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THE SPIRIT OF 76:

WILL PROPOSITION 76 END CALIFORNIA'S SPENDING SPIRAL?

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Will Proposition 76 End California's Spending Spiral?

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Introduction

It is the inevitable tendency of government, in all places and at all times, towards growth. To resist its encroachment on individual freedom and initiative requires eternal vigilance and vigorous public debate. To promote such informed and focused debate, and to provide private alternatives to government intervention, is the role of the Pacific Research Institute.

The Institute addresses the critical issues of our day, including one that is particularly glaring and urgent in California—government spending. The state's continuous spending spiral has been unchecked for far too long, jeopardizing future economic growth and stifling innovation. Californians have been left with fewer of their hard earned dollars to spend as they choose. If left unchecked, this trend poses a grave threat to the state's future.

These times call to mind a more dramatic, but highly relevant, episode in history. In January 1776, Thomas Paine's pamphlet "Common Sense" was released among an oppressed populace that was, nevertheless, still loyal to its king. This scant 46-page work argued for what would become the bedrock principles of American democracy: sovereignty of the people and checks and balances on the government. In doing so, it lit a fire to a movement and produced a revolution.

PRI's ambitions are not as dramatic. But no less lofty is our aspiration to empower the people. No less fervent is our passion for liberty. And no less determined is our commitment to reaching and inspiring the everyman—the California voter.

In launching a new series of *PRI Pamphlets*, our purpose is to reinvigorate public debate and to ensure that more policy decisions are made by people, rather than governments. While we do not suffer the tyranny of a king, the state has grown far beyond its original scope and is testing the means of its taxpayers. PRI seeks to restore the proper limits on government growth. And more important, we aim to remind Californians, and all Americans, that the power to govern rests squarely with them.

The ideals of 1776 are as valid and precious today as they were then, and the results are as important to every individual.

Executive Summary

On November 8, California voters will decide the fate of Proposition 76, the Schwarzenegger-backed "Live Within Our Means" Act. The initiative promises to live up to its title by restricting state spending and fixing California's lingering fiscal problems.

Since 2001, California has experienced sizable budget deficits and has accumulated a considerable amount of debt. Though most of the blame for this was placed on the post-9/11 recession decline in revenue and the dot-com bust, constant increases in expenditures are the biggest culprit.

These perpetual spending increases are due to two factors: formulaic spending mandates that require categorical expenditure increases regardless of the state's fiscal health and an absence of fiscal responsibility on the part of the state's elected officials.

California is in a state of unregulated government growth. The costs are borne by the taxpayers in the form of tax hikes and lower economic productivity. Reform is needed if California is to improve its fiscal climate.

Proposition 76 is one opportunity for reform. It aims to restrain California's state expenditures by limiting their growth, controlling the state's autopilot spending mandates, and permitting the governor to make mid-year expenditure cuts. It also contains a number of beneficial provisions

dealing with expenditure allocation and the budget-adoption process.

The Pacific Research Institute is committed to the principles of individual freedom and limited government, the building blocks of a robust economy. PRI encourages and supports policies that reduce government spending in order to foster economic growth.

This *PRI Pamphlet* assesses the provisions of Proposition 76 to determine if they meet the standard of effective fiscal reform, namely, to ensure a restrained, fiscally responsible state government.

The assessment is mixed. Though the initiative fails to establish adequate safeguards against potential abuses that could lead to government expansion, it would instill some fiscal discipline that could reduce the size and severity of the state's budget problems.

On the positive side, Prop. 76 would:

- Reduce budget volatility by smoothing out revenue peaks and valleys.
- Reduce deficit spending by controlling spending mandates and resurrecting some of the executive powers exercised by previous governors.
- Reduce debt accumulation by requiring the state to repay its debts.

Unfortunately, Prop. 76 also has the following negative characteristics:

- Retains deficits, because the three-year revenue average will not necessarily reflect current revenues or expenditures.
- Retains legislative power to increase taxes and fees.
- Contains no guarantee to rebate excess revenues to the taxpayers.

Prop. 76 does provide a framework for limiting the growth of government, something that has been lacking in California for many years. With its spending reduction and budget balancing provisions, Prop. 76 is a good first step towards decreasing the level of government spending relative to the state's output.

Yet the initiative also contains some loopholes that if exploited could lead to possible government expansion. Since the legislature would retain its power to tax at will, any increase in taxes would in turn influence the spending limitation, and thus increase the amount of expenditures permitted each year.

Therefore, Prop. 76, if adopted, should be strengthened by subsequent legislation or ballot initiatives that would close the loopholes. This can be achieved by granting voters direct approval of special fund designations and tax and fee increases via ballot initiative. Also, the state should require that a portion of the excess revenues collected during high-revenue years be given back to the taxpayers.

With these additions, California's spending limitation would resemble the successful spending caps of several other states, especially Colorado's Taxpayer Bill of Rights (TABOR). Since its adoption in 1992, Colorado has

experienced a stable fiscal environment and reduced government growth. It has also rebated billions of tax dollars back to its residents.

Out-of-control spending and annual deficits have plagued California for years, bringing it to the brink of bankruptcy and overburdening taxpayers. Fiscal restraint is needed to limit government, keep its elected officials accountable, protect the earnings of the public, and encourage future economic growth and innovation.

James Madison wrote: "In framing a government, which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed, and in the next place, oblige it to control itself." On November 8, California voters will decide whether they want to impose the needed controls on state government through Proposition 76.

I. Decision in November

On November 8, California voters will decide the fate of Proposition 76, the "Live Within Our Means" Act backed by Governor Arnold Schwarzenegger. The initiative claims to fix California's lingering fiscal problems by restricting state spending.

The Act would limit the growth of state expenditures to a three-year average in tax-revenue growth. For example, if in the next three years tax revenues grow by three percent, four percent, and five percent respectively, then the following year's expenditures are permitted to increase by four percent.

This limitation would cap spending in high-revenue years and provide reserves in low-revenue years. In years when revenues outpace expenditures, the excess revenues will be allocated to various accounts, one of which is the Budget Stabilization Account (BSA), the state's "rainy-day" fund. Prop. 76 would allow legislators to dip into the fund to cover deficits when they occur.

Proponents maintain that the proposition would force the state's legislators to spend only what the state brings in, thereby reducing the size of the state's budget. The measure also contains a number of provisions dealing with expenditure allocation and the budget-adoption process.

These provisions include:

- Changing the formula for calculating California's education-spending mandate.
- Shortening the state's repayment period to local governments.
- Barring legislators from raiding special funds.
- Permitting the previous year's appropriations to continue in the event of a budget-adoption delay.
- Granting the governor authority to declare fiscal emergencies and cut expenditures if the legislature fails to act.

II. A Call for Reform

California's fiscal woes created the impetus for this reform. Since 2001, expenditures have been greater than state tax revenues, leaving the state with annual operating deficits and massively increasing cumulative debt.

The budget crisis reached the boiling point in 2003, when the state had a cumulative deficit of more than $38 billion. It was the worst budget deficit California—or any other state for that matter—had ever seen.[1] The state teetered on the brink of fiscal insolvency, as witnessed by its abysmal credit rating, lowered to just above junk bonds.[2] Since then, the situation has slightly improved (the credit rating moved up a step in July 2005), but annual deficits continue to hamper the state.

While much of the blame for California's deficits was placed on the decline in tax revenue resulting from the post-9/11 recession, the constant sizable increases in expenditures have severely handicapped the state.

These perpetual spending increases are due to two factors: formulaic spending mandates that require categorical expenditure increases regardless of the state's fiscal health, and an absence of fiscal responsibility on the part of the state's elected officials.

Autopilot Spending

The California State Constitution contains a number of spending requirements that lock the state into rigid formulas. While there are spending requirements for a variety of social services, the largest and most stringent is the education mandate prescribed in Proposition 98.

Approved by the voters in 1988, Prop. 98 mandates yearly education appropriation increases that must rise with the combined total of enrollment growth and inflation. It also dictates that any funds allocated above the Prop. 98 requirement in a given year be added to the base sum in the funding calculation, thereby increasing future education spending at a higher rate. Since the adoption of Prop. 98 just 17 years ago, the portion of the budget allocated to education has risen from 40 to 50 percent.[3]

Currently, education spending consumes the biggest slice of the budget pie, with K-14 (including community college) education receiving more than $50 billion in fiscal year 2005-06, up 6.4 percent from 2004-05.[4] Projections of Prop. 98 funding show that it will reach $62 billion by 2009: a 24-percent increase in four years.[5]

> While much of the blame for California's deficits was placed on the decline in tax revenue resulting from the post-9/11 recession, the constant sizable increases in expenditures have severely handicapped the state.

These mandated spending increases leave the state prone to sizable budget deficits because they must be adhered to even when revenues cannot support them. Forced to fulfill the obligation, the state's legislators turn to the public for help via tax hikes and heavy borrowing. With these spending mandates taking up more of the budget, taxpayers are required to pick up the tab.

Fiscal Irresponsibility

While categorical spending mandates severely handicap state budgeting, legislators still have the power to make discretionary cuts in the budget. Many elected officials lack the political will to make budget cuts. They cave in to special interest demands, regardless of fiscal conditions.

An example of this capitulation is the generous pension boosts within the state's public employee pension system. In 1999, the public employee unions successfully lobbied the legislature to grant them gold-plated pension perks, including allowing some workers to retire at 55 with 90 percent of their peak salary. This additional benefit alone costs the state more than $600 million a year.[6]

The past eight years tell the story of the state's profligate ways. In 1997, General Fund expenditures totaled just under $53 billion. In 2005, the General Fund allocated $90 billion, a 70-percent increase. During that same period, revenues only increased by 53.7 percent, while inflation and population increased just 40 percent.[7]

Clearly, the state continues to live beyond its means.

> Many elected officials lack the political will to make budget cuts. They cave in to special interest demands, regardless of fiscal conditions.

Even under Governor Schwarzenegger, spending has risen dramatically. The recently adopted 2005-06 budget increased spending by 10 percent and relied on borrowed funds to cover a $6 billion deficit.[8]

When the predictable deficits occur, legislators fail to act responsibly and cut spending. Instead, they frequently choose to borrow their way out, leaving sizable debt obligations for future budgets. California's total outstanding debt is more than $25 billion. Projections show that the state's debt service expenses are to increase at an average annual rate of 10.1 percent.[9]

III. Will Proposition 76 Solve California's Budget Problems?

Fed up with the out-of-control spending and annual deficits, Governor Schwarzenegger chose to move forward with a budgetary reform, pushing for an initiative that aimed to reduce deficits and limit spending. This reform measure, Proposition 76, will be on the special-election ballot on November 8.

Though the proposition claims to solve the state's budget problems, many people question whether it will actually restrain state expenditures. The initiative's provisions are analyzed in the following sections, in order to assess whether Prop. 76 meets the standards of an effective fiscal reform.

Economic Research Shows Costs of Government Spending

Thomas Jefferson described how a proper government should operate. He stated, "A wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement and shall not take from the mouth of labor the bread it has earned. This is the sum of good government."[10]

Jefferson astutely realized that a restrained government fosters an environment where individuals can flourish in their own endeavors. After two centuries of practice, Jeffersonian

theory has been verified. Economic research confirms that nations with heavy government spending are less productive than nations that restrain expenditures.

In a recent study by the Heritage Foundation, economist Daniel J. Mitchell measured the impact of government spending on economic growth. He found that economic growth would be bolstered if government spending were reduced relative to GDP and that a budget restraint is imperative if a nation is to achieve such gains.[11]

One study that Mitchell uncovered was in *Public Finance Review*. It found that "higher total government expenditure, no matter how financed, is associated with a lower growth rate of real per capita gross state product."[12] Another study in the *Quarterly Journal of Economics* found that "the ratio of real government consumption expenditure to real GDP had a negative association with growth and investment."[13]

Because economic freedom, growth, and prosperity should be the goals of any government in a free society, and because government growth has been the norm rather than the exception, controlling California's government spending is vital to greater individual prosperity.

A third study in *Public Choice* found that "a one percent increase in government spending as a percent of GDP would raise the unemployment rate by approximately .36 of one percent."[14]

Mitchell goes on to describe the economic transitions of Ireland, New Zealand, and Slovakia, all of which have reduced state expenditures and have seen dramatic increases in

economic growth. These same principles apply domestically as well.

The *U.S. Economic Freedom Index*, co-authored by PRI's Lawrence J. McQuillan, reported that there was a significant positive correlation between the freest states (those with less intrusive governments) and higher per capita incomes. The study found California to be the second most economically oppressive state. The state's residents lose $1,180 per year in income relative to the freest state.[15]

Because economic freedom, growth, and prosperity should be the goals of any government in a free society, and because government growth has been the norm rather than the exception, controlling California's government spending is vital to greater individual prosperity.

Criteria for Reform

An important determinant of economic freedom is a "fiscal rule of law" that limits government to providing essential government services (public goods) at the lowest cost to taxpayers and with the fewest distortions to the private-sector economy. A government that operates according to this principle will:

- Limit itself to providing true public goods, thereby forcing elected officials to set priorities and make tough decisions.
- Limit its growth so that it will not crowd out private exchange.
- Keep taxes at the lowest level necessary to provide essential government services.

- Adopt a broad, level tax base. Since everyone is benefiting from the government services, everyone should pay taxes to support these public goods.
- Reduce deficit spending and debt accumulation, since more debt today means higher taxes in the future.
- Provide voters with control over spending priorities and tax increases.

One means of providing this "fiscal rule of law" is to establish an explicit "fiscal constitution." This is the approach favored by our Founding Fathers, especially James Madison, who once wrote "The aim of every political constitution is, or ought to be, first to obtain for rulers men who possess most wisdom to discern, and most virtue to pursue, the common good of the society; and in the next place, to take the most effectual precautions for keeping them virtuous whilst they continue to hold their public trust.[16]"

An expenditure limitation is a form of fiscal constitution, a way to keep rulers virtuous, while protecting the earnings of the people. Proposition 76 is just one in a number of fiscal constitutions that have been presented or adopted in various states. The subsequent sections will uncover whether Proposition 76 satisfies the aforementioned criteria.

IV. Inside Proposition 76

A. A Restriction on Spending

1. PRO: Smoothes Out Revenue Volatility

Proposition 76 will restrict annual increases in state expenditures to the average in revenue growth over the previous three fiscal years. This cap would be applicable to the state's general fund and all of its special funds.

If revenues during the current year are higher than the permitted expenditures, then the excess revenues will be allocated to various accounts, one of which is the Budget Stabilization Account (BSA), the state's "rainy-day" fund. If revenues fall short of the permitted spending increase, legislators are then able to use the BSA funds to fill in the gap.

By capping expenditures and filling in deficits, the measure will smooth out spending over business cycles. Since tax revenues are tied to the economy, when times are good, abundant revenues follow. When a recession hits, revenues usually plummet. Prop. 76 aims to capture some of the boom year gains and redistribute them to years with poor revenues.

2. CON: Three-Year Averaging Still Permits Deficits

While this measure would restrain annual budget increases, deficits would still remain in down years. The problem lies in the provision's three-year averaging. Because high-revenue years are averaged with low-revenue years, the resulting figure does not reflect the current year's revenue picture. Since it will allow more spending than current revenues, deficits will appear in years with rapid declines in tax revenue.

Were this plan in effect, expenditures for fiscal year 2004-05 would have been limited to a 2.94-percent increase in spending (instead of the actual 12.73 percent increase), but from 2000-01 to 2003-04, deficits would have remained, although the majority of those deficits would have been less severe than those the state has actually experienced. The exception to that rule is fiscal year 2000-01, when the provision would have allowed a greater deficit than actually occurred because the previous three years (1997-2000) saw tremendous growth in revenues.[17]

3. PRO: Possible Aid from "Rainy-Day" Fund

Two things must be noted. First, "backcasting" by applying Prop. 76 to the state's fiscal past may be a useful tool to see how the spending cap would behave throughout business cycles. However, it cannot predict the behavior of future legislatures actually operating under Prop. 76. Second, deficits would be aided by the BSA, but to what degree is unknown. This would be based on the condition of the account at the time of the deficit.

> Prop. 76 aims to capture some of the boom year gains and redistribute them to years with poor revenues.

If the BSA was fully funded or had adequate reserves, then a portion of the account could cover deficits. But if the BSA did not have adequate reserves, then spending cuts would be necessary to stay under the cap.

Given that, here is how a severe recession scenario would most likely play out: Tax revenues would decline substantially and produce deficits. The BSA would be tapped into until extinguished. If deficits continued, expenditures would have to be cut to the appropriate spending limit, even if that level meant spending actually declined from the previous year. Therefore, under this severe recession scenario, state government would not expand.

4. PRO: Declaration of Fiscal Emergency May Produce Expenditure Cuts

Among the provisions in Prop. 76 is the ability for the governor to declare a fiscal emergency based on specific circumstances. If during a given fiscal year, the Department of Finance determines that General Fund revenues have fallen by at least 1.5 percent below the estimate for that year, or if the balance of the BSA will decline by more than half, then the governor can declare a fiscal emergency.

After such a declaration, the legislature must assemble to address the emergency. It may choose to reduce expenditures, increase taxes, or both. If the legislature chooses to raise taxes, the funds obtained from these immediate tax hikes can

only be used if total revenue is below planned expenditures for that year. The new tax cannot be used for additional expenditures, but it would serve to boost the revenue average for future spending-growth calculations.

With a supermajority requirement for tax hikes, expenditure cuts would likely be the most politically feasible option, since the minority party would have the power to block tax hikes. Yet this theory can't be relied upon, since most elected officials can be swayed into voting for higher taxes.

If the legislature fails to act within 45 days, then the governor must make discretionary expenditure cuts until the shortfall is eliminated. This provision ensures that expenditures will match revenues in a given fiscal year. It allows budget deficits to be dealt with during the middle of a fiscal year rather than prolonging the problem until the next budget adoption cycle, saving the state from increased debt.

5. PRO: Counteracts Problems with Lenient Gann Limit

If adopted, Prop. 76's expenditure limitation wouldn't be the only one on the books in California. In November 1979, the voters approved Proposition 4. It instituted what became known as the Gann Limit, named after anti-tax crusader Paul Gann. The Gann Limit restrained increases in state appropriations to the rate of inflation and population growth. It also required that any excess revenues over the limit be returned to the taxpayers via tax rebates or tax-rate changes.

In determining the annual limit, inflation growth was defined as the lesser of the change in either the U.S. Consumer Price Index or California per capita personal

income, while population growth referred to the change in the state population as a whole.

At first, the Gann Limit did not restrict expenditures at all because the stagflation scenario of the early 1980s left significant room under the cap. By mid-decade, inflation had been controlled and an improving economy brought in more tax revenue. In fiscal year 1986-87, revenues exceeded the Gann Limit by $1.1 billion. That sum was refunded to the taxpayers via rebate checks.[18]

This was the one and only time that California taxpayers received rebates from surpluses, for it was the only time the Gann Limit functioned as originally intended. Two initiatives, Proposition 98 in 1988 and Proposition 111 in 1990, adjusted upward the Gann Limit inflation factor enough as to render it meaningless.

Prop. 98 established a minimum level of state funding for school and community college education, effectively exempting education funding from the Gann Limit. Prop. 98 mandated that the state adopt yearly education appropriation increases and that these increases are not lesser than the combined total of enrollment growth and inflation (as measured by per capita personal income). It also mandated that additional education appropriations above the Prop. 98 requirement in a given year would be added to the base sum in order to increase the education funding calculation in future years.

In addition, Prop. 98 dictated that a portion of any excess funds over the Gann Limit be allocated to K-14 education. The funds are to be allocated until the point where they would be equal to four percent of the education spending in a given year. This sizable sum meant fewer dollars would be given back to taxpayers during periods of high revenues.

Proposition 111, passed by the voters in 1990, made several changes that greatly raised the Gann Limit. First, it mandated that per capita personal income be the sole inflation measure when determining the size of the cap. Second, the population factor was augmented to include public school attendance records as well as overall statewide population.

Prop. 111 also made additional requirements on excess revenues. It stated that half of all excess revenues must go to public schools and community colleges. Further, Prop. 111 required that there be two consecutive years of excess revenues before any rebates could be given to taxpayers. Revenues exceeding the limit in the first year can be carried over to the following year and appropriated in that year's budget.

This expanded Gann Limit created a sizable gap between permitted expenditure levels and tax revenues, freeing the legislature to spend with virtually no restraint whatsoever. Throughout the late 1990s, as the state found itself awash in tax revenue, the legislature chose to spend the surplus rather than give it back to the people.

While the original Gann Limit used inflation and population growth to restrict government growth, Prop. 76 uses revenues, a less stringent measure.

With the Gann Limit now largely gutted, spending is continually allowed to outpace revenues. The original Gann limit would have permitted only $68.9 billion in spending in the 2005-2006 budget. Yet under the current limit, General Fund expenditures were

permitted to reach $90 billion, despite the fact that revenues totaled only $84 billion.[19]

Since 1990, the Gann Limit has failed to limit spending and has permitted California's fiscal crisis to deepen. Although Gann would officially remain law, Prop. 76 would restrain spending to a level below the current Gann Limit.

6. CON: Excess Revenue Provisions Conflict

Under the Gann Limit, excess revenues are to be allocated to education funding and taxpayer rebates. Prop. 76, on the other hand, operates under a different excess revenue allocation. With both laws remaining on the books, there is a very slim chance that revenues could be greater than the Gann Limit.

Of course, the chance of revenues nearing the Gann Limit is extremely rare. Revenues would have to jump significantly for that to happen. But it raises a question of whether the excess revenue provisions in Gann or Prop. 76 would apply. This would have to be resolved either in the courts or with further legislation.

7. CON: Might Not Cap Long-Term Growth of State Government

In his work on expenditure limitations, Barry Paulson of the Independence Institute has shown that revenues generally grow at a greater rate than inflation because of continual increases in labor productivity and the progressivity of the tax code. While the original Gann Limit used inflation and

population growth to restrict government growth, Prop. 76 uses revenues, a less stringent measure.[20]

Revenues are also subject to the fiscal policy whims of the legislature and the public. If the legislature, or the public via ballot initiative, wishes to greatly increase the tax burden, it is still able to do so under Prop. 76. In doing so, it would allow the government-spending limit to grow substantially.

Further, special interest groups may push for exemptions in the spending limitation, much like the Prop. 98 and Prop. 111 proponents did with Gann. This could include placing more demands on excess revenue allocation, or may exempt certain spending from the cap altogether, which would create greater shortfalls and place more demands on the BSA.

B. Excess Revenue Allocation

1. PRO: Excess Revenues Used for Rainy Day Fund, Debt Repayment, and Infrastructure Investment

If any collected revenues exceed the amount required to fund permitted expenditures, those surplus funds will be divided three ways. Twenty-five percent of excess revenues will go directly to the Budget Stabilization Account (BSA) originally set up in Prop. 58.

The BSA will act as a reserve for future budget deficits. When a shortfall occurs, the BSA is to be used to fill in the budget gap, thereby smoothing out spending over business cycles. As determined in Prop. 58, the BSA is not to hold more than $8 billion in reserve.

Fifty percent of excess revenues will go to repaying: (1) the Prop. 98 maintenance factor, which is the difference

between the adopted Prop. 98 education funding and the normal Prop. 98 funding requirement; (2) the debt on Prop. 57 deficit-recovery bonds approved by voters in March 2004; and (3) the debts incurred from raiding the Transportation Investment Fund in 2003 and 2004.

California currently has more than $25 billion in outstanding debt, much of that loans and bond sales. Prop. 76 allows for half of the excess revenues to go towards debt repayment, especially towards the $15 billion in bonds approved in Proposition 57. Of course, this provision only uses excess funds and does not preclude the legislature from paying off debts out of the General Fund. Most likely, debt repayments during low-revenue years would be difficult, encouraging further cuts in expenditures.

Debt repayment is fiscally prudent given that today's debt must be paid off eventually, most likely by tax increases. Paying down the state's debt would lessen this future burden.

The remaining 25 percent of excess revenues will be used for school and highway construction. California may gain from this infrastructure investment, but that would depend on the size of the negative externalities that are involved in any public-goods project (traffic delays, construction noise, pollution, etc.), and whether the projects were completed efficiently, without wasting taxpayer dollars.

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After the surplus revenues are divided amongst those accounts, any remaining balance would then be placed in a secondary budget reserve for any future budget gap or

given back to taxpayers in the form of rebates or tax reductions.

2. CON: Revenue Surpluses Unlikely to be Given Back to Taxpayers

Nowhere does Prop. 76 specifically call for excess revenues to be refunded. Rather, it states that moneys *could* be rebated to taxpayers. Between the sizable BSA and a possible secondary reserve, it seems unlikely that refunds or tax cuts would occur.

This differs greatly from the original Gann Limit, which mandated that all surplus dollars be given back to the public. Tax rebates stimulate the economy by transferring dollars from the less-productive government sector to the more-productive private sector.

States that have enacted a stricter expenditure limitation, like Colorado did with its Taxpayer Bill of Rights (TABOR) in 1992, have rebated billions back to the public. In Colorado, the state's taxpayers received 3.25 billion dollars between 1996 and 2001. That equates to around $3,200 per family.[21]

Nowhere does Prop. 76 specifically call for excess revenues to be refunded. Rather, it states that moneys *could* be rebated to taxpayers.

These tax rebates foster a climate in which voters may believe that tax hikes are unnecessary, since higher taxes will eat into refunds. They also strengthen support for the expenditure limitation, decreasing the chance that special interest

groups will lobby for legislation that will effectively gut the limit, as they did with Gann in 1988 and 1990.

3. CON: Approval for State and Local Tax Increases Still Lies with Legislature and Local Governments

Unlike Colorado's Taxpayer's Bill of Rights, Proposition 76 lacks a provision for voter approval of all state and local tax increases. Prop. 76 leaves that power with the state legislature and local governments.

Voter approval of tax increases not only reduces the frequency of such increases, it also gives the voters oversight for spending priorities. With such transparency, voters can equate the tax hike with the new program or spending increase and determine if the cost is worth it.

Prop. 76 does not provide for this, although California does require a supermajority for tax increases (two-thirds in both the senate and assembly). Under Prop. 76, the legislature would still retain the right to increase taxes at any time. This is a serious flaw since revenue calculations would set the spending limit. Eager politicians who want to spend more may move to adopt tax increases (especially during low-revenue years) in order to raise the spending cap.

While Prop. 76 does limit the use of new revenues from immediate tax increases if revenues are equal to expenditures, any revenue hike will be added

Eager politicians who want to spend more may move to adopt tax increases (especially during low-revenue years) in order to raise the spending cap.

into the three-year revenue average.

It is important to note that supply-side theory—cut taxes to increase revenue—has worked in California, most notably in the mid 1990s.[22] But this theory has a cadre of detractors who believe that tax increases are the cure for fiscal crises.

4. CON: Concerns over Tax Increases

In addition, the proposition fails to address the so-called *Sinclair Paint* provision, a California Supreme Court decision that allows the legislature to raise revenues by a simple majority if the increases are dubbed fees, not taxes. The legislature often misnames taxes as fees in order to secure easy passage. With spending pegged by revenue, this loophole might be abused more frequently to extract more from hardworking Californians.

C. A Change in Proposition 98's Growth Calculation

1. PRO: Eliminates Some of Prop. 98's Funding Restoration Provisions

Prop. 98 requires that there be a minimum level of education funding in a given year. The calculation states that education spending must be greater than the previous year's allocation and that this spending must rise annually with the combined total of enrollment growth (measured by school attendance rates) and inflation (measured by per capita personal income).

Prop. 98 also permits a lower funding calculation to be administered during years in which revenues are down. This is called the "Test 3" provision. The difference between the Test 3 amount and the regular funding level is called the "maintenance" factor. This maintenance factor is used by the legislature for non-education expenditures during low-revenue years. When revenues rise in future years, the maintenance factor must be repaid in full at the regular funding level.

With a two-thirds vote, the legislature may also suspend Prop. 98 and set spending levels as desired. But just as with the Test 3 provision, the maintenance factor must be repaid at the normal level when the revenue picture is brighter.

Prop. 76 would eliminate both Test 3 and the maintenance factor, meaning that the legislature would no longer be obligated to restore funding at the normal level. This provision would greatly free up the budget from additional spending requirements, and creates the possibility that education spending would be tied to available revenues. This would occur if Prop. 98 is suspended or if the governor reduced Prop. 98 funding during a fiscal emergency. These measures would allow for decreases in spending when revenues are low. Further, these decreases would set a new minimum base for

The legislature often misnames taxes as fees in order to secure easy passage. With spending pegged by revenue, this loophole might be abused more frequently to extract more from hardworking Californians.

future years' calculations, reducing the growth in autopilot spending.

In addition, under Prop. 76, the outstanding maintenance factor of $3.8 billion would become a one-time debt to be repaid over 15 years.

2. PRO: Encourages Over-Appropriation without Penalty

Prop. 76 also states that any additional education funds allocated over the Prop. 98 minimum would not be counted within the base for future Prop. 98 funding calculations. This permits a legislature to provide more education funding without saddling future budgets with mandates.

3. CON: Retains Spending Mandate

Even with the slow growth provisions, Prop. 76 retains the Prop. 98 mandate in the budget. A sizable sum of General Fund dollars will still be allocated to education based on the calculation. It is possible that a reduction in school spending could force the state to reevaluate education priorities, but it is unknown whether there will be any effect on per-student spending or, most important, student achievement.

D. Granting of New Executive Powers to Governor

1. PRO: Governor Obtains Right to Mid-year Expenditure Cuts

Under California law, the governor has limited expenditure reduction powers. The law permits the governor to declare fiscal emergencies, but prevents him or her from making any sizable cuts to balance the budget. The governor does have the ability to veto line items in the budget after it is approved by the legislature and may freeze capital purchases and state hiring as cost saving measures.

Prop. 76 strengthens the governor's power to declare a fiscal emergency, strictly limited to when revenues drop by 1.5 percent from the estimated revenues for that year or when the BSA has declined by more than half during a fiscal year. After the declaration, the legislature has 45 days to address the shortfall. If the legislature does not act, then the governor has the right to cut expenditures to balance the budget. This reduction power permits the governor to make discretionary cuts to all spending except that required by Congress, state contracts, or debt obligations.

Granting the governor power to make discretionary mid-year cuts would greatly reduce the state's operating deficits, because expenditures would be more in line with current revenue, and would decrease the incentive to raise taxes to solve future deficits. And with the threat that any part of the budget might be cut, individual legislators may be more inclined to focus spending on true public goods, such as infrastructure or law enforcement, rather than the pork thrown into the budget on behalf of special interests.

Granting the governor power to make discretionary mid-year cuts would greatly reduce the state's operating deficits, because expenditures would be more in line with current revenue, and would decrease the incentive to raise taxes to solve future deficits.

On the other hand, there is a concern that since the governor would have the right to choose what budgetary priorities are important, he or she might cut infrastructure money. This would be unfortunate because proper government spending can help the state's economy flourish by making commerce more efficient and secure. Anything other than essential government services, however, is a wasteful redistribution of wealth from one person to another. That is where cuts should be made.

2. PRO: Governor Would End Budget Delays

Prop. 76 would also make the following changes to the budget-adoption process: First, if the legislature fails to pass a budget by July 1, then the previous year's appropriations go into effect until the impasse is resolved. Second, if the legislature is still deadlocked after 30 days, then the governor can declare a fiscal emergency and is permitted to make expenditure cuts.

By forcing a 30-day window on the legislature, the two political parties might be more inclined to resolve budgetary differences in committees rather than in closed-door leadership conferences. This may move the legislature to compromise more quickly to avoid giving the governor discretion over the amount and mix of the budget. If this is the case, then more on-time budgets might occur.

On the other hand, this provision does empower the minority party since a two-thirds majority is still needed to enact a budget. This might create an impetus to delay if it seemed likely that the governor would make cuts that the minority party supports.

E. Special Fund Protection

1. PRO: Bars Special-Fund Raids

Prop. 76 contains a provision that would prohibit the borrowing of special-fund dollars to cover General Fund shortfalls. This means state lawmakers would no longer be able to balance budgets by raiding funds earmarked for infrastructure investment. This option has been used frequently, most notably with transportation-fund raids over the past three years.

In 2002, the voters approved Proposition 42, a measure requiring that gasoline sales tax revenue be allocated to the Transportation Investment Fund (TIF) for highway-improvement projects.

It also contained a provision that if General Fund revenues greatly declined in a given fiscal year, then the TIF could be partially or fully suspended, with the moneys loaned to the General Fund for current expenditures rather than transportation investments.

This provision turned the TIF into a piggy bank that the lawmakers could crack open for a quick score. Being one of the biggest special funds, it was raided often.

In 2003, the first year the gas taxes were earmarked for the TIF, the General Fund faced an operating shortfall of more than $11 billion. Seizing the opportunity, Governor Davis and the legislature took $811 million of the $1.1 billion collected in 2003, leaving only $289 million for the transportation account. This added another debt obligation to future budgets since the loan had to be repaid.

When a budget deficit again threatened California in 2004, legislators raided the fund once more. The General Fund absorbed all of the TIF's $1.2 billion, which again added more debt.[23]

This would be stopped under Prop. 76. It would forbid legislators from using special funds as a General Fund reserve, ensuring that the TIF is used for transportation projects only. It also contains a provision that would pay off any outstanding Prop. 42 loan over a 15-year period.

2. CON: May Inspire Lobbying Groups to Push for Special-Fund Status

If special-fund accounts are free from legislative dipping, it may inspire special-interest groups to push for special-fund accounts to finance their pet projects. A group could petition the legislature to enact special taxes and allocate the revenues specifically for its benefit. Many more special funds could be created if this behavior becomes common.

Counteracting this is the argument that special funds are subject to the cap and the governor has the ability to make special-fund cuts if he so desires. But while this may reduce the growth of special-fund spending, it may not limit the number of special-fund accounts.

F. Local Government Interaction

1. PRO: Shortens Debt Repayment Period to Local Governments

Prop. 76 would force the legislature and the governor to repay moneys owed to local governments for mandated services. It would require that the state pay local governments back within five years (down from 15) for noneducation-related items and within 15 years for education-related items (there was no previous time requirement for education mandates).

Although this provision still permits unfunded mandates, it could make the state more fiscally responsible by reducing the frequency of mandate deferrals. It also provides money more quickly to local jurisdictions that are closer to the people and theoretically more accountable.

V. Does Proposition 76 Meet the Criteria?

After analyzing all of Proposition 76's provisions, it is fair to say that the results are mixed. While the initiative fails to prevent potential abuses that could lead to government expansion, it would infuse the state with greater and much-needed fiscal control.

PRO: Reduces Budget Volatility, Deficit Spending, and Debt Accumulation

The proposition has features that will reduce deficit spending, namely the adjustments to the autopilot expenditures in Prop. 98 and the new budget balancing powers granted to the governor. Both ensure that spending mandates don't swallow up the budget during fiscal downturns.

Prop. 76 also makes debt repayment a higher priority, as it calls on the state to pay back funds borrowed from local governments, special funds, Prop. 98, and deficit-recovery bonds. This lowers the risk of future budget crises and tax hikes.

Prop. 76 will also reduce California's budget volatility by smoothing out revenue peaks and valleys. Fiscal black holes like the 2003 fiasco will be a thing of the past, while drunken

legislative spending sprees will cease as well. By placing a limit on what elected officials can spend, Prop. 76 will make legislators more fiscally responsible.

CON: Retains Deficits, No Direct Voter Approval on Tax Hikes, No Tax Rebate Guarantee, and Potential for Sizable Government Growth

On the other side of the ledger, Prop. 76 retains a number of features that could produce unwanted consequences. It doesn't require surplus revenues to be rebated to the taxpayers. With this omission, the state's economy will miss out on much-needed tax relief.

Also, since the three-year revenue average will not necessarily reflect current revenues or expenditures, deficits will remain. If the state continues to experience deficits year after year, the political desire for tax increases will intensify.

With no direct voter control over tax increases, the state's elected officials may tax at will. This is dangerous considering that the expenditure limit is based on revenues. Any change in tax policy will affect the limit, leading to a potentially unlimited growth in state

government. Therein lies the potential to unravel Prop. 76, much in the way the Gann Limit was derailed from its original intent of fiscal restraint.

Will Proposition 76 Force California to Live within its Means?

Although flawed, Prop. 76 will provide California with additional fiscal discipline. By limiting state expenditures, Prop. 76 will reduce the size and severity of the state's budget problems, control autopilot spending, repay debts, and force elected officials to make tough fiscal choices.

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VI. Room for Improvement

Of course, that said, the legislature and/or the voters through ballot initiative must strengthen Proposition 76 by adopting the following provisions:

- Require voters to approve all special-fund designations through statewide ballot. This will prevent the legislature from enacting untouchable set-asides for special-interest groups that do not benefit the general public.
- Mandate that voters approve all state and local tax and fee increases. This will provide greater accountability to the expenditure cap, and will let voters have a say in every adjustment to the cap. It will also counteract the *Sinclair Paint* loophole.
- Ensure that a portion of the excess revenues during high-revenue years be given back to taxpayers through tax rebates. This will strengthen public support for the spending cap because voters will see the direct gains from limiting expenditure growth. Doing so would also give the legislature and/or the public an opportunity to clearly dictate where excess funds are to be allocated, resolving the conflicting language between Prop. 76 and the Gann Limit.

With these additions, California's spending limitation will resemble the many successful spending caps of various states, especially Colorado's Taxpayer Bill of Rights or TABOR. Since its adoption in 1992, Colorado has experience a stable fiscal environment, reduced government growth, and rebated billions of tax dollars back to the people.

If California had a TABOR in place since 1999, it would not have sunk into such fiscal shortfalls. Instead of massive debts, Californians would be enjoying more than $40 billion in surpluses, a sum that invested in the economy could create hundreds of thousands of jobs.[24]

TABOR has worked because it follows the model of successful tax-and- expenditure limitations: it restricts spending increases to the rate of inflation plus population growth; it mandates that the voters approve of all tax increases; and it requires a balanced budget.

California isn't the only state pushing for spending caps. A number of other states, including Maine, Ohio, Florida, Oregon, and Wisconsin, are considering TABOR-like tax-and-expenditure limitations. These reforms are encouraged and supported by the Pacific Research Institute, as well as its sister organizations under the State Policy Network umbrella. This movement to restrain the growth of state governments spending harkens back to the principles of the Founding Fathers, namely that there must be limits on government in order to allow citizens the freedom to prosper in their chosen pursuits.

VII. Conclusion

During his campaign for governor, Arnold Schwarzenegger continually called for budgetary reform, pledging to end business-as-usual in Sacramento. He publicly stated that California's budgetary mess was due to the state's formulaic spending, as well as the spending addiction of the legislature. As a result, Schwarzenegger called for the state to adopt a fiscal reform that would reign in state spending.

Proposition 76 is that reform. While it is unfortunate that it is not as strict as California's original Gann Limit or Colorado's TABOR, which fulfill more of the criteria of a "fiscal rule of law," it will more closely tie the state's expenditures to its revenues. And although additional laws are needed to strengthen the expenditure limitation, Prop. 76 provides a framework for controlling the growth of government.

Californians must focus on reducing the level of government spending relative to the state's output. For it is only by reducing the size and scope of government that the state will continue to see economic growth and innovation. Prop. 76 should be seen as one important step in that direction.

James Madison wrote: "In framing a government, which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the

governed, and in the next place, oblige it to control itself."[25] On November 8, California voters will decide whether they want to impose the needed controls on state government through Proposition 76.

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Appendix A
TABOR Resource List

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www.spn.org / nfo@spn.org

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Phone: 850-386-3131 / Fax: 850-386-1807
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Maine

Maine Heritage Policy Center
P. O. Box 7829
Portland, ME 04112
Phone: 207-831-4674 / Fax: 207-773-4385
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