Analysis of Proposition 76

INTRODUCTION

Proposition 76, the State Spending and School Funding Limits initiative is a response to the state's fiscal crisis that emerged in the 2001-2002 fiscal year. By 2003 the state's projected budget deficit had reached $38 billion according to the state's Department of Finance, an amount equal to about one-third of annual spending, and the state's debt had been downgraded to junk bond status. The fiscal crisis contributed to the recall of Governor Gray Davis in 2003 and to the election of Arnold Schwarzenegger as his replacement. Since taking office, Governor Schwarzenegger has focused much of his energy on finding ways to bring state revenues and spending more into balance. Proposition 76 is one of a number of ballot measures that are part of his current reform efforts.

The root cause of the fiscal crisis, in the view of most observers, was the explosive growth of spending in the late 1990s, rising from $75 billion to $107 billion over 1998-to 2002, a growth that was fueled by extraordinarily high revenue during the dot-com boom. The fiscal crisis emerged when the governor and legislature failed to respond aggressively to the deteriorating revenue situation beginning in 2001-2002 after the dot-com bubble burst. The state's revenue was further reduced when the temporary reductions in the Vehicle License Fee (VLF) were made permanent by governor Schwarzenegger.

Proponents of Proposition 76 have titled it the "California Live Within Our Means Act," reflecting their goal of preventing the state from spending more money than it collects in revenue. To achieve its aims, the measure makes several significant changes to the state constitution, the most important being:

- The measure requires the state to balance its budget every year. If the budget falls out of balance during the fiscal year, the governor may declare a "fiscal emergency" forcing the governor and legislature to take action to cut spending or raise revenue to correct the problem.
- If the legislature and governor are unable to reach a budget agreement before the start of a fiscal year, budget appropriations from the previous year will continue for the next year until a budget is passed.
- The measure limits the growth of spending to the average growth in revenues over the previous three years.
- If a budget shortfall emerges during the fiscal year and the legislature and governor cannot agree how to eliminate the deficit, the measure authorizes the governor to make cuts in almost any program to bring the budget into balance.
- The measure revises the education spending provisions of the California Constitution—Proposition 98 approved by voters in 1988.

This report provides an objective assessment of Proposition 76. It reviews the provisions of the proposition in detail and the arguments offered by proponents and opponents. Then it analyzes the likely effects of the measure, and investigates how the budget would have evolved over the last two decades if Proposition 76 had been in place. The report concludes by evaluating the arguments of proponents and opponents, and calls attention to misleading claims.

BACKGROUND

The issues that Proposition 76 is designed to address are complex. In this section, we provide background information on the origins of the current fiscal crisis, existing budget constraints in place in California, and a brief discussion on constitutional provisions governing public school funding in the state.

Current Fiscal Crisis

Many states experienced fiscal difficulties during the 2000-2001 recession, but California's problem was particularly severe. The basic causes of the crisis are now well understood:

> Starting in the late 1990s, general fund tax revenues began to grow sharply, particularly from the personal income tax. In fiscal year 1997-1998, total general fund revenues were $53.9 billion. By fiscal year 2000-2001, they had increased to $75.7 billion. Personal income tax revenues grew during that same period (with no changes in tax rates) from $27.9 billion to $44.6 billion, accounting for the lion's share of the rise in revenues. State spending grew in tandem with these revenue increases. But then revenues began to collapse. Personal income tax revenues fell back to $32.1 billion in 2002-2003, and total state revenues fell to $64.2 billion. Policymakers failed to adjust spending to these reduced revenues or to find significant sources of new revenue.[1]

The reason state income tax receipts exploded in the late 1990s was because of extraordinarily high capital gains and stock options associated with stock market runup. The progressivity of California's personal income tax enhanced the elasticity of the state's tax collections during that time. According to one estimate, capital gains taxes made up 26 percent of state revenue in 1999.[2] In response, the governor and the legislature increased state spending dramatically and reduced taxes somewhat. After the stock market bubble burst in the first quarter of 2000, revenues returned to normal levels and the state's spending commitments were unsustainable with its existing tax structure.

Existing Budget Constraints

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[1] Sheffrin, Steven M., "State Budget Deficits and the California Debacle," *Journal of Economic Perspectives*, Spring 2004, Vol. 18(2), 205-226.

[2] Sjoquist, David L. and Sally Wallace, "Capital Gains: Its Recent, Varied, and Growing (?) Impact on State Revenues," *State Tax Notes*, August 18, 2003, Vol. 29(7), 497-506.
Tax revenue from capital gains was $17 billion in 2000-2001, and fell to $6 billion in 2001-2002.

California's budget process—revenues and expenditures—are governed by several constitutional amendments, most of which were passed by California voters over nearly 30 years. These include:

Proposition 13 (June 1978): Although not a direct limitation on state spending, Proposition 13 limits local property taxes to 1 percent of assessed value and further limits the definition of assessed value. The cap on revenue this creates for local governments creates pressure for state spending for many locally provided services by cities, counties, and school districts across the state.

Proposition 4 (November 1979): The so-called Gann limit establishes a state appropriations limit that is a function of the previous year's spending adjusted by changes in population and personal income. In 1987, the state hit the limit and refunded $1.1 billion to taxpayers. Since then, in part due to changes in the limit brought about by Proposition 111 in 1990, the Gann limit has never been binding. The Gann limit had no braking effect on the spending of the late 1990s, and for the current fiscal year (2005-2006), spending is $11.3 billion below the limit, about 10 percent of the budget. In short, the Gann limits appear to be fairly ineffective at slowing the growth of spending.

Proposition 58 (March 2004): This measure requires that the legislature pass a balanced budget each year and requires that if there is a substantial shortfall in revenues or increases in spending after passage of the budget that the legislature be called back into session to address these issues and bring the budget back into balance. It also states that if a solution is not agreed upon within 45 days, the legislature may not take up any other issues until an agreement is reached. The measure does not indicate what would happen if such an agreement could not be reached.

Education Spending

Proposition 76 makes substantial changes state spending on education as currently guaranteed by Propositions 98 and 111. Therefore, in order to understand the education funding-related provisions of Proposition 76, we present a quick background on how K-14 education is currently funded in California.

Proposition 98, passed by the voters in 1988 and amended by Proposition 111 several years later, establishes a minimum level of funding for K-12 schools and community colleges. The basic intent of Proposition 98 is to insure that education funding grows at the same rate as student population and California personal income. Called "Test 2," this minimum guarantee increases if the legislature appropriates funding for schools above the minimum. In effect, when more than the guarantee is appropriated, that amount becomes the new "floor" for future years.

There are two situations where the guarantee can be reduced on a temporary basis. Proposition 111 created "Test 3" that comes into play when the growth in the state's general-fund revenues is less than the growth in personal income. When "Test 3" becomes operative, the level of funding guaranteed to schools is reduced. This test was used in 2001-02 as a result of the revenue shortfalls early in the decade.

The second way the guarantee can be reduced is when the legislature votes to suspend it for a year with the same two-thirds supermajority required to pass the budget. This has only happened once, when the guarantee was suspended for the 2004-05 fiscal year. In both instances, Propositions 98 and 111 require that the funds saved must be restored to education in the next year that the state's general-fund revenues grow faster than personal income. Thus under current law, "Test 3" and suspension of Proposition 98 result in a state future obligation to education. Because of the 2004-05 suspension of Proposition 98 to help balance the state's budget, there is currently an obligation to K-14 education of $3.8 billion.[3]

A third component of the Proposition 98 guarantee is "Test 1" which requires a minimum portion of the state's general fund budget be devoted to K-14 education. While this provision has not established the guarantee level since 1988-89, Proposition 76 does not remove it from the constitution meaning it could establish the guarantee at some time in the future.

PROPOSITION 76 PROVISIONS

Proposition 76 makes 14 pages of additions and changes to the state constitution. These provisions can generally be summarized into four broad categories:

- Limit Spending Growth;
- Balanced Budgets;
- Education Spending; and
- Treatment of Special Funds.

These provisions are explained in layman's language in an attempt to make the provisions better understood by the average California voter as they consider the measure in the November election.

Limit Spending Growth

Proposition 76 limits the growth of state spending in any year to the average growth of state revenue over the previous three years. Thus, if revenue grew 3 percent, 4 percent, and 5 percent in the previous three years, spending could grow no more than 4 percent. "State spending" here means spending from the state General Fund and any special funds, which essentially means all state spending except for bond funds and nongovernmental cost funds (such as unemployment insurance). The cap could be exceeded in the event of an emergency such as a natural disaster or an attack on the United States, but not for purely fiscal emergencies.

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[3] Legislative Analyst's Office (2005). California Spending Plan 2005-06: The Budget Act and Related Legislation. Sacramento, CA: Legislative Analyst's Office. September.

If available revenues exceed the limit, the excess money is automatically allocated to three places: 25 percent to the state's reserve fund; 25 percent to school construction and to transportation projects; and 50 percent to repay outstanding debt.

If legislators were to increase taxes to generate revenue for a new program, they would not be able to spend the new revenue until the subsequent year unless current spending was below the cap at the time the taxes were increased.

Proposition 76 continues the Gann-appropriations limit, which means that future state spending could be subject to two limitations. Both measures prescribe how funds in excess of the limit will be allocated, but the formulas differ. It is not clear how the excess funds would be appropriated if the formulas conflict.[4]

Balanced Budgets

The California Constitution has long required the governor to *propose* a balanced budget, but it did not require the legislature and governor to *adopt* a balanced budget until the voters approved Proposition 58 in March 2004. Proposition 58 requires that estimated revenue equal estimated expenditure when the budget is adopted at the outset of the fiscal year. If the revenue and expenditure projections on which the budget is based turn out to be incorrect, there is no requirement for legislators to make corrections to bring the budget back into balance unless the governor declares a fiscal emergency. If a fiscal emergency is declared, the legislature is not permitted to act on other bills or adjourn until the emergency is resolved.

Proposition 76 gives the governor the option to call a special session of the legislature if general-fund revenues fall more than 1½ percent below estimates or if the state's Budget Stabilization Account shrinks by more than half. If a special session is called, the legislature has 45 days to pass and have the governor sign a bill to address the "fiscal emergency," presumably meaning to close the deficit.[5]

After 45 days, if a budget resolution were not achieved, Proposition 76 would authorize the governor to reduce appropriations to remedy the fiscal emergency. The governor is permitted to reduce most any appropriation, including those associated with collective bargaining agreements. Appropriations for debt service and appropriations necessary to comply with federal law or to avoid a violation of a contract cannot be reduced by the governor. So a significant change here is to give the governor unilateral authority to make cuts if he or she cannot strike a deal with the legislature. What the Governor does not appear to be able to do is reduce entitlements, meaning that payments under entitlement programs will continue at the level required by law until the newly reduce appropriations run out. If appropriations end, payments would stop.

[4] California Budget Project. Limiting the Future?: What Would the "Live Within Our Means Act" Mean for California? Sacramento, CA: June 21, 2005.

[5] It seems the governor can define the nature of the emergency that has to be remedied, for example, a deficit, not enough revenue, and so on.

The governor currently has a line-item veto, which means that he can eliminate individual budget items before signing the budget. A veto can be overridden by a two-thirds vote of the assembly and senate. Proposition 76 does not explicitly give the legislature the option to over-ride a reduction in spending made by the governor when there is a revenue shortfall compared to predicted expenditures. However, since the legislature presumably retains the power to approve a new budget with the normal two-thirds vote, the over-ride option appears to be unchanged. However, it is unclear if the legislative over-ride would apply when the governor makes unilateral reductions in spending after the 45-day impasse.[6] Still somewhat speculatively, it seems that if the governor's appropriation reductions were over-ridden, the governor could declare another fiscal emergency and cut the funds again.

The measure also clarifies a gray area in state law concerning what happens when the state's budget is not adopted on time. The ability of the state government to continue to operate without a budget has for the most part been determined by courts to this point. Proposition 76 specifies that if the budget is not adopted on time, each program is automatically appropriated an amount equal to what it was given in the previous year. Those appropriations apply until the legislature and governor agree on a new budget. Given that the California budgetary process requires the budget to pass two-thirds of both houses of the state legislature and signed by the governor, a potentially important consequence of this provision is to allow a group of one-third of the state senate, one-third of the state assembly, or the governor to freeze the budget at the previous year's level because each of them can prevent adoption of a new budget.

Education Spending

Proposition 76 includes several provisions dealing specifically with education spending. These provisions:

- Eliminate the "Test 3" provisions of Proposition 111;
- Define the repayment schedule for $3.8 billion of outstanding obligations;
- Change how future calculations of the Proposition 98 minimum-funding guarantee; and
- Require the repayment of deferred mandate funding.

These provisions are summarized below.

Eliminates "Test 3" Under Proposition 111

Proposition 76 makes a number of fundamental changes in the way these minimum guarantees will work in the future. First, it eliminates the "Test 3" provisions of Proposition 111. Under "Test 3," if state revenues spike (upward or downward) the guarantee can be adjusted to minimize the impact of the spike subject to future repayments to school districts (when revenues rise) or a slowdown in future payments to

[6] The proposition is a bit unclear about this and our feedback from budget experts revealed some differences of opinion. Given the ambiguity, it seems possible that the issue would end up being worked out in court.

school districts (when revenues fall). This would occur only when "Test 1" was in effect. Otherwise the guarantee would be based on "Test 2" as modified by Proposition 76 and described below.

Define Repayment Schedule of Existing Obligations

Proposition 76 requires the state to repay the existing $3.8 billion obligation to schools and community colleges within 15 years. However, the $3.8 billion would not be added to the minimum-funding guarantee as currently required by Proposition 98. In addition, the payback is spread out substantially longer than current law appears to require. EdSource, an organization dedicated to understanding California public education, estimates that removing this payment from the future Proposition 98 guarantee change would reduce the ongoing guarantee by an amount equal to about $15,000 annually per classroom across the state, approximately 8 percent, if all education funding was provided directly to classrooms.[7]

Calculating Future Minimum-Funding Guarantees

Proposition 76 also states that any reduction in the minimum guarantee in the future (i.e., a suspension of Proposition 98) would not have to be repaid. That is, if in the future the legislature suspended Proposition 98 and reduced the "Test 2" guarantee, or if the governor unilaterally cut education spending in a fiscal emergency as allowed by Proposition 76, the reductions would not have to be repaid, ultimately reducing the minimum guarantee in future years. This has the potential of reducing the long-term growth of education spending since a suspension of Proposition 98 would no longer have to be repaid. While Proposition 98 has only been suspended once, such suspensions are not out of the question.

Conversely, if the legislature chose to increase education funding above the level required by Proposition 98, that funding would no longer become part of the "Test 2" guarantee. Instead, appropriations above the minimum-funding guarantee in any given year would represent a one-time appropriation of funds. In short, the guarantee would not increase if additional funds were provided in any year, but it would shrink if funding were reduced.

Deferred Funding for Mandates

There is another area where Proposition 76 changes the funding of local school districts. The State Constitution requires the state to reimburse local governments for the costs of mandated programs. Since 2001-02, payments for mandates have been deferred resulting in a debt to school districts of $1.5 billion. Proposition 76 allows the state to delay these payments for up to fifteen years and resolves the future increase in such mandate payments by stating that the first call on Proposition 98 funds is to pay for mandates. The result is to reduce potential future funding by the amount of the cost of the mandates.

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[7] EdSource. Proposition 76: State Spending and School Funding Limits. (Mountain View, CA, 2005.

Moreover, for all other services, mandates must be paid off in five years compared to 15 years for education, which could further reduce funds available for education.

Treatment of Special Funds

Proposition 76 also contains provisions restricting the state's ability to borrow from special funds to cover a deficit in the general fund. Special funds are essentially revenue sources that voters have dedicated to specific purposes such as transportation or smoking-prevention campaigns. In the last few years, the state has borrowed from these funds to cover its deficit. The proposition sets a time limit for repaying the borrowed money (there is currently no time limit), and prohibits future borrowing from the funds.

What Proposition 76 is Not

Colorado's controversial TABOR (Taxpayer Bill of Rights) amendment, one of the strongest tax limitation measures currently in place in the states, has received a great deal of attention this year. Media claims to the contrary, Proposition 76 is not a TABOR-type amendment. TABOR restricts tax increases in a variety of ways, such as requiring voter approval for all new taxes; Proposition 76 contains no limits on taxes other than those that already exist in state law. TABOR limits the government's spending authority by capping spending growth at the rate of inflation and population growth. By restricting growth in state spending to the average of the last three years, Proposition 76 slows down spending growth, but does not place a firm limit on the level of spending over the long term. It does require the legislature to raise enough money to fund the spending, and a number of other limits in place in California may preclude unlimited growth in state spending over time.

PROPOSITION 76: PROPONENT AND OPPONENT ARGUMENTS

This section presents a summary of the arguments put forth for and against Proposition 76 as found in the Official California Voter Information Guide published by the California Secretary of State's office.[8] The language in this section is that of the proponents and opponents and does not reflect the opinions of the USC California Policy Institute.

Main Arguments in Support of Proposition 76

Proposition 76 is supported by Gov. Arnold Schwarzenegger's California Recovery team and an alliance of business and taxpayer organizations. Supporters had raised $28 million from over 400 separate contributors for the Proposition 74, 76, and 77 campaigns by the end of September. Major contributors include Gov. Schwarzenegger's California Recovery Team, businessmen A. Jerrold Perenchio, and William A. Robinson, the

[8] California Legislative Analyst, "Proposition 76: Analysis by the Legislative Analyst" In Official Voter Information Guide: Special Statewide Election, published by the California Secretary of State, 2005.

Chamber of Commerce's California Business PAC, and other businesses and business PACs.[9]

Governor Schwarzenegger, his budget director and Berkeley business school dean Tom Campbell, and Children's Initiative director and 1994 National Teacher of the Year Sandra McBrayer signed the ballot pamphlet argument in favor of Proposition 76. The main arguments articulated in the voter-guide pamphlet are:

- California's budget process is broken, leading to overspending and recurring deficits on the magnitude of $4-$5 billion per year;
- Proposition 76 would limit spending, balance the budget without raising taxes;
- The measure would promote bipartisan cooperation between the legislature and the governor
- Proposition 76 would stabilize education spending; and
- Guarantees that taxes raised for highways and roads are spent on those projects and not used to balance the budget.

Supporters listed on the campaign Web site <www.joinarnold.com> in addition to the above include the California State Association of Counties and League of California Cities (local elected officials), California State Sheriffs Association, Howard Jarvis Taxpayer Association, California Taxpayers Association, and a variety of local Republican organizations.

Main Arguments in Opposition of Proposition 76

The largest teacher's union in the state, the California Teachers Association (CTA), leads the opposition to Proposition 76. The opposition campaign committee had raised $60 million by the end of September. Funds for the no campaign were raised from a handful of groups, primarily the California Teachers Association and Alliance for a Better California, a coalition of teacher and other public employee labor unions.

The ballot pamphlet argument against Proposition 76 is signed by Brenda Davis, President of the California PTA, Hank Lacayo, President of the Congress of California Seniors, and Wayne Quint, Jr., President of the Coalition of Law Enforcement Associations. The main arguments articulated by the opponents are that the measure:

- Will permanently reduce the money appropriated to schools by over $4 billion;
- Deprives cities and counties of funding for police, fire, and health care;
- Gives too much power to the governor in budget decisions;
- Allows 14 of 120 legislators to put the budget on autopilot and subject to "fiscal emergency" powers available to the governor; and
- Does not prevent tax increases and may even lead to higher taxes.

[9] Campaign finance information is taken from the California Secretary of State's web site <http://cal-access.ss.ca.gov/Campaign/>. The most recent numbers reported at the time of writing were through September 30.

Supporters listed on the Alliance for a Better California Web site <www.betterca.com> in addition to the above include the American Federation of State, County, and Municipal Employees, California Association of Highway Patrolmen, environmental groups (Sierra Club, California League of Conservation Voters), California chapters of the League of Women Voters and NOW, and a variety of local Democratic organizations.

POTENTIAL IMPACTS

When making predictions about what a proposition will and will not do, it should be understood that the text of a measure does not determine in itself what will happen. Predicting an outcome generally depends on assumptions about how political actors will behave if the measure is in force. For example, while giving the governor the power to make unilateral cuts in a crisis plausibly will hold down spending, it is conceivable that fear of unilateral cuts might push the legislature to increase taxes to avoid the cuts. Since no one can say for certain how political actors will respond, assessments of a measure's effects are inherently conjectural. We can turn to empirical evidence on how political actors have responded in the past under various conditions for some insight.

Balanced Budgets

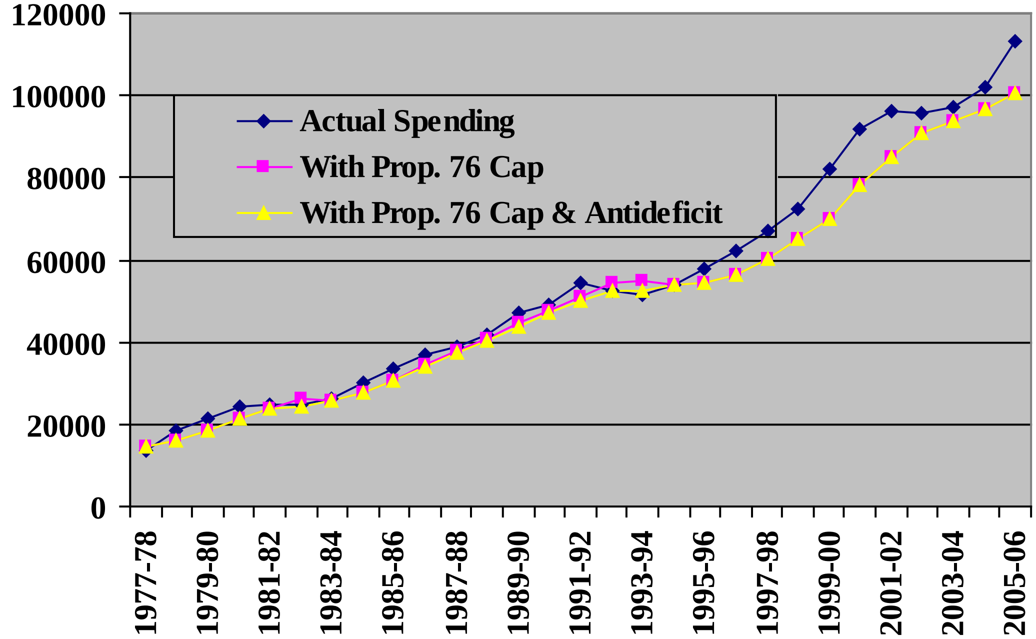
The first goal of Proposition 76 is to assure the budget is balanced every year. Proposition 58, approved by voters in March 2004, had the same goal. Proposition 58 was designed to prevent deficits by requiring the legislature to pass and the governor to sign a budget that was balanced based on current revenue and expenditure forecasts. The provisions of Proposition 58, however, did not require any corrections if the budget fell out of balance during the fiscal year. Thus, Proposition 58 allows the government to run a deficit if revenue is estimated incorrectly at the time the budget is passed. Proposition 76 closes the loophole by requiring budget imbalances that appear during the fiscal year to be corrected in that year.

Research on deficit policies for 47 states over a 20 year period shows that a requirement to balance the approved budget does not generally eliminate deficits, but a ban on deficit carry-overs, that is, a requirement to balance the final budget does prevent deficits.[10] Other research shows that states with strong antideficit rules respond more aggressively to revenue shortfalls than states with weak antideficit rules.[11] Thus, the evidence suggests that the antideficit provisions of Proposition 76 will likely be fairly effective in preventing future deficits and will cause elected officials to respond more aggressively to unanticipated revenue shortfalls.

[10] Bohn, Henning and Robert P. Inman, "Balanced-Budget Rules and Public Deficits: Evidence from the U.S. States," *Carnegie-Rochester Series on Public Policy*, 1996, Vol. 45, 13-76.

[11] Poterba, James M., "State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics," *Journal of Political Economy*, 1994, Vol. 102(4), 799-821.

Figure 1. Actual and Hypothetical Spending Under Prop. 76



Spending Growth

Another goal of Proposition 76 is to control the growth of spending. The measure is designed to prevent the state from rapidly increasing spending in response to short-run revenue growth. To get a sense of the measure's effect, we can use the actual revenue and spending numbers from the past 25 years and imagine how spending would have been different if Proposition 76 had been in effect (Figure 1).[12] For the purposes of this exercise, we assume that revenue is not affected by the measure, that is, all adjustments come through spending. Because this is a strong assumption, the following estimates should be seen as upper bounds of the measure's effect on spending. In years when spending exceeded the hypothetical cap, we assume that spending is set at the cap. The dark line (diamonds) is actual spending and the pink line (squares) is spending with the cap in place. Spending may also be limited by the balanced budget requirement if it leads to cuts in response to current revenue shortfalls. The yellow line (triangles) shows hypothetical spending when both the cap and the antideficit rule are in place, assuming that current revenue shortfalls are completely matched by spending cuts. Details of the calculation are in the appendix. Several conclusions emerge from the analysis:

[12] The starting year matters because the limit depends on spending in the previous year. For the period 1994-2004, the starting point does not matter as long as it is before 1994. These estimates do not incorporate the restriction that spending not exceed revenue. That constraint would have mattered from 1981-1994 but not afterwards. The figure does not take into account the extra spending on transportation that would occur when revenues exceed the cap, but this effect is modest in the aggregate.

- Spending in the current fiscal year (2005-06) is about $12 billion above where it would have been with the cap. Of course, this does not mean that spending would have to be cut by $12 billion if the measure passes since the benchmark will be set at 2004-05 if the measure passes, not at 1977-1978 as the exercise assumes. Moreover, the state could have chosen to increase taxes to fund spending above the hypothetical estimate here.

- Spending growth would have been slower throughout the 1990s, but still fairly high. Because revenue grew so fast during the 1990s, the cap would have grown significantly over time, although more slowly than actual spending grew.

- Absent a tax increase, the cap would have been binding in 23 of the last 25 years.

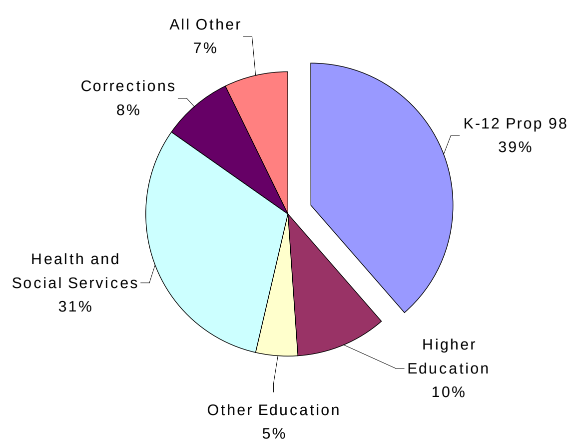
- The antideficit provision is not that important for controlling spending. It is the spending cap that does most of the work.

- The Legislative Analyst's opinion in the ballot pamphlet states that the measure would probably smooth state spending, which seems plausible for the spending caps. However, the balanced-budget requirement may increase volatility by tying spending more closely to revenue. Figure 1 does not show much of a smoothing effect.

- The state went through recessions in 1980-82 and 1990-1991. The cap is not binding at the outset of a recession, probably because spending falls in response to projected revenue shortfalls. When a recession ends, however, the constraint binds because spending is not allowed to respond to the growth in revenue.

To understand what might be cut if revenues fell short of expectations in any year, it is important to understand where the money is currently spent. The major general fund-expenditure categories for 2005-06 are education, health and social services, and corrections.

Figure 2. California General Fund Budget Allocations, 2005-06



Source: California Legislative Analyst's Office

One could think of this as 85 percent for payments to individuals and other governments and 15 percent for state government operations. It seems unlikely that budget cuts would come only from government operations; the bulk of cuts would most likely have to come from payments to education, state and local governments, and individuals. Proposition 76 does not force cuts in any program, let alone target cuts in particular programs. It is possible that the legislature and governor would choose to satisfy the balanced-budget requirement by cutting spending on schools and police, but they could also raise taxes or cut welfare programs.

Should the state decide to raise taxes, the limit on spending would reduce the impact of a tax increase as only one-third of such an increase could be spent in the first year and two-thirds of the increase in the second due to the three-year averaging included in the spending limit

Cities and Counties

Local governments could be severely impacted as well. For example, in 1991, the state shifted increased responsibility for a variety of health, human service, and mental health programs to counties, and helped fund it with a ¼ cent sales tax and a portion of the Vehicle License Fee revenues. The new spending cap established by Proposition 76 would apply to funds provided to counties to support these programs. It is not clear how counties facing such a situation would react given California localities are limited in their abilities to raise revenues.

Education Spending

The measure could lead to higher education spending in prosperous years. Currently, legislators and the governor might hesitate to exceed the Proposition 98 minimum-funding guarantee understanding that increases beyond the guarantee would increase the base for future years. Proposition 76 would allow legislators and the governor to make above-minimum appropriations to education without adding to the base for future years. Conversely, Proposition 76 could also lead to lower growth in spending over time because when Proposition 98 is suspended, or if the governor reduces funding in a given year, those reductions reduce the future minimum-funding guarantee.

Proposition 76 would not "cut" spending in the normal sense of the word. The measure does not eliminate the school-funding guarantees of Proposition 98. Proposition 76 would lengthen the time required to pay back the $3.8 billion maintenance factor and would remove that $3.8 billion from the long-term funding guarantee. Over time, as the Proposition 98 guarantee increases due to cost-of-living adjustments, the size of that reduction would also increase; the impact of this provision appears to be substantially more than the $3.8 billion itself. Under current law, the $3.8 billion is part of the Proposition 98 minimum-funding guarantee, and it continues to grow as part of the minimum guarantee. Assuming an annual cost-of-living adjustment of 5 percent per year for fifteen years, the minimum-funding guarantee would increase by over $7.5 billion more than it would if the $3.8 billion is simply paid over fifteen years and not added to the funding guarantee. If cost-of-living adjustments were less than 5 percent per year, this reduction in the future funding guarantee would be lower, but even at an average of 3 percent per year, the impact would be a reduction of $5.75 billion.

Education spending would continue to grow, but not as fast as it would have without the measure. Furthermore, the legislature is free to appropriate the $4 billion, or more, if it chooses, but those above-minimum appropriations would no longer become a part of future Proposition 98 guarantees. However, it does create downward pressure on the growth of the guarantee since appropriations above the guarantee no longer become part of future guarantees, and the current maintenance factor obligation of $3.8 billion is taken out of the current guarantee. Proposition 76 would likely result in lower education spending nevertheless, although such an assessment is based on a hypothesis of how politics will play out in the state rather than any hard evidence or the text of the measure.

Whether it is a good idea to reduce the Proposition 98 minimum-funding guarantees for education depends on a subjective view of how much should be spent on education and how important it is to give legislators flexibility when budgeting. If legislators are believed to be prone to under-fund education, then tough guarantees may be appropriate. Unfortunately, there is no objective standard of how much spending on education is optimal. Even the simple question of how California educational spending compares nationally depends to some extent on what statistic is cited. For example, California teachers are currently the highest paid in the country according to the NEA, but California class sizes are among the largest in the 50 states. Per-pupil spending is below the national average, and the percentage of personal income devoted to education in California is again lower than the national average. Part of the reason is demographic: one attempt to assess the ranking of California investment of education concluded that California was about in the middle of U.S. states with similar demographics, and that is about where it has been for decades.[13] California's educational standards—what we expect our children to know and be able to do—are among the highest of the 50 states.[14] How much it should reasonably cost to ensure all children have access to education that will enable them to meet those standards is at present unknown.

Legislature-Gubernatorial Relations

The provisions of Proposition 76 somewhat increase the governor's power, but does nothing to augment the legislature's power, a net shift in the balance of power toward the

[13] Gerber, Elisabeth R., Arthur Lupia, Mathew D. McCubbins, D. Roderick Kiewiet, Stealing the Initiative, 2001.

[14] California's math standards were given an "A" by the Thomas B. Fordham Foundation. Klein, Davis, et al., "The State of State Math Standards 2005," The Thomas B. Fordham Foundation, January 2005, Washington, D.C.

governor. The governor's power to veto items in the initial and revised budgets remains the same as current law. The augmentation comes from the governor's ability to make cuts without the agreement of the legislature in a fiscal emergency. The legislature would have to muster a two-thirds majority to over-ride the governor by passing a new budget, though the language of the measure remains unclear of this procedural option.

The shift in power to the governor may be more apparent than real: under current law, the governor presumably already has veto authority in a fiscal emergency and can be over-ridden by two-thirds votes in the legislature. The main difference under Proposition 76 would be to empower the governor to act unilaterally if the legislature does pass a budget with a two-thirds majority.

Clearly, one-third of the legislature and the governor gain additional power within the budgetary process given the provisions of Proposition 76. Proposition 76 seems to place more power over the use of state funds in the hands of the governor in the case of a fiscal emergency. The power of a legislative minority also seems to be enhanced given that one-third of the legislature can ensure a governor's appropriation cuts become permanent, both by stopping an over-ride when the reductions are made and then by holding up passage of future budgets.

The requirement that appropriation levels continue at current levels if a new budget is not approved, also in the hands of the legislative minority and the governor, may have a substantial impact on future spending levels as well.

On the question of whether legislators should have more budget flexibility, there is an oft-repeated claim that voter initiatives have tied the hands of legislators so much that they are prevented from making sensible budget tradeoffs. However, the empirical analysis of the actual constraints casts doubt on the claim—voter initiatives place minimal constraints on legislative budgeting.[15]

Entitlements and Contracts

Similarly, under current law the governor cannot veto entitlements, but under Proposition 76, those payments would be conditional because the governor could veto the appropriations for those entitlement payments.

The consequence of giving the governor the ability to make cuts in existing contracts is more difficult to predict, but just how far this extends may require clarification from the courts. The risk of having a project cancelled may result in higher prices for the state as contractors seek insurance from cancellation.

CONCLUSION

[15] Matsusaka, John G., "Direct Democracy and Fiscal Gridlock: Have Voter Initiatives Paralyzed the California Budget," *State Politics and Policy Quarterly*, Fall 2005, Vol. 5(3).

Our analysis suggests that Proposition 76 is likely to achieve its main aim of preventing deficits. The chance of a fiscal crisis like the one that emerged in 2001-2002 will be significantly reduced, and budgets are likely to be balanced. Although the measure will probably dampen the growth of state spending, spending will continue to rise in rough proportion to state income. Education will continue to be protected from extremely large cuts by Proposition 98 and education spending will continue to grow, but probably at a somewhat slower rate than without Proposition 76. The power of the governor will increase in fiscal emergencies because he gains the power to make cuts if negotiations with and within the legislature break down. As a result, the allocation of spending across programs will shift toward the policy priorities of the governor, and the priorities of the legislature will matter less.

Reasonable people can disagree on whether these changes are for the better or worse. The elimination of budget deficits seems like a worthwhile goal. When bond-rating agencies downgraded California's debt to near junk bond status in 2003, the state had to pay an additional $34 million in credit enhancements.[16] Furthermore, budget decisions that are not made under fiscal duress may be wiser.

On the other hand, relatively modest deficits are not likely to result in lower debt ratings and so are unlikely to cost the taxpayers anything. And there is something to be said for using borrowing to get through a temporary revenue shortfall rather than making precipitous cuts in spending. If the measure passes, the state would end up trying to smooth out spending over the business cycle by using its rainy-day fund.

Whether reducing the growth of government is a good or bad idea is even more subjective and heavily dependent on one's policy priorities. Proposition 76 probably won't change the debate over what governmental services are more or less important in individuals' minds, but it may leave them with fewer budget resources to argue about, or force tax increases to pay for agreed upon necessary government services.

[16] Sheffrin, Steven M., "State Budget Deficits and the California Debacle," *Journal of Economic Perspectives*, Spring 2004, Vol. 18(2), 205-226.

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Appendix

The analysis in Figure 1 uses historical revenue data from *State of California Revenues, 1950-01 to 2005-06*, by the Legislative Analyst's Office, available at <http://www.lao.ca.gov/LAOMenus/lao_menu_economics.aspx>. Revenue is combined General Fund and special funds revenue. Expenditure data are taken from Chart B of the *Summary Schedules* published by the California Department of Finance, available at <http://www.dof.ca.gov/html/bud_docs/backingo.htm#SummSchedules>. Expenditure is combined General Fund and special funds expenditure. The Proposition 76 caps were calculated as the arithmetic average of the growth rate in revenue over the previous three years.

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