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Managing California's Fiscal Roller Coaster

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by David Gamage

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This article is an edited version of remarks delivered at "Proposition 13 at 30: The Political, Economic, and Fiscal Impacts," a conference hosted by the Institute of Governmental Studies at the University of California, Berkeley, on June 6. The conference papers will be published in a forthcoming book.

When Proposition 13 passed in 1978, many commentators predicted disaster for California's state and local finances. Now, 30 years later, California is experiencing severe fiscal instability and a round of budget crises that has been worse than other states'.

It would be wrong to blame Proposition 13 for all of California's financial woes. Nevertheless, Proposition 13 is both an important component and a powerful symbol of California's flawed fiscal constitution.

The phrase "fiscal constitution" refers to the rules and processes whereby states and localities make decisions regarding taxes and spending. California's fiscal constitution consists of its initiative process as well as its legislative budgeting process.

Many commentators have critiqued California's fiscal constitution from ideological perspectives. From the vantage point of someone who wants higher taxes and spending, the problem lies with the restrictions imposed on raising revenue — such as Proposition 13's limits on property taxes. But from the perspective of someone who thinks taxes and spending are too high, the problem may lie with automatic spending programs or overspending during economic upturns, or in a disconnect between legislators' spending preferences and voters'.

This article attempts to navigate between those ideological perspectives to offer nonpartisan solutions to California's repeated budget crises. Regardless of one's preferences for levels of taxes and spending, state and local finances need to be managed in the face of political disagreement and changing economic conditions. Although liberals might view California as having a revenue problem, and conservatives a spending problem, everyone can agree that the disconnect between revenue and expenditures is a problem.

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Despite the predictions of some overly enthusiastic commentators, the Internet revolution of the 1990s did not eliminate the business cycle. As long as state economies cycle between booms and busts, states will face predictable uncertainty regarding future revenue. We can thus expect budget crises to be a regular feature of California's fiscal landscape in the coming decades. Those crises will likely be interspersed with periods of strong economic growth and revenue surpluses. But without dramatic changes to California's fiscal constitution, those growth periods will be only temporary calms between fiscal storms.

This article will begin by discussing the relationship between state budget crises and the business cycle, and why California's unique tax structure creates a worse fiscal roller coaster than in the other states. However, the focus of this article is on the manner in which California's fiscal constitution exacerbates its fiscal roller coaster problem. The article will present and analyze a number of alternatives for reforming California's fiscal constitution so as to ameliorate the dynamics that now lead to repeated budget crises.

The Role of the Business Cycle

Perhaps the most important cause of state budget crises is the ordinary workings of the business cycle. Unfortunately, the economic causes of the business cycle are not fully understood. Many of the most prominent theories involve elements of psychology and neoclassical economic reasoning. It seems likely that economic actors become overly optimistic about future prospects during upturns, leading to excess investment and inventory buildup, which ultimately creates the need for readjustments and cutbacks during economic downturns.

Whatever the underlying causes of business cycles, there is general recognition that business cycles exist and that they are likely to continue to exist for the foreseeable future. From the perspective of state fiscal management — rather than macroeconomic management — the most important features of the business cycle are its implications for taxes and spending programs. During economic downturns, tax revenue plummets just as the demand for many spending programs increases. The reverse happens during upturns: Revenue accumulates while the demand for spending programs decreases.

The shift from an upturn to a downturn can be abrupt, with profound consequences for state budgeting. For instance, California's general fund revenue grew 20 percent in 2000 — the final year of the Internet boom — only to fall by 17 percent in 2002.[1] Liberals and conservatives can argue about whether spending was too high in 2000 or too low in 2002, but it cannot be disputed that the budgets passed assuming a continuation of the economic conditions of the late 1990s proved a poor match for the conditions of the current decade.

With hindsight, it is easy to blame poor budgeting on shortsighted or irresponsible behavior by legislators or by forecasting staffs.[2] But that ignores the realities of the forecasting process.[3] Although many experts predicted the end of the tech boom, forecasters had no way of knowing exactly how long the boom would last. Indeed, there was no shortage of commentators proclaiming an end to the business cycle and arguing that the strong growth of the late 1990s would continue for decades.

Even if forecasters had been able to ignore the most optimistic projections, it isn't enough just to know that a boom will eventually end (or that a bubble will eventually burst). Forecasters need to make predictions yearly. Forecasters sometimes stress the uncertainty of their projections. But disclaimers and other means for conveying uncertainty are easy to ignore in favor of the hard numbers of the actual projections. Ultimately, state budget processes require hard numbers, and even uncertain numbers have a great deal of influence.

Unless economists or other scholars create new technologies for predicting the future course of state economies and budgets that are far superior to the methods we have today, states will continue to experience dramatic revenue swings as their economies cycle between booms and busts. The painful adjustments that states will need to make at the beginning of each downturn are the primary cause of budget crises.

The Role of California's Tax Base

California relies on income taxation as a proportion of its overall revenue more than almost any other state does, while relying on property taxation much less than the other states do. Proposition 13 is perhaps the most important cause of California's unique tax structure.[4] Property tax collections in California fell by over 50 percent following the enactment of Proposition 13 in 1978. The growth of property tax revenue in the last 30 years has been much slower in California than in the other states, while the growth of income tax collections has been considerably faster.[5]

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California's tax mix results in significantly greater fiscal volatility, because income tax revenue is among the most volatile of the major state funding sources while property tax revenue is among the least volatile. That greater volatility of California's revenue structure has led to California enjoying improved fiscal capacity during economic upturns, but it has also led to much more severe budget crises during economic downturns.

The defenders of Proposition 13 sometimes draw attention to the fact that it has decreased the volatility of California's property tax revenue.

[1] Jon David Vasche and Brad Williams, "Revenue Volatility in California," *State Tax Notes*, Apr. 4, 2005, p. 35, *Doc 2005-4744*, or *2005 STT 63-2*.

[2] There is some evidence that state forecasting is slightly biased in a politically motivated fashion, but this bias does not explain inaccurate forecasts of changing economic conditions. Richard T. Boylan, "Political Distortions in State Forecasts," *Public Choice*, April 2008.

[3] *See* National Association of State Budget Officers, "Budgeting Amid Fiscal Uncertainty: Ensuring Budget Stability by Focusing on the Long Run." 2004.

[4] Proposition 13 had three major components: it limited ad valorem property taxes to a maximum rate of 1 percent (with a few exceptions); it limited the rate at which the assessed value of property can increase for property tax purposes to 2 percent, even during periods when the real value of a property is increasing far more rapidly; and it imposed a two-thirds supermajority requirement on any legislatively enacted change to state taxes for the purpose of raising revenue.

[5] Public Policy Institute of California, "Fiscal Realities: Budget Tradeoffs in California Government," 2007, p. 26.

Because Proposition 13 limits the growth of appraised values for the purposes of property tax assessment even when market values are growing rapidly, most homeowners find that over time, their homes' appraised values are much lower than the market values. If market values later fall — as is now happening in California — homeowners will not see a reduction in their tax bills unless the market values fall to below the appraised values for property tax assessment. Hence, property tax revenue may continue growing even during periods of housing price declines.

> ***Although Proposition 13 reduces the volatility of California's property tax revenue, that effect is dwarfed by the greater volatility that has resulted from shifting California's tax base.***

Although Proposition 13 reduced the volatility of California's property tax revenue, that effect is dwarfed by the greater volatility that has resulted from shifting California's tax base away from property taxation and toward income taxation. Even in states without property tax limitations, property taxes remain one of the least volatile sources of revenue.[6] Moreover, whereas the other major sources of state revenue tends to rise and fall simultaneously, property tax revenue tends to follow their own course. Property tax revenue sometimes rises and falls with the overall state economy — as is now happening. But it is not uncommon for property tax revenues to continue rising while the state economy and its other revenue sources are entering a downturn — as occurred in 2001. Because of the greater stability of property taxes and their countercyclical tendencies, if California could increase its use of property taxation, the volatility of the state's revenue structure would be greatly reduced and budgetary crises would become both less common and less severe.

Another factor leading to greater fiscal volatility in California and thus to more severe budget crises during downturns is the state's relatively high reliance on capital gains taxation. California is one of only seven states that taxes capital gains at the same rates as ordinary income, and California derives a much higher percentage of its overall revenue from capital gains taxation than do most of the other states.[7] Over the last 30 years, capital gains have been five times more volatile than wages and salaries or than consumption. Hence, revenue from capital gains taxation is considerably more volatile than revenue from the taxation of ordinary income or sales taxes.

Some commentators have suggested that California move away from taxing capital gains and shift toward a less volatile tax base. Yet the most volatile sources of state revenue are also the most progressive sources of state revenue. Switching toward a more stable tax base requires moving toward a regressive tax base — by moving away from taxing capital or taxing ordinary income at high marginal rates. Property taxes are unique among the major sources of state revenue in that they are relatively nonvolatile, while taxing capital (at least to some extent) and being capable (at least arguably) of progressivity in their incidence.[8]

If California voters wish to retain the level of progressivity embedded in the state's tax structure, and do not wish to overturn Proposition 13 and enact significantly higher property taxes, the revenue structure will continue to exhibit high levels of fiscal volatility. Without major reforms to either California's tax base structure or to the fiscal constitution, we should expect repeated budget crises over the coming decades. If current trends continue, those budget crises are likely to become more severe. Californians may end up looking back on their current budget troubles with nostalgia.

The Role of California's Fiscal Constitution

Because of the workings of the business cycle and long-term trends in the economics of healthcare and education spending, budget crises will continue to be a recurring part of California's fiscal landscape.[9]

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[6]J. Fried Giertz, "The Property Tax Bound," *National Tax Journal*, September 2006; Russell S. Sobel and Gary A. Wagner, "Cyclical Variability in State Government Revenue: Can Tax Reform Reduce It?" *State Tax Notes*, Aug. 25, 2003, p. 569, *Doc 2003-19091*, or *2003 STT 164-2*.

[7]The other states are Hawaii, Idaho, Iowa, Maine, Minnesota, and North Carolina. David L. Sjoquist and Sally Wallace, "Capital Gains: Its Recent, Varied, and Growing (?) Impact on State Revenues," *State Tax Notes*, Aug. 18, 2003, p. 497, *Doc 2003-18743*, or *2003 STT 159-2*.

[8]The extent to which property taxes burden capital as opposed to other sources is controversial, as is the degree to which property taxes can be made progressive. *See* George R. Zodrow, "The Property Tax Incidence Debate and the Mix of State and Local Finance of Local Public Expenditures," *CESifo Economic Studies*, Jan. 2008. Note, however, that property taxes can be made more progressive through the use of circuit breakers and related devices. *See* Karen Lyons, Sarah Farkas, and Nicholas Johnson, "The Property Tax Circuit Breaker: An Introduction and Survey of Current Programs," report by the Center on Budget and Policy Priorities, Mar. 21, 2007.

[9]Education and healthcare spending in the United States has been growing faster than gross domestic product. In particular, healthcare spending jumped to 15 percent of GDP in 2007, from under 5 percent of GDP in 1960. If current trends continue, the Congressional Budget Office projects

(Footnote continued on next page.)

Because of California's choice of a highly volatile (and more progressive) tax base, those crises will almost undoubtedly be more severe in California than in the other states. In light of those challenges, it is crucial for California's political establishment to be able to confront the hard choices presented by budget crises. Unfortunately, the structure of the fiscal constitution stands in the way of proactive solutions to California's budgetary dilemmas.

Like all other states', California's political establishment is composed of diverse interest groups that have different preferences for tax and spending policy. Some of those groups would like to see taxes lowered, while others would like to see additional revenue raised to fund their desired spending programs. During times of significant budgetary shortfalls, the conflicts between those groups can become particularly intense.

If the State Legislature were the sole arbiter of budget policy, and the Legislature weren't bound by supermajority requirements, responses to budget shortfalls would depend primarily on which mix of interest groups controlled a majority of votes in the Legislature. If pro-spending groups controlled a majority, we would expect to see tax increases. Similarly, we would expect spending cuts if antitax interest groups controlled a majority. Or if neither side controlled a strong majority, we might expect a compromise policy containing both tax increases and spending cuts.

Yet California's fiscal constitution differs from that picture in several important respects. Not only does it take more than a simple majority of the Legislature to enact budgetary reforms, but the Legislature is far from the only arena in which budgetary policy can be enacted. Those factors combine to create an environment in which interest groups often find it far easier to advance their policy preferences through the initiative process than through the legislative process.

California's constitution requires a two-thirds majority vote in both chambers to pass a budget or to raise taxes.[10] Those supermajority requirements enable a determined minority of the Legislature to block any budgetary reform the minority disagrees with. When combined with the governor's veto and other legislative roadblocks, the two-thirds supermajority requirement makes it unlikely that any political party or coalition of interest groups will have a sufficient majority to enact its desired budgetary reforms in the face of determined opposition.

Exacerbating that problem is California's system of term limits, which gives state legislators little incentive to compromise in the short term to build longer-term working relationships. There is little that a majority coalition can offer the minority to gain the minority's acquiescence in passing a legislative response to a budget crisis.

If the legislative process were the only arena in which interest groups could hope to have their policy goals enacted, those obstacles to majority decision-making might force compromise. With no other option available, the diverse interest groups might be forced to come together to agree on solutions to budget shortfalls. But the legislative process is hardly the only game in town.

California's initiative process gives interest groups a ready alternative to the Legislature for achieving their budgetary policy goals. California's voters can constrain and override decisions of the Legislature through use of ballot initiatives. Proposition 13 is the most notable example of voters using initiatives to shape California's fiscal constitution, but it is not the only example.

Consider this partial list of the initiatives affecting California's budget that were passed following the adoption of Proposition 13 in 1978:

- in 1979 Proposition 4 created state spending limits, such that annual appropriations are limited based on previous-year appropriations, and revenues in excess of those limits must be returned;
- in 1982 propositions 5 and 6 abolished the state's inheritance and gift taxes. Also, Proposition 7 required a partial indexing of the state's income tax;
- in 1986 Proposition 47 required that revenue from motor vehicle license fees be allocated to cities and counties. Also, Proposition 62 required that new local taxes be approved by a two-thirds vote of the governing body and a majority of local voters;
- in 1988 Proposition 98 mandated that 40 percent of the state's general account budget be dedicated to K-12 education and to community college funding. Also, Proposition 99 added a 25-cent-per-pack tax on cigarettes, with the proceeds dedicated to healthcare, education, and recreation;
- in 1990 Proposition 111 relaxed some of the previously adopted appropriation limits;
- in 1993 Proposition 172 raised the state's general sales tax by 0.5 percentage points, with the revenue dedicated to public safety programs;

that healthcare spending will grow to over 45 percent of GDP by 2080. That massive growth threatens to overwhelm the funding power of both the states and the national government, causing programs like Medicaid to take over an increasing percentage of state budgets. Congressional Budget Office, "The Long-Term Budget Outlook," December 2007, pp. 22-24.

[10]The two-thirds supermajority requirement for raising taxes was placed in the state constitution by Proposition 13 in 1978. The two-thirds supermajority requirement for passing budgets dates back to the Riley-Stewart Amendment enacted in 1933.

- in 1996 Proposition 218 strengthened the voter approval requirements for new local taxes, mandating that two- thirds of voters approve new local nongeneral taxes;
- in 1998 Proposition 10 increased the tax on cigarettes by 25 cents per pack, with the revenue dedicated to childhood development programs;
- in 2002 Proposition 42 required that motor vehicle fuel sales and use tax revenue be dedicated to transportation purposes. Also, Proposition 49 mandated an increase in state funding for after-school programs; and
- in 2004 Proposition 1A established several measures to protect local funding sources. Also, Proposition 58 established a budget reserve fund and placed restrictions on the use of deficit bonds, and Proposition 63 levied an additional 1 percent income tax on taxpayers with incomes in excess of $1 million, with the revenue dedicated to mental health services.

As that partial list should make clear, voter initiatives play an important role in shaping California's budget policy. Even the voter recall of Gov. Gray Davis in 2003 can be viewed as part of California's fiscal constitution, because the success of the recall has been viewed as coming at least partially in response to Davis's tripling of vehicle license fees.

Admittedly, the need to gather a large number of signatures to qualify an initiative for the ballot is a major hurdle in using the initiative process as an alternative to the legislative process. But once an initiative qualifies for the ballot, it requires only a simple majority of voters to become law, even when the initiative contains a constitutional amendment. Whereas legislative budgetary reforms require two-thirds votes in both chambers, a budgetary initiative needs the support of only half of the voters plus one. For an interest group coalition whose will is thwarted in the Legislature, that dynamic can make the initiative process an attractive alternative.

Moreover, it is often easier to pass budgetary initiatives than the 50-percent-plus-one math would suggest. Recent research in political psychology has confirmed that voters find it very difficult to understand budgetary tradeoffs. Voters are far more supportive of tax cuts, or of increased spending on popular programs, when those questions are asked independently. When voters are asked to evaluate a budgetary package including both tax cuts and reductions in specific spending programs (or increased funding for spending programs along with specified tax hikes), the voters are far less likely to approve of the measures. Psychologist Jonathan Baron and law Prof. Edward McCaffery have labeled that voter tendency the "isolation effect." Reviewing the experimental evidence, they conclude that political actors — such as the sponsors of ballot initiatives — can manipulate voter responses by controlling how budgetary decisions are described.

That political psychology research confirms what many political analysts have been claiming for decades. As many a liberal politician has been heard to joke: Voters seem to think there is a budgetary line item called "waste and inefficiency" that can be reduced to pay for tax cuts — or to resolve budget crises.

Because of the isolation effect, any tax cut or tax restriction measure that makes it to the ballot is likely to generate significant voter support.

Because of the isolation effect, any tax cut or tax restriction measure that makes it to the ballot is likely to generate significant voter support. Similarly, any ballot measure that increases spending on popular programs is also likely to receive significant voter approval. The opponents of those measures will undoubtedly try to explain the tradeoffs and budgetary implications of reducing revenue or tying up funds, but those opponents will start with a major disadvantage because the sponsors of the ballot initiatives will initially control the framing of the initiatives. Without a large media campaign to explain the stakes to the voting public, it will be all too easy for voters to approve both the tax cuts and the spending increases, regardless of the consequences for the state's budget.

California's fiscal constitution is thus characterized by a supermajority requirement and other restrictions that impede budgetary decision-making at the legislative level and a relatively accessible alternative in the initiative process. That combination gives interest groups little incentive to compromise or to work together on solutions to California's budgetary problems.

What Can Be Done?

Of course, the best way to resolve a budget crisis is for legislators to come together to pass some combination of tax increases and spending cuts. If exhortations could suffice, this article would end with a call for legislators to rise above their parochial interests to reach a sustainable compromise.

Yet the U.S. political system was built on a Madisonian understanding that political actors will pursue their own narrow interests and must thus be constrained by institutional structures. This article has argued that the failure of California's politicians to deal responsibly with the state's budgetary problems is at least partially the fault of the state's flawed fiscal constitution. Therefore, it is worth considering potential reforms to California's fiscal constitution. The remainder of this section will analyze several possible reforms.

Increase the Use of Rainy Day Funds

Once its economy recovers, California will likely enjoy a period of budgetary surpluses before the next downturn and resulting budget crisis. If California could save in a rainy day fund the surplus revenue generated during the upturn, that would go a long way toward minimizing the pain during later downturns.

Rainy day funds (or budget stabilization funds) help to ward off budget crises in two ways. First, the revenue saved can be used to maintain spending during subsequent downturns without the need to raise taxes. Second, any revenue placed in a rainy day fund during an upturn is unavailable for increased spending or for tax cuts during the upturn. Hence, to the extent revenue is stored in a rainy day fund, they cannot be used to create unsustainable policy changes that will haunt the state in the next budget crisis.

California already has a rainy day fund. Revenue stored in the fund exceeded 10 percent of general fund expenditures in fiscal 1999-2000 and 2005-2006 — the final year of the 1990's tech boom and of the mid-decade partial recovery driven by the housing bubble.[11] Recognizing the advantages of rainy day funds, Gov. Arnold Schwarzenegger (R) has called for mandatory caps on future spending increases, with any excess revenue automatically diverted to the state's rainy day fund.

California would undoubtedly benefit from greater use of rainy day funds. But other states' experiences with proposals for mandatory contributions to rainy day funds do not provide much cause for optimism. Remember that state forecasters — both government employees and their private-sector equivalents — tend to be overly optimistic in their future projections during economic upturns. When state coffers are overflowing, large surpluses stored in rainy day funds become a tempting target for any politician who seeks to implement a new spending program or to pass a tax cut. Political actors are generally rewarded for bringing home the bacon — passing tax cuts or spending increases that their constituents desire. Fiscal prudence is seldom rewarded at the ballot box, because the beneficial consequences of that prudence are not felt until years later. California's system of term limits exacerbates that problem by causing legislators to focus even more on the short term.

Nevertheless, it is probably still worth experimenting with different methods for increasing the use of rainy day funds during boom years. Mandatory spending caps seem a poor way to achieve that end, however, because spending caps have generally proven easy to evade and do not apply to unsustainable tax cuts — including spending-like tax expenditures. Ultimately, increased funding for rainy day funds will occur only to the extent there is political support for protecting the fund revenue. Any mandates or prohibitions passed during bust years will be all too easy to overturn or circumvent if they are not backed up by enough political support.

> ***The best mechanism for increasing the use of rainy day funds might be to dedicate all revenue from capital gains taxation to the rainy day fund.***

Consequently, the best mechanism for increasing the use of rainy day funds might be to dedicate all revenue from capital gains taxation to the rainy day fund, making that revenue unavailable for general account spending. Because capital gains taxes are by far the most volatile of state funding sources, that approach has the advantage of reinforcing a norm that capital gains revenue should not be used to fund long-term budgetary commitments. To divert capital gains revenue or other rainy day funds to support general account spending, the Legislature could be required to declare the existence of a budget crisis through a supermajority vote (ideally requiring a larger supermajority than needed to pass a budget, perhaps a three-fourths supermajority if the current supermajority requirements for passing a budget are maintained).

Whether capital gains revenue is dedicated to rainy day funds, or whether some other approach is devised to increase the use of rainy day funds, it will be necessary to create a clear political understanding that rainy day funds are to be used only when the state is experiencing a significant economic downturn. Without political support for that norm, no mandatory rule is likely to be successful.

Amend the Supermajority Requirement for Passing Budgets

Many reform commissions have recommended abolishing California's two-thirds supermajority requirement for passing state budgets. As the discussion here has made clear, this article supports those recommendations. However, when given the option of ending that requirement by passing Proposition 56 in 2004, voters defeated the proposition by a

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[11]California Department of Finance, "Historical Data Budget Expenditures," January 2006, *available at* http://www.dof.ca.gov/Budget/BudgetCharts/chart-b.pdf.

nearly 2-to-1 margin.[12] At least for now, it seems likely that the supermajority requirement is here to stay.

Perhaps more politically feasible would be to relax the supermajority requirement so as to allow the passage of an emergency budget with a simple majority vote during economic downturns. A constitutional amendment might be passed such that when the state controller declares a downturn or a budget crisis, and that declaration is ratified by a simple majority in both legislative chambers, the supermajority requirement would be temporarily waived.

Emergency budgets passed without a supermajority vote could be limited so that only temporary tax increases or spending cuts are permitted. At the beginning of each year, both the controller and the Legislature might be required to reauthorize the existence of a downturn or budget crisis, with all of the provisions in the emergency budget lasting only as long as that reauthorization continues.

To assuage potential concerns about one party controlling both the Legislature and the controller's office and using that control to reauthorize emergency budgets into perpetuity, the approval of those budgets could require an escalating supermajority vote.[13] Whereas a simple majority might suffice to keep the emergency budget in effect for the first couple years, the vote threshold for reauthorizing the budget could be gradually increased in subsequent years until it reached the two-thirds supermajority requirement for authorizing nonemergency budgets.

Determining the political feasibility of a proposal to exempt emergency budgets from the two-thirds supermajority requirement is beyond the scope of this article. However, the approach has the advantage of giving the Legislature more flexibility in responding to budget crises while still requiring a substantial consensus to change the long-term path of California's taxes or spending. By exempting emergency budgets from the supermajority requirement, California might avoid some of the dynamics that have led to long delays in passing budgets and to the repeated use of gimmicks when budgets are passed during downturns.

Reform the Initiative Process

California's ballot initiative process was designed so that voters would have a check on unresponsive legislatures. At least to some extent, that process may be achieving its goals in the fiscal realm. It is certainly plausible that Proposition 13 was passed because of legislative unresponsiveness to voter anger about property taxes. Similar stories could be told about most — if not all — of the other budget-affecting ballot initiatives adopted over the last 30 years.

However, when combined with the two-thirds supermajority rule for the Legislature to raise taxes or to pass a budget, the initiative process has moved much of the locus of fiscal policymaking away from the Legislature. The overall structure of California's fiscal constitution has thus impeded voter accountability.

California's Legislature is currently dominated by Democrats who appear to want higher taxes and spending. If the legislative process were allowed to proceed unchecked, we might expect that coalition to increase taxes and spending until voters protested by electing more fiscal conservatives. But under the current system, the minority coalition is generally able to block significant budgetary changes, resulting in gridlock and the lack of a clearly accountable party.

In light of those dynamics, a case might be made for disallowing all voter initiatives with budgetary consequences. Considering the conclusions from recent political psychology research that voters find it particularly difficult to understand budgetary tradeoffs, fiscal policy is perhaps an area for which the Legislature is better suited to making policy than are the voters directly.

Without going to the extreme of prohibiting all initiatives that affect the budget — which is unlikely to be politically feasible in any case — a strong argument can be made for a rule requiring that future ballot initiatives that affect the budget be revenue neutral (or "self-funding"). In other words, any initiative that has the effect of lowering taxes would have to specify in detail which spending programs would be cut to offset the loss in revenue. And any ballot initiative that increases spending would need to specify which taxes would be raised to pay for that spending.

To make that proposal effective, the controller's office (or some other body) would probably have to fill in some of the details regarding the budgetary consequences of a ballot initiative after the initiative received the required number of signatures but before it appeared on the ballot. The sponsors of an initiative might thus write that a new spending program would be funded by an increase in the sales

[12]Proposition 56, known as the Budget Accountability Act, would have reduced the supermajority requirement for passing the budget from requiring a two-thirds majority to requiring a 55 percent majority. The proposition would also have made the governor and legislators lose salary for every day the budget was delivered late. The measure failed to pass, with 2,185,868 (34.3 percent) votes in favor and 4,183,188 (65.7 percent) against.

[13]The concept of an escalating supermajority vote is drawn from a proposal by Bruce Ackerman for how Congress should deal with authorizing emergency powers. Bruce Ackerman, *Before the Next Attack: Preserving Civil Liberties in an Age of Terrorism,* 2006.

tax rate, with the controller's office responsible for ruling on how large a sales tax increase would be required to fund the new program. The initiative would then go to the voters with the controller's numbers on what would be required to make the initiative revenue neutral.

> ***A requirement for revenue-neutral ballot initiatives should improve at least some of the dynamics that now result in legislative gridlock and irresponsible management of California's budget crises.***

Although mandating revenue-neutral ballot initiatives would not end all of the dynamics wherein interest groups have incentives to use the initiative process instead of reaching a compromise at the legislative level, the proposal would at least counteract the consequences wherein voter psychology and the isolation effect make it too easy to pass budget-affecting ballot initiatives. A requirement for revenue-neutral ballot initiatives should thus improve at least some of the dynamics that now result in legislative gridlock and irresponsible management of California's budget crises.

Adopt Budgetary Autoadjusters

Another approach for reforming California's fiscal constitution would institute budgetary autoadjusters.[14] In essence, these are proposals for changing the default policy outcomes that occur in the absence of legislative action. As this article was being written, California's Legislature had again missed its constitutional deadline for passing a budget. While Democrats and Republicans bicker about how to resolve the state's massive budget shortfall, the state's financial picture continues to deteriorate, generating uncertainty about the future of both tax and spending policies.

Imagine an alternative scenario wherein appointed budgetary officials adjusted tax rates or spending authorizations based on formulas previously adopted by the Legislature. In the absence of affirmative legislative action, that default budget would be adopted and would remain in effect until amended by the Legislature.

To be effective, the baseline (or default) budget would be set based on prespecified formulas for how tax and spending policies should be adjusted to reflect changing economic conditions. When the state economy enters a downturn, the appointed budgetary officials would be charged with raising the tax rates or reducing spending authorizations in the manner specified by prior legislation so that the baseline budget would remain balanced. Hence, the authorization formulas would have to be set so as to authorize some combination of tax rates being raised during downturns and lowered during upturns, and spending levels being reduced during downturns and increased during upturns.

Besides its effects on the formal budget process, creating an official baseline budget would have further consequences, because what constitutes a tax cut, tax increase, cut in spending, or spending increase depends entirely on what figures are used for the default levels of taxes and spending. Those terms are crucial for the way the budget process is perceived. For instance, a majority of Republicans in the Legislature have pledged not to support any "tax increases." But what do we mean by the term "tax increase" in an environment in which the ordinary workings of the business cycle are constantly changing the relationship between tax rates and revenue raised?

> ***What do we mean by the term 'tax increase' in an environment in which the ordinary workings of the business cycle are constantly changing the relationship between tax rates and revenue raised?***

The current political understanding of the budgetary baseline in California appears to be based on a notion that tax rates are to be held constant (while revenue fluctuates with the business cycle) and that spending levels are to be gradually increased based on prior authorizations. Yet that notion of California's budget baseline is essentially arbitrary. An equally plausible budgetary baseline might have tax revenue remaining constant in the absence of legislative action, with the tax rates adjusted annually to maintain consistency in the revenue as the economy cycles between busts and booms.

Presumably, the justification for both the two-thirds supermajority requirement for increasing taxes and the Republicans' anti-tax-increase pledge is to help restrict the size of government. Yet cyclically adjusted tax and spending levels are a much better measure for the size of government than are current-year tax and spending levels. Under the current system, fiscal conservatives have little power to prevent spending increases during economic boom years when the Legislature enjoys extra revenue as long as tax rates are kept constant. Instead, fiscal conservatives primarily fight tax rate

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[14]The term "budgetary autoadjusters" refers to a set of proposals for coping with state budget crises that the author of this article is developing. Readers interested in learning about budgetary autoadjusters in more detail should contact the author to receive copies of his draft manuscript.

increases during economic downturns, because that is the only time in which the conservative minority coalition has the power to restrict the size of government.

California's existing understanding of its budgetary baseline thus effectively means debates about the size of government occur primarily during bust years. Unsurprisingly, the Legislature finds it difficult to resolve those deep ideological debates during the short time periods required for passing a budget following a downturn in revenue. Long periods of impasse followed by irresponsible budgets that rely on borrowing and gimmicks are the almost inevitable result.

Moving toward a system of budgetary autoadjusters would have at least three advantages over California's existing process. First, the Legislature would find it easier to pass budgets during bust years (or to allow the default budget to go into effect), thus reducing the use of borrowing and gimmicks. By ending the dynamics that have led the Legislature to repeatedly miss its constitutional deadline for passing budgets, a system of budgetary autoadjusters might help restore California's creditworthiness and the voters' trust in state government.

Second, debates about the proper size of state government would no longer be forced into a compressed process with looming deadlines. Under a system of budgetary autoadjusters, those debates could occur anytime during the business cycle and would be determined more by changing voter preferences than by changing economic conditions. In place of the current system in which governors and legislators who happen to take office during boom years are able to enact their preferences for new spending programs and for tax cuts, while governors and legislators in office during bust years must take the blame for enacting painful coping measures, a system of budgetary autoadjusters would help to equalize both opportunity and blame across the business cycle. In that manner, budgetary autoadjusters would enhance the accountability of elected officials to voters.

Third, adopting a system of budgetary autoadjusters should make it easier to predict both tax and spending policy. The current budget process creates uncertainty because the Legislature regularly increases spending while lowering taxes during boom years, only to reverse course to enact a combination of tax increases and spending cuts during economic downturns. Increasing the predictability of tax law changes would improve the economy, as businesses and investors would find it easier to plan. Similarly, increasing the predictability of spending authorizations would help program managers better use their funds. Under the current system, there are far too many problems like buildings being constructed during upturns only to be left vacant during downturns as budgets are cut.

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