FISCAL REFORM

WORKING PAPER:
An In-Depth Analysis of the Facts, Origins, and Trends of Fiscal Reform in California

CALIFORNIA
VISION & STRATEGY FOR THE NEXT CENTURY
ABOUT CALIFORNIA 100

The California 100 Initiative envisions a future that is innovative, sustainable, and equitable for all. Our mission is to strengthen California’s ability to collectively solve problems and shape our long-term future over the next 100 years.

California 100 is organized around 15 policy domains and driven by interrelated stages of work: research, policy innovation and engagement with Californians. California 100’s work is guided by an expert and intergenerational Commission. Through various projects and activities, California 100 seeks to move California towards an aspirational vision—changing policies and practices, attitudes and mindsets, to inspire a more vibrant future.

This California 100 Report on Policies and Future Scenarios was produced as part of California 100’s research stream of work, in partnership with 20 research institutions across the state. California 100 sponsored grants for data-driven and future-oriented research focused on understanding today and planning for tomorrow. This research, anchored in California 100’s 15 core policy domains, forms the foundation for the initiative’s subsequent work by considering how California has gotten to where it is and by exploring scenarios and policy alternatives for what California can become over the next 100 years.

The California 100 initiative is incubated through the University of California and Stanford.

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For additional background information, read the related Facts-Origins-Trends report at California100.org. The Facts-Origins-Trends report contains all of the references and citations to support the content of this report.

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FOREWORD

“As California Goes, So Goes the Nation, Alas.” That was a headline from a Los Angeles Times opinion column on April 30, 1989, which noted that, even though “Californians have long considered their state the cutting edge of social and political change... [it] no longer seems the vanguard of political innovation. Other states rarely look to California for policy initiatives.”

Fast-forward to 2022, and few would proclaim that California lacks in policy innovation. Quite the contrary. The state has enacted a variety of policies ranging from expansions in immigrant rights and voting rights to health care and higher education, and from large-scale experiments in guaranteed income to ambitious moves towards net-zero emissions in a variety of sectors. And despite the periodic waves of “doom and gloom” reporting about the state, California’s economic output over the last 25 years has grown faster than the national average, and on par with GDP growth for the state of Texas.

Even so, much remains to be done. The California Dream has always been marred by a high degree of racial exclusion, and it remains out of reach for millions in the state—whether measured by health outcomes, unaffordable housing, or massive disparities in income and wealth. California also recognizes that future progress depends on recognizing and correcting historical wrongs. Its Truth and Healing Council, for example, will provide recommendations aimed at prevention, restoration, and reparation involving California Native Americans and the State. If California’s racial diversity represents America’s demographic reality by 2100, our work is essential—not only for the long-term success of the state, but also for our country’s innovative and equitable future.

This future-focused work is especially pressing today. The COVID-19 pandemic has scrambled a state and nation already undergoing significant changes in economics, politics, and society. The harmful consequences of climate change are at our doorstep,
with forest fires and droughts that grow in frequency and intensity each year. The weakening of local media and the growth of disinformation threaten both our civic health and our public health. And staggering inequities in income and wealth, homeownership and health, threaten the state’s reputation as a haven for migrants, domestic and international alike.

In addition to immediate threats that affect our long-term future, we also see plenty of opportunity. Record increases in federal and state spending mean that billions of additional dollars are flowing to state, local, and tribal governments in California. Many jurisdictions are looking to invest in infrastructure that meets the long-term needs of their communities. Philanthropic institutions and individual donors are also looking to make transformative investments that have enduring impact. We have an opportunity to inform and enrich all of these plans and conversations.

Most institutions and organizations in California are focused on immediate challenges, and don’t have the luxury of time, dedicated talent, and resources to focus on long-term futures. California 100 is grateful for the opportunity to provide added value at this critical time, with actionable research, demonstration projects, and compelling scenarios that help Californians—government agencies, stakeholder groups, and residents alike—to envision, strategize, and act collectively to build a more innovative and equitable future.
INTRODUCTION

Fiscal policy, at its most basic, is the collection of decisions a government makes to collect revenue (taxes) and pay for programs (spending). Both of these elements come together in the form of a budget, the collection of figures and calculations that represent the government’s resource plan for the coming year. It is much more than an accounting exercise. Collectively, the numbers represent a community’s values and aspirations. Fiscal policy, for example, can support growth by investing in infrastructure for a growing economy. A government that values economic mobility can focus on public education for students and training adults as they prepare for a changing workforce. And, public resources can provide a safety net, using funds to provide support for vulnerable citizens during a crisis.

Looking forward, fiscal policy becomes a question of first defining what it is that the state values, and then figuring out how to pay for the government its residents want in a sustainable manner. Though easily stated, the challenge has proven immense. Historically, state policy has ridden a fiscal roller coaster through periods of prosperity when the economy was growing and faced fiscal crises during downturns. If Californians are going to enjoy a golden state in the coming decades, solving the fiscal sustainability puzzle will have to be part of that future.

Engaging discussions about the future direction of fiscal policy requires a firm understanding of the present situation. Toward that end, this report first outlines the facts that comprise the current California fiscal landscape. It then explores the major landmark actions and events that constitute the origins of the state’s current fiscal condition. Finally, it examines how past trends are expected to shape the future of state fiscal policy.

FACTS

Before attempting to project the future of California’s fiscal policy, it is important to understand where things stand today and what were the key contributors to the current situation. This section is intended to establish the essential fiscal facts as well as the context in which policy makers function. It begins by describing the structural context in which policy is made and then presents the numbers that make up the state’s fiscal picture. It also provides a perspective on those numbers by presenting them relative to other states. While those numbers provide a sense of the scale and scope of public finance in the state, we attempt to provide a sense of what those dollars buy with a discussion of the impact of the state’s taxing and spending in terms of Californian’s general well-being.

Fiscal federalism

This report focuses primarily on state government and how it collects revenue via taxes as well as distributes resources via a myriad of programs. While the focus may be on the state, California pursues fiscal policy as part of a larger federal system. The state sits in the middle of what might be thought of as a pyramid, where governments at each level make decisions about their priorities and funds generally flow “down” from the federal to the state and on to the local level.
Each year, the state receives billions of dollars from the federal government to support programs spanning from providing health care to children to building roads and transit systems. Funding for health care and social safety net programs represent the largest share of the federal resources California receives. On average, federal funds have accounted for about one-third of total state spending over the past four decades. That figure, however, has fluctuated, with the federal government increasing its assistance to states when recessions hit followed by a relative decline as the economy begins to bounce back. For example, during the great recession, federal government assistance jumped to 43 percent in 2009 as a consequence of the recovery dollars (Figure 2).

Source: California Legislative Analyst’s Office 2021. Historical Data.

1 We adjust the dollar amounts for changes in purchasing power. Throughout, where the authors have made the calculation, we used the Federal Reserve’s personal consumption expenditures implicit price deflator.
Although the specific regulations for these programs differ, they follow a similar pattern. Once a total amount is appropriated at the federal level, individual state shares are calculated by the application of a formula. For example, funds for an education program are divided up based on how many school-aged children live in a state. California, as the largest state in terms of population, will typically garner the largest share of any state, typically at least 10 percent of the total.²

Two features about the role federal programs play in California’s fiscal picture that are important to note. First, the federal dollars come to the state with strings attached and the amount of flexibility state policy makers can exercise in deploying the funds can be limited. Not only is it the case that highway funds can only be used for highways or education dollars have to be spent on students, but there are volumes of regulations that define what is an acceptable expenditure for a particular program and whether states need to show they maintained their own effort in funding specific programs.³ In other words, although federal resources are welcome, it is not as though their presence enables the state to spend less in a particular area as a consequence. To implement the federal program, a state agency usually is responsible for its administration passing on the dollars to local governments or individuals and reporting back to the federal government how the funds were used.

Second, this discussion of federal resources only pertains to the government-to-government transfers. Not included are transfers from the federal government that go directly to California’s residents. For example, federal programs such as the Earned Income Tax Credit (a program designed to provide additional assistance to low-income households), the Supplemental Nutrition Assistance Program (SNAP, formerly food stamps) and the Supplemental Security Income (SSI administered by Social Security) contribute billions directly to Californians. Although state policy makers have limited input into the structure of this assistance, the impact on the state’s residents is significant. For example, federal EITC dollars alone kept more than 600,000 Californians (Bohn, S., Danielson, C., & Malagon, P., July 2021) above the poverty line in 2019. Federal Social Security retirement benefits also play a significant role in lifting older Californians out of poverty, cutting the rate in as much as half of what it otherwise would be.⁴

Local governments sit on the other side of the state in the federalism structure. Although most of the local jurisdictions have their own sources of revenue (e.g., a portion of property taxes, sales taxes, etc.), the state government passes along federal dollars as well as funds from the state general fund. According to the U.S. Census of the Governments (2017), California had more than 4,400 local government units in 2017.

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² California’s population represents 12 percent of the total U.S. population. Federal programs often guarantee small states a minimum amount regardless of their size and the provisions of the program may not track exactly to total population. The 10 percent number is a useful rule-of-thumb when thinking about the potential impact of federal programs on California. For example, if policymakers are talking about a new $1 billion program in Washington, D.C., analysts in Sacramento can visualize a possible $100 million augmentation to California’s budget.

³ In fact, statute and regulations often include very specific passages designed to prohibit states from reducing existing funding upon receipt of the federal dollars. There is a near obsession in Washington with trying to make sure that federal dollars “supplement” and not “supplant” state dollars and states are often required to report, among other items, how they are “maintaining” their funding effort related to a program.

⁴ For 2011, PPIC’s California Poverty Measure for adults 65+ was 19%. Without needs-based safety net programs it would have been 25 percent and without Social Security payments, it would nearly double, to 48 percent (Bohn, et al, 2013).
Table 1. Local Government in California

<table>
<thead>
<tr>
<th>Type of Government</th>
<th>Number in California</th>
</tr>
</thead>
<tbody>
<tr>
<td>Counties</td>
<td>58</td>
</tr>
<tr>
<td>Incorporated cities</td>
<td>482</td>
</tr>
<tr>
<td>School districts</td>
<td>1,011</td>
</tr>
<tr>
<td>Special districts</td>
<td>2,894</td>
</tr>
<tr>
<td>Total</td>
<td>4,444</td>
</tr>
</tbody>
</table>

Source: U.S. Census of Governments, Table 2: Local Governments by Type and State, 2017.

In terms of fiscal policy, local governments represent where many of the dollars are actually spent and services delivered. In California, counties in particular are critical participants, as is the case in many other states. Counties administer everything from the county jails and to health care and social services, with many of the responsibilities delegated from the state (California State Association of Counties, n.d.).

In a situation similar to the one that exists between the federal government and states, California can attach requirements (“strings”) to the dollars it distributes to local governments. A key feature of the California constitution, however, limits what the state government can require (mandate) locals to do. If the state legislature imposes any new duty on a county, city, school district or other special district, it must provide the resources to cover the cost of the new responsibility. The state even has a separate commission to police the use of mandates (Commission on State Mandates, n.d.).

The basic structure of the federal, state and local governments has existed in the United States essentially since the U.S. Constitution was written in 1787, and the California constitution since it was ratified in 1879. The fiscal relationships have changed over time, sometimes dramatically. For example, the federal New Deal programs of the 1930s and the Great Society programs of the 1960s expanded the federal fiscal role and the resources provided to state governments. Both federal expansions extended the reach of the public social safety net, increasing benefits and services for the unemployed, elderly, and the poor. They clearly reflected the sentiment that government had a responsibility to secure a minimal standard of living for the county’s most vulnerable. Arguably, the slew of legislation passing in the wake of the pandemic may be approaching a similar scale of growth and reflect similar values.

Within California, the relationship between the state and local governments has also shifted over time and reflected different values. Proposition 13 (1978), for example, stoked a distrust of government and succeeded in, among other things, capping property tax revenue. Passage of the ballot initiative set in motion a series of events that resulted in the centralization of policy making in Sacramento, as the state government assumed

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5 In theory, the federal government also is limited in what mandates it can place on states as well. Lately, the highly partisan nature of the country’s politics has most of the issues of state/federal relationship being litigated in the courts, however.
responsibility for financing a larger share of schools and other local activities. And, periodically, the state and local governments have “re-aligned” their fiscal relationship. Notable realignments have taken place around responsibilities for providing health care and social services (1991) and for the incarceration of those convicted of crimes (2011).

While most of the following discussion of California’s fiscal future will focus on the state government for its analysis, it is important to acknowledge the state’s role as part of a federal system from a fiscal perspective. The fact that federal resources account for 33 percent of the dollars of state spending gives the federal government an outsized role in fiscal policy decisions. And, since the state is dependent on local governments as its “boots on the ground” when it comes to program implementation, the interdependency needs to be recognized. The CA 100 examination of the implications of Federalism and Foreign Policy offers additional perspective and depth on this relationship.

Revenue in California

Looking back over the four-plus decades of taxing and spending in California, the pattern demonstrates overall real growth over the period. A closer examination, however, reveals periods of growth, followed by a contraction, and then a return to growth. Those contractions are associated with downturns in the economy when tax revenue falls. Since the state is required to balance its budget, program spending falls proportionately at the same time.

California collected $189 billion in state tax revenue in FY 2020 (Figure 3). Since the mid-1980s, California’s real state tax revenues have grown at an average rate of 3.1 percent per annum (p.a.). As the figure shows, however, the growth isn’t consistent, with periodic drops in revenue (1987, 1990, 1992, 2001, 2008).

To provide some sense that recessions have on California’s revenues, the two sharpest contractions over the past forty years saw tax receipts decrease 18% from FY 2000 to FY 2001 and drop 15 percent from FY 2007 to FY 2008. Absent those sharp falls, California’s state tax revenues would have grown in real terms at least 4 percent year over year – almost a full percentage point more (State of California Department of Finance, 2021).

Sources:

6 Ironically, this centralization flew in the face of the “conservative” sentiment that contributed to Proposition 13’s passage. By limiting resources for schools, towns and counties, the state was forced to step in and play a more intrusive role. Such a shift runs counter to the philosophy that local governments should exercise control over the decisions that most directly affect their residents, particularly with regard to fiscal issues.

7 Growth during the periods immediately following recessions was particularly impressive. California experienced 4.5 percent average annual growth from FY 1984 to FY 1999, 4.6 percent average annual growth from FY 2001 to FY 2007, and 4.1 percent average annual growth from FY 2008 to FY 2020.
State spending in California follows a similar pattern as a consequence of the balanced budget requirement. California spent $329 billion across general ($153 billion), special ($64 billion), federal ($107 billion), and bond funds ($5 billion) in FY 2020 (Figure 4). Since the mid-1980’s, California’s real expenditures have grown at an average annual rate of 3.6 percent, again with two sharper decreases in expenditure from FY 2003 to FY 2004 (-6.6%) and FY 2011 to FY 2012 (-9.3%). Over the last 10 years, during the recovery from the Great Recession, per annum growth rate in expenditures has averaged 4.5 percent (California Legislative Analyst’s Office, 2021).
Beyond this broad overall pattern of growth, punctuated by periodic drops, the composition of both revenue and spending have shifted over time. Over the period, the personal income tax, sales & use tax, and corporate tax have represented California’s largest state revenue sources. Proportionately, personal income tax revenues have grown while income from sales & use and corporate sources has decreased over the past several decades, however. The relative share of state revenue has shifted from 1984 to 2020 as follows:

- Personal income tax increased from 37 percent to 58 percent
- Sales and use tax decreased from 34 percent to 20 percent
- Corporation tax decreased from 13 percent to 9 percent
- All other tax revenues decreased from 16 percent to 13 percent.

**Figure 5. Total State Taxes, with Percentages from Three Largest Sources, in Billions**

Source: Authors’ calculations based upon California Department of Finance Summary Schedules and Historical Charts.

Outside of these “big three” sources of state tax revenue, revenue from other sources totaled $25 billion in 2021. From 1984 to 2021, real state tax revenue from other sources grew by 2.6% p.a. (Figure 6), lower than the overall growth rate of 3.1% p.a. These other taxes include vehicle fees, motor vehicle fuel, insurance, tobacco, alcoholic beverage, cannabis excise (starting in 2017), and estate inheritance and gift (ended in 2009).
Although the collection of revenue has grown steadily over the years, so has the state population. California’s state taxes in 2021 represented revenues of $4,700 on a per capita basis. Real per capita state taxes grew 1.9 percent p.a. from 1984 to 2021 (Figure 7).\(^8\) Disaggregating the overall growth rate in real per capita state taxes, personal income taxes grew 3.1 percent per annum while sales and use and corporation taxes remained relatively flat in the same time period (Figure 8).

**Figure 6. Total State Taxes, from Other Sources, in Billions**

![Graph showing total state taxes from other sources in billions.]

Source: Authors’ calculations based upon California Department of Finance *Summary Schedules and Historical Charts*.

8 California also experienced average population growth of 1.2 percent p.a.
The per capita tax calculation demonstrates that state tax revenue has grown faster than the state’s population. The real increase (1.91% p.a.) in taxes collected on a per capita basis over the period contributes to California's reputation as a high tax state (Figure 9).

California, however, is also a wealthy state, and an examination of tax revenue compared to growing incomes in the state tells a second, and different, story. State taxes per $100 of personal income have remained flat (with
0.04% growth p.a.) in the same period. The relatively flat line isn’t all that surprising if you think of government services as a normal good. As the economy prospers and incomes increase, residents would be expected to consume more of many goods, including more government. This relationship also makes sense given California’s dependence upon the personal income tax as a source of revenue. The expanding economy has made many state residents individually wealthy. The state’s progressive income tax structure keeps pace with that growth, although it does mean that on a per capita basis revenue collections rise (State of California Department of Finance, 2021). Finally, the dependence upon a progressive personal income tax reflects the state’s values. Who pays taxes and how that burden is distributed is a function of how elected representatives interpret the notion of fairness (see text boxes). California has decided that it is fair to have wealthier individuals contribute more in the form of taxes.

**Who should pay taxes?**

The answer to this question stems from a notion of fairness. Should all residents pay the same total amount of taxes? Should everyone pay the same rate or percentage on whatever is taxed? Or, should some pay more or less relative to others? California’s sense of fairness has led the state to embrace a progressive tax system, one where those who make more income pay a higher share of that amount to the government.

The argument in favor of progressive taxation stems from the notion that taxes should be based on an individual’s the ability to pay. Those with more income can meet their basic needs of food and shelter while still being able to afford to pay taxes (Diamond and Saez, 2011). At the other end of the income scale, the share of each paycheck going to pay for taxes should be lower and not cause households to have to skip paying for basic needs. Progressive taxation, then, protects low-income individuals and attempts to mitigate inequality.

The arguments against progressive taxation stem from concerns about income creation, the choices businesses make, and administration of the system. The most voiced concern is that higher taxes on wealthier individuals decreases the incentive for wealth creation, innovation, and entrepreneurship. High marginal rates – the rate levied on the next dollar earned – also increases the incentive for taxpayers to look for ways to shield their income from taxes. Some will seek to legally avoid paying taxes through basing their choices upon how the system treats income, distorting markets (Goolsbee, 1997). High marginal rates can also incentivize tax evasion – the illegal under reporting or hiding of income (Poterba, 1987).

Beyond its impact on the decisions of individual taxpayers, progressive tax systems also have a cumulative impact on total revenue collection. By definition, a progressive system collects a larger share of the revenue from fewer taxpayers. That concentration causes total state revenue to be sensitive to the ups and downs of a relatively small number of California’s residents. The Pew Charitable Trust rated California’s revenue system to be the sixth most volatile in the country with large swings possible from one year to the next because of its dependence on the personal income taxes (Murphy et al, 2018). From a budgeting perspective, policy analysts tend to favor a combination of tax sources that ensure a stable, predictable, and sustainable stream of revenue (Randall and Rueben, 2017).
Who pays taxes in California?
At the state level in California, the three largest sources of income are the personal income tax, the sales and use tax, and the corporate income tax. At the local level, property taxes provide the most revenue (though the state is responsible for their distribution). Who pays each of these?

**Personal income taxes** are paid by individual taxpayers and, as just discussed, higher income individuals pay a much greater share of the total revenue collected under its progressive structure. In California, the lowest-earning one-fifth (quintile) of taxpayers pay no state income tax at all, on average, and can be eligible for a rebate. Those in the second lowest quintile pay 0.5% of their income while the top 1% of earners paid 9.8%.

**Property taxes**, in most states, have the potential to be progressive under the notion that those with more income will own larger, more expensive homes. Proposition 13, however, skews that concept. Also, from an economist’s perspective it isn’t entirely clear how much of the tax burden a landlord passes along to tenants (Zodrow, 2006). One estimate has California’s poorest households paying 4% of their income on property taxes while the top 20% pay less than 3% (Institute for Taxation and Policy, nd.).

**The sales and use tax** applies mostly to goods purchased at the retail level. Economists consider sales taxes to be regressive in that lower-income individuals spend a larger share of their paycheck on consuming goods. Although California exempts basic needs such as food and medicine from the sales tax in an effort to limit the impact, the state’s poorest pay an estimated 7.2% in sales and use taxes, a figure that declines steadily across income levels, with the top 1% paying 0.8% in sales tax.

Assigning the burden of **corporate taxes** is the most difficult. On one hand, all of the cost could be assigned to corporations and their shareholders. However, other analysis suggests that a portion of corporate taxes (18%) are passed on to workers in the form of reduced wages (Cronin, et al, 2012).

In terms of the total tax burden on individuals, the Institute for Taxation and Economic Policy ranks California 51st on its index in terms of worsening income inequality. In other words, though portions of the state’s tax portfolio have regressive features, it does better than all of the other states in terms of having a system that exacerbates inequality. Assigning tax burdens based on race and ethnicity is even more challenging and individual state estimates are not available. Researchers have noted that some features of the tax code, particularly certain credits and deductions, can provide significant benefits to households more likely to be white (Brown, 2021; Boddupalli and Rueben, 2020).

Spending in California
Just as the composition of the state’s revenue picture has changed over time, so has its spending patterns. California’s top three expenditure categories are health and human services, education (including K-12 and higher education), and transportation (Figure 10). In FY 2020, California spent $149 billion on health and human
services, $94 billion on education, and $24 billion on transportation, representing 45, 28, and 7 percent of expenditures respectively. Corrections, a category that many Californians assume is a large share of the state budget, accounted for $17 billion, or 5 percent of spending. As a proportion of total expenditures, healthcare and corrections spending has increased while education spending has decreased. From FY 1984 to 2020, as a percentage of total state and local expenditures:

- Healthcare expenditures increased from 29 percent to 45 percent,
- Education expenditures decreased from 41 percent to 28 percent,
- Corrections expenditures increased from 3 percent to 5 percent.⁹

**Figure 10. Total Expenditures, in Billions**

**Total expenditures**

$B

Source: Authors’ calculations based on data from California Legislative Analyst’s Office 2021. [Historical Data](#).

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⁹ Spending from all sources, including federal dollars, special funds, and borrowing.
Focusing on education expenditures, 75 percent of California’s education expenditures went to K-12 education in FY 2020, with the remaining 25 percent going to higher education. Since FY 1985, the proportion of K-12 spending has increased (from 63%) while the proportion of higher education expenditures has decreased (from 37%) (Figure 12).\textsuperscript{10}

\textbf{Figure 12. Education Expenditures, in Billions}

\textit{Education expenditures}

\begin{itemize}
\item Higher Education
\item K-12
\end{itemize}

Source: Authors’ calculations based on data from California Legislative Analyst’s Office 2021. \textit{Historical Data}.

\textsuperscript{10} If one just looks at General Fund spending, the difference is greater, with K-12 education accounting for 77.3 percent of education spending.
On a per capita basis, per capita corrections and healthcare spending experienced fairly high average growth rates from FY 1985 to FY 2020 at 3.9 percent and 3.6 percent p.a., respectively. Per capita higher education expenditures remained flat while per capita K-12 expenditures grew by 1.8 percent p.a. (Figure 13).

**Figure 13. Per Capita Expenditures**

![Per Capita Expenditures Diagram](image)

Source: Authors’ calculations based on data from California Legislative Analyst’s Office 2021. [Historical Data](#).

Multiple funds make up the California budget, segregating dollars depending upon their source and their purpose. Most state generated revenues go into the general fund, which is the focus of most of the budget deliberations each year. Special funds have been established where a specific revenue source, such as gasoline taxes, can only be used for a particular purpose, such as transportation and roads. Bond funds use borrowed dollars on the bond market to pay for longer term investments such as infrastructure spending. As a proportion of total expenditures, general fund expenditures have decreased while federal and special fund expenditures have increased. From FY 1985 to 2021, as a percentage of total state and local expenditures:

- Spending from the general fund decreased from 58 percent to 46 percent
- Spending from federal funds increased from 30 percent to 33 percent
- Spending from special funds increased from 10 percent to 19 percent
- Spending from bond funds increased from 1 percent to 2 percent (Figure 14).\(^\text{11}\)

\(^{11}\) Much of the growth in federal funds is a consequence of the Affordable Care Act and Medicaid expansion. The growth in special fund spending is discussed below.
The proportion of total expenditures from debt service has increased from $0.9 billion (0.9%) in FY 1985 to $6.4 billion (2%) in FY 2020 (Figure 15), representing average p.a. growth of 5.7 percent (California Legislative Analyst’s Office 2021). The largest debt service expenditure categories are K-12 education, transportation, and natural resources.

Source: Authors’ calculations based on data from California Legislative Analyst’s Office 2021. [Historical Data](#).
California’s Fiscal Picture Relative to Other States

To put California’s revenue and spending numbers in perspective, consider the state’s per capita tax figures relative to six other large and/or comparable states: New York, Washington, Pennsylvania, Illinois, Texas, Florida. In this context, California ranks second, after New York, on several measures of state and local tax revenue (Figure 16). The overall trends in California’s state tax revenue tend to mirror those of other states, particularly New York. As noted above, the absolute levels only tell part of the story. Who pays taxes, and how that burden is distributed is critical to understanding the role that taxes play relative to questions of equity and inclusion.

Figure 16. Total Revenue, Per Capita


Not surprisingly, California also spends more per capita relative to other states. Out of all 50 states and DC, California’s per capita expenditures rank:

- 5th in total current expenditures,
- 16th in total direct elementary education expenditures,
- 6th in total direct higher education expenditures (excluding fees),
- 10th in direct health & hospital expenditures,
- 2nd in total direct corrections expenditures, and
- 6th in total transit utility expenditures (Urban Institute 2021).

The table presents the expenditure rankings for the other comparison states.
Table 2. State and Local Spending across Comparison States

<table>
<thead>
<tr>
<th>State</th>
<th>Total current expenditures</th>
<th>Total elementary education expenditures</th>
<th>Total direct higher education expenditures (ex. fees)</th>
<th>Direct health &amp; hospital expenditures</th>
<th>Total direct corrections expenditures</th>
<th>Total transit utility expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>5</td>
<td>16</td>
<td>6</td>
<td>10</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>Florida</td>
<td>47</td>
<td>50</td>
<td>42</td>
<td>26</td>
<td>23</td>
<td>22</td>
</tr>
<tr>
<td>Illinois</td>
<td>16</td>
<td>21</td>
<td>35</td>
<td>44</td>
<td>29</td>
<td>7</td>
</tr>
<tr>
<td>New York</td>
<td>3</td>
<td>2</td>
<td>26</td>
<td>11</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>18</td>
<td>11</td>
<td>47</td>
<td>21</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Texas</td>
<td>43</td>
<td>26</td>
<td>8</td>
<td>18</td>
<td>25</td>
<td>21</td>
</tr>
<tr>
<td>Washington</td>
<td>14</td>
<td>14</td>
<td>16</td>
<td>8</td>
<td>21</td>
<td>5</td>
</tr>
</tbody>
</table>


California’s relatively high-level of spending does not translate into a proportionately large public workforce. Compared to all other states, California’s state and local public payroll is smaller than most (ranking 43rd) on a per capita basis. Measured against the other large states, Pennsylvania supports fewer public jobs per 100 residents while New York and Texas employ noticeably more (Figure 17). The difference between California’s relative level of spending compared to the size of its public workforce is likely to be attributed to higher levels of compensation. Given the state’s high cost of living, public employees generally are paid more than those in other states (Gordon, et al, 2007).
Figure 17. Public Employees per 100 Residents, 2019

<table>
<thead>
<tr>
<th>State</th>
<th>Employees per 100 Residents</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>4.0</td>
</tr>
<tr>
<td>Florida</td>
<td>3.5</td>
</tr>
<tr>
<td>Illinois</td>
<td>3.3</td>
</tr>
<tr>
<td>New York</td>
<td>5.0</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>3.7</td>
</tr>
<tr>
<td>Texas</td>
<td>4.9</td>
</tr>
<tr>
<td>Washington</td>
<td>4.7</td>
</tr>
</tbody>
</table>


Long-Term Liabilities

The above discussion focuses on the items that appear in the state’s budget and changes in revenue and spending from one year to the next. A long-term discussion of California’s fiscal situation would be incomplete without providing insight into other fiscal concerns that are present today, and loom large as one looks to the future. Two areas in particular stand out:

- California’s commitments to current and former state employees regarding pensions and health care benefits.
- The state’s historical underinvestment in infrastructure, which creates a significant obligation for the future to maintain its bridges, roads, and facilities.

These two long-term liabilities create different types of fiscal pressure. Public employee benefits have long included defined benefit pensions, a commitment to pay a retired employee a specific amount each retired year. The pension benefit is calculated using a formula that takes into consideration the individual’s salary and years of service. California also promises many state employees assistance with health care costs during retirement.

A series of court cases have affirmed that once an employee has been promised a pension, it is treated like a contract where a government cannot, after the fact, change the basic provisions of it to save money. (Case law is less clear regarding other post-employment benefits like health care.) Consequently, both the state and many of its local governments are obligated to pay retiree pensions, creating a significant financial liability. It is important
to note that if the state were to somehow change the parameters of its pension system tomorrow, the obligation it has to current employees and retirees would not change.

California’s state pension plans had a total liability of $640 billion as of 2018 but had set aside only $456 billion in assets, leaving a funding gap of $184 billion (The Pew Charitable Trusts, 2018). That figure ranked California at 26th in the country (with #1 being the closest to full funding).

Pension assets grow as a result of contributions (from employees and employers/governments) and the returns earned on those investments. Twenty years ago, California’s pensions were essentially fully funded (Murphy & Mehlotra, 2019). But, years of not making large enough payments into the funds and changes in pension performance expectations, combined with the stock market crash of the Great Recession, created the substantial unfunded liability. The state, like many others, is now playing catch up.

In 2013, the state did manage to make changes to its pension system. At that time, the legislation (PEPRA) reduced the promised defined benefits for future employees, increased contributions for employers and employees, and delayed retirement ages (CalPERS, n.d.). In addition, as part of a larger strategy to fully fund the teachers portion of the pension liability, legislation (AB 1469) set school districts’ share of teacher pension costs to increase from 8.3 percent of payroll in 2014–15 to 19 percent by 2020–21 (Murphy & Mehlotra, 2019). At the time of the reform, the changes were projected to fully fund the state pension liability by 2040, if the assumptions made at that time held. Since then, the returns on the state funds have been positive, but fallen below the assumptions made when PEPRA was passed. As a result, there has been little progress on closing the unfunded liability, pushing out the date at which full funding is projected. To the state’s credit, it has used recent surpluses to make additional payments into the pension funds in an effort to keep the gap from growing wider (Legislative Analyst’s Office, 2020).

Other post-employment benefits (OPEBs), like retiree health care, operated differently than the pension system in California. In the case of OPEBs, the state essentially pays as it goes, covering the costs of a given year as it is incurred, leaving the total liability unfunded. The Pew Charitable Trusts (2018) estimated that California faced a state OPEB liability of over $78 billion in 2016.

Table 3. Other Post-Employment Benefit Liabilities, Selected States, 2016

<table>
<thead>
<tr>
<th>State</th>
<th>Unfunded OPEB liability (thousands)</th>
<th>Funding Ratio</th>
<th>Unfunded liability as a % of state income</th>
<th>Ranking (of 48 states)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>$53,579,373</td>
<td>-0.2%</td>
<td>8.1%</td>
<td>43</td>
</tr>
<tr>
<td>New York</td>
<td>$91,768,000</td>
<td>0.0%</td>
<td>7.9%</td>
<td>41</td>
</tr>
<tr>
<td>Texas</td>
<td>$87,780,859</td>
<td>0.7%</td>
<td>6.9%</td>
<td>40</td>
</tr>
</tbody>
</table>

12 This aggressive payment schedule, while good for the pension liability does come at the cost of putting pressure on school budgets. Even though total school spending was rising at the same time the share of local district pension payments were increasing, the net effect was to reduce the dollars that could have made it to the classroom. See Krausen and Willis, 2018 and Pivot Learning, 2017.
Pennsylvania $23,690,222 2.2% 3.8% 29
California $78,441,888 0.3% 3.6% 26
Washington $10,878,616 0.0% 2.8% 25
Florida $9,198,289 0.0% 1.0% 14


Compared to other states, California isn’t unusual in taking a pay-as-you-go approach to OPEB funding. It is worth noting that while most states do something similar, some states do pre-fund their OPEB liability, invest the funds, and reduce their future costs. The state of Ohio, for example, has pre-funded about 60 percent of its $15 billion OPEB liability. Comparing California’s liability to other states, relative to state income, ranks it at 26th.

Putting a number on the potential liability associated with neglected infrastructure investment is more difficult. First, it is difficult to discern what the optimum investment should be (Neumark, 2005). Second, there is the question of estimating the costs associated with new investments to meet emerging needs as well as the price tag of simply maintaining the existing structures (Legislative Analyst’s Office, n.d.) and facilities. Over the years, it is arguable that the state has underinvested in its infrastructure – the power grid, water, roads, bridges, transit, and public buildings – but estimating the size of that gap with any confidence is difficult and beyond the scope of this report.

Easier to identify are analyses that examine states’ infrastructure relative to a number of different factors such as pavement quality or time spent on congested highways to the condition and integrity of the actual structures. These types of assessments paint a relatively bleak picture nationally. The American Society of Civil Engineers (2020) gives the U.S. a letter grade of C- in its 2021 report. California rates the same lackluster grade by their methodology (American Society of Civil Engineers, 2019). The Reason Foundation approaches the question differently, but California’s performance remains unimpressive. By their method, the state finds itself in the bottom 10 of their national rankings, with California at 43 (Feigenbaum et al., 2020).

The American Society of Civil Engineers estimates that nationally, the United States needs to invest an additional $2.59 trillion over the next ten years, which would entail increasing spending from 2.5 to 3.5 percent of GDP. Given these numbers, the scale of the unfunded infrastructure liability in California is likely to be large – perhaps as much as $250 to 300 billion.13 Developing a method to estimate the size and scale with some precision may be the first step to constructing a plan to addressing these costs. But, making the picture even more bleak, these estimates are simply to catch up on maintenance and do not include new infrastructure projects that may be desired (e.g., to expand capacity at the state’s colleges and universities) nor those projects needed to respond to the climate change threats.

13 These are back-of-the-envelope estimates based on the ASCE’s back-of-the-envelope estimates, so the precision is limited. The California estimates are based on about 10% of the national figure (of $2.59 trillion, California’s share would be $259 billion) or what an additional 1 percent of state GDP ($30 billion) would be over ten years.
Impacts

As the above discussion describes, California’s budget has expanded rapidly over the past decades. This growth, for the most part, mirrors national trends. While this expansion has allowed the state to invest in social services, education, and transportation, the state’s demographic changes, increased costs, and evolving needs have also expanded demand. Despite California’s massive budget and progressive tax system, many Californians still struggle to afford to live in the Golden State, and across various measures of wellbeing, California sits in the middle of the pack nationally. In sum, income inequality and wealth disparities loom large; educational outcomes are middling; housing is increasingly unaffordable; incarceration rates are high; and road performance is relatively poor. In this section, we examine how California’s fiscal policy translates into social and economic opportunity and contributes to the general quality of life for its people.

Economic Prosperity and Inequality

One of the most important roles of state fiscal policy is to create economic prosperity for people and reduce or eradicate poverty. California’s progressive tax structure allows it to raise considerable revenues from Californians with high incomes and investments, which it then invests, in large part, in a range of state policies and programs aimed at supporting low and middle-income families, such as CalWorks, CalFresh, the state Earned Income Tax Credit, and Medi-Cal. These investments supplement a host of federal efforts to reduce poverty.

Income and Poverty. Despite these progressive fiscal policies and programs, 11.8 percent of Californians lived in poverty in 2019 based on the official poverty measure (U.S. Department of Agriculture, 2021), but that number climbs to 16.4 percent when accounting for the cost of living and a range of family needs and resources (Bohn, S., Danielson, C., & Malagon, P., 2021). An additional 16.5 percent of Californians lived near the poverty line, which means that more than a third of Californians were poor or close to poverty in 2019. Some Californians are more likely than others to experience poverty, with poverty rates higher for children, Latinos, immigrants (especially undocumented immigrants), and less-educated adults, as compared with other demographic groups. The mammoth state and federal fiscal stimulus programs of 2020 and 2021 during the COVID-19 pandemic may help reduce these poverty rates, especially for children.

Table 4. Poverty rates across demographic groups in California, California Poverty Measure (CPM), 2019

<table>
<thead>
<tr>
<th>By racial/ethnic groups</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Latino</td>
<td>21.4%</td>
</tr>
<tr>
<td>Black</td>
<td>17.4%</td>
</tr>
<tr>
<td>Asian/Pacific Islander</td>
<td>14.5%</td>
</tr>
<tr>
<td>Multiracial and other</td>
<td>12.9%</td>
</tr>
<tr>
<td>White</td>
<td>12.1%</td>
</tr>
<tr>
<td>By age</td>
<td></td>
</tr>
<tr>
<td>-----------------------------</td>
<td>--------</td>
</tr>
<tr>
<td>Children (0-17)</td>
<td>17.6%</td>
</tr>
<tr>
<td>Older Adults (65+)</td>
<td>18.0%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>By immigration status</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Immigrant</td>
<td>21.6%</td>
</tr>
<tr>
<td>U.S. born</td>
<td>11.5%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>By educational attainment</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No high school diploma</td>
<td>29.1%</td>
</tr>
<tr>
<td>High school graduate</td>
<td>17.9%</td>
</tr>
<tr>
<td>Some college</td>
<td>12.8%</td>
</tr>
<tr>
<td>Bachelor’s degree or more</td>
<td>7.2%</td>
</tr>
<tr>
<td>All Californians</td>
<td>16.4%</td>
</tr>
</tbody>
</table>


The disparity in poverty across groups is consistent with differences in income. African Americans, Native Americans and Latinos in California earn less than the median household income. The situation is similar in comparison states (Figure 18).

**Figure 18. Income Disparities Compared to State Median by Race/Ethnicity, 2019**

Source: Kids Count Data Center, Annie E. Casey
Wealth disparities and home ownership. Wealth disparities are even wider than income disparities. Nationally, the gap between Black and white wealth has been well documented by the Federal Reserve’s Survey of Consumer Finance. Nationally, the average white family has 8 times as much wealth as the average African American family and 4 times as much as the average Latino family (Bhutta, N., Chang, A. C., Dettling, L. J., & Hsu, J. W., 2020). Making similar comparisons for California alone is difficult, but there is little reason to think that the differences are any less stark – and some reasons to suggest that they are worse (Hutchful, 2018). An analysis of the racial wealth gap among Los Angeles residents from 2014 found that median wealth for white households was 12 times greater than for U.S.-born Blacks and 8 times larger than for Latinos (De La Cruz-Viesca, M., Chen, Z., Ong, P. M., Hamilton, D., & Darity, W. A., 2016). The LAO (2019) found wealth disparities across the state’s regions as well.

These racial disparities in wealth accrual are not unique to California: they can be traced back to historic and systemic inequities in access to home ownership and affordable housing, as well as inequitable access to good-paying jobs, equal educational opportunities, and other avenues for accruing wealth that can be passed down from one generation to the next. However, California made its own unique contributions to housing-based wealth disparities through its history of redlining (Rothstein, 2017) and passing fiscal reforms like Proposition 13, which is discussed in greater detail in the Origins section.

On average, fewer Californians own their own home when compared to the rest of the nation. When broken down by race/ethnicity, the picture is starker. While home ownership among white Californians is close to the national average, for African Americans and Latinos, the gap is much greater – 20 to 25 percentage points lower than for whites (Goodman, L., & Zhu, J., 2021) (Figure 19).

Figure 19. Home Ownership Rates in California, 1990 and Projections to 2040

Source: Urban Institute, Forecasting State and National Trends in Household Formation and Homeownership
Looking at overall trends, while Latinos are projected to close some of the homeownership gap in the coming years, the gap is expected to widen between whites and African American Californians in the future.

**Educational Opportunities and Outcomes**

At the individual level, the surest path to economic mobility is through education. At the macro level, economic productivity is achieved through a well-educated and prepared workforce. Further, with higher levels of education, states must make fewer investments in the areas of health, welfare, and crime prevention (Levin, Belfield, Muennig, & Rouse, 2007). In addition to its fiscal benefits, education contributes to greater civic engagement and a thriving democracy (Glaeser, Ponzetto, & Shleifer, 2007). For these reasons, it is no wonder that education comprises the state’s second largest expenditure.

Yet despite the state’s significant investment in K-12 education, it continues to underinvest relative to other states. Based on the most recent data (EdWeek, 2020; Hahnel, Hough, & Willis, 2020), California ranked:

- 38th in K-12 education spending, when adjusted for cost of living;
- 40th in K-12 education spending as a percentage of the total economy;
- 48th nationally in teacher-to-student ratios; and
- 48th in its share of guidance counselors.

**Elementary and secondary outcomes.** This underinvestment may partly explain California’s middling K-12 outcomes. At the K-12 level, California ranks in the bottom quintile in fourth- and eighth-grade reading and math, according to the most recent National Assessment of Educational Progress (NAEP). In 2018-19, 84.5 percent of California’s public high school students graduated after four years, ranking California roughly 30th nationally (National Center for Education Statistics, 2020).

**Higher education outcomes.** California’s college-going rates are better comparatively, with 66 percent of California students going on to college directly after high school, as compared with 64 percent nationally (NCHEMS, 2018). Even so, many students fail to complete a certificate or degree program. This is particularly true for Black, Native American/Alaskan Native, and Pacific Islander students (California Competes, 2020). By one estimate, California needs 60 percent of adults to have a college credential or degree to meet the state’s workforce demands (Campaign for College Opportunity, 2018); currently, only 43 percent of California’s adults have an associate’s or bachelor’s degree (California Competes, 2020).

**Healthcare**

California’s largest single expenditure is in the area of health and human services, and overall, the state ranks 10th nationally in spending in this area. Although this funding area covers a wide variety of programs, from CalWorks to foster care and child welfare services, the state’s largest spending area is in health care, namely on Medi-Cal, the state’s Medicaid health program. Access to health care has dramatically increased in recent years with the implementation of 2014’s Affordable Care Act. Since then, the uninsured rate has dropped from 17 to 7 percent with the federal government picking up most of the cost of the expansion (McConville, 2021).
Criminal justice

Similar to a number of policy areas, California led the nation in a swing toward a punitive response to crime. The use of mandatory minimum sentences, aggressive drug law enforcement, and the three-strikes ballot initiative filled the state’s prisons beyond capacity – in 2006 165,000 were incarcerated in facilities designed to house 85,000 (ProPublica). That system also disproportionately locks up people of color (Vera, nd.). A federal court order to reduce overcrowding, combined with realignment and a series of sentencing reforms passed at the ballot box has led to a decline in the state’s prison population, indicating a shift toward a less-punitive approach. Recently, state officials hastened to decrease overcrowding further in response to the coronavirus. By the end of 2020, state prisons were incarcerating 94,500 (Harris, 2021).

Table 5. Summary of State Rankings across Various Measures of Well-Being

<table>
<thead>
<tr>
<th>Indicator</th>
<th>California Performance</th>
<th>CA</th>
<th>FL</th>
<th>IL</th>
<th>NY</th>
<th>PA</th>
<th>TX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty Rate</td>
<td>11.8%</td>
<td>26</td>
<td>32</td>
<td>23</td>
<td>37</td>
<td>29</td>
<td>41</td>
</tr>
<tr>
<td>Official U.S. poverty measure (USDA, 2021)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income Disparity</td>
<td>48.9 on Gini index</td>
<td>47</td>
<td>46</td>
<td>44</td>
<td>50</td>
<td>32</td>
<td>39</td>
</tr>
<tr>
<td>Highest earners compared to lowest. A value of 0 indicates perfect equality while a value of 1 or 100 indicates perfect inequality. (Population Reference Bureau, 2021)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home Ownership Rate</td>
<td>54.6%</td>
<td>49</td>
<td>28</td>
<td>27</td>
<td>50</td>
<td>14</td>
<td>46</td>
</tr>
<tr>
<td>K-12 Education Spending</td>
<td>$10,867 per pupil</td>
<td>38</td>
<td>42</td>
<td>13</td>
<td>2</td>
<td>10</td>
<td>48</td>
</tr>
<tr>
<td>Adjusted for regional cost differences (EdWeek, 2020)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High School Graduation Rate</td>
<td>84.5%</td>
<td>31</td>
<td>20</td>
<td>27</td>
<td>37</td>
<td>25</td>
<td>8</td>
</tr>
<tr>
<td>(NCES, 2020)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health Coverage</td>
<td>7.8% uninsured</td>
<td>23</td>
<td>49</td>
<td>21</td>
<td>8</td>
<td>9</td>
<td>52</td>
</tr>
<tr>
<td>Percentage of total population without health insurance (Kaiser Family Foundation, 2020)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Criminal Justice</td>
<td>310 per 100,000 residents</td>
<td>18</td>
<td>40</td>
<td>16</td>
<td>9</td>
<td>25</td>
<td>42</td>
</tr>
<tr>
<td>State Imprisonment rate (The Sentencing Project, 2020)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall Highway Performance and Cost (Feigenbaum et al., 2020)</td>
<td>n/a</td>
<td>43</td>
<td>40</td>
<td>37</td>
<td>44</td>
<td>39</td>
<td>18</td>
</tr>
</tbody>
</table>
### Summing Up the Facts

Tax revenue and spending in California have risen over the past decades in a pattern of steady growth, until a recession causes a real, and at times sharp drop. After the re-set, the pattern of growth continues again. This pattern in part reflects California’s reliance on a progressive income tax that is disproportionately affected by the economic shifts. Compared to other states, California taxes and spends at a higher rate on a per capita basis but not as a share of personal income or GDP.

Given the scale of public investment California has made, one might expect the state to shine across a number of indicators. Despite the high level of spending, however, many residents struggle to afford California and the state’s performance on a number of social metrics has been modest. Some accommodation can be made for the fact that the overall cost of living in California is higher than in most other states, with a dollar unable to purchase as much as it would elsewhere. Also, features that have contributed to the state’s identity – embracing migration and diversity; protecting the environment; etc. – come at a cost. It is quite likely that inequality in the state would be considerably worse if it wasn’t for its progressive tax system and substantial social service programs. We suspect, nevertheless, that Californian’s vision for the state is to create a community where individuals from a range of incomes are welcome and can afford to live. The challenge of reducing inequality, combined with the threat of long-term liabilities, such as pensions and neglected infrastructure, suggest that significant complications loom ahead for California’s fiscal policy.

### ORIGINS

The current outlook for fiscal affairs in California is a mixed one. From a dollars and cents bottom line perspective, the outlook is positive, despite the ongoing pandemic and its impact on the state’s economy. The state budget is the largest in history while at the same time posting a record surplus. The reserve fund is flush, a hedge against the proverbial rainy day. And, while federal COVID recovery funds account for a significant portion of the abundant resources, it is likely that more funding will be forthcoming from Washington, D.C. As noted in the prior section, however, prosperity in the state is not shared equally. A sound, sustainable fiscal future entails much more than showing a positive number on the annual budget balance sheet.

So then, how did California get to this point? This section describes the origins of current fiscal policy as it exists in 2021. The discussion divides the drivers of fiscal policy in California into three broad categories: economic, demographic, and policy. It first examines the composition of the state’s economy as well as how its rise and fall play out relative to the state’s public finances. It then examines how California’s changing population is a key variable to understanding the fiscal picture. Finally, we discuss the evolution of finance policy over California’s history, concentrating on the past 40 plus years of legislation, propositions, and public opinion that shape the current landscape.
**Economy**

Government revenue in California is a function of economic activity in the state. Taxing income, sales, and other elements of the economy generates the funds used to pay for state programs. Because state and local governments are required to balance their budgets, the link is direct. As the economy grows, there are more resources available; if the economy slows or contracts, budget deficits emerge at a time when the need for services typically increases. Unpacking the relationship between the economy and the state’s public finance system, then, is central to describing the origins of the current fiscal situation. As will be covered later this connection can be mitigated or exacerbated by policy choices, for example reliance on a progressive income tax leaves the state more vulnerable, but establishing rainy-day funds can mitigate this.

California, home to 12 percent of the country’s population, represents nearly 15 percent of the United States domestic output. In 2019, its $3.1 trillion gross domestic product would rank it as the 5th largest in the world behind only the rest of the United States, China, Japan, and Germany. Relative to comparable states, California’s economy was larger than the output of Florida, Illinois and Pennsylvania combined.

**Table 6. State GDP, 2019, current dollars**

<table>
<thead>
<tr>
<th>State</th>
<th>GDP (millions)</th>
<th>GDP per capita ($)</th>
<th>Per capita rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>3,132,801</td>
<td>80,563</td>
<td>5</td>
</tr>
<tr>
<td>Texas</td>
<td>1,843,803</td>
<td>66,149</td>
<td>18</td>
</tr>
<tr>
<td>New York</td>
<td>1,772,261</td>
<td>90,043</td>
<td>2</td>
</tr>
<tr>
<td>Florida</td>
<td>1,106,500</td>
<td>51,745</td>
<td>40</td>
</tr>
<tr>
<td>Illinois</td>
<td>885,583</td>
<td>71,727</td>
<td>12</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>808,738</td>
<td>64,412</td>
<td>21</td>
</tr>
<tr>
<td>Washington</td>
<td>612,997</td>
<td>80,170</td>
<td>6</td>
</tr>
</tbody>
</table>


Heading into 2020, the state was experiencing what would become the longest period of economic expansion in history and the state budget showed a surplus, with collected revenues exceeding planned spending. From a fiscal perspective, the state has made tremendous progress after the dark days of the Great Recession. It was difficult not to be optimistic about the future. Two years earlier, however, then Governor Brown offered this observation when presenting his final budget “What’s out there is darkness, uncertainty, decline and recession, so good luck baby!”
Certainly, the governor wasn’t prophesying a global pandemic on the horizon. He was merely offering a blunt reminder that California has known great highs, but also has experienced tremendous lows. And, the impact of the recessions is felt more acutely in California as compared to other states. For example, when recessions have pushed up the unemployment rate nationally, California consistently sees a higher percentage of its workers lose their jobs (Figure 20). To put the difference between the economic peaks and valleys into perspective, during the Great Recession, the state tumbled from the 6th to 10th largest economy in the world ($2.1 trillion in 2012).

**Figure 20. Monthly Unemployment, U.S. and California, Seasonally Adjusted, January 1976 – May 2021**

![Unemployment Graph]

Source: U.S. Federal Reserve, St. Louis, FRED data portal.

Historically, California’s economy grows steadily, but then stalls when a national recession hits. It is tempting to ascribe the steep rises and falls to the risk-taking, entrepreneurial image that is associated with the state. Putting the state’s economic changes into perspective, however, suggests that California isn’t all that exceptional. Comparing quarterly growth in state GDP over the past 15 years reveals impressive rises and falls for the state. Other large states, Texas and New York for example, demonstrate similar swings in their output, albeit the timing may be slightly different (Figure 21).
The reality is that economies speed up and slow down as a consequence of a number of factors, and though they are not predictable, recessions do happen. Over the last 75 years, the US has seen 13 recessions – about one every 6 years – followed by periods of growth of varying length. On average these downturns lasted for about 11 months and the period of growth for more than 5 years (Figure 22). The most recent recession associated with the pandemic was officially declared to have lasted just 2 months, however, the shortest on record (National Bureau of Economic Research, 2021). That economic activity fall-off had followed the longest period of expansion the country had experienced, 128 months (NBER, 2020). The country is currently in the recovery period following that brief recession.
What has set California’s economy apart has been its ability to continue to grow despite the periodic rises and falls. Just looking at the size of state economies, not all states have grown as fast relative to the others. For the comparison states we have been using, California, Texas, Florida and Washington have risen on the list, while New York and Pennsylvania have fallen.

**Table 7. Changes in relative size of state economies**

<table>
<thead>
<tr>
<th>State rank by GDP</th>
<th>1963</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Illinois</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Florida</td>
<td>11</td>
<td>4</td>
</tr>
<tr>
<td>New York</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Texas</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>Washington</td>
<td>16</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: U.S. Department of Commerce, [Bureau of Economic Analysis](https://www.bea.gov)

Looking back at the state’s economy over the past decades, its diversity and ability to evolve clearly have contributed to its capacity to sustain growth over such a period. In the 1940s, the concern was that war-driven industrial build up in southern California, and the accompanying demand for housing, was threatening the future of the citrus industry (Coons, 1942). After the war, the agricultural sector adapted and diversified, while the investment in defense and aerospace industries saw new business emerge and existing ones expand. Federal defense spending as a share of the California economy [peaked in the 1960s](https://www.bea.gov) and would eventually decline; the fall of the Berlin Wall in 1989 served as a symbolic end of that era (Legislative Analyst’s Office, 1995).

Even before the Cold War ended, however, the groundwork was laid for the state’s next innovative pivot. California was playing a major role in technology developed for war, as well as its derivative spin-offs. Hewlett-Packard was established in Palo Alto in 1939. War investment accelerated the speed of development. The seeds of the semiconductor industry had begun to emerge in the 1950s. By the time [Apple, Atari, and Oracle](https://www.bea.gov) were founded in the 1970s, Silicon Valley had already become the accepted center of tech innovation (Stuart et al., 2020).

Once that reputation was established, the attraction of access to research universities, professional networks, and perhaps most important, investment capital, and the region helped to fuel the state’s growing economy. The rise of the internet saw the emergence of companies like Google, eBay, Yahoo, and PayPal in the 1990s. Facebook, Tesla, Twitter, and Uber followed shortly afterward.

What is worth noting is that while the umbrella label of “tech” can be applied to these companies, they too are a diversified group. Facebook and Google make money through advertising. Oracle and Uber are both service
providers, one to business, the other to individuals. While Apple and Tesla manufacture consumer products. In other words, what is often referred to as the technology industry, like the California economy, isn’t concentrated in any one sector.

**Figure 23. California’s Industries as a Share of State GDP, 2019**

![Pie chart showing the distribution of industries as a share of California's GDP in 2019.](image)

Note: Other categories include utilities, mining, education services and other business services.

Source: U.S. Department of Commerce, [Bureau of Economic Analysis](https://www.bea.gov)

This combination of diversification and innovation is one of the reasons the state has been able to continue to grow over the decades despite periodic setbacks. As Figure 23 shows, the state’s economic pie is split into rather thin wedges. Financial services represent the largest single sector at one-fifth of the economy, as a percentage of GDP value. Other industries such as government, manufacturing, entertainment, and trade are represented nearly equally, each about one-eighth of total output. The agricultural sector, which constitutes only 2 percent of California's economy, still represents the most agricultural output by value of any state.

The state’s diversified economic portfolio has, at least to date, enabled it to recover from recessions. Because the state isn’t dependent on a single sector for most of its economic activity and employment, and continues to innovate and evolve, it has had a hedge against shifts in the global economy or other financial variations in the long run. As noted in the Facts Section of this report, however, the benefits of that growth have not been shared equally by all Californians. Also, while the state’s economy does perform well over multiple years, California's public finance system suffers in the short-run when economic activity slows down.

The easiest way to understand the close connection between the state’s economy and its fiscal system is to examine what happens to California’s budget during recessions. Government revenues everywhere are sensitive to economic swings. California is no different, but its revenue roller coaster has steeper slopes, both up and down. The personal income tax, the corporate income tax, and the sales and use tax are the three primary
sources of state revenue. All three are tied to economic activity with revenue increasing during periods of growth and falling during slowdowns. The state’s progressive personal income tax system amplifies these effects, with its dependence on a relatively small number of high-income earners. To provide some sense of how dependent the system is on high-income households, for the 2018 tax year the California Franchise Tax Board reported that less than 20,000 taxpayers accounted for more than one-quarter of the personal income taxes paid that year (State of California Franchise Tax Board, 2018).

The volatility of the PIT goes beyond the fact that the progressive tax structure results in relatively few people accounting for a large share of revenue. The type of income those individuals earn – with capital gains playing a major role – amplifies the volatile nature of this source of revenue. Even a simple comparison that tracks changes in year-over-year returns from the S&P 500 to changes in the PIT illustrate the relationship between state tax revenue and the equities market.

**Figure 24. Year over Year Changes in California Personal Income Tax Revenue and S&P Returns**

![Graph showing year over year changes in California personal income tax revenue and S&P returns.](image)

**NOTE:** S&P returns are calculated based upon price change and dividend distributions.

**SOURCES:** Authors’ calculations based on California Department of Finance Schedule 3: Comparative Yield of State Taxes and Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED); Damodaran, 2019.

Though each recession is caused by a distinctive set of conditions, their impact on the state’s fiscal picture can be generalized. As the economy slows, state revenues fall, with a lag due to the way taxes are collected. The pandemic recession stands out as the exception to this pattern.

At the same time as the recession hits, individuals lose their jobs, unemployment rises, and the demand for additional safety net services (e.g., food assistance and public medical care assistance) increases (Murphy et al., 2019). It becomes easy to see why recessions can so quickly thrust the state into a fiscal crisis. Just when caseloads for social service programs are on the rise because people have lost their jobs, the tax revenue that

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14 There were more than 17 million tax returns filed in California in 2018. These 19,401 represent just over 0.1 percent of the total.
would be used to pay for those programs starts to fall. This fiscal double-whammy comes to a head as policy makers have to balance the budget.

While there is a general pattern of how recessions affect the state, the magnitude of that impact is far from uniform. In four of the past five recessions, the state saw its revenue decline although the steepness and length of the decline varied. The impact of the Dot Com recession was felt across three years with revenues dropping below the baseline between 4 and 9 percent. The Great Recession, however, saw general fund revenues decline about 25 percent below the baseline over four years.

Table 8. Impact of Recessions on California State Revenue Relative to the Baseline

<table>
<thead>
<tr>
<th></th>
<th>NBER Duration (mos.)</th>
<th>Fiscal years impact on CA Revenues</th>
<th>Estimated total revenue loss (Billions $)</th>
<th>Lost revenue per year (Billions $)</th>
<th>Lost revenue (per year) as a share of general fund (base year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil price shock II</td>
<td>22</td>
<td>1980-83</td>
<td>$19-30</td>
<td>$5-8</td>
<td>9-15%</td>
</tr>
<tr>
<td>Early ‘90s slump</td>
<td>8</td>
<td>1990-94</td>
<td>$37-58</td>
<td>$7-12</td>
<td>11-17%</td>
</tr>
<tr>
<td>Dot Com/9-11</td>
<td>8</td>
<td>2001-03</td>
<td>$13-26</td>
<td>$4-9</td>
<td>4-9%</td>
</tr>
<tr>
<td>Great Recession</td>
<td>18</td>
<td>2008-12</td>
<td>$137-175</td>
<td>$27-35</td>
<td>23-29%</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations based upon California Department Summary schedules and historical charts.

The pandemic recession is the outlier, where revenues did not drop, mostly a result of the fact that those that lost their jobs were mostly low-income workers. Taxpayers with higher incomes stayed employed. That fact, combined with a strong stock market, led to higher revenues. In this case, the state’s progressive tax system had a positive impact on revenues (Murphy, 2021).

Common to all recessions has been increased demands on the state’s social safety net programs. Here the slowing economy sets off a different chain of events that has an impact on the spending side of the state’s budget equation. As the economy slows, individuals lose their jobs, and their income drops. In turn, they begin to access the state’s programs designed to support those in poverty. Recent research demonstrates a strong relationship between changes in California’s unemployment rate and the demand for its programs like CalFresh (California’s food assistance program), CalWORKS (California’s Temporary Assistance for Families in Need program) and WIC (the Special Supplemental Nutrition Program for Women, Infants, and Children) (Danielson, 2021).

The most recent recession is unusual in this regard as well, but only in terms of degree. During and after the pandemic recession, unemployment in California set records as hundreds of thousands of workers lost their jobs. In the last week of February 2020, nearly 42,000 Californian’s filed for unemployment claims. One month later, new claims topped the 1 million mark. Not surprisingly, unemployment spiked, jumping from 3.9 percent in February to 16.4 percent in April. To put these numbers in perspective, the peak unemployment figure for California during the Great Recession was 13.2 (March, 2010). New claims for unemployment in California during
that period only exceeded 100,000 in a week once (January 16, 2010). Beginning in March 2020, new unemployment claims in the state exceeded 180,000 for twenty-three consecutive weeks (St. Louis Federal Reserve, 2020).

Considering the impact of recessions on the state’s residents, two features stand out. First, the impact of recessions can be \textit{sticky}, in that their consequences for individuals linger years after other indicators suggest that the economy and government revenues have bounced back. During the recovery after the Great Recession, for example, the share of Californians falling below the official poverty line remained elevated for several years after \textit{state revenues had recovered} (Murphy et al., 2019). Second, the impact on individuals is uneven across income-levels, race and ethnic groups, and regions. For example, during the Great Recession, low-income families (those in the bottom 10 percent) saw their income fall over 21 percent from 2007 to 2010. California families at the 90th percentile of income experienced \textit{only a 5 percent decline} (Bohn & Schiff, 2011). Across race/ethnic groups, African Americans experienced the greatest loss, with income falling 25 percent compared to 10 percent overall. This uneven pattern continued across the state’s regions with households on the central coast experiencing a drop in income of 18 percent while those in San Diego actually saw median household incomes rise about 5 percent over the period.

\textbf{Table 9. Changes in Median Income in California, 2007-2010, Across Different Groups}

<table>
<thead>
<tr>
<th>Group</th>
<th>Percent decline in income</th>
</tr>
</thead>
<tbody>
<tr>
<td>California overall</td>
<td>-10.4%</td>
</tr>
<tr>
<td>Income level</td>
<td></td>
</tr>
<tr>
<td>10th percentile</td>
<td>-21.5</td>
</tr>
<tr>
<td>25th percentile</td>
<td>-10.0</td>
</tr>
<tr>
<td>Median</td>
<td>-10.7</td>
</tr>
<tr>
<td>75th percentile</td>
<td>-7.9</td>
</tr>
<tr>
<td>90th percentile</td>
<td>-4.9</td>
</tr>
<tr>
<td>African American</td>
<td>-25.1</td>
</tr>
</tbody>
</table>

\textit{Of course, the pandemic recession was different in that the loss of jobs was, in part, driven by public policy decisions to shut down parts of the economy. Also different was the fact that government assistance increased relatively quickly in an attempt to offset the impact on individuals and businesses.}

\textit{National data on the pandemic recession indicates that it disproportionally affects} women in the workforce.
<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asian American</td>
<td>- 3.3</td>
</tr>
<tr>
<td>Hispanic</td>
<td>- 8.1</td>
</tr>
<tr>
<td>White</td>
<td>- 8.3</td>
</tr>
<tr>
<td>Less than High School</td>
<td>- 9.4</td>
</tr>
<tr>
<td>HS graduate</td>
<td>- 8.6</td>
</tr>
<tr>
<td>Some college</td>
<td>-13.3</td>
</tr>
<tr>
<td>College degree</td>
<td>- 8.1</td>
</tr>
<tr>
<td>Native</td>
<td>-14.3</td>
</tr>
<tr>
<td>Immigrant</td>
<td>- 5.3</td>
</tr>
<tr>
<td>Bay Area</td>
<td>-12.1</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>-11.3</td>
</tr>
<tr>
<td>Orange County</td>
<td>-12.7</td>
</tr>
<tr>
<td>San Diego</td>
<td>4.8</td>
</tr>
<tr>
<td>Inland Empire</td>
<td>- 9.7</td>
</tr>
<tr>
<td>Central Coast</td>
<td>-17.9</td>
</tr>
<tr>
<td>Sacramento region</td>
<td>-15.9</td>
</tr>
<tr>
<td>Central Valley region</td>
<td>-15.6</td>
</tr>
<tr>
<td>Rest of CA</td>
<td>-14.0</td>
</tr>
</tbody>
</table>

Source: Bohn and Schiff, 2011.

The role of the economy in shaping California’s fiscal policy is bifurcated. Along one branch, the ability of the state to innovate, adapt, and grow over the long term has been the driver of an overall growth in revenues and spending. In the short run, however, the impact of an economic downturn can precipitate a fiscal crisis. As will be discussed below, policy often is changed in the wake of recessions, unfortunately, it is not clear that those recession-driven reforms always have a positive impact in terms of fiscal sustainability.
Demographics

The size and the composition of the state’s population as a driver of the fiscal picture can be easy to overlook. At the most basic level, however, the relationship isn’t difficult to engage in. For example, if there are more people living in the state, that means more people paying taxes and therefore more revenue for the state. At the same time, a larger population also can create more residents in need of services, raising spending. From that foundational understanding, it becomes easy to imagine how shifts in California’s population can have profound implications for fiscal policy that extend beyond that basic relationship. Beyond the overall size, the composition of the state’s population in terms of factors such as age, skills, and educational attainment also have contributed to the current fiscal situation in California.

California is the country’s largest state in terms of population, with one-in-eight U.S. residents living in the state (Johnson et al., 2021). The fact that the overall population has grown relatively fast throughout much of the state’s history has been a significant and positive contribution to the state’s fiscal outlook. Adding more residents to the workforce and contributing to the growing economy has, among other things, helped build a large, robust tax base. But just adding more people doesn’t translate into fiscal sustainability. There is a need for the population to match the needs of that growing economy, and as discussed above, California’s economy is diverse and has evolved considerably over past years. If the population’s workforce doesn’t keep pace with those changes, the fiscal picture deteriorates. Fortunately, that hasn’t been the case, at least so far, in the state.

Figure 25. Population Growth Rates for California and the Rest of the United States, 1961-2000

Demographic forces have reshaped the racial and ethnic composition of the state as well. Latinos have become the single largest group, and no race/ethnic group makes up a majority of the state’s population (Johnson et al., 2021). A significant portion of the state’s diversity has been fueled by migration into California. Migration – both from other states and other countries – has been a key contributor to California’s capacity to have enough
workers, with the right skills, to meet the needs of an innovating and growing economy. Prior to WWII, it wasn’t unusual for migration to account for 80, 90, or even 100 percent of the total population growth. Over the 45 years following the war, new residents from other states and abroad still contributed between 25 and 60 percent of the population increase each year (Figure 26).

**Figure 26. California Annual Total Population Change and Net Migration**

![Graph showing California Annual Total Population Change and Net Migration]

Source: CA Department of Finance, Table E-7, California Population Estimates, with Components of Change and Crude Rates, July 1, 1900-2020.

Domestically, California has long imported educated individuals from other states. For many years, the state’s high-quality higher education system attracted students from across the country. Many of them simply didn’t leave. More recently, the migration pattern has shifted some, as California has lost millions of residents to some states, but also gained millions from others (albeit the flows in are smaller than the flows out). Those leaving tend to be lower income and less educated than those arriving (Johnson, 2021). Those leaving California also often relocate to states in the western region while new Californians hail from further afield (see table).
Table 10. California Net Domestic Migration, Top and Bottom Five States, 2006-2016

<table>
<thead>
<tr>
<th>Top Five Destination States</th>
<th>Top Five Sources of New Californians</th>
</tr>
</thead>
<tbody>
<tr>
<td>Texas</td>
<td>New York</td>
</tr>
<tr>
<td>Arizona</td>
<td>Illinois</td>
</tr>
<tr>
<td>Nevada</td>
<td>New Jersey</td>
</tr>
<tr>
<td>Oregon</td>
<td>Michigan</td>
</tr>
<tr>
<td>Washington</td>
<td>Alaska</td>
</tr>
</tbody>
</table>

Source: Next Ten, California Migration A Comparative Analysis, 2019.

International migration, arguably, has played an even larger role in supporting the state’s economic growth. Migrants from Latin America were critical in propelling the state’s agricultural sector to its place of international leadership (Rogers & Buttice, 2013). Migration patterns, however, have shifted in recent years, in many ways, driven by the demands of the changing economy. Recently, Asia passed up Latin America as the source of the greatest number of immigrants to California (Johnson et al., 2021). Migrants from Asia tend to be more educated and many of the new residents tend to earn higher wages than current state residents (Johnson et al., 2021).

Not all migrants head directly into the workforce, with a large number of the state’s postsecondary students being foreign born. More foreign-born students, either permanent residents or those on visa, are enrolled in California’s colleges and universities than students from any single U.S. state, and this group constitutes more than one-quarter of the state’s graduate students (Figure 27). Migrants also make up a disproportionate share of the students pursuing STEM degrees with 46 percent of engineering and 42 percent of computer and information sciences majors studying in California being foreign born (Johnson et al., 2021).
In sum, migration into California has long constituted a critical source of labor for the state’s diverse economy and more recently has played a growing role in supplying workers with levels of education attainment to meet the needs of the state’s innovative economic sectors. Robust migration into the state historically has been a key driver of the economy and resulting public revenue growth. In recent years, both migration and natural population growth have slowed significantly. Whether it is restrictive federal immigration policies that keep people from moving into the state or housing prices that push people out of the state, California cannot just assume that it will be able to import the workforce it needs to support its economy going forward.

**Policy Change**

Understanding the impact that the economy and changing demographics have on the state’s revenue and spending is critical to charting a future path for California’s fiscal policy. As important as these elements are, however, there are features of both that are beyond the control of the state. Public policy – the constitutional provisions, state laws, and regulations that govern fiscal programs – are levers that policy makers influence directly.

Elected officials in Sacramento, via the legislative process, voters, via the initiative process, and at times the courts through their decisions, have repeatedly shaped the contours of California fiscal policy. Over time, these policies have altered the fiscal relationship between the state and local governments. They have defined and redefined the boundaries of the tax base. They have, at times, limited what governments can do relative to taxing and spending, and in other instances they have loosened some of those restrictions. Table 11 presents a subset of the fiscal changes over the past decades that have had the most influence on the current fiscal situation.
Table 11. Key Dates in California Fiscal History

<table>
<thead>
<tr>
<th>Year(s)</th>
<th>Event and impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>1910</td>
<td><strong>Separation of Sources Act</strong></td>
</tr>
<tr>
<td></td>
<td>● Acknowledges a <em>distinction between state and local revenue</em> (Silva &amp; Barbour, 1999)</td>
</tr>
<tr>
<td></td>
<td>● In theory, the government that imposes the tax should determine how it is used</td>
</tr>
<tr>
<td>1930s</td>
<td><strong>New Deal</strong></td>
</tr>
<tr>
<td></td>
<td>● Greatly expands federal transfers to the state</td>
</tr>
<tr>
<td></td>
<td>● State enlists counties to administer safety net programs</td>
</tr>
<tr>
<td>1952</td>
<td><strong>Prop. 18: Redevelopment Agencies</strong> <em>(Blount et al., 2014)</em></td>
</tr>
<tr>
<td></td>
<td>● Local governments can pledge property tax growth to pay for debt service.</td>
</tr>
<tr>
<td></td>
<td>● Voter approval isn’t needed to issue debt</td>
</tr>
<tr>
<td>1972</td>
<td><strong>SB 90 School finance reform</strong></td>
</tr>
<tr>
<td></td>
<td>● Set maximum local property tax rate; state will pay for mandated programs and equalize school resources</td>
</tr>
<tr>
<td></td>
<td>● Disrupts link between local property taxes and school districts (Response to Serrano v. Priest, 1971, aka Serrano I)</td>
</tr>
<tr>
<td>1976</td>
<td><strong>Serrano II court decision</strong> <em>(Serrano v. Priest, 1976)</em></td>
</tr>
<tr>
<td></td>
<td>● State supreme court ruled that SB 90’s effort to equalize school funding was insufficient</td>
</tr>
<tr>
<td>1978</td>
<td><strong>Prop. 13 Property tax reform</strong></td>
</tr>
<tr>
<td></td>
<td>● Caps the rate at which property assessments can increase at 2%</td>
</tr>
<tr>
<td></td>
<td>● State responsible for allocating property tax</td>
</tr>
<tr>
<td></td>
<td>● 2/3rds requirement for new taxes at the state level; 2/3rds requirement to increase or pass special taxes at the local level</td>
</tr>
<tr>
<td>1979</td>
<td><strong>AB 8 Prop. 13 “Bailout”</strong></td>
</tr>
<tr>
<td></td>
<td>● State expands funding for safety net and schools</td>
</tr>
<tr>
<td></td>
<td>● Allocate <em>intra-county property tax</em> based on pre-Prop. 13 share of revenue <em>(Elledge, 2006)</em></td>
</tr>
<tr>
<td>1979</td>
<td><strong>Gann limit</strong> <em>(Beam, 2021)</em></td>
</tr>
</tbody>
</table>
● Restricts how much the state and many local jurisdictions can spend based on changes in population and inflation

1988  
**Proposition 98**

● Established a **guaranteed floor or** set share of total state revenues that would be allocated to education spending (K-12 and community colleges) (EdSource, 2009).

1991  
**Health/social services realignment**

● **Swapped program responsibility** and funding allocations between state and counties (Taylor, 2018)

1992/1993  
**Educational Revenue Augmentation Fund (ERAF) shifts**

● Redirects funds from cities and counties to schools accompanied by a **sales tax** (Prop. 172) to backfill dollars lost by local governments (Coleman Advisory Services, n.d.)

● ERAF amounts based on AB 8 levels

2004  
**Triple Flip** (Alamo, 2015) (Prop. 57)/**State Mandate Funding (Prop. 1A)** (Coleman Advisory Services, n.d.)

● State reduced VLF & sales tax; replaced lost revenue with ERAF funds

● Limited future state intervention into local revenues

2010  
**Proposition 25**

● Budget process reform that changed from a supermajority to simple **majority vote** to pass the state budget (Macías & Ross, 2010)

2011  
**Public safety realignment (AB109)** (Stanford Criminal Justice Center, n.d.)

● Shifted responsibility for incarceration to county jails in exchange for additional funding

● Reduced the state prison population

2011  
**Dissolution of Redevelopment agencies (ABXI 26)** (Blount et al., 2014)

● Ended the diversion of local property tax revenue for debt payment

2012/2016  
**Tax increases (Prop. 30/Prop. 55)** (Miller et al., 2017)

● Increased the state sales tax and raised personal income tax rates on highest income

● Prop. 55 extended the income tax increase

2014  
**Rainy Day Fund (Prop. 2)** (Graves & Kaplan, 2014)
• Strengthened reserve fund provisions in the budget to establish a credible reserve
• First, required to pay down existing liabilities

The list of key policy changes is hardly an exhaustive one. There are several other examples of when fiscal policy has been altered that could be added. And, arguably, one could include nearly every annual budget process for inclusion, since the governor and legislature have often used the budget bill and companion legislation to make changes to programs that extend beyond an individual fiscal year. This list, however, attempts to highlight the changes that have had the greatest impact on the state’s current fiscal condition. For the purposes of discussion, we are going to focus here on the four most critical to today’s situation:

• Proposition 13 – property tax cap and limits on government.
• Proposition 98 – guaranteed education funding
• Proposition 25 – state budget process reform
• Proposition 2 – rainy day fund

The Fiscal Straightjacket: Proposition 13

It is not an exaggeration to say that Proposition 13 was, and continues to this day to be, the most important change to California’s fiscal landscape. Explaining the impact of Proposition 13 requires delving deeply into the details of California property tax law. Given the oversized impact that the change continues to have on fiscal policy, that level of discussion is, unfortunately, necessary.

What did Proposition 13 do? The initiative was put on the ballot by anti-tax groups who stated that local property taxes were too high and had been rising too quickly (Doerr 1978). The constitutional amendment that was on the ballot for the June 1978 election was supported by 65 percent of the vote (California Proposition 13, n.d.). Under its provisions:

• Property taxes were capped at 1 percent. Prior to passage, the average property tax rate was 2.67 percent (Taylor, 2016).
• Property values would be based on the purchase price and each year afterward, could only increase at a maximum of 2 percent.
• Responsibility for the distribution of property tax revenue was given to the state government.
• A two-thirds vote of the state legislature was required to raise taxes.

Passage of Proposition 13 set in motion a number of consequences, many of which continue to define the parameters of fiscal policy today. One of the most direct effects was to immediately reduce the revenue generated by property taxes which dropped 60 percent the following year (Figure 28). Despite what one might think about the size of government, a drop of that magnitude forced the state government to step up and (1) determine how property taxes would be distributed per the provision of Prop. 13, and (2) essentially find ways

17 It is worth noting that Fischel (1989) argues that voters were motivated by more than high taxes. He maintains that the state supreme court’s Serrano (1971) decision drove voters to decide to move responsibility for property taxes to the state.
to backfill local governments for the loss in revenue. Three weeks after its passage, the state legislature would pass SB 154 as a stopgap to provide funding to local governments quickly.

**Figure 28. Share of Total K-12 Funding in California, 1970-2018**

![Graph showing share of total K-12 funding in California, 1970-2018.](image)


The following year, they would seek to codify the distribution of property taxes with passage of AB 8 in 1979. AB 8 sets in law the share of the total property taxes collected within a county to be distributed to each unit of local government. Each share is based on the proportionate share of property taxes that the jurisdiction received in the 1970s. What is important about this fact is that prior to Proposition 13, local governments could set their own property tax rate. Not surprisingly, there was considerable variation in the level of local taxation. AB 8 essentially froze that variation in place, with communities that were low-tax districts in 1977 continuing to receive a smaller share of the property tax pie in 2021.

The net effect across the state is two-fold. First, the total value of property a county can tax varies simply because some counties have more, and a more valuable property base. Since the rate is set at 1 percent, there is only so much communities can raise via property taxes with their existing tax base. Put simply, wealthy counties have more valuable property and a larger tax base than poorer ones. Second, within a county, the distribution of those taxes is fixed in time with local jurisdictions receiving the same share of property taxes that they did decades earlier, even though they may have grown in population more quickly or want to provide a different mix of services.
Table 12. Variation Across Counties and Full-Service Cities in Los Angeles County, 2009-10, Property Tax Dollars Per Capita

<table>
<thead>
<tr>
<th>California’s 10 Largest Counties</th>
<th>Property Tax Revenue per Capita</th>
<th>Full-Service Cities in LA County</th>
<th>Property Tax Revenue per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>Santa Clara</td>
<td>$1,714</td>
<td>San Marino</td>
<td>$ 721</td>
</tr>
<tr>
<td>Contra Costa</td>
<td>1,404</td>
<td>Redondo Beach</td>
<td>283</td>
</tr>
<tr>
<td>Orange</td>
<td>1,396</td>
<td>Pasadena</td>
<td>262</td>
</tr>
<tr>
<td>Alameda</td>
<td>1,310</td>
<td>Los Angeles</td>
<td>243</td>
</tr>
<tr>
<td>San Diego</td>
<td>1,274</td>
<td>Burbank</td>
<td>238</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>1,095</td>
<td>Long Beach</td>
<td>178</td>
</tr>
<tr>
<td>Riverside</td>
<td>983</td>
<td>Arcadia</td>
<td>150</td>
</tr>
<tr>
<td>Sacramento</td>
<td>890</td>
<td>Santa Fe Springs</td>
<td>117</td>
</tr>
<tr>
<td>San Bernardino</td>
<td>855</td>
<td>Alhambra</td>
<td>93</td>
</tr>
<tr>
<td>Fresno</td>
<td>654</td>
<td>Pomona</td>
<td>85</td>
</tr>
</tbody>
</table>


In the 40-plus years since passage of Proposition 13 and AB 8, the state and its local governments have wrestled with how to provide services to its residents while working within the constrictive parameters of their provisions. The fact that Proposition 13 shifted more fiscal decisions away from local governments merits emphasis. Doing so excluded some groups when power was moved away from school districts, towns, and counties, and cities and put it in the collective hands of state elected officials. The cost to participate in political debates in Sacramento is far higher than the effort it takes to engage a local school board, for example. Consequently, those with fewer resources, as well as groups that have been traditionally shut out of the policy process, face even greater obstacles to having their voices heard.

The effort to function within the fiscal straightjacket of Proposition 13 has had other knock-on policy effects at both the local and state level. Locally, jurisdictions constrained by the property tax cap have looked for workarounds as they seek support for the programs their communities value. In some cases, the effort has manifested itself in the direct exercise of existing tax authority. Soon after, city councils and other elected officials proposed increasing local sales taxes, imposing transient (hotel occupancy) taxes, and imposing other fees. Proposition 13 even, unintentionally, gave rise to a new type of special tax – the parcel tax – where a jurisdiction levies a set tax on parcels of real property (Sonstelle, 2014). Of course, to raise taxes any tax required the support of two-thirds of the voters, complicating the task considerably.
Local jurisdictions have also adapted to the constraints imposed by Proposition 13 in ways that have consequences for their local communities that go beyond having to pay more in taxes. Consider the growing city that is locked into its share of property taxes because of AB 8 and though a majority of voters may support increasing sales taxes or imposing a property tax, they cannot clear the two-thirds majority that is required. One response is to simply cut spending for public safety, public works, library programs, etc. It is possible, however, through less transparent means to raise revenue.

Absent the ability to raise the property tax rate and unable to muster a super-majority to support other tax increases, one path local governments have taken is to impose additional impact fees on new developments. The concept behind impact fees is that they are intended to offset the costs associated with new construction. Perhaps as important, impact fees do not require voter approval. As a result, impact fees are much higher in California compared to other states; a 2015 survey found the average single-family non-utility impact fee in California to be almost $23,500 (Duncan Associates, 2015). The average for the rest of the country was $5,783. The use of these fees has increased in recent years, and not surprisingly, they are higher in jurisdictions that haven’t passed a parcel tax (Taylor, 2016). Given that developers will build the additional costs into the price of the home, the use of impact fees just raises the barrier to homeownership in the state that much higher.

A second method to raise revenue that doesn’t require voter approval is the use of local zoning authority. If a jurisdiction under fiscal stress can generate more retail sales within their borders, sales tax revenue will rise without having to go to voters for their approval for a sales tax increase. This concept, the fiscalization of land (Misczynski, 1986), favors zoning to support a new car dealership or big box store over the using the same parcel for housing. Capped property tax rates, then, alter land use decisions with jurisdictions incentivized to seek the maximum amount of commercial activity per square foot. Some research refutes the claim that revenue considerations drive land-use policy, though that work did find that cities that rely more on sales taxes were slightly more likely to rezone land for retail use (LAO 2016).

A number of significant policy changes listed in Table 11 are a consequence of state and local leaders attempting to rebalance the state/local fiscal relationship that Proposition 13 upended. In addition to realigning responsibilities for health and social services realignment (1991) and public safety (2011), policy makers have restructured revenue flows in elaborate ways. Two examples:

- **Educational Revenue Augmentation Fund (ERAF) shifts** (Coleman, 2012). After the economic slow-down of the early 1990s, the Governor and legislature redirected a larger share of property taxes from cities and counties to schools, freeing up general fund dollars. To placate the local officials, they put on the ballot a sales tax increase (Prop. 172) to backfill dollars lost by local governments (Coleman, n.d.).

- **Triple Flip (State Board of Equalization, 2004).** Following the Dot-com recession of 2000, policy makers in 2004 organized a $15 billion bond initiative to finance the state deficit. To repay the bonds, the state pledged a portion of local sales taxes (flip one). The state then shifted back property tax funds that it had diverted under ERAF (flip two). To make the schools and community colleges who saw their funding drop whole, general fund resources (using borrowed dollars) were used to backfill (flip three). It took another recession and several years of recovery before the 2015-16 budget unwound the Triple Flip (Johnson & Hammer, 2016).
Though California isn’t the only state to struggle with dividing responsibility between government levels for paying for different services, it is important to note that, in most cases, these shifts were motivated by fiscal concerns. Either during, or in the aftermath of a recession, state policy makers sought ways to free up resources for their priorities by shifting funding streams. Since Proposition 13 gave the state responsibility to distribute the key source of local revenue, property taxes, the local governments had less leverage in negotiating these arrangements.

Taken together, Proposition 13 and the subsequent set of policy changes that repeatedly adjusted and defined the relationship between the state and local governments created an impressively complex, byzantine fiscal system. As a result, one consequence of Proposition 13 is clear: it is extremely difficult to explain to individual taxpayers where their money goes and where the funds that pay for local services come from.¹⁸

The consequences of Proposition 13 extend beyond creating headaches for the state’s elected officials and public administrators. The tax cap and the rules that govern when a property’s assessment is re-set to the market value distorts both the residential and commercial housing markets. Residential property owners who hold onto their homes for a relatively long period enjoy a tax subsidy that generally increases over time. As a consequence, homeowners in California hold onto their homes longer than those in other states. This lock-in effect (Picker, 2005), reducing the rate that homes turnover, can mean that younger households have to wait longer to transition from renting to owning (Wasi and White, 2005).¹⁹ For commercial real estate, Proposition 13 has the effect of reducing the cost of holding on to property and leaving land vacant as the annual tax burden will rise modestly. Building on the property would trigger a reassessment and higher taxes. As a result, vacant properties that have been held for a long time become increasingly less likely to be developed (Taylor, 2016).

Though there is a scarcity of current research on the consequences of Proposition 13, information on its impact on individuals is particularly scarce. For example, one of the central arguments for capping property taxes at the time was that seniors were being forced out of their homes because they could no longer afford a growing tax bill. There has not been, to our knowledge, any research effort demonstrating a significant change in the number of older homeowners feeling compelled to sell after passage as compared to before the cap took effect.

There have been efforts to make clear the fact that two homeowners, living in similar houses in the same neighborhood can have very different property tax bills (The Tax Fairness Project, n.d.). This situation, where two similarly situated individuals face different tax rates violates the public finance principle of horizontal equity (Cordes, 1999). Beyond the pages of an academic textbook, however, it also just strikes many taxpayers as simply unfair.²⁰ An extension of this inequity is that most of the benefits of Proposition 13 – the subsidy that it

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¹⁸ In 2006, the Santa Clara County Controller attempted to do just that in a publication entitled Demystifying the California Property Tax Apportionment System. The document was 81 pages long.

¹⁹ The effect was found to be more pronounced in coastal cities, increasing the average tenure by 2 to 3 years. The authors also found the delay in transitioning to ownership to be greater for African-American households and migrants to the state compared to whites and those native-born.

²⁰ It is worth noting that businesses can face a similar situation. One small business that owns its building could be faced with an unlevel property tax playing field compared to a competitor who purchased their property at an earlier date. One analysis found that in Los Angeles County in 2015, a typical new commercial property owner paid $2.69 per square foot in property taxes. This figure compared to $1.18 for commercial property owned ten years or longer and $0.87 per square foot for commercial properties owned for 20 years or longer (LAO, 2016).
provides to homeowners – accrue to those owning more expensive homes (Taylor, 2016). It is likely, then, that the benefits of the cap on property taxes are regressive.

One impact of Proposition 13 on individuals that has yet to be tested – an extension of its regressive features – is its effect on the formation of intergenerational wealth. It isn’t difficult to construct hypotheses as to what that impact could be given the provisions and timing of the initiative. When a residential property is sold, its assessment value is re-set at the sales price. A provision of Proposition 13, however, allows homeowners to transfer a house to their children or grandchildren and maintain the reduced assessment figure. As a consequence, a property that was owned by a family in 1978 and stays owned by that family would enjoy an assessed value that has only risen by 2 percent a year, well below the market rate representing a substantial tax break. Considering that home ownership represents the single largest portion of most families’ wealth combined with the fact that Prop. 13 grandfathers in its tax subsidy, it is quite possible that the initiative has contributed to a widening wealth gap over the past four decades.21

Proposition 13 was an example of California leading the nation. In the years following its passage, another 45 states followed suit in some form, either capping property tax rates, the speed at which assessments can climb, or both (Walczak, 2018).22 Although, only six other states require a supermajority vote of the legislature to approve any tax increase (Graves, 2014).23

It was the start of what would be called the Great Tax Revolt, which libertarians and conservatives would celebrate as a critical step on the way to “starving” the government of resources and therefore limit its size (New, 2003). In California, government has continued to grow, but it has done so within the confines of the fiscal straightjacket that is Proposition 13. Today, policy makers must navigate the convoluted set of formulas and tests that govern how revenue collected at the local level, comes under the control of Sacramento, and then is redistributed back in support of counties, schools, cities, and other governments. The provisions also distort markets, introduce other inefficiencies, and quite likely, contribute to growing inequality in the state.

**Education Funding Autopilot: Proposition 98**

Passed in 1988, Proposition 98 amended the state’s constitution and established a minimum funding level for K-12 schools and California’s community colleges. This minimum level is determined by one of three tests that take into consideration the total amount of revenue collected by the state, the size of the student population, and changes in personal income in the state (Taylor, 2017). The change was championed by education advocates and teachers’ unions in an effort to stabilize school funding after ups and downs brought on by the recessions of the 1980s. In general, Proposition 98 has provided a relatively stable level of resources dedicated to education.

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21 Proposition 19 (2020) did include changes that limited the grandfathering of the tax subsidy to owner-occupied homes and not to second homes or rental properties. At the same time, Prop. 19 did make the subsidy more “portable,” enabling older homeowners to take the subsidy with them should they move elsewhere within the state.

22 Some states have imposed limits on the overall amount of revenue generated by property taxes or levy limits.

23 The other states are Oregon, Nevada, Arizona, Louisiana, and Mississippi. Some states do require supermajority votes for certain state tax increases. Others, Colorado and Missouri require the legislature to send tax increases to the voters for approval.
As with so many policy reforms implemented at the ballot box, Proposition 98 has had its own share of unintended consequences. One has been to set the level of K-12 spending in the state on autopilot, where the discussion each year is whether the amount required under the Proposition 98 test has been met, not whether that amount is the funding necessary to provide an adequate education for all of the state’s students. In other words, while Proposition 98 was intended to set a floor for education funding, it also set a ceiling.

**Figure 29. K-12 Education Expenditures as a Proportion of the General Fund**

![Graph showing K-12 education expenditures as a proportion of the general fund over time.]

Source: Authors’ calculations based on data from California Legislative Analyst’s Office 2021. [Historical Data](#).

The legislature often makes some adjustments to the Prop. 98 calculations, but those mostly involve the timing of when funds are provided and if its intent has been generally followed. Nevertheless, there is no evidence that schools are any better off under Prop. 98 than they otherwise would have been (Taylor, 2017). And, an enacted budget with total education spending greater than the constitutionally required amount has been extremely rare.

A second unintended consequence has been the rise of Special Funds in the state budget. Special Funds are created by initiative or legislation to fence off resources for a specified purpose. They often are supported by a designated stream of revenue such as the fees paid by visitors to state parks, or the money generated by the gas tax. Over the past 35 years, total spending out of special funds has increased 6-fold in real terms, at an average annual rate of 5.4 percent. Proposition 98 is one reason for the increase. Under its provisions, a portion of revenue that flows into the state’s general fund is guaranteed to go to education programs. Advocates for non-education programs who seek to create new revenue sources to increase funding for their priorities have a strong incentive to fence off those dollars in a special fund. Otherwise, they end up seeing about 40 percent of any new revenue go to education.

**Sustainable Fiscal Future: Proposition 25 and Proposition 2**

While many of the significant changes in fiscal policy have introduced constraints on policy makers and produced unintended consequences, two provisions have improved the state’s ability to follow a fiscally sustainable path.
In 2010, voters approved a provision to change the 1933 constitutional requirement that the budget pass with a two-thirds vote of both houses in the legislature. Proposition 25 followed a ten-year period where the fiscal year began July 1 without a budget being passed nine times. The ramifications of missing the budget deadline reached meltdown proportions in 2009, when the state found itself issuing IOUs to pay its bills (Steinhauer, 2009). At the time, California was one of only five states with a supermajority requirement to pass a budget (Rueben & Randall, 2017).

In the eleven years since Proposition 25 was approved, budgets have passed on time. The proposition was sold to voters as a way to hold legislators accountable by withholding their pay if the budget wasn't passed on time. Recently, the legislature has taken to passing a “placeholder” budget to meet the deadline and trigger their continued pay. They then use the following weeks to complete the details and settle any outstanding areas of disagreement. What is clear is that the drama that surrounded the budget deadline has been reduced dramatically, likely contributing to voters having a better opinion of the job performance of their elected officials. The lower bar for passage, however, also means that there are multiple solutions to the vote counting problem, making compromise easier. With the two-thirds threshold, the bar for passage was high and negotiators risked losing support from some legislators while trying to appease others to win over their vote.

The establishment of an effective reserve fund represents a policy change that has had a more quantifiable impact on the state’s fiscal picture. Since 1980, California has made several attempts to establish rules that set aside funds building reserves for years when revenues fall. Given the volatile nature of California’s tax receipts, saving for the expected rainy day has been an unrealized imperative until 2014. That year, voters passed Proposition 2 increasing the annual reserve amount from 1 percent of General Fund revenues to 1.5 percent as well as an added portion of excess capital gains revenues. (The other half of any capital gains tax windfall was designated to pay down eligible debts.) Given that capital gains drive much of the revenue volatility in California, Proposition 2’s provision ties a large portion of reserves to those ups and downs.

In addition, Proposition 2 amended the rules for withdrawals (LAO, 2014) from the rainy day fund, building upon lessons learned during the Great Recession. Today when economic hard times hit, the legislature may reduce its deposits into the reserve or make a withdrawal only after a budget emergency has been declared by the Governor and majority votes of both houses in the legislature. During a budget emergency, the legislature may only withdraw the lesser of: the amount needed to maintain general fund spending at the highest level of the past three enacted budget acts, or 50% of the reserve balance. These strong checks on withdrawals are an important safeguard to ensure that allocation and maintenance of reserve funds remains a priority.

The benefits of the restructured rainy day fund were apparent at the start of the pandemic. As the state headed into lockdown and the short but severe recession began to take hold in the spring of 2020, California’s reserves made it one of the better prepared states to weather an economic storm. For Fiscal Year 2019, states on average had set aside enough reserves to fund their annual budget for about a month (28 days). California had enough reserves on hand to cover 53 days of spending (Figure 30). Overall, California had the sixth largest

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24 The declaration is based on: whether estimated resources in the current or upcoming fiscal year are insufficient to keep spending at the level of the highest of the prior three budgets, adjusted for inflation and population, or in response to a natural or man-made disaster.
reserve fund on hand, behind some of the resource extraction states like Alaska and North Dakota where oil prices and production drive their revenue volatility.
Figure 30. Number of Days States Could Run on Rainy-Day Funds, 2019

What is the right level of reserves on hand is a difficult question to answer. The idea of setting aside funds as a hedge against the state’s volatile revenue stream has, at least in recent years, been embraced by elected officials as both necessary and desirable. However, even though the level of reserves required by Proposition 2 are likely to offset the revenue drop associated with a mild recession, the reserves are not enough to avoid program cuts should the state encounter a moderate to severe recession (Murphy et al., 2019). The crisis generated by the pandemic brought home both the benefits and limitations of the state’s reserves. In the summer of 2020, when revenue projections were dire, policy makers declared a budget emergency and turned to reserves to avoid additional program cuts of between 6 and 7 percent of the total budget (Murphy, 2020).

The changes made to fiscal policy in California have, in many cases, restricted the choices elected officials can make, making it particularly difficult to respond when a crisis hits. Given that crises periodically present themselves (on average, every 6-7 years), being able to respond with programs that meet the needs of residents is important. And while some policies have made positive contributions and put the state on a more sustainable path, they have been recent and don’t address some of the structural challenges ahead.

**Public Opinion**

It is worth noting that the four fiscal policy reforms discussed above all came about as a result of ballot initiatives. Given the central role that voters have in setting, and then changing, fiscal policy in California, it is appropriate to examine the role that public opinion plays in making public finance decisions. While public opinion may not, in and of itself, drive fiscal policy, it serves as a key variable in the overall discussion. And in California, groups can relatively easily bring policy questions to the voters wielding the initiative process as a blunt tool to make policy. As a consequence, understanding the intersection of public opinion and fiscal policy is a necessity.

Unraveling the relationship between public opinion and policy is complicated, however. That complexity starts with a number of qualifications to any conclusions that one might draw. To begin, individuals are typically poorly informed when it comes to questions of public finance, a fact that is true at the national level as well as in California. For example, the PPIC survey has asked its adult respondents to identify which funding area represents the most spending in the state budget. Of the four options, K-12 spending followed by health and human services should be at the top of the list (Figure 31). Over the period the question was asked (2005-2019), anywhere from one-quarter to almost one-half of the adults would identify corrections spending as being the state’s highest fiscal priority (PPIC, 2019).
Public opinion also isn’t formed in a vacuum. As a consequence, external events will affect the mood and positions of those being surveyed. A recent mass shooting can cause a bump in support for more stringent gun control measures. While fiscal issues may be less punctuated, similar patterns can be observed. For example, economic downturns can be reflected in Californian’s assessment of the general direction of the state. As recessions bring slower growth and increased unemployment, the state’s residents become more pessimistic about the future, although opinion seems to lag slightly (Figure 32).

**Figure 32. Do You Think Things in California are Generally Going in the Right Direction (All Adults)?**

Targeted efforts designed to change the public’s opinion, including political campaigns, can have an impact, at least at the margin. Advocates for property tax reform found this out when, heading into 2020, over 50% of likely voters said they would support the idea of amending Proposition 13 and taxing commercial property at the market rate (the “split roll” initiative) to raise revenue for education. Even before the ballot initiative (what would become Proposition 15, 2020) qualified, the California Chamber of Commerce and other business groups began spending millions of dollars to oppose the change (Figure 33). The impact of the business groups’ campaign was to drive down the “yes” votes and increase the share voting “no.” The initiative would fall in November, receiving only 48 percent of voters.

**Figure 33. Likely Voter Support for “Split Roll” Property Tax**

![Graph showing voter support for split roll property tax initiative over time.]

Source: PPIC statewide survey database, [October 2020](#).

**Complexity makes things complicated.** The complexity of fiscal policy makes it particularly difficult to draw a direct line from a public opinion poll and policy. Take, for example, questions put to California residents about school districts issuing bonds versus instituting parcel taxes. Issuing a local bond would result in the local district borrowing money and then paying off the loan with an increased assessment on property taxes. Parcel taxes also are levied locally and show up on a homeowner’s property tax bill. In both cases, the benefits of the additional revenue are explicitly for education and will stay in the district. Neither question mentions a dollar amount, so they cannot be compared that way. Yet, when the two questions are presented to the same group of respondents, they differentiate, expressing more support for the bond than the parcel tax (Figure 34).
It is possible that those responding are, indeed, expressing a preference for the capital investments that are commonly associated with bond issues. A plausible explanation is that they don’t really understand how bonds work. In fact, it is quite possible that some individuals are more likely to respond negatively upon seeing the word “tax” in a question or proposal.

These qualifications suggest caution when trying to draw conclusions from public opinion polls, particularly as they apply to fiscal questions. If, however, one looks beyond single snapshots in time and keeps in mind the limits of public opinion in this context, it is possible to identify some general findings about Californians opinions regarding fiscal questions. For example, the state’s residents appear to have formed relatively stable opinions about what should be a priority for the state. These priorities, for the most part, mirror how spending is parsed at the state level, with the biggest shares being allocated to K-12 education and health and human services programs. Although long-term trend data aren’t available, in recent years support has coalesced around the same areas that represent the largest share of the state budget. At the same time, public support for higher education has dropped significantly over a relatively short period of time, as has its share in the budget (Figure 35).
Figure 35. Name the Area that You Think Should Have the Highest Priority When it Comes to State Government Spending (All Adults).

Source: PPIC statewide survey database, May 2021 (Baldassare et al., 2021).

It is likely that the increase in support for spending on health and human services is related to the rise of concern around the issue of health care generally. Health care, in fact, is one area that demonstrates how public opinion appears to be capable of changing, with adults shifting from being evenly divided about the Affordable Care Act (ACA) to a strong support (Figure 36).

Figure 36. Californians’ Opinion of the Affordable Care Act (all adults)?

Source: PPIC Survey Database, May 2021 (Baldassare et al., 2021).
Support for the ACA, not surprisingly, is divided. Partisanship represents the biggest source, with 86% of Democrats supporting the law while 70% of Republicans oppose it. Other significant differences exist across race/ethnicity, regions, income and age, though they are not as stark.

**Table 13. Support for the Affordable Care Act**

<table>
<thead>
<tr>
<th>Group</th>
<th>Favorable</th>
<th>Unfavorable</th>
<th>Don’t know</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Adults</td>
<td>60</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>Likely voters</td>
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<td>34</td>
<td>7</td>
</tr>
<tr>
<td>Democrat</td>
<td>86</td>
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<tr>
<td>Republican</td>
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<td>70</td>
<td>7</td>
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<tr>
<td>Independent</td>
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<td>Asian Americans</td>
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<td>19</td>
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<tr>
<td>Latinos</td>
<td>65</td>
<td>23</td>
<td>11</td>
</tr>
<tr>
<td>Whites</td>
<td>55</td>
<td>40</td>
<td>5</td>
</tr>
<tr>
<td>Less than $40k/year</td>
<td>70</td>
<td>21</td>
<td>10</td>
</tr>
<tr>
<td>$40-79k</td>
<td>60</td>
<td>32</td>
<td>8</td>
</tr>
<tr>
<td>More than $80k</td>
<td>54</td>
<td>39</td>
<td>7</td>
</tr>
<tr>
<td>18-34 years old</td>
<td>63</td>
<td>21</td>
<td>15</td>
</tr>
<tr>
<td>35-54</td>
<td>56</td>
<td>36</td>
<td>7</td>
</tr>
<tr>
<td>55+</td>
<td>62</td>
<td>31</td>
<td>7</td>
</tr>
<tr>
<td>Central Valley</td>
<td>58</td>
<td>35</td>
<td>7</td>
</tr>
<tr>
<td>Inland Empire</td>
<td>49</td>
<td>45</td>
<td>6</td>
</tr>
</tbody>
</table>
Regarding taxes, the opinions of Californians mirror those of most Americans as they have their doubts about the tax system generally (Pew Research Center, 2019). For example, when the state faced budget deficits and respondents were asked whether the gap should be closed by either spending cuts, tax increases, or a combination of the two, just increasing taxes was the least common response. There is support, however, for increasing revenue when either (a) someone else will be paying, or (b) when the revenue will be used to fund programs that are broadly popular, such as education or health. Specifically, support for raising revenue by increasing taxes for the state’s wealthiest residents has been consistent and strong (Figure 37).

**Figure 37. Californians’ Support for Taxing the Rich (All Adults)**

The picture is murkier when you try to connect public support for tax increases on specific items or for certain purposes. Taxing cigarettes might be popular, but after that, opinions are divided on questions of higher education or transportation.

<table>
<thead>
<tr>
<th>Region</th>
<th>Favor (%)</th>
<th>Oppose (%)</th>
<th>Favor (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Los Angeles</td>
<td>64</td>
<td>24</td>
<td>12</td>
</tr>
<tr>
<td>Orange/San Diego</td>
<td>53</td>
<td>33</td>
<td>13</td>
</tr>
<tr>
<td>Bay Area</td>
<td>67</td>
<td>21</td>
<td>12</td>
</tr>
</tbody>
</table>

Source: PPIC Survey Database, May 2021 (Baldassare et al., 2021).

Source: PPIC Survey database, October, 2016 (PPIC, 2016).
### Table 14. Summary of Recent Responses to Questions about Specific Types of Taxes

<table>
<thead>
<tr>
<th>Question</th>
<th>Favor</th>
<th>Oppose</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do you favor or oppose REPEALING the recently passed increase in the gas tax?</td>
<td>47%</td>
<td>48%</td>
<td>January 2018 (Baldassare et al., 2018)</td>
</tr>
<tr>
<td>Would you be willing to pay higher taxes to increase funding for higher education?</td>
<td>44</td>
<td>53</td>
<td>October 2017 (Baldassare et al., 2017)</td>
</tr>
<tr>
<td>If your local ballot had a measure to increase the sales tax to pay for roads and transportation projects, would you support it?</td>
<td>50</td>
<td>48</td>
<td>January 2017 (Baldassare et al., 2017)</td>
</tr>
<tr>
<td>Prop. 56 would increase cigarette tax by $2.00/pack with revenue used for health care. Would you vote yes?</td>
<td>56</td>
<td>38</td>
<td>October 2016 (Baldassare et al., 2016)</td>
</tr>
<tr>
<td>Prop. 55 would extend the personal income tax increase on earnings over $250,000. Would you vote yes?</td>
<td>59</td>
<td>31</td>
<td>October 2016 (Baldassare et al., 2016)</td>
</tr>
<tr>
<td>If your local ballot had a measure to increase the sales tax to pay for roads and transportation projects, would you support it?</td>
<td>43</td>
<td>52</td>
<td>May 2016 (Baldassare et al., 2016)</td>
</tr>
<tr>
<td>Extending the state sales tax to services?</td>
<td>30</td>
<td>59</td>
<td>September 2014 (Baldassare et al., 2014)</td>
</tr>
<tr>
<td>Extending the state sales tax to services while lowering the rate?</td>
<td>44</td>
<td>43</td>
<td>September 2014 (Baldassare et al., 2014)</td>
</tr>
<tr>
<td>Raising state taxes paid by corporations?</td>
<td>51</td>
<td>43</td>
<td>September 2014 (Baldassare et al., 2014)</td>
</tr>
</tbody>
</table>

Source: PPIC Survey Database, various months and years.

Because of the initiative process, the role that the public plays in policy making in California cannot be ignored. And, looking back at the origins of the current fiscal situation in the state, major public finance decisions began as either ballot initiatives or had to gain the voters’ approval before they could take effect. And despite the fact that depth of knowledge is limited and opinions are sensitive to changes, the current fiscal priorities of the state reflect the collective opinions of its residents and vice versa. Support for health care and K-12 spending are priorities for Californians and together, they constitute the majority of state spending. Residents are skeptical about taxes in general, but support the idea of taxing the wealthy. The state’s dependence on its progressive income tax system is clearly aligned with this perspective. The limits of the polling process, the mutability of opinions, and the limited understanding of the issues makes it difficult to offer conclusions beyond these generalizations.
Summing up the Origins of the Current Fiscal Landscape

It is an oversimplification to distill the origins of California’s current fiscal situation down to just the three drivers of the economy, demographics, and policy, but these elements represent the most critical factors. From an economic perspective, the state has enjoyed an economy that has grown, often more quickly than the rest of the nation, over the long term. The capacity to innovate and diversify accounts for much of that success. And, from a demographic perspective, California’s growing population – significantly supplemented by migrants into the state – have provided the workforce to meet the needs of the changing economy.

That positive economic history hasn’t rendered California immune to economic downturns. Recessions hit the state particularly hard and those impacts are amplified as they work their way through the state’s public finance system. Over time, recessions have typically created a fiscal crisis in the state. Policy makers and voters have made changes to how the state approaches fiscal policy, sometimes in direct or indirect response to the experience of prior recessions. Often, those changes have introduced restrictions on policy makers, creating rules or formulas that leave little discretion to elected officials and have little to do with improving the sustainability of the state’s finances. Proposition 13 is most notable in this regard. Many of these policy changes further complicate the task of responding to fiscal crises. Some recent reforms, however, have contributed to a more sustainable fiscal future, particularly the institution of an effective reserve policy.

TRENDS

When it comes to looking at the future of fiscal policy, it is difficult to imagine a situation where the key drivers that have shaped the current fiscal landscape would not continue to be factors going forward. This section builds upon the previous discussion of the origins of California’s current fiscal policy – the economy, demographics, and policy changes – and attempts to frame what might be expected along these different dimensions. The section then discusses other emerging (or emerged) trends that could prove to have a larger impact on California’s fiscal sustainability in the future. The section concludes with a discussion of how confronting a challenge the magnitude of the state’s persistent inequality or climate change will require major changes to existing fiscal policy if it is to be effective.

Economy

The biggest question regarding the role of the economy and state’s fiscal soundness looking forward is if California can continue to have its economy expand at a rate that outpaces the rest of the country and/or other developed countries. There is reason to be optimistic given that much of that success has been enabled by continued innovation and investment. There also are challenges and uncertainties.

On the side of optimism, much of the innovation has been accelerated by a research and development environment subsidized by public investment. The federal government invested directly in California during WWII and the subsequent period of expansion. It continues to invest in the form of grants to the state’s public and private research universities and the national laboratories. The state, through its support of the UC system, also effectively subsidizes research.

Private investment also continues to flow to the state, even after the run of media stories foretelling the demise of the Silicon Valley region during the pandemic. For example, one source that monitors venture capital
investment reported that a total of $69 billion was invested in startups nationally in the first quarter of 2021 (Pitchbook et al., 2021). Of that amount, more than 36 percent ($25.3 billion) was in companies in the Silicon Valley/Bay Area. Another $6.7 billion was invested in Southern California. For that quarter, the two regions in the state accounted for nearly one-half of the venture capital investment in the country – more than the cities of Austin, Boston, Chicago, Denver, Philadelphia, Seattle, and Washington, D.C. combined.

California’s ability to retain its position as an economy that is the envy of other states and most of the countries in the world is not a given. Vibrant universities engaged in cutting edge research have the potential to contribute directly to innovation, as well as contributing to a climate that fosters creative thinking. As was discussed in the first section, however, state spending on higher education as a share of the budget has declined in recent years. Other challenges to the evolution and long-term growth of the state’s economy are its ability to supply workers with the necessary skills and the general changing nature of work. Both are discussed further below.

**Demographics**

While the economic future of California gives rise to optimism, the demographic outlook is more concerning. Three demographic trends have emerged that will prove challenging to the state’s future fiscal sustainability. The aging population, the slow rate of natural increase, and reduced migration to the state present problems that could reduce the growth of tax revenues while increasing spending (Johnson & McGhee, 2021).

The projected changes in the composition of California’s population have potential direct and indirect impacts on the state’s fiscal outlook. For example, the slowing rate of population growth – a product of fewer births and lower migration – translates into fewer taxpayers to generate revenue for the state. In other words, fewer people means less money for the state, assuming no change in the structure of the revenue system.

On the spending side of the budget, California's senior population will nearly double by 2030. That alone would suggest an increased demand for services and assistance. But, current projections predict that the senior population will be more diverse and a larger share will be living on their own, apart from family members who can assist them. Consequently, the need for more and culturally competent care should increase (Johnson & Beck, 2015).

While health care for the elderly is typically associated with Medicare, which is primarily federally funded, that program isn’t the only source of assistance to seniors. Medi-Cal, of which California pays one-half of the costs for the elderly, accounts for 65 percent of the funding for seniors in nursing homes (Johnson & Beck, 2015). Nationally, Medicaid spending for the 65 and older population was $19,098 per person in 2014, over 5 times higher than spending per child ($3,749) and almost 3 times the spending per working-age person ($7,153) (Centers for Medicare & Medicaid Services, 2020). Spending for the aged accounted for 21 percent of all Medicaid spending in California in 2014 even though residents 65 and older only accounted for 9 percent of those enrolled in the program (Kaiser Family Foundation, 2014).

The slow-growing population also will have indirect consequences for California fiscal policy. One outcome that could be considered positive is the fact that there will be fewer students enrolled in public K-12 schools. Should this trend continue, it would suggest that the rate of growth in the school-aged population will be slower than the rate of growth in the resources devoted to education (Proposition 98 would require a share of the state’s total revenue to be spent on education), therefore, the funding per student would increase. Having more
resources to spend on each student, depending how they are allocated, could lead to better outcomes and improve opportunities for a larger number of students.

That modest silver lining may be overshadowed by other negative implications of slowing population growth. The origins section described how the economy’s ability to grow was fueled by a growing, educated, and creative workforce. And, migrants to the state – from other states and other countries – have fueled a significant share of the innovation that characterizes the California economy. Slow natural population growth, out-migration to other states, and slowed international immigration are all concerns for the sustainability of both the economy, and by extension, the state’s public finances.

Concerns about a potential skills gap and its potential to hold back California’s economic growth have been voiced for over a decade (Johnson & Bhatt, 2009). To their credit, state institutions, particularly the systems of public education, have taken measures to close some of that gap. Both the UC and CSU systems have looked for ways to expand access, support current students, and remove barriers to degree completion. These reforms have produced measurable results. At CSU, the six-year graduation rate increased from 57 percent to 62 percent from 2015 to 2020 (Johnson & Mejia, 2021). At UC, four-year graduation rates for California freshmen rose from 64 percent to 71 percent over the same period. These improvements, combined with higher enrollments, translates into a net gain of thousands of more college graduates in California. In other words, the state has demonstrated the capacity to shift policies and address some of the needs of its workforce. Not surprisingly, making these types of changes cost money. The increase in the production of college graduates, however, apparently has not met all of the economy’s demand. Those individuals moving to the state continue to feature individuals who are working age, employed, and earn high wages (Johnson, 2021). That would suggest that some of California’s workforce needs continue to be met by importing workers from elsewhere.

The notion that California can home-grow the workforce the state will need for its future economy or import the necessary talent from within the borders of the United States, is appealing. It is likely, however, that there are limits to such a strategy, making the trending decline in international migrants troubling. The educational level of recent international migrants to California would suggest that they have a high potential to contribute to the trend of economic innovation. With the immigration policies of the Trump Administration starting to fade, there is reason to be optimistic that international migration to California will trend up. There are two concerns on that front, however. First, the Trump policies stand out as a stark example of the fact that policies made in Washington, D.C. can have a significant impact on California’s demographic outlook. Second, looking forward, California will not be the only place seeking to attract bright, creative innovators. Australia and Canada are notable examples of nations that have instituted policies to give immigration preference to individuals with skills associated with making a contribution to the economy (Karas, 2019).

Looking at migration trends and their potential to move California’s economy forward is only part of the migration story. It is difficult to ignore the fact that individuals who leave the state in recent years cite economic or family reasons for their move (Johnson, 2021). Yes, the state continues to attract individuals at the upper ends of the income scale, but the out-migration is a symbol of the state’s growing inequality, raising the question of whether the state can continue to be an attractive place for individuals of all income levels.

A final word of caution should accompany the discussion of demographic trends as the state looks forward. Projecting population shifts is notoriously difficult. A 1999 analysis of demographic projections, methods, and
outcomes for eight different series produced in the late 1990s (Johnson, 1999). The projections reviewed included those from the California Department of Finance, the U.S. Census Bureau, the U.S. Bureau of Economic Analysis, UCLA, and the Center for Continuing Study of the California Economy. The models, produced in 1995, projected California’s population forward for 30 and 45 years. The report concluded that:

For 2025, the highest and lowest projections differ by more than 10 million people, with the lowest series projecting a population of 41.5 million and the highest projecting over 52 million. By 2040, the difference is over 16 million people (almost half the state’s current population), with the lowest projection setting the state’s future population at 46.8 million and the highest at 63.4 million. . .

. . . Each of the projections is plausible if you accept its assumptions regarding migration to and from California. The differences in migration assumptions drive almost all of the differences among the various projections. . . Planners need to be aware of the range of plausible future population levels of the state, and should, accordingly, consider alternative scenarios in their planning (Johnson, 1999).

Policy

Policy trends are the most difficult to predict and the origins that underpin the existing fiscal situation don’t suggest a clear future path. Many of the fiscal reforms instituted in the past have been driven by the crisis of the moment – or at least the last crisis endured. A number of these modifications have built incrementally upon the seismic change that was Proposition 13 in 1978. As a consequence, the origins of the fiscal situation in California is a Rube-Goldberg construction that defies any sense of coherence.

The one feature that most of the past fiscal reforms have in common is that policy makers have tended to implement changes with a short-term time horizon, incentivized to address the problem of the moment. This is not to say that policy officials in Sacramento are disinterested in understanding the underlying structural challenges of the finance system. The volatility of California’s revenue streams, for example, has been a focus of discussion for a number of years, often resurfacing during periods of recession. Although there have been proposals put forth to shift the state to a more stable revenue portfolio (Parisky, 2015), those efforts have resulted in little change in policy (Sheffrin, 2010). Recently, during a period of budget stability, legislation was introduced that represented a dramatic modernization of the state sales and use tax (Skelton, 2014). It didn’t move forward. Absent any sense of urgency, there simply hasn’t been the political will to build the momentum needed to drive complex reform on such a scale. The absence of motivation to tackle large, long-term problems bodes ill for progress on issues like the outstanding pension liability or underinvestment in infrastructure.

Because of complexity and the nature of communication, it might be tempting to look for policy solutions that lend themselves to simple messaging in the future. Evidence suggests, however, that doesn’t have to be the case. For example, nearly ten years ago the state overhauled how K-12 education funds would be distributed. The Local Control Funding Formula (LCFF) eliminated nearly 50 individual (categorical) grant programs and established a new way to divide state education resources. LCFF was designed to provide additional resources to the school districts with greater numbers of English-language learning and low-income students. Determining how to structure the program and navigate the transition was complicated. Now, years later, overall parents overwhelmingly support LCFF with that support being consistent across all regions, income, race/ethnicity, political party, and education levels. The group offering the lowest level of endorsement is Republicans at 51
percent. At the other end of the spectrum, 87 percent of non-citizens endorse LCFF. In most cases, two-thirds of adults agree that providing more resources to students with greater needs makes sense, even though it may be a more complicated way of doing things. It is worth pointing out that LCFF was crafted in the legislature as part of negotiation and compromise as opposed to the product of a ballot campaign. Analysis of the impact of LCFF finds that the additional resources are reaching high-needs students, generally (Lafortune, 2019) and producing better outcomes (Johnson and Tanner, 2021).

Given the absence of a clear direction in policy, then, it is tempting to look to trends in public opinion as a possible leading indicator of future policy changes. There is some indication that Californians are becoming more supportive of investing further in public programs. For example, in a May 2021 survey, there currently appears to be bipartisan acknowledgment that the gap between rich and poor has grown. Support for the state to do “more” to close that gap is favored by a majority of Democrats and independents (Figure 38). That support for doing more has been relatively steady among those groups (Bonner, 2021).

Figure 38. Should the State Government be Doing More to Reduce the Gap Between the Rich and the Poor in California, or Is this Something that the State Government Should Not be Doing? (all adults)

![Figure 38](image)

Source: PPIC April 2021, time trends.

Beyond the “do more” question, a more telling test is to ask residents to contemplate trade-offs, since after all, the notion of reconciling competing interests that cannot be accommodated at the same time lies at the heart of fiscal policy making. For nearly two decades, PPIC has been asking its poll respondents a generic trade-off question about taxes. Despite the conventional wisdom that Californians oppose all tax increases, this question shows steady if modest support of about half the respondents for more taxes if they were in exchange for additional services (Figure 39).
Figure 39. Which Statement Do You Agree with More: (1) Pay Higher Taxes and Have a State Government that Provides More Services, or (2) Pay Lower Taxes and Have the State Provide Fewer Services? (all adults)

Source: PPIC April 2021, time trends.

It would be difficult to interpret such divided support as a mandate for either growing or shrinking the size of government in the state. The picture, however, becomes even more muddled when the responses are disaggregated across different groups.

Table 15. Which Statement Do You Agree with More: (1) Pay Higher Taxes and Have a State Government that Provides More Services, or (2) Pay Lower Taxes and Have the State Provide Fewer Services? (May 2021)

<table>
<thead>
<tr>
<th>Group</th>
<th>More taxes</th>
<th>Fewer taxes</th>
<th>Don’t know</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Adults</td>
<td>52</td>
<td>44</td>
<td>4</td>
</tr>
<tr>
<td>Likely voters</td>
<td>52</td>
<td>44</td>
<td>4</td>
</tr>
<tr>
<td>Democrat</td>
<td>75</td>
<td>22</td>
<td>4</td>
</tr>
<tr>
<td>Republican</td>
<td>14</td>
<td>83</td>
<td>4</td>
</tr>
<tr>
<td>Independent</td>
<td>48</td>
<td>45</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------</td>
<td>-------</td>
<td>-----</td>
<td>---</td>
</tr>
<tr>
<td>African American</td>
<td>67</td>
<td>31</td>
<td>2</td>
</tr>
<tr>
<td>Asian Americans</td>
<td>60</td>
<td>33</td>
<td>7</td>
</tr>
<tr>
<td>Latinos</td>
<td>56</td>
<td>40</td>
<td>4</td>
</tr>
<tr>
<td>Whites</td>
<td>46</td>
<td>50</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than $40k/year</td>
<td>58</td>
<td>39</td>
<td>3</td>
</tr>
<tr>
<td>$40-79k</td>
<td>55</td>
<td>41</td>
<td>5</td>
</tr>
<tr>
<td>More than $80k</td>
<td>47</td>
<td>50</td>
<td>3</td>
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<tr>
<td></td>
<td></td>
<td></td>
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<tr>
<td>18-34 years old</td>
<td>60</td>
<td>36</td>
<td>3</td>
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<td>35-54</td>
<td>50</td>
<td>46</td>
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<tr>
<td>55+</td>
<td>47</td>
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<tr>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Own home</td>
<td>42</td>
<td>54</td>
<td>5</td>
</tr>
<tr>
<td>Rent</td>
<td>60</td>
<td>35</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: PPIC Statewide Survey database, March 2021 (Baldassare et al., 2021).

The modest support for a larger state government becomes robust among certain groups, particularly African Americans, Asian Americans, younger, and lower income residents. And, not surprisingly, partisans are polarized on the question.

**Policy and Ballot-Box Budgeting**

Public opinion, policy, and budgets have met frequently at the ballot box in California. As already noted, different interests have long used the state’s initiative process to secure favorable tax treatment, carve out funding protection for a preferred activity, or create and then fence off a new revenue source to support. There is little doubt that past decisions made by voters restrict the flexibility that current policymakers have when it comes to fiscal policy. Estimates of the collective impact of these votes vary from a low of about one-third (Matsusaka, 2005) to as much as 86 percent (Gordon, et al, 2019) of the state budget being locked in by propositions.

There are three possible directions California’s relationship with ballot-box budgeting could head in the future. One path would be a continuation of the current path, where fiscal initiatives are a biennial feature of state elections as interests seek special tax or spending treatment. An alternative course would be for the use of the initiative process to set fiscal priorities to cease, or at least only be limited to decisions such as tax increases that
are required to go to the voters. Whether the historical trend will continue going forward isn’t certain. Cummins (2018) analyzed 20 years of California state ballots ending in 2004 and concluded that divided government and political polarization drove the use of the initiative process to make tax and spending decisions. Though political polarization continues, government in the state is no longer divided, suggesting less of a need for using direct democracy to make budget choices. Given the relative ease with which interests can put questions before the voters, however, it is unlikely to see the practice continue without significant reform of the initiative process.

The third, and most dramatic, direction for fiscal initiatives to take would be to begin to unwind some of the policies from the past. Given the outsized impact that Proposition 13 has had in the past, and will continue to have in the future, on fiscal policy, it is worth contemplating what is the probability of reforming it. In the 2020 election, advocates for school funding came close, with Proposition 15, a proposal to assess commercial property at market value. The reform campaign lost, but it was a respectable effort, securing 48 percent of the vote. Part of the challenge in taking on Proposition 13 is that voters generally hold a positive opinion of the measure. When Californians are asked about their position on Proposition 13, in particular, support is relatively steady (between 55 and 60 percent among all adults) and similar across all regions (Figure 40).

**Figure 40. Assessment of the Good or Bad Impact of Proposition 13**

![Figure 40](image)

Source: PPIC Statewide Survey database, April 2021 (Baldassare, 2021).

Differences emerge, however, when that support is disaggregated (Baldassare et al., 2019). The largest gap, 24 points, exists between homeowners (73% positive impression) and renters (49%) when the question was last asked in 2019. There also is variation by political party, race/ethnicity, income, and age. It is worth noting, however, that renters are the only group that do not express a majority of support for the idea of Proposition 13.

Given the complexity of that constitutional amendment, it is not clear if voters support all its provisions or understand its consequences. Regardless, this consistency suggests that any effort to reform Proposition 13 and
release some of the constraints it places on the state’s public financing system would require a dedicated effort to explain to Californians the problems associated with its provisions. Unwinding Proposition 13, or any of the other significant initiatives that affect fiscal policy, would require a concerted effort. The experience in 2020 with Proposition 15, along with polling data, suggests that there is an appetite for that type of change, at least among some segments of the electorate. A research agenda focused on Proposition 13’s contribution to increased inequality in the state would be a place to begin.

Beyond the question of understanding the implications of complex issues such as Proposition 13, the impact that the ballot box has on future fiscal reforms also will be affected by who participates in California’s electoral process. It is well documented that, at least historically, voters who take part in elections on a regular basis are not representative of the eligible voter population and the differences become even more pronounced relative to the population as a whole. The “exclusive electorate” in California is composed of voters who tend to be older, white, college educated, affluent, and homeowners. They also identify as “haves” rather than “have nots” (Baldassare, 2019). Eligible voters who, on average are less likely to participate in elections, are more likely to be renters, Latinos, less affluent, and less likely to be college educated. One uncertainty regarding the future of fiscal policy, should the ballot box continue to play the role it has in the past, is whether the composition of the electorate will change or remain the same. In theory, if more current nonvoters were to begin to participate, the spectrum of viable policy alternatives will shift, most likely, to the left.

Other Trends

Beyond the drivers of the state’s economy, demographics, and policy, there are other trends that have the potential to have a significant impact on the state’s fiscal future. These other trends include climate change, the changing nature of work and business, and federal policy shifts.

Climate change. Climate change could represent the single largest potential threat to the fiscal future of California and as a driver of change, it could overshadow all of the other factors discussed here.

The effects are, and will continue to be, felt in a number of ways. Rising temperatures and droughts have raised the cost of business for not only the state’s farmers (USDA Climate Hubs, n.d.) but other industries as well, even garment manufacturers (Gottlieb, 2021). Wildfires are now bigger, longer, and more destructive than ever, and costing governments accordingly. In the 1979-80 fire season, Cal Fire drew down about $12 million dollars from the state’s emergency fund. In 2020, the figure rose to more than $1 billion (Cart, 2021). Those represent only the direct costs and don’t take into consideration the impact on economic activity.

In coming years, sea level rise could inflict even bigger costs as coastal property is lost underwater and tides cause daily flooding, with the state’s most vulnerable residents bearing the brunt of the effect (Petek, 2020). Planning and preparing for the effects of rising seas will be costly. Not preparing could cost even more. One study estimated that over 600,000 residents could be subjected to dynamic flooding and a loss of $150 billion in property (Barnard et al., 2019).

The body of research that estimates the impacts of climate change on California already is robust and continues to grow. None of the news is good. What is positive is the fact that most of the state’s policy makers acknowledge climate change and some steps have been taken in response. Policies addressing automobile efficiency standards and the creation of the cap-and-trade system to regulate greenhouse gas emissions
demonstrate the willingness of officials to engage the issue. Going forward, it is difficult to predict what the policy response will be, how much it will cost, and to what degree it will disrupt businesses. More certain is the fact that the state is unlikely to ignore the problem and that additional policy responses can be expected.

**The changing nature of work and business.** The world of commerce is moving much faster than fiscal policy. These changes present a challenge for the future collection of revenue, among other problems. For example, most state sales taxes, California’s included, were designed in the first half of the 20th century to tax the sale of goods. Since then, consumption patterns have shifted, with consumers spending a larger share of their disposable income on untaxed services as opposed to taxed goods. As a consequence, **taxable sales have grown slower than the economy** (Taylor, 2013). There appears to be little interest in modernizing the state’s sales tax, where broadening the taxable base would enable rates to drop. Even the most significant change to the administration of the sales tax -- the **collection of taxes on online sales** -- was the consequence of a court case as opposed to the work of legislators (California Department of Tax and Fee Administration, 2019).

The dated sales tax structure isn’t the only example where the evolution of business will challenge the collection of tax revenue. At the corporate level, the mobility of capital and intellectual property have altered what it means to locate a business. Intellectual property is the critical asset of innovative companies, particularly tech and pharmaceutical businesses. Intellectual property also can prove key to **structuring corporations for tax avoidance** (Blair-Stanek, 2015). Should California seek to increase taxes on corporations in the future, it will increase the incentive for companies to find ways to avoid those increases.

At the individual level, the nature of work has changed. Gig work and remote work present different challenges to the collection of revenue. Because gig workers don’t have the same income reporting requirements, the **tax picture becomes more complicated** for both the collector and tax payer (Forbes Magazine, 2020). Teleworking, a trend accelerated by the pandemic, presents a different set of problems for state tax collectors. The current system, which is based on outdated assumptions about where and how work can be performed, is **ill-suited to remote work** (Pandey, 2021). Both trends are likely to continue in the future and it is not clear policy makers are interested in adjusting revenue laws to account for them.

**Federalism.** We have already discussed how California’s workforce could bear the brunt of restrictive immigration policies. Other policy decisions made at the national level could have both positive and negative consequences for the state. Should the federal government begin to embrace policies designed to mitigate the effects of climate, California would be well positioned to take advantage of any new investment or markets that would emerge as a result. Similarly, foreign policy shifts could advantage California. A genuine “pivot to Asia” that included a trade agreement along the lines of the **Trans-Pacific Partnership** could prove beneficial to the state given its existing trade relationships and geography (McBride et al., 2021).

Other policy shifts at the federal level could have a negative effect. A deterioration of relations with Mexico would undoubtedly spill over to California, disrupting both commerce and migration. Tax policy changes, such as corporate tax reform or **world-wide minimum corporate tax agreements** could impact how the state’s global companies structure themselves and where they invest in the future (Rappeport, 2021). And, there has been bipartisan interest, though motivated by different reasons, in exploring **changes to the nation’s antitrust laws**, designed to break up some of California’s large tech companies (Overly, 2019).
Need for Non-Incremental Change and Inequality

Two elements run throughout the above discussion of the Facts, Origins, and Trends that shape fiscal policy in California. The first is the realization that the history and perhaps future of fiscal policy is characterized by incremental decision making, with the possible exception of Proposition 13. Though it is an oversimplification, since 1978 fiscal policy change fits one of two patterns. The first emerges after a jolt to the state’s economy precipitates a fiscal crisis for the government. In response, policy makers look for a fix to fill the deficit gap they face that year, and perhaps the next. The alternative path is one where advocates seek funding for a particular program, and they head to the ballot box to carve out revenue to be set aside for their priorities. The advocates may have a long-term vision for their program, but it ignores the larger view of the other competing priorities that make up the rest of the budget. In both cases, long-term fiscal sustainability is not a consideration.

The second ongoing theme, one related to the first, is that of inequality. Inequality in California is a fact. Layered upon the state’s economic inequality are the accumulated effects of racial discrimination, which amplifies the costs. Institutional racial discrimination that has limited economic opportunities and wealth creation makes it that much harder for some of the state’s residents to weather recessions or get ahead. That inequality exists despite the fact that California has one of the most – if not the most – progressive revenue systems in the United States. It also has one of the country’s more robust safety nets and collection of social programs. Despite this approach, sizable differences exist between the rich and poor along multiple dimensions. If the state is going to try to reduce inequality, it will have to pursue policy change on a very large – and costly – scale. And, to fund such an effort would require more than just incremental changes to existing revenue policy if the new policies are going to be fiscally sustainable. The numbers are just too big.

Which brings the discussion back to the incremental approach of the past. Inequality is a big problem that will require a big solution. Other large problems loom ahead – affordable housing or climate change – present similarly-sized challenges. In the face of these, policy makers can choose to continue to muddle through, pursuing reforms that make progress at the margins, shoehorning the costs into the existing fiscal structure (Lindblom, 1959). An alternative path would be to consider non-incremental solutions to these problems. Doing so, however, would be to commit at the same time to overhauling portions of the fiscal system to ensure that the solution is a sustainable one.
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Project Interview List

As part of this project, we were fortunate to have the opportunity to discuss California’s fiscal future with several experts and attentive observers of state policy. We are grateful for their participation.

- Irena Asmundson, SIEPR, former chief economist, Department of Finance
- Alan Auerbach, Director, Robert D. Burch Center for Tax Policy and Public Finance
- Michael Coleman, California City Finance, Consultant to the California League of Cities
- Tim Gage, Blue Sky Consulting; former Department of Finance Director
- Mark Herbert, Chief Strategy Officer, Small Business Majority
- Robert Hertzberg, California State Senator
- Graham Knaus, Executive Director, California State Association of Counties
- Anna Matosantos, California Governor’s Cabinet Secretary; former Department of Finance Director
- Lenny Mendonca, Chief Economic and Business Advisor to Governor Gavin Newsom
- Gabe Petek, Calififornia Legislative Analyst
- Fred Silva, California Forward
- Gerald Parsky, Former member of Tax Review Commission; UC regent
- David Rattray, UNITE-LA
- Heather Rose, Economist, UC Davis School of Education
- Laura D’Andrea Tyson, former Chair, Council of Economic Advisors