of the sales tax base and differential taxation of similar services such as land-line telephone service and internet telephony. The internet has also led to a rapid expansion in remote sales and the ability to avoid sales and use taxes through online purchases. This too leads to revenue losses and an increasingly regressive sales tax. Technological changes may also impact house-

hold and business location decisions by making remote locations feasible because of the opportunity to telecommute, elevating the importance of taxes in business location decisions.

Finally, industry deregulation and convergence, in the absence of tax reform have resulted in a tax system that discriminates between incumbents and new entrants and between competing technologies. Our tax system has traditionally placed heavier burdens on regulated industries such as electricity and telecommunications. With deregulation and technological change, new, competing services are available, but consumers and producers of these services are exempt from many of the taxes still levied on previously regulated services. Tax reform is needed to prevent revenue losses to state and local governments caused by a shift in demand toward the lower taxed services and to prevent our tax laws from adversely influencing the development of these new technologies.

These are just some of the problems with our existing tax structure. Changing demographics will also bring about significant changes on the expenditure side that need to be addressed outside the budgetary process. Our state and local fiscal system is out of date and inadequate for our 21st century economy, and substantial fiscal reform is needed.

In *California in the Balance*, Decker provides an insightful description of the state budgetary process and the

components of the state's fiscal structure: revenue streams, expenditure patterns, and debt commitments. He explains how the state developed a large and ongoing permanent deficit and recommends reforms to improve the budget process and achieve a balanced spending plan.

This book is a valuable read for anyone involved or interested in state and local government finance including economists, political scientists, policy makers, and the general public. It will be added to the reading list for my state and local finance students.

Erratum

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