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Reforming California's Budget Process

Preliminary Report and Recommendations of the California Citizens Budget Commission

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Preface

The Preliminary Nature of This Report

The California Citizens Budget Commission has spent nearly two years analyzing California's budgeting procedures—the frequently stultifying, complicated and inflexible requirements which the legislature and governor must follow in adopting the state's annual budget. The Commission unanimously recommends that this report's preliminary set of reforms be seriously considered for adoption by the state's elected officials, policy leaders and members of the public.

In light of the complexity and seriousness of the state's budgeting problems, as well as the comprehensive nature of the Commission's recommendations, the Commission has concluded that it would be helpful to present its findings and proposed reforms to the public in this ñpreliminaryî form. Such an approach will enable the Commission to solicit comments on its findings and recommendations from state officials, legislators, academics, the media and interested members of the public, reconsider those findings and recommendations and strengthen them where appropriate in its final report.

In the coming months, the Commission plans to hold informal meetings with interested individuals and organizations around the state, both to obtain their views on the nature of California's budgeting problems and to consider their comments on the Commission's proposed recommendations. The Commission will incorporate the comments it receives into a final set of findings and recommendations which it will publish later this year.

The Commission's final report will include detailed research, as well as model legislation to implement the Commission's recommendations.

Comments on the Commission's preliminary findings and recommendations are welcomed. They should be sent to:

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Foreword

The California Citizens Budget Commission is a nonprofit, bipartisan, private organization formed in 1993. Twenty-six Californians from the state's business, labor, academic, judicial, civic and public service communities, including Independents, Democrats and Republicans, have volunteered their time and talents to serve as Commission members.

Over the past two years, the Commission has examined the budgeting practices of California and other states, interviewed a large number of elected officials, legislative staff and budgetary experts and canvassed the existing literature on state budgets. The Commission has identified a wide range of problems afflicting California's budgeting process. These include difficulties in accurately predicting state revenues and expenditures, constitutional and statutory barriers to flexible and responsible budgeting procedures, unsound long and short-term borrowing practices and unequal fiscal relationships between state and local governments.

The Commission has developed a comprehensive set of recommendations which—if implemented by the governor, the legislature and, where necessary, by the voters—could significantly reform California's budgeting process and eliminate the state's annual budgetary crises which are in danger of becoming a way of life. (A list of the Commission's recommendations appears in Appendix A.)

This preliminary report summarizes the budgeting problems the Commission has identified and the recommendations it has proposed. The Commission's recommendations are not intended to affect the state's substantive budgetary decisions—such as how much money should be spent on education or welfare, or whether specific taxes should be increased or cut—although the proposals occasionally touch on major substantive policy questions, such as how to cure the state's accumulating deficit, or how to restore the autonomy of local government. Generally, however, the Commission has designed its recommendations to reshape California's budgeting *process*—that decisionmaking *system* which undergirds and affects every significant substantive public investment and economic policy decision made by the state.

The Commission is an operating project of the Center for Governmental Studies, an independent, nonprofit, research organization located in Los Angeles. The Commission extends its warm appreciation to the William and Flora Hewlett Foundation, the James Irvine Foundation and the Sierra Health Foundation for their generous support, without which this project could not have been undertaken.

The Commission also expresses special gratitude to its talented staff. Project Director Susan North and Executive Director Tracy Westen, with the able assistance of Robert M. Stern, were responsible for assisting the Commission in its deliberations and the preparation of this report. C.B. Holman and Matthew T. Stodder assisted with substantive research; Janice Lark prepared the report for publication; and Pam Homan assisted in the report's production. Steve Levy, Director of the Center for the Continuing Study of the California Economy, provided the Commission with valuable economic information. Robert Herstek designed the report's cover.

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PART I

Summary of the Commission's Preliminary Findings and Recommendations

Summary of the Commission's Preliminary Findings and Recommendations

California's annual budget embodies the most important decisions state government makes each year. The budget in large measure determines how much the state's citizens should be taxed, what business incentives and personal spending priorities should be established and how the state's resources should be spent. Yet the *process* by which the state makes these annual budget decisions is encumbered with unnecessary procedural obstacles and serious informational inadequacies.

California is today experiencing unprecedented pressures on its financial resources. If California is to weather the difficult passage from dangerous debt to fiscal stability, it must begin by repairing its budgeting process.

The state must renew its sense of fiscal discipline, balance its budget and clearly identify all debt and its sources of repayment. Elected officials must be given newer and more flexible tools to make the difficult political choices between spending and taxing. The public must be given a clearer understanding of the options it faces. Local governments must be given greater control over their revenues, so they can wean themselves from dependency on state government. Without significant procedural budget reform, fiscal gridlock may recur, long-term capital investments may be delayed, deficit spending may increase, state bond ratings may further deteriorate and the long-term economic growth of the state may be impaired.

Outline of the Commission's Recommendations

The Commission has organized its recommended budget process reforms around five principal themes.

- First, the governor and legislature should be required to balance California's annual state budget each year.

- Second, the Budget Act itself should become a comprehensive document. It should describe and enumerate all spending and revenue decisions, detail their impacts on local governments and establish clear public priorities for state government.

- Third, the legislature should be allowed to adopt a budget bill by a simple majority vote, although it should still be required to raise tax rates or override any gubernatorial veto by a two-thirds vote.

- Fourth, the budget process should both be simplified and include more comprehensive information.

- Fifth, California's local govern-ments must be given greater control over local revenues and programs, so they can be more responsive and accountable to their citizens' needs and wants.

These preliminary recommendations are summarized immediately below and discussed in greater detail in the remainder of this report. A complete list of the Commission's recom-mendations appears in Appendix A.

California's Budget Should Be Balanced

The California constitution clearly contemplates that each year's adopted budget should be in balance—that is, that projected expenditures for all state programs should not exceed predicted revenues from all sources, including capitol funds approved by the electorate.[1] The constitution charges the governor with the responsibility to present the legislature with a proposed budget in which predicted revenues equal proposed spending. And it prohibits debt in excess of $300,000 to support the operation of state government without a vote of the people.

Over the past century, however, the courts have interpreted this prohibition in ways that allow the government to incur long-term debt by issuing bonds, and to incur short-term debt to meet the state's immediate cash flow needs by borrowing against anticipated tax revenues. But the state's borrowing has grown far in excess of what the state can repay from reasonably predicted future revenues, and this borrowing is now used for purposes that significantly exceed adjusting to administrative cash flow fluctuations. State debt has now reached unprecedented and possibly dangerous levels.

The Commission believes that California should follow the practice of many other states and balance its budget within each budget year. California must stop its practice of ñoff budgetî loans and short-term borrowing to fund programs at levels that cannot be sustained in light of reasonably predicted future revenues. The state must honestly and forthrightly identify its accumulated deficit and develop a plan to retire it within no more than five years. The state must create a budget reserve account for emergencies and create a legislative Joint Fiscal Oversight Committee to monitor the budget's implementation during the year.

California's Budget Should Be Comprehensive

The California constitution also contemplates that the budget identify all the state's spending priorities in one comprehensive package. This implies that state decision makers will have the power to consider all spending decisions within the budget process, and that they will actually do so. Neither is the case in California today. The state budget reflects only half of all state spending, and the governor and the legislature are able to control less than 10% of that amount.[2]

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[1] Even a budget which is balanced as adopted may encounter severe imbalancing pressures during its year of operation. Revenues may be less or more than expected due to changes in the economy. Expenditures may be subjected to unexpected contingencies, such as earth-quakes or other emergencies. "Balance" in this context means that at the time the budget is adopted, honestly predicted spending should not exceed honestly estimated revenues.

[2] In 1990, the legislative analyst issued a report, *The California Budget Process: Problems and Options for Change,* which found that 88% of all spending decisions in the budget were restricted by the state constitution or state or federal laws, leaving only 12% of the budget under the effective control of state budget decision makers. Other identified constraints brought the true "discretionary" decisions made in the by state budget down to 8.5%.

Special interests have frequently obtained protective legislation to channel state revenues toward spending activities which lack legislative budget oversight. ñSpecial fundsî—revenues from dedicated sources (e.g., gasoline taxes) which can only be used for certain purposes (e.g., highway repair), some of which are not reviewed as part of the budget process—are expanding. In addition, the legislature has enacted more than $20 billion in annual ñtax breaksî—tax deductions, credits and exemptions—which are not reviewed as part of the annual budget process.

The Commission believes that all special funds and tax breaks should be included in the state budgeting process, so that overall spending priorities can be fairly and intelligently established.

The state Budget Act should also provide a simple comprehensive picture of the state's overall fiscal condition and spending priorities. New budgeting methods should be adopted to enable the legislature to compare programs with each other. Performance outcome measures should be adopted. Long range or multi-year budgets should be implemented for major programs.

California's Budget Should Be Adopted by a Simple Majority Vote

California is the only state in the country that requires both houses of its legislature to enact the state budget by a supermajority two-thirds vote under all circumstances. There is, however, no evidence that a supermajority vote restrains increases in state spending. Instead, it places the power to control, block or veto the state budget into the hands of a small minority in either house of the legislature. It also allows legislative parties to avoid responsi-bility for unpopular budget decision and blame them on others. The public is left finding it difficult to hold anyone, including the governor, responsible.

During the past 20 years, despite the supermajority vote requirement, the legislature has increased state spending as often as it has decreased it—in order, some contend, to secure the two-thirds vote needed to pass the budget. There is no evidence that a supermajority budget vote requirement does anything other than promote political gridlock and create opportunities for special interest abuse.

Under the constitution, the annual Budget Act cannot change substantive law. The legislature has therefore increasingly used so-called Budget Act ñtrailer billsî to change existing laws and conform them to budget decisions. But these trailer bills can also be used to avoid legislative and public debate over controversial policy changes. In the 1994-95 budget, for example, the legislature passed 19 trailer bills. They covered such topics as domestic violence, management of prescription drugs under the Medi-Cal program, contracts for prison medical care and reauthorization of Proposition 99 tobacco tax-supported programs. Nearly all were drafted during the budget debates, and few were subjected to scrutiny in public hearings. The Commission recommends that trailer bills be adopted by majority vote, that they not be used to make permanent changes in law and that they also be subject to the governor's line item veto.

Vote requirements for tax breaks are also anomalous. (See Appendix B for a guide to California's various vote requirements on fiscal matters.) Under current law, the legislature can reduce taxes (e.g., by creating tax breaks) by a simple majority vote, but it cannot increase revenues (e.g., by eliminating tax breaks) without a two-thirds supermajority vote. It is thus considerably easier to create tax breaks than to repeal them. The Commission believes this disparity should be eliminated.[3]

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[3] Although the Commission considered the argument that tax increases and decreases should both be adopted by a simple majority vote rather then by a two-thirds vote, the Commission did not achieve unanimous approval of this.

California's Budget Should Rely on Improved Information

Although California's budget process produces massive amounts of information, too little of it is summarized in a form that can be easily understood by interested members of the public. Voters cannot participate in making difficult fiscal decisions unless the underlying information is accessible to them. The budgetary information that does exist is often incomplete in significant ways. The state, for example, transfers over 70% of the money it commits in the current state budget to local governments, which in turn spend it on education and state-mandated programs such as health care for the poor. Many local governments add their own resources to the same programs. These local expenditures are thus a consequence of state budget decisions and should be considered in state budget discussions. State and local government budget terminology should also be simplified and standardized.

The Commission recommends that the legislature shorten its session and adjourn on July 1st of each year, thereby allowing it to accelerate its budget decisions and its members to spend more time with constituents. The legislature should also conduct joint Assembly-Senate Fiscal Subcommittee hearings, and the department of finance should be required to issue a final narrative budget report within 90 days after the budget's adoption. The legislative analyst should distribute to all taxpayers a short, easy-to-read, annual ñbudget primerî summarizing key budget decisions.

California's Budget Should Give Local Governments Greater Independence

Proposition 13 in 1978 limited local governments' ability to increase property taxes. One of Proposition 13's consequences, however, was that it reduced local governments' ability to respond to citizen requests for services. The measure also forced the state to allocate local property tax revenues among local governments, but the state has increasingly done so based on the state's immediate interests, rather than local needs. Not only has independent local governance—particularly that of counties and school districts—all but evaporated, but the concept of home rule for local voters has also been jeopardized.

Local governments have responded to these financial pressures by creating a variety of financing instruments that require a simple majority vote, rather than the two-thirds supermajority vote historically required to adopt local general obligation (ñGOî) bonds. Local governments have used these alternative devices to incur significant amounts of debt—frequently on more costly terms and conditions than for GO bonds. Better ways of protecting the public against such costly debt must be devised.

Because current state and local fiscal interrelationships undermine local governments' authority to address their own financial needs, the Commission believes the state's ability to use the property tax to support state programs should be limited. Property tax revenues should be available to support local needs, thus restoring the ability of local voters to determine how best to serve their own interests.

The Commission also recommends that local budgeting cycles be more closely synchronized with the state's, that local voters be allowed to raise their own property taxes, that local general obligation bonds be approved by a simple majority vote, that the state allocate sales tax revenues back to local governments on the basis of need and not the situs of the sales tax collection, that counties be given greater discretion to set property tax exemptions and that the state's tax system be made clearer, fairer and more broadly based.

Conclusion

The Commission's preliminary recommendations offer a set of reforms which, if adopted in full, would significantly improve California's budgeting process—and simultaneously improve the quality of the state's most important fiscal decisions.

The Commission members reached a unanimous consensus on these proposed reforms by balancing a number of needed changes against each other. The Commission therefore urges readers to consider the following preliminary recommendations as an integrated package of proposed California budgetary reforms and not as a menu of individual items.

PART II

California's State Budget: An Introduction

California's State Budget: An Introduction

California possesses the eighth largest economy in the world and the most populous and diverse citizenry of any state—with over 31 million residents and over 85 languages spoken in its public schools. With an estimated 1992 gross state product of $771 billion, California accounts for 15% of the nation's gross domestic product.

California also has the largest state budget in the country (see Table 1), even though the recent recession has left the state's current ñgeneral fundî[4] at only $42.4 billion (see Table 2)—two-thirds the level of revenues formerly projected to be available for 1994-95.[5] Funding for some of California's individual budgetary programs—education and welfare, for example, at $22 billion and $5.2 billion, respectively—are larger than the entire budgets of most other states. (See generally Table 3.)

Table 1

FIVE LARGEST STATE GENERAL FUND BUDGETS

(in millions of dollars)

Fiscal Year 1993-94

State	General Fund Expenditures
California	$39,347
New York	32,563
Texas	19,919
New Jersey	15,138
Pennsylvania	14,967

Source: National Association of State Budget Officers, Fiscal Survey, April 1994

The Impact of State Budget Decisions on the Public

[4] ñThe general fund . . . is the money raised by state income tax, sales tax, business and corporation taxes, and so forth; it is the money that the legislature can debate about, appropriate and to some degree control.î 18 Rand Research Review 2 (Fall 1994).

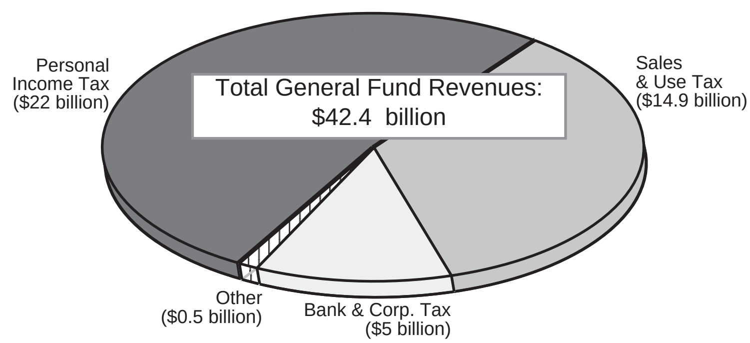
[5] Presentation by Russell Gould, Director of the Department of Finance, before the California Constitutional Revision Commission, May 4, 1994.

Individuals and businesses in the state rarely see a direct connection between their daily lives and the state's budget process, yet the two are significantly intertwined. When a young California family tries to buy a home in 1995, for example, it may find that special property assessments—levied in lieu of property taxes after enactment of Proposition 13 in 1978—can add as much as $20,000 or more to the home's price. This family may also find it particularly frustrating that other long-time residents who benefit from these assessments (for schools, roads, etc.) do not pay them. Finally, the family may also discover that these assessments, unlike property taxes, are not deductible under federal income tax laws. Business entrepreneurs may find that local fees and state laws often complicate their ability to expand and grow. And all citizens may find that library hours, the number of policemen on the street, the numbers of attendance officers and school nurses at school are all determined in large measure by what happens in California's state budget process. In essence, the state budget embodies those public spending decisions which, in a series of chain reactions, affect most public services delivered within the state at all levels of government.

Table 2

CALIFORNIA'S GENERAL FUND REVENUES—BY SOURCE

Fiscal Year 1994-95



Source: Governor's Budget Proposal, 1995-96

The State Budgeting Process

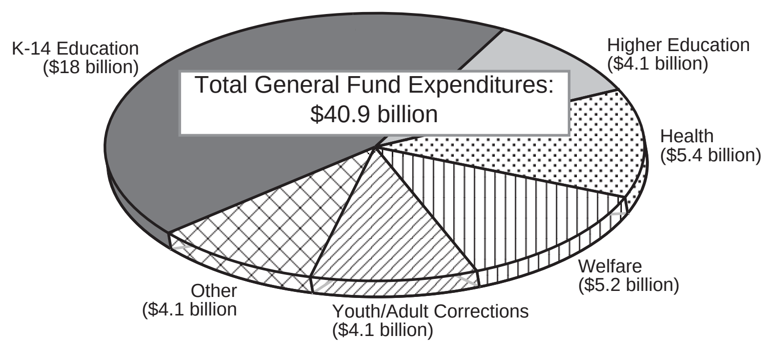
Under current law, the governor must submit to the legislature each year in early January a proposed budget containing his best estimates of how much revenue the state will receive in the coming fiscal year (July 1 through June 30) and a specific plan for how the legislature should spend or allocate the state's available funds. During the following five months, the fiscal committees of the legislature review these revenue estimates and spending proposals and amend the governor's proposal to reflect their own priorities for the budget. Once these committees have completed their proposed amendments, each house of the legislature must approve its own version of the budget, after which a joint budget conference committee is formed with three legislators from each house. This conference committee negotiates and resolves all conflicts between the two versions and sends one budget bill back to each house of the legislature for approval. According to the state constitution, each house must approve this budget bill by a two-thirds supermajority vote. The governor then has the authority under the constitution to ñline itemî veto any individual appropriation and its associated language in the budget bill, but the legislature may override specific gubernatorial vetoes by a two-thirds supermajority vote.

California's current fiscal problems are not the product of administrative neglect. California's fiscal agencies have been a model for other states throughout the country. The department of finance, the legislative analyst's office, the state controller and State Treasurer arguably comprise the best set of fiscal managers in any state. California's problems, as discussed in this report, are far more often the product of procedural obstacles to effective substantive and political decisionmaking—such as an unrealistically high supermajority vote requirement which makes it difficult to reach political consensus, budget practices which fail to list all of the financial obligations facing the state, routinely ignored balanced budget requirements, constitutional and statutory restrictions which remove certain revenues and spending from effective gubernatorial and legislative control and pervasive crisis management practices which embrace short-term solutions and avoid long-term fiscal responsibilities and planning.[6]

Table 3

GENERAL FUND EXPENDITURES—BY PROGRAM

Fiscal Year 1994-95



Source: Governor's Budget Proposal, 1994-95

Total State Spending and Revenues

California's state government actually spends far more than the total amounts listed in the budget document. In 1994-95, for example, California is expected to spend over $117 billion from all sources. The total expenditures listed in the state budget, however, are approximately $57.5 billion, of which general fund expenditures are $40.9 billion. The difference between total spending ($117 billion) and budget spending ($57.5 billion) includes $6 billion in special funds not appropriated through the Budget Act, $30 billion in federal funds and $23.5 billion in ñnon-programî spending, such as tax breaks and disbursements from retirement and investment funds. (See Table 4.)

On the revenue side, the budget also does not fully reflect state policy decisions to exempt certain interests from payment of specific taxes. Tax breaks,[7] for example, are

[6] Current "crisis management" practices include reliance on short-term "solutions" (e.g., debt), which simply *assume* that the fiscal problems of the state will disappear by the end of the budget year. Too often these short-term solutions create other problems which then beget yet more short-term solutions. Lost in this process is a deliberate look at where the state is heading over time and fundamental adjustments to state programs, revenues and levels of spending.

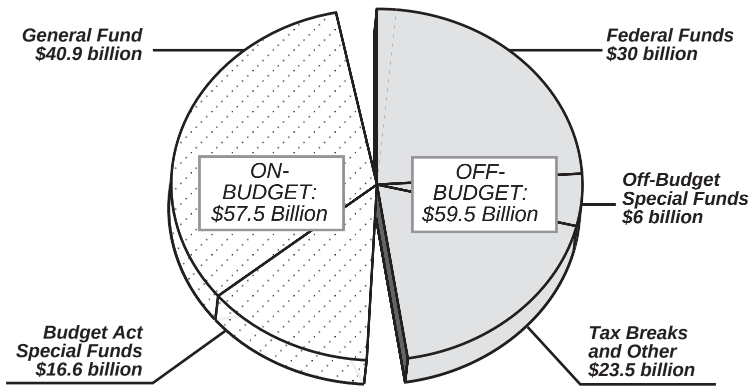
[7] A variety of terms—"tax expenditures," "tax breaks," etc.—have been used to describe the variety of exemptions, credits and deductions granted in state law to individuals and businesses from property, income, sales and bank and corporation taxes. For the purposes of this report, these forms of tax forgiveness mechanisms are designated as "tax breaks."

potential revenues which the state chooses not to collect. Tax breaks total between $13 and $20 billion annually (depending upon the definition used) and are not routinely reviewed in the budget process.

Table 4

**ALL STATE SPENDING OF $117 BILLION:
ON-BUDGET vs. OFF-BUDGET***

Fiscal Year 1994-95



*"On-Budget" refers to all funds appropriated through the state Budget Act ($57.5 billion). "Off-Budget" refers to all funds appropriated separately from the Budget Act ($59.5 billion).

Source: Governor's Budget Proposal 1994-95, and 1994 Budget Act as adopted.

The state budget thus does not identify half of actual total state spending, and it does not list revenues lost through tax breaks.

California's Fiscal ñDenialî

California must confront unpleasant fiscal realities. When the recession hit California in 1990, state government was already spending more money than it had—indeed, California has ended more than half of the past 13 years in deficit. The current recession has dramatically accelerated the problem. The state deficit has grown 150% in each of the past three years—despite $10 billion in spending cuts and $7 billion in tax increases. These deficits increase the state's debt service costs and deprive it of resources for badly needed state programs.

To make matters worse, spending on some of California's largest programs, such as Medi-Cal, welfare and prisons, is growing more rapidly than available revenues, while spending on other growing programs, such as elementary and secondary education, is constitutionally mandated and cannot be decreased. The combination of shrinking revenues, growing and often mandated expenditures and widening deficits has placed California's policy makers in a fiscal strait jacket. Not surprisingly, these decision makers have frequently avoided coming to terms with reality.

California's new era of fiscal ñdenialî began in 1992. California missed its constitutionally imposed deadline for producing a budget agreement on June 30, 1992, by a record 63 days. Moreover, the 1992 budget agreement was based on a new, unprecedented form of deficit spending involving the creation of so-called ñoff-budgetî loans for schools[8]—loans pledged against future constitutionally mandated appropriations—which the state financed through its own short-term borrowing.

Although state leaders were severely criticized for the 1992 budget delays, they have until recently taken few steps to improve the budget process itself.[9] What is worse, the deficit spending that began in 1992 has become chronic, and the fiscal imbalance between revenues and expenditures has increased each year. Because the state has failed to reduce this budget imbalance, its credit position continues to weaken, requiring the state to borrow more and more at higher and higher interest rates to finance its growing debt.

Two recent statements illustrate the lack of reality that infects legislative attitudes towards California's budget crisis:

> *ñI think everybody is trying to get past the elections. I frankly think it's more important that you do the budget on time than the contents of it.î*
>
> — *Assembly Speaker Willie L. Brown, Jr.*
> *Sacramento Bee, April 16, 1994*

> *Under the circumstances, when you have this large a deficit, you'd expect there would be more debate. We're undoubtedly in denial.î*
>
> — *Senate Minority Leader Ken Maddy*
> *Sacramento Bee, April 16, 1994*

A year before, financial advisors also warned that denying the existence of growing deficit spending could have dangerous consequences:

> *The State of California is in danger of falling into many of the same traps that contributed to the savings and loan crisis and such bankruptcies as Drexel, Burnham Lambert, Integrated Resources and the Trump Taj Mahal. These traps are: (1) denial that anything fundamental is wrong; (2) taking advantage of accounting loopholes; and (3) reducing asset liquidity while pyramiding short-term debt.î*
>
> — *Wilbur Ross, Senior Managing Partner,*
> *Rothschild, Inc., before the California Debt*
> *Advisory Commission, May 12, 1993*

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[8] The first "off-budget" loan authorized for the 1992-93 fiscal year totaled $973 million was followed by another off-budget loan in 1993-94 of $564 million. These ñloansî resulted in higher appropriations to schools than required under a constitutional guarantee provided by voters in Proposition 98. Although the additional appropriations were represented at the time as ñloans,î to be repaid from future year appropriations, no accompanying legislation was passed to set forth the terms and conditions for the ñloansî to establish how and when the schools will repay the borrowed funds and from what source. Since the state did not have sufficient revenues to finance these ñloans,î the state aggravated an existing deficit through short-term borrowing. Recently, a lower court ruled that the state cannot require repayment of these loans from future appropriations legally required under Proposition 98. If sustained on appeal, this ruling means that the ñloansî do not exist and the state has no claim for repayment. This will worsen the state's ability to repay its existing debt.

[9] Recently, the state created a Constitutional Revision Commission, which is charged with recommending constitutional changes to the state's budget process, the organization of state government and state and local financing and governance relationships. Under its authorizing legislation, the Constitutional Revision Commission is expected to release its recommendations by August 1995 for legislative and public review and approval.

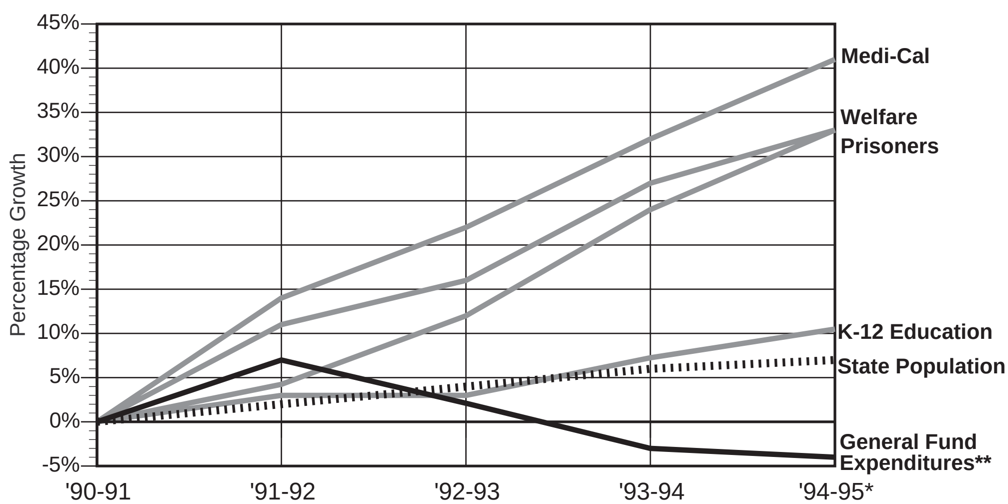
Problems in California's Budgeting Process

The state identifies and in large part sets its annual spending priorities for public services through the constitutionally defined Budget Act, a statute which has a one-year life beginning each July 1. Yet the process leading up to that Budget Act is fraught with delays, contradictions, inadequate information, lack of options and confusion among legislators and the public alike. The supermajority two-thirds vote required in each legislative house for budget passage makes decisions difficult, accountability almost impossible and special interest influence more powerful. The sheer number of budget decisions the legislature must make is very large, while the flexibility and choices available to it are small.

State budgeting is complicated by policy makers' need for both timely decisions and long range program management strategies. A state as dynamic as California needs an annual appropriation process. Significant fiscal changes can occur rapidly and require budgetary adjustments. Yet 90% of the state general fund spending is tied to just five state programs—Medi-Cal, welfare, K-12 education, higher education and corrections—most of which are growing more rapidly than the revenues available to finance them. (See Table 5.) None of these programs lends itself to annual fiscal policy decisionmaking. Large expenditure programs need multi-year planning, both to review spending trends and to implement changes. Annual budgeting by itself is not up to this task.

Table 5

STATE POPULATION AND PROGRAM GROWTH



*Forecast by the State Department of Finance
**Medi-Cal, welfare, prisoner and K-12 education programs have grown substantially as a percentage of the general fund, while overall general fund expenditures have actually declined.

Source: Governor's Budget Proposal, 1994-95

The state budget process also powerfully affects local services, yet most of these decisions receive little or no debate in the state budget process. Although the state budget determines the budgets of libraries and police and fire services for hundreds of local governments, these local entities have all but lost their independent powers to control these budgets.

In short, California's budget process fails to review key revenue decisions, to account for all state spending, to set program priorities, to provide effective fiscal management of state spending programs or adequately to address local governments' concerns.

PART III

The Commission's Preliminary Findings and Recommendations

The Commission's Preliminary Findings and Recommendations

The California Citizens Budget Commission has spent almost two years analyzing California's budgeting procedures. The Commission has not attempted to address substantive budgetary questions—such as how much money should be spent, on what programs, with what tax revenues and from which taxpayers. These substantive and political questions are best left to the public's elected representatives.

The Commission, instead, has sought to diagnose deficiencies in the budgeting process by which the state makes these substantive fiscal decisions. The Commission believes that the preliminary findings and recommendations discussed below would, if adopted, give the state's decision makers the information, discretion and ability to make the most informed decisions in the public's best interest.

A. California Must Balance Its Budget More Rigorously

The Commission has reached the following conclusions concerning the state's recurring inability to balance its annual budget.

Findings

California's state constitution requires the governor to present the legislature with a balanced budget proposal. While the constitution does not explicitly require the adopted budget to balance, it forbids the legislature to incur any debt in excess of $300,000 during a single fiscal year without a vote of the people. Over the past century, however, this prohibition has been interpreted so broadly by the courts that the governor and legislature now apparently feel free to borrow and deficit spend widely without voter approval.

California's Current Balanced Budget Requirements Do Not Work

Until recently, California's budget makers were in general agreement that the adopted state budget should balance. Since the 1989-90 fiscal year, however, budget officials have consistently adopted budgets with built-in year-end deficits. During the past two years, state budget decision makers have dropped any pretense at balancing the budget and have openly adopted unbalanced budgets that rely on billions of dollars of deficit spending financed with short-term borrowing. The governor and legislature have not asked for votes of the people to sanction these debts.

Other States Consistently Balance Their Budgets

Nearly all states have some form of a balanced budget requirement. In practice, these states usually include all funds in this balanced budget requirement, not just general funds. In 44 states, including California, the governor must submit a balanced budget proposal to the legislature. In 37 states, excluding California, the subsequently enacted budget must be balanced. Only 13 states, including California, allow year end deficits to be carried over into the next year and financed by various debt arrangements.[10] Thirty-three states also require their capital investment budgets to balance each year.[11]

State balanced budget requirements are often worded in general terms. Some individual states therefore rely on tradition, not the law, to balance their budgets. In a 1992 survey by the National Association of State Budget Officers, 22 states reported that they had enforcement provisions associated with their balanced budget requirements, yet 13 of these cited ñtraditionî as their enforcement mechanism, rather than any specific statutory or constitutional provision.[12]

California Is Creating a ñTraditionî of Year-End Deficits

California has not accurately estimated the true amount of its fiscal deficit, has not devised strategies for liquidating it, and has not informed the public of the deficit's true magnitude and seriousness. Reported year-end deficit figures do not reflect the full cost of internal borrowing from special fund accounts. The state urgently needs a comprehensive analysis to determine precisely the actual amount of the debt it has incurred to bridge the gap between revenues and expenditures.

Before 1989, California lawmakers avoided substantial deficits in the annual budget, although from time to time they used overly optimistic revenue projections and questionable assumptions about spending when they passed the Budget Act. When deficits did occur, the amounts of underfunded but budgeted spending represented a very small proportion of the overall annual budget.

Since 1989, however, each of California's annual budgets has contained a year-end deficit, the size of which has increased substantially during the last four years. (Table 6 shows the deficits in the state's general fund incurred during the past several years.) Yet during this period, lawmakers have publicly described every budget as ñbalancedî or characterized the last two years of explicit deficits as ñbalanced over two years, rather than one.î To do so, legislators in each Budget Act for the past five years have assumed that the end of the recession and the beginning of economic growth was imminent, and that an economic turnaround would balance the budget through increased revenues. In each instance, however, the anticipated increased revenues did not materialize, and the state was left with a deficit by year's end. California's acknowledged state deficit now

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[10] National Association of State Budget Officers, *State Balanced Budget Requirements: Provisions and Practice,* June 24, 1992, at p.1.

[11] These states include the debt payments on their capital investment programs expected during each budget year, not the entire debt over the life of the capital program, as part of the state's expenditure liabilities for balancing purposes.

[12] National Association of State Budget Officers, *supra* note 10, at p.5. In response to questions about California's authority to carry over year end deficits, California officials ironically cited Article 16, Sec. 1, of the state constitution, which in fact prohibits the legislature from borrowing in excess of $300,000 without a vote of the people. They also cited ñthe governor's concern over deficit spendingî as the state's major factor affecting compliance.

stands between at least $2 and $3 billion,[13] while short-term borrowing from private investors (covering both the deficit and short-term cash needs) exceeds $8 billion.

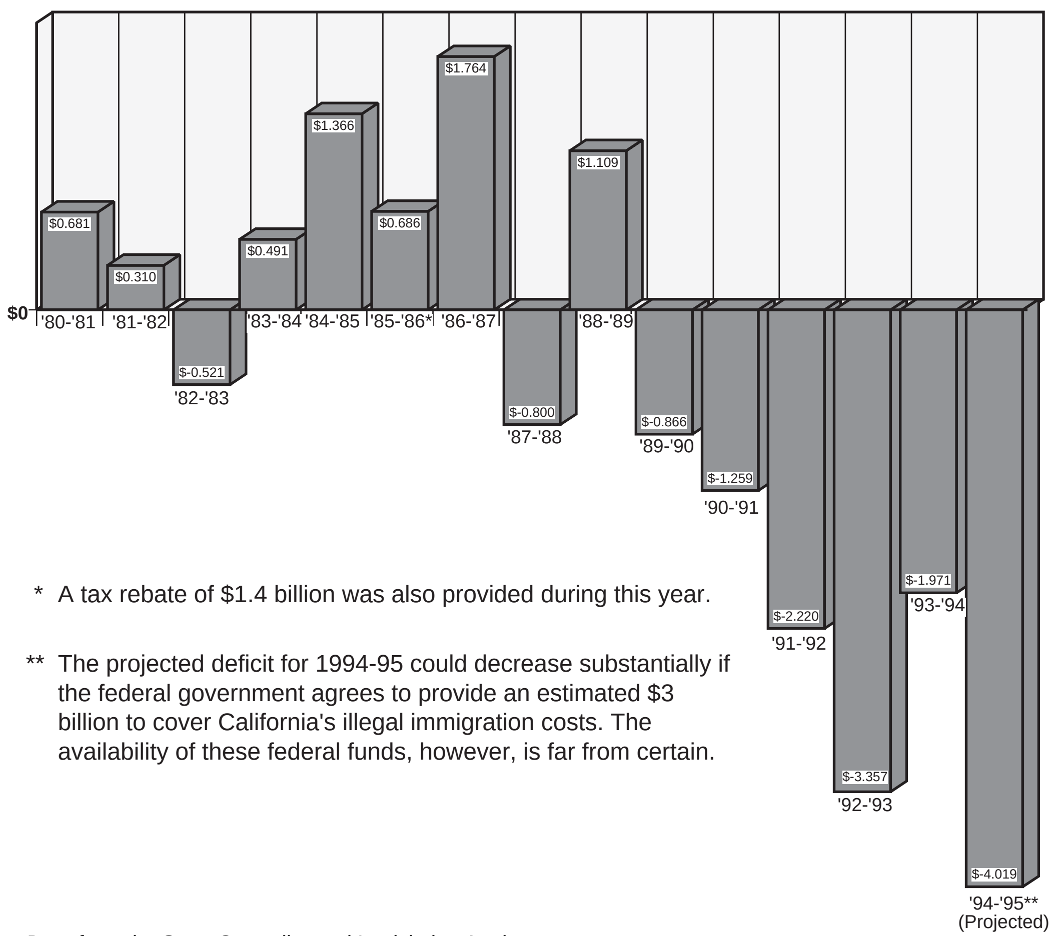
California's general fund revenues have remained essentially flat from 1989 to 1994, despite population growth of more than 3 million people during the same period. General fund revenues have failed to grow, both because the recession cut revenues and because the state enacted more tax breaks (such as sales tax exemptions) while also shifting revenues from the general fund to special fund accounts. Although fluctuations in the economy inevitably affect the level of state revenues over time, tax cuts and revenue shifts permanently shrink the general fund's ability to support the on-going costs of most large state service programs, such as K-12 education, higher education, Medi-Cal, prisons and welfare.

Table 6

YEAR-END SURPLUSES OR DEFICITS IN CALIFORNIA'S GENERAL FUND

Fiscal Years 1980-81 to 1994-95

(in billions of dollars)



* A tax rebate of $1.4 billion was also provided during this year.

** The projected deficit for 1994-95 could decrease substantially if the federal government agrees to provide an estimated $3 billion to cover California's illegal immigration costs. The availability of these federal funds, however, is far from certain.

Source: Data from the State Controller and Legislative Analyst

[13] The Commission has not analyzed the myriad devices used for counting revenues and expenditures and has not sought to calculate the precise amount of state deficit spending.

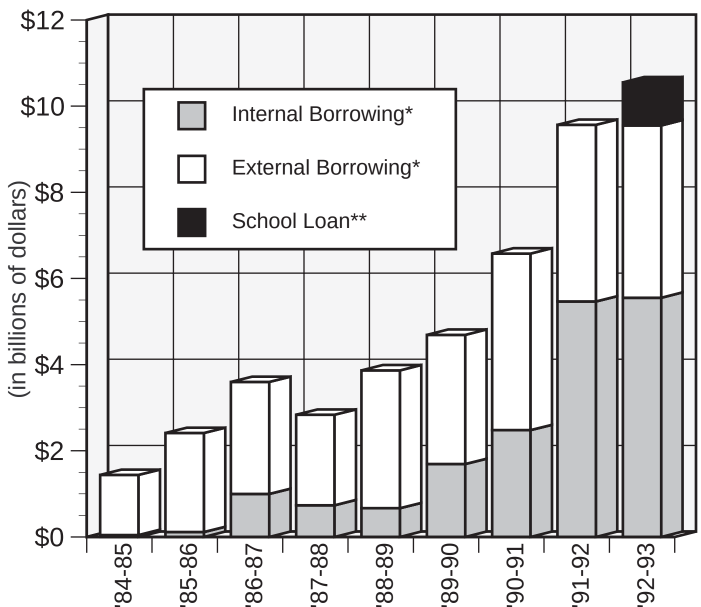
California has a larger economy than most nations, but it is nonetheless a state and cannot print money or directly influence national fiscal policy. Like private households, California must finance an imbalance between revenues and spending in traditional ways. First, it can draw on existing reserves (savings accounts). Second, it may borrow, traditionally for temporary short-falls, from internal funds (e.g., capital outlay funds, highway gas tax money, etc.). Third, it may turn to sources of private financing, by issuing either long-term bonds or short-term notes. California has paid for its spending programs through increased short-term borrowing—both internally from other state funds and externally by issuing private market notes. As Table 7 reflects, since the beginning of the recession in 1990, California's internal borrowing has more than tripled, and its external borrowing has more than doubled.

California lawmakers have now created a new state ñtradition.î Instead of making difficult political choices by either cutting spending or raising revenues to balance the state budget, they have created multiple layers of year-end deficits, increased ñoff-budgetî borrowing, invented new definitions of ñnon-debtî long-term financing and counted local resources as belonging to the state to create a fictitious state budget balance. In doing so, California has deviated from the practices employed by most other states. California may once again be leading the nation—this time in blazing new trails of state deficit spending.

Table 7

GENERAL FUND SHORT TERM BORROWING

Fiscal Years 1984-85 Through 1992-93



Amounts Borrowed (in billions of dollars)

	Int.	Ext.	Sch. Ln.
'84-85	$0.044	$1.395	--
'85-86	$0.112	$2.30	--
'86-87	$0.996	$2.60	--
'87-88	$0.735	$2.10	--
'88-89	$0.666	$3.20	--
'89-90	$1.691	$3.00	--
'90-91	$2.478	$4.10	--
'91-92	$5.465	$4.10	--
'92-93	$5.552	$5.00	$1

* Internal Borrowing occurs when the state borrows from other state accounts (e.g., special funds or trust funds) to cover cash flow needs. External Borrowing occurs when the state raises capital in private financial markets through the issuance of debt notes.

** Because the $1 billion school loan was "off-budget," it is not calculated in the total debt amount for FY 92-93.

Source: California Debt Advisory Commission, "California Cash Crisis: Surviving on Borrowed Money," Report on May 12, 1993 Public Hearing

California Uses Gimmicks to Spend Money It Does Not Have

When California exhausted its possible borrowing from internal funds in fiscal year 1991-92 and 1992-93 (more than $5 billion each year, as shown in Table 7), it created ñRevenue Anticipation Notesî or ñRANsî (some have referred to these instruments as the state's ñVisaî card) to raise needed cash.[14] In 1992, sufficient revenues did not materialize to redeem these notes, so the state created another series of notes called ñRevenue Anticipation Warrantsî or ñRAWsî (some have described these as the state's ñMasterCardî) to pay off the RANs.[15] In fiscal year 1992-93, California borrowed over $5.5 billion from internal accounts and $5 billion through privately financed RANs and RAWs.

In 1992-93, the state's internal and external total borrowing represented more than five times the $2.1 billion that all states combined borrowed through short-term notes in 1990. In July 1994, California again issued an estimated $5 billion in RAWs, to be followed by another $2 billion in RANs later in the year. California now holds the dubious distinction of having the highest proportion of short-term borrowing activity relative to its budget of any state in the nation.

California's practice of pyramiding short-term debt is analogous to the type of private fiscal behavior which has often led to corporate bankruptcy. The financial community has repeatedly warned California that it may face insolvency if it continues this behavior. When New York City, the only other governmental body to accumulate such massive short-term debt, failed to heed the same warnings, the financial community stopped lending to it altogether, and the city came perilously close to declaring bankruptcy.

Because the Federal Reserve has repeatedly raised short-term interest rates during 1994, the costs of California's short-term borrowing will increase significantly. And because California's top credit rating has slipped from one of the highest in the nation five years ago to one of the lowest today, long-term bond financing will also cost taxpayers substantially more. (Table 8 chronicles the history of recent changes in the state's credit rating.) The increase in financing costs comes at a time when overall state revenues are already failing to cover budgeted expenditures. The public must be given an accurate picture of the state's debt and a credible plan for repaying it on the most realistic and best possible terms.

California's deficit financing brinkmanship is not fully understood, even by many who participate in the budget process itself. Discussions of debt and borrowing are all but absent from the state legislature's annual budget debates.[16] Although newspaper financial pages carry periodic stories about the state's level of borrowing, few legislators or members of the public are aware of it or understand how the state continues to function with it. California cannot effectively address its many long-term problems—education, crime, infrastructure, transportation, health and welfare—without first eliminating its deficit.

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[14] Revenue Anticipation Notes (RANs) are short-term debt instruments which are to be repaid, within the same fiscal year in which they are issued, from anticipated revenues expected under an existing appropriation.

[15] Revenue Anticipation Warrants (RAWs) are debt instruments used to finance short-term debt which exceeds an existing appropriation time period. They are used to finance debt towards the end of one fiscal year and to be repaid during the following fiscal year—when there is as yet no enacted budget—or to finance debt expected to be repaid over a time period longer than 12 months.

[16] During the 1994-95 budget debate, the state controller refused to certify that the state would have adequate revenues to repay the $5 billion in RANs and RAW's California needed to issue in July 1994. After much debate, private bankers insisted that the state devise a plan to reduce spending if adequate funds did not materialize to cover repayment of this debt. The financial community demanded that the legislature and the governor develop a contingency plan, but the resulting scheme only addressed the 1994-95 debt package, not the state's accumulated overall debt. In addition, California taxpayers paid a consortium of banks $60 million for the privilege of sharing their credit in order to get the notes rated for sale.

Some solutions to the deficit can be implemented through simple procedural changes. Others will require voter approval.

Off-Budget Loans Are Jeopardizing Future Programs

K-12 education and community college budgets, though not growing faster than the budget as a whole, have been funded during the past few years by the unprecedented use of ñoff-budget loansî (funds borrowed from ñfutureî year appropriations mandated under the provisions of Proposition 98).[17] This form of deficit spending has allowed budget decision makers to avoid difficult political decisions over tax increases or funding cuts. They have used ñoff-budget loans,î however, without specifying their conditions or sources of repayment.

Table 8

CALIFORNIA'S RECENT BOND RATING HISTORY

1980 to 1992†

Year	Bond Rating Activity	Reasons for Change
1980	•Downgraded: AAA to Aa (Moody's) •Downgraded: AAA to AA+ (Standard & Poor's)	Effects of Prop. 13, Prop. 4 and national economic slowdown
1983	•Downgraded: AA+ to AA (Standard & Poor's)	State's issuance of Revenue Anticipation Notes; state was also placed on "credit watch" due to cash shortages
1985	•Upgraded: AA to AA+ (Standard & Poor's)	Improvements in state's financial performance and cash position
1986	•Upgraded: AA+ to AAA (Standard & Poor's)	State's continued good performance
1989	•Upgraded: Aa to AAA (Moody's)	Restoration of adequate fund balance in state's reserve; state economic strength and diversity
1991	•Downgraded: AAA to AA (Standard & Poor's) no reserve and rapid expenditure growth	Two successive years of year-end deficits,
1992 (Feb.)	•Downgraded: AAA to Aa1 (Moody's) budget lacking provision for a reserve)	Institutional constraints; economic trends (occurred soon after Gov. Wilson proposed
1992 (July)	•Downgraded: *GO: Aa1 to Aa (Moody's) •Downgraded: GO: AA to A+ (S & P) •Downgraded: GO: AA+ to AA (Fitch's) •Lease Payment Bonds: Aa to A1 (Moody's) •Lease Payment Bonds: BBB+ (Standard & Poor's) •Lease Payment Bonds: A to A- (Fitch's)	Attributed to breakdown of state budget process which created a cash shortage and forced issuance of registered warrants

† In 1994, both Standard & Poor's and Moody's again downgraded California's credit rating.
* "GO" refers to General Obligation Bonds

Source: "State Treasurer's Bond Sales Management Master Plan," Jan. 1993

[17] Proposition 98 adopted by voters in 1988 provides funding formula guarantees for K-12 and community college education programs. It is against these guaranteed funding levels that these so-called ñoff-budget loansî were created, giving the schools more funding than Proposition 98 required on the promise that the funds would be repaid from a funding level guaranteed under Proposition 98 in future years.

Long-Term Financing Is Now Used to Fund Operating Costs

Another major defect of the state's budgeting process is the use of long-term debt instruments by state and local governments to finance day-to-day operating expenses instead of long-term capital improvements. The University of California, for example, used a five-year private loan to raise $70 million to pay for one year's operating budget during 1992-93. Students in 1997-98 will therefore pay for University spending that occurred back in 1992-93, even though few of those students will have attended the University during those years.

Similarly, some school districts and local governments have used ñcertificates of participationî—which involve leasing shares of publicly owned properties to investors over a period of years—to finance operating budgets for one year.[18] Since these investments are predicated on the availability of future local government revenues for repayment, they are subject to higher risk ratings and borrowing costs than traditional general obligation bonds, which are backed by the ñfull faith and creditî of the government. Local governments are not required publicly to disclose the existence or amounts of lease certificates, since they are not legally considered to be ñdebt,î even though the local government may be using them to finance deficit spending.

California's Government Lacks Fiscal Discipline

California's state government has ignored the advice of the financial community to acknowledge the full extent of its debt and ask the public to approve a clear plan for its repayment. Instead, California continues to borrow more and more each year to finance expenditures which exceed available revenues. Recovery from the recession will not spontaneously produce sufficient revenues to repay this deficit and simultaneously allow California to meet its on-going financial obligations. Unless California eliminates the deficit in its operating budget, the gap between its revenues and the obligations illustrated in Table 9 will continue to grow, building greater amounts of debt and diverting more and more state revenues to pay interest. California thus risks turning short-term borrowing and deficit spending into an accepted pattern of long-term fiscal behavior.

Recommendations

The Commission recommends the following reforms to help California decision makers exercise the fiscal discipline they need to make sound spending and revenue decisions.

1. Balanced Budget

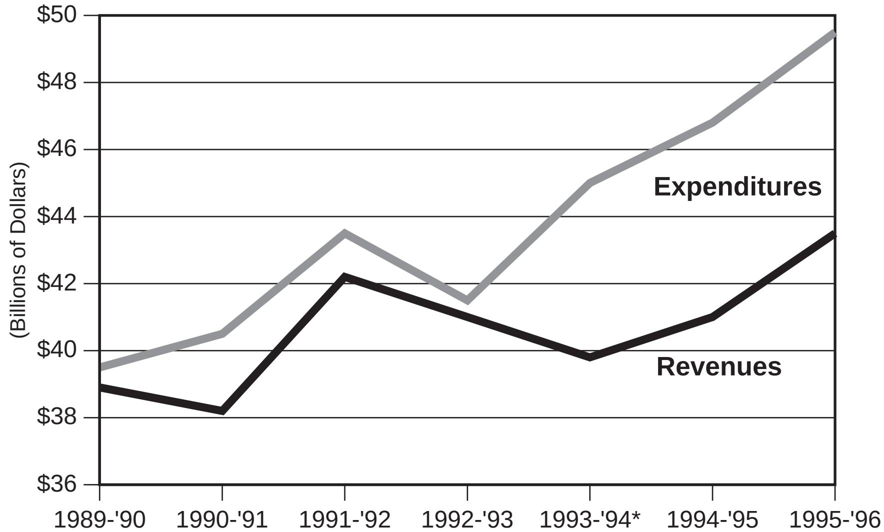
The Commission recommends that all future California state budgets be balanced, both as presented to the legislature and as adopted. Each fiscal year's projected spending should not exceed anticipated revenues during that year. The state should also adopt a specific repayment plan to eliminate its accumulated multi-billion dollar deficit over no more than a five year period.

Table 9

[18] Certificates of participation are sold to investors and give them a portion of an interest in a lease on public property. Most are used to raise revenue for local governments to finance capital improvements to property. But these certificates have also been used to finance operating budgets for local programs. Standards & Poor's estimated in 1985 that California's municipal lease-backed market comprised 72% of the entire market in the nation. The California Debt Advisory Commission estimated in 1992 that over $4 billion in outstanding Certificates of Participation had been issued by California's local governments.

THE WIDENING GAP BETWEEN REVENUES AND EXPENDITURES

State Revenues and Expenditures, FY 1989-90 Through 1995-96



*Although this chart suggests a $5 billion difference between revenues and spending in 1993-94, the gap actually totaled $8 billion due to pay back of prior year's deficit of $3 billion.

Source: Commission on State Finance, "Quarterly General Fund Forecast," June 1993

California's current constitutional balanced budget requirement is insufficient to assure a balanced budget. The California constitution does not require the legislature to pass, or the governor to approve, a balanced budget. It only requires the governor to submit a balanced budget proposal to the legislature. By contrast, most other states require their budgets to be balanced as adopted.

A balanced budget requirement, to be sure, will not always insure a balanced budget. Even the best revenue estimates may exceed actual receipts, and expenditures cannot always be precisely controlled. Nevertheless, the Commission believes a stricter balanced budget requirement would provide the state with a much-needed form of fiscal discipline.

California should thus join the 37 other states and amend its constitution to require its *enacted* budgets to be in balance. To enforce this concept, the Commission also recommends that the Budget Act explicitly state the revenue and spending estimates on which it is based and describe and explain any variances in these figures from the estimates provided by both the department of finance and the legislative analyst. This would allow the press and the public to examine the budget's revenue and expenditure estimates and ask elected officials to explain and justify those figures.

2. Off-Budget Loans

Multi-year borrowing is appropriate to finance public investments which have multi-year public benefits (such as parks or court houses), so long as prospective revenues can service the debt. Multi-year borrowing for operating expenses, however, is a poor management practice, since no public benefit is received beyond one budget year. The Commission therefore recommends that spending for operating programs be explicitly financed from existing or legitimately projected revenues.

So-called ñoff-budget loans,î[19] or borrowing for the operating expenses of state programs, have no place in California's public financing system and should be prohibited. They are not counted as debt in the state's debt reporting mechanisms. They are inappropriate and dangerous because they obscure the state's true fiscal condition. The Commission also recommends that the reasons for any legitimate loan, as well as the provisions for its repayment, be explicitly stated in the enacted law which allows the borrowing.

3. Total Cumulated Deficit

The Commission recommends that the state clearly acknowledge and identify the total amount of its accumulated deficit in a specially designated part of the budget. A knowledgeable and independent public agency, such as the Auditor General, should thoroughly review existing state revenues, spending and borrowing and accurately summarize the entire debt facing the state. The Commission also recommends that the state budget set forth a plan for the debt's repayment, even though the financing instruments used for such debt repayment may be outside the Budget Act itself.

This new section of the budget will allow close monitoring of the fiscal health of the state, a necessary ingredient in the budget process. Both legislators and the public will be able to assess the state's overall fiscal condition as they make decisions on individual spending programs. The public also will be able to monitor the state's progress towards eliminating its accumulated debt.

4. Debt Repayment Plan

The Commission recommends that California create a specific debt repayment plan with dedicated revenues and a guaranteed repayment by a date certain. The magnitude of California's accumulated deficit is simply too large to be financed entirely in one year from existing revenue sources. The Commission believes that a reasonable time frame for liquidating the debt is five years. This would require the state to start balancing budgets now, while deliberating retiring a portion of the accumulated debt in each future year.

The Commission also recommends that the state adopt a specific plan to repay at least 20% of its accumulated debt in each of the next five years. Debt service costs would have to be funded within current-year revenues, along with all other state spending. Most other states which have repaid recession-accumulated debt have adopted a similar timetable.

As a final element in guaranteeing a credible financing plan, the Commission recommends that the state assure its creditors and the public that the state's deficit will be zero by December 31, 1999.

California is one of many states which has experienced recession-induced revenue shortfalls and deficits. Unlike California, however, other states have directly tackled their revenue and cash shortfalls in one of four ways.

First, some states have reduced their spending and/or raised their revenues. Maryland, Virginia and a number of other states have addressed their shortfalls solely in this manner.[20]

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[19] Since 1992-93, the state has spent over $1.5 billion by authorizing an appropriation level in the budget which was based on the assumption that some future year budget will repay this support. Lacking the funds to spend in this manner the state incorporated this spending into its short-term borrowing. In essence, this was simply deficit spending by another name.

[20] California Debt Advisory Commission, *California's Cash Crisis: Surviving on Borrowed Money,* transcript of hearing held May 12, 1993.

Second, some have issued debt notes or bonds to finance their deficit and restore their cash balances within one year.[21] New York, like California, used short-term borrowing to carry deficits from year to year, but most other states have financed their deficits through the creation of long-term debt—which, in California, would require voter approval.

Third, some states have used one-time measures, such as deferrals of pension contributions, sales of assets or restructuring of existing debt, to generate the cash necessary to finance general fund obligations. New Jersey sold a part of its highway system to a state-created highway authority, and New York sold Attica prison to a state-created Prison Authority, each for the purpose of realizing a one-time infusion of cash.[22]

Finally, some states have used combinations of these three financing approaches to eliminate their deficits. Louisiana tackled its accumulated budget debt by creating the Louisiana Recovery District in 1988 to issue bonds. It also enacted a 1% sales tax to repay the $982 million in ten-year bonds issued by the District. But since Louisiana failed to address the spending and revenue imbalances in its subsequent budgets, it continues to face financing difficulties.

Other states provide useful models for California. In 1991, for example, Connecticut sold general obligation Economic Recovery Notes to fund its $966 million debt over a five-year period. It obtained the cash to repay these notes by creating a Debt Retirement Fund in the budget, setting aside the cash needed to repay the bonds each year and avoiding the need for a dedicated deficit reduction tax. The state has maintained its repayment schedule, notwithstanding continuing recessionary trends throughout the period.

Massachusetts and New York, according to one observer of state fiscal behavior, also offers California possible ways to escape its financing dilemma.[23] Massachusetts issued $1.3 billion in fiscal recovery bonds to address accumulated deficits and retire short-term borrowing notes. The state repaid this deficit over seven years with dedicated revenues from its existing income tax. It also increased revenues, cut spending and based subsequent budgets on very conservative revenue estimates. Massachusetts has now greatly curtailed its short-term borrowing and has seen its bond ratings upgraded.

New York created the Local Government Assistance Corporation, since its deficit was created in large measure by state transfer payments to local governments. The Authority borrowed $4.7 billion, an amount equivalent to the accumulated debt. The state repaid the loan using a one percent set-aside from the sales tax. New York then passed its two subsequent budgets on time—a noted improvement over past behavior. In 1993, the state surprised the financial community by announcing it needed to borrow only one-half the expected amount ($850 million rather than the expected $1.6 billion). Although the state is still plagued by the consequences from years of short-term financing decisions, bond raters have recently moved the state from the ñnegativeî to the ñstableî list and are considering additional upgrades of bond ratings. In California, by contrast, the state's bond rating has continued to fall, due largely to the state's continuing failure to eliminate its deficit.

5. Short-Term Borrowing

The Commission recommends that the state constitution be amended to prohibit all short-term borrowing—unless it is used to meet the state's temporary cash flow fluctuations and is repaid within the same fiscal year from designated revenues.

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[21] Ronald Snell, *Do State Balanced Budgets Really Happen?,* National Conference of State Legislatures, State Legislative Report, vol. 18, no. 6, April 1993, at p.2.

[22] It should be noted that not all of these approaches constitute sound methods for achieving true solvency.

[23] Testimony of Wes Hough before the Public Resources Advisory Group, May 1993.

In recent years, the legislature and the governor have significantly increased the state's debt by borrowing from new financing sources and creating new debt instruments. In addition to unprecedented increases in short-term borrowing, without voter approval, the governor and legislature have increasingly used so-called ñlease revenue bonds,î which also do not require voter approval, to fund a variety of long-term financing projects which depend on tax revenues for repayment.

ñGeneral obligations bondsî are backed by ñthe full faith and credit of the stateî and require voter approval. ñFull faith and creditî means that the voters are deemed to have agreed in advance to increase their taxes if necessary to repay the loan. This form of bond generally costs taxpayers less than other financing devices because the level of commitment for repayment is more secure. ñRevenue bonds,î which do not require voter approval, are used to finance any activity (e.g., bridge or school dormitory constructions) which will generate revenues to repay those bonds (e.g., bridge tolls, college dormitory fees). California, however, has begun to use ñrevenue lease bondsî to fund public buildings (e.g., prisons, office buildings) for which the principal source of repayment is the leasing entity's (e.g., the prison's) operating budget funded by *general purpose tax dollars,* not revenues generated by the activity itself. Revenue lease bonds do not require voter approval, despite the fact that they may require the same degree of tax support for repayment as general obligation bonds.

In addition to various forms of bond financing, the state approached private financial markets in 1992 to obtain further loans to remedy California's cash shortages. The state created $5 billion in intra-fiscal year notes called ñRANsî (Revenue Anticipation Notes), which had to be repaid during the same fiscal year.[24] Because the state could not repay these RANs, it created new notes called ñRAWsî (Revenue Anticipation Warrants), which could be paid over a two-year period, and used them to repay the earlier RANs. The legislative analyst's office estimates that the interest alone on these short-term instruments cost the taxpayers over $300 million in 1994, and these costs will increase if market evaluators perceive the state's fiscal condition as worsening.

Notwithstanding the broad range state supreme court case law interpretations of the debt prohibition in the constitution, the legality of borrowing without the consent of the voters for the purposes of deficit spending is questionable.[25] As a representative of Rothschild, Inc., a company specializing in corporate bankruptcies, commented at a May 1993 meeting of the State Debt Advisory Commission:

> *There is no substantive difference between a 22 month bond that needs voter approval and an 11 month RAN followed by an 11 month RAW [that do not]. Why should the combination of a RAN and RAW provide a loophole to escape voter scrutiny?*[26]

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[24] The state last created Revenue Anticipation Notes (RANs) in 1982, when a recession caused a brief lapse in state revenue growth.

[25] The California Supreme Court has decided a number of important cases over the past century which have interpreted the meaning of the debt limitation in the state constitution. Of particular relevance to the current borrowing practices of the state, the court established the ñappropriations doctrine,î which essentially allows the state to borrow against anticipated revenues, holding that this borrowing is a cash transaction, rather than a debt, since its repayment is tied to legal revenue obligations which are reasonably anticipated to yield the cash necessary to redeem the short-term note. The court has concluded that this practice does not constitute a legal debt of the state as the framers of the constitution meant it. No court test, however, has challenged the most recent type of debt, which assumes that the state will repay of notes with revenues raised from more short-term notes, rather than from expected tax revenues.

[26] Testimony of Wilbur Ross, before the California Debt Advisory Commission, May 1993.

These debt practices clearly violate the spirit, if not the letter, of the constitution. By using them, California's government has effectively placed the state's fiscal future at the mercy of the private financial community.

6. Budget Reserve Account

The Commission urges the governor and the legislature to establish a budget reserve or ñrainy dayî fund, once the existing deficit has been liquidated. This cash reserve account could be drawn upon to meet emergencies, unexpected expenses or revenue shortfalls—as specifically defined in the authorizing legislation. The legislation should also define how the fund should be maintained and replenished. As difficult as it may be for elected officials to accept the notion of keeping ñsome money in the bank,î the recent recession points out the need for state government to acknowledge the existence of economic cycles and their impact on government spending.

A contingency account is particularly necessary to provide for certain ñcounter cyclicalî government programs, such as health and welfare, which tend to add needy recipients as the economy cools down. The state's existing ñFund for Economic Uncertaintiesî is inadequate for this purpose.[27] It has no provisions which require it to be maintained at specified levels of funding or any criteria or method for replenishing funds when they are exhausted.

7. Joint Fiscal Oversight Committee

The Commission recommends that the legislature create a Joint Fiscal Oversight Committee to monitor the implementation of the budget, analyze actual spending and revenue patterns and recommend any changes needed to keep the budget in balance. This Joint Committee would also meet after the legislature recesses for the year. The deliberation and recommendations of this Joint Committee would spark an on-going public debate about the state's fiscal condition and help the legislature exercise its constitutional responsibility to make revenue and expenditure decisions as needed.

Many other states assign this responsibility to the governor—mandating or allowing the governor during the fiscal year to impose spending reductions within a specified range. Most states with such provisions require their governor to make any reductions on an ñacross-the-boardî percentage basis. The Commission considered, but rejected, this alternative for several reasons.

California's legislature meets for eight months each year. Unlike many other states with part time legislatures, California's legislature is capable of initiating such mid-course corrections itself. In addition, arbitrary ñacross-the-boardî spending reductions tend to create a myriad of other problems, since some programs can accommodate cuts better than others. As a result, the Commission believes it is wiser to encourage thoughtful deliberation between the governor and the legislature, rather than to enact arbitrary ñtriggerî mechanisms. Consistent with the duties assigned to the governor and legislature by the state constitution, the governor should propose a solution to a budget imbalance, and the legislature should take action to address the problem. The governor would maintain final approval authority to enact spending or revenue changes.

B. The Budget Must Be Honest, Accurate and Comprehensive

[27] The ñFund for Economic Uncertaintiesî is an account in the governor's budget which is available for ñemergencies.î The governor generally maintains whatever level he decides is needed in this account by vetoing other legislative appropriations to generate an amount sufficient to create the desired level of reserve.

A comprehensive discussion of state goals and priorities within the budget process requires that all forms of state spending be accurately summarized in the budget. Information must be included in the budget process sufficient to support a review of the state's long range demographic and fiscal trends. New techniques for building public consensus on state priorities are required.

Findings

California's budget process today is a hodge-podge of short-term incremental decisions made without regard to long-term program needs and fiscal trends. Investments to meet future state objectives are debated within the narrow perspective of individual programs, rather than as part of an overall priority-setting process. Setting priorities and goals is all but non-existent. Yet, ironically, the budget process is the most valuable opportunity California has each year to address the state's future requirements in a rational way.

ñTax Breaksî Are Not Reexamined During Budget Deliberations

California allocates resources for public purposes in two different ways: it spends its own tax revenues to finance public programs, and it promotes specific kinds of spending by private individuals and businesses by exempting them from taxation through ñtax breaksî or tax credits, deductions and exemptions. (These ñtax breaksî are sometimes called ñtax expenditures,î because the process of declining to collect taxes on a specific business activity is arguably equivalent to collecting and then spending taxpayers' money on that activity.) During state budget debates, however, these ñtax breaksî are not considered, since they are not formally itemized as a part of the budget. Once granted, they often continue in perpetuity and are isolated from public debate and scrutiny.

According to the legislative analyst, California has at least 268 tax break programs, including 197 state-level programs and 71 programs related to local property taxes. The 1991-92 estimate of annual revenue lost to the state from these programs is nearly $20 billion, or the equivalent of 37% of the state's budget for that year. (See Table 10 for the composition of these tax breaks.) The annual loss to local governments is an additional $4.5 billion or the equivalent of 32% of local governments local revenues for that year.

The department of finance defines tax breaks more narrowly. It does not, for example, include in its calculations ñbroad-basedî tax breaks such as the home mortgage interest deduction, nor does it include tax breaks placed in the constitution such as Proposition 163 adopted in 1992, which constitutionally exempts snacks, candy and bottled water from taxation.[28] As a result of its narrower definition, the department estimates total tax breaks to cost about $13 billion.[29]

Since 1985, the legislature and governor have enacted 105 new tax break measures. The total annual revenues lost to the state from these new tax breaks total approximately $763 million. Nearly two-thirds of this amount ($486 million) is the result of 25 new tax breaks added since the recession hit the state in 1990. (See Table 11.) The new programs

[28] The 1991 state budget included a provision repealing these sales tax exemptions. The affected industries initiated a campaign to reverse this decision. They drafted Proposition 163 as a *constitutional* exemption, thus assuring them of the exemption into perpetuity or until voters reverse themselves in a subsequent vote.

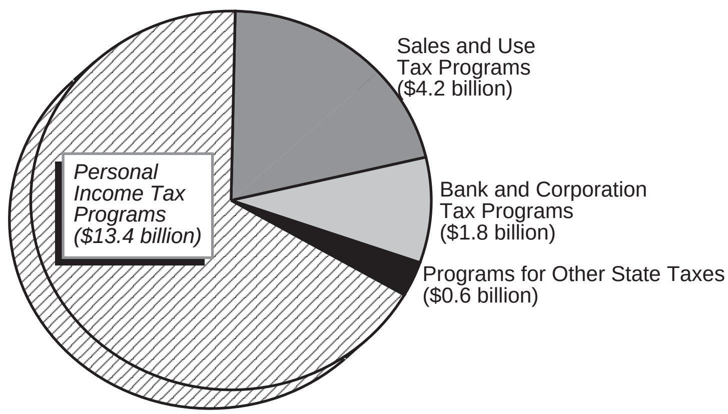
[29] State of California, Department of Finance Financial Research Unit, *Tax Expenditure Report 1993-94*, May 1993.

include a stay-at-home parent income tax credit and a sales tax exemption for watercraft common carrier fuel.[30]

Table 10

COMPOSITION OF 1991-92 IDENTIFIABLE STATE TAX BREAKS

Total State Tax Breaks: $19.9 billion



Source: Legislative Analyst's Office, "Analysis of the 1991-92 Tax Expenditure Budget," May 1991

Reviewed individually, tax breaks often appear relatively minor. A $25 million tax credit for ñStay-At-Home Parents,î a $1 million tax credit for ñIncentive Stock Options,î a $5 million ñFarming Business Net Loss Carryoverî—all look inconsequential against a $40 billion base of state revenues. The total foregone revenues from these hundreds of credits and exemptions, however, adds up to billions of dollars.

ñSpecial Fundsî Can Be Used to Circumvent Legislative Oversight

Special funds are established to receive dedicated tax revenues and expend them for specific purposes. Both the voters and the legislature are increasingly using special funds to direct state spending. Voters have demonstrated their willingness to raise taxes where the proceeds are dedicated for certain purposes (e.g., tobacco taxes for health care, sales taxes for public safety, etc.). The legislature has also tied its own hands by transferring general purpose tax revenue into special accounts.

Through legislation and ballot measures, California has now created more than 700 separate special funds with unique financing mechanisms, revenue sources and appropriation authorities.[31] These funds will spend nearly $14 billion in 1994-95. Of this amount, more than $7 billion will be spent outside the state budget. Tables 12 and 13 illustrate the growth in special funds in recent years. Despite the budget crises over the past few years, the legislature and governor have continued to create 30 to 40 more special funds on average each year. During the 1989-90 fiscal year, they created 23 new special funds; in 1990-91 they created 34 more special funds; and in the 1992-93 fiscal year they added 60 more special funds.[32] These funds lie beyond the effective reach of the legislature, even in fiscal emergencies. Special funds are exceedingly complex and

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[30] *Id.*

[31] Telephone interview with Carla Leonard, Assistant Deputy Controller and Chief of Accounting, California State Controller's Office, January 12, 1994.

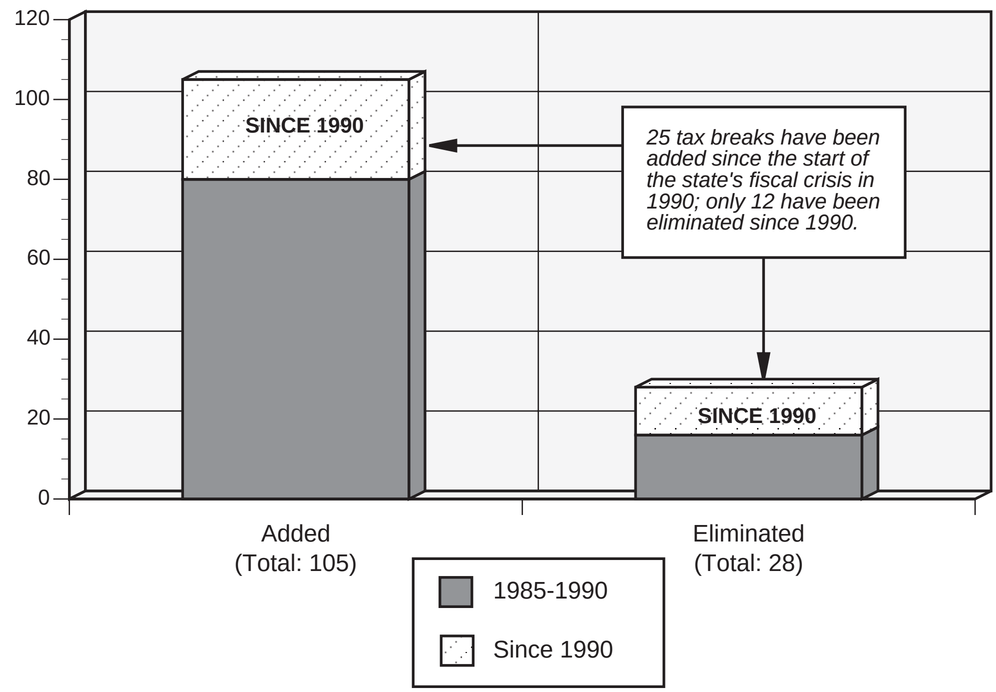
[32] *Id.*

virtually unregulated. What began as a simple mechanism to set money aside for the state's long-term needs (capital outlays, for example) has now become a boundless new frontier for unsupervised program creation.

Table 11

RECENT TAX BREAKS

Comparison of the Number of Tax Breaks Added or Eliminated in the Years Before and Since the State's Economic Recession (Starting in 1990)



Source: State Department of Finance

Dedicated or ñearmarkedî taxes have become increasingly popular as public skepticism over general legislative budget decisions has risen to new heights. Some observers believe the public would rather pay taxes for a specific purpose than fund ñgeneralî expenditures. The passage of several ñballot box budgetingî items in recent years—such as Proposition 99's increased tobacco tax in 1988 and Proposition 172's half-cent sales tax increase to pay for law enforcement in 1993—supports this belief.

Some special funds, because they receive and spend dedicated tax revenues for preordained purposes, are not formally reviewed as part of the normal budget process. Moreover, even in fiscal emergencies, their funds cannot be used by the legislature to sustain other—even more important—programs. For this reason, special interest groups have persuaded the legislature to enact special funds or budgeting procedures to protect favored programs from budget cuts or loss of tax breaks. This forces those less powerful interests to fight over the dwindling remainder of general purpose revenues. As Democratic Party political consultant Richie Ross has observed:

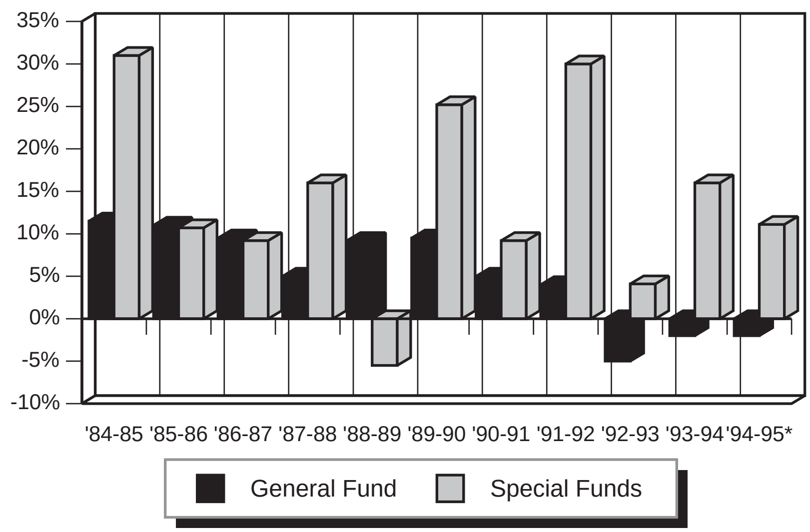
> *ñTo get a special fund created, you have got to have some juice, a well organized constituency—like the highway lobby. These are the groups that are in the skyboxes, and one by one they have taken themselves out of the picture. And who are the people left behind in the general fund, the people in the bleachers? They are the people who are ill, retarded, poor or below*

eighteen. So the whole budget debate is a charade. They debate the price of beer in the bleachers, but no one talks about the skyboxes.î [33]

Table 12

COMPARISON OF ANNUAL GROWTH IN SPECIAL AND GENERAL FUNDS

Fiscal Years 1984-85 Through 1994-95



Source: Elizabeth Hill, Legislative Analyst, "The 1994-95 Budget: Perspectives and Issues"

Acting through the ballot initiative process, the public has also imposed unprecedented restrictions on various revenues (e.g., Proposition 13—property taxes) and spending programs (e.g., Proposition 98—school budgets). The cumulative effects of these actions have severely constrained state budget choices. While these initiatives may have reflected public policy when they were adopted, circumstances invariably change. Today the public is unable to review or modify earlier initiatives unless the legislature first places amendments to them on the ballot or new initiatives are qualified to amend or repeal past measures.

The Budget Act Fails to Describe the State's True Fiscal Condition

California's state budget document is seriously deficient in the information it contains. The budget does not reflect all state spending, all state revenues or the amount of accumulated state debt. Short-term and long-term borrowing are not explicitly reviewed in the budget process. Major state priorities are not linked to the state's overall fiscal condition.

Debt is not necessarily something that state government should avoid. Facilities that will provide services over a number of years, for example, can reasonably be paid for by their users. Using debt to finance these facilities allows the state to construct them now and pay for them with the future revenues they generate. A number of other states have incurred much higher rates of bonded indebtedness than California, yet they have enjoyed significantly higher credit ratings. California's credit rating has fallen, however, due largely

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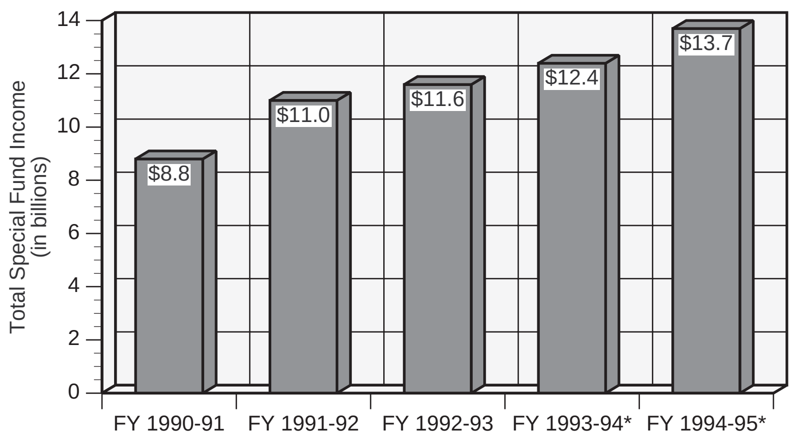
[33] *Quoted in* Peter H. King, *On California: A Budget That Can't Be Touched*, Los Angeles Times, July 12, 1992.

to the financial community's repeated concerns that the state's debt picture is the product of fiscal ñdenial,î not a conscious and deliberate investment program in the state's future.

Table 13

GROWTH IN SPECIAL FUND INCOME

Fiscal Years 1990-91 to 1994-95



*Estimated by the California Department of Finance

Source: Governor's Budget Proposals 1992-93, 1993-94 and 1994-95

Neither the public nor those who adopt the budget have sufficient information to determine whether the state's fiscal condition will be strengthened or weakened by any one particular budget decision. This suggests the need for an annual review of the state's basic budgeting assumptions about the overall fiscal condition of the state.

The Budget Lacks Long-Term Planning and Public Participation

In each of the past three years, the state has used short-term solutions to address its multi-billion dollar revenue shortfalls. These ñsolutionsî typically paper over revenue gaps by deferring major decisions, causing the underlying deficit to grow. Short-term ñsolutionsî compound future budget balancing problems and increase costs to taxpayers. Budget decision makers will continue to face multi-billion dollar shortfalls each year into the foreseeable future—long after economic recovery occurs—unless they implement programs that address the underlying problems in a long-term context.[34]

Large multi-billion dollar state spending programs require aggressive oversight and management. Fiscal oversight conducted solely through the annual budgeting process is not adequate to control government expenses. Spending reductions or program restructuring often cannot be implemented in the budget year, since they take longer periods of time and often require federal approval. Managers of large spending programs generally do not conduct long range fiscal planning, nor do they develop plans to reduce costs or modify programs to ease future funding shortfalls.

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[34] In 1992, the legislative analyst predicted a ñstructural deficitî—a built-in lack of sufficient revenues to cover predicted expenses—of $5 billion per year by 1996. A Business-Higher Education Forum report predicts a state budget balance will be achieved in 1996-97 only if major state programs are transferred to counties *without the state revenues to finance them.* The report also assumes the accumulated deficit will be separately financed.

Expenditure controls are always tested in a severe recession. None of the state's five largest programs, for example, which collectively account for more than 90% of the state's general fund expenditures, has implemented an aggressive plan to control its costs. Only Medi-Cal has made any significant attempt to control costs over the past ten years. While some of these attempts have been effective, they have not reduced the growth of program expenditures to a rate consistent with the growth of general fund revenues.[35] For the first time in the state's history, there are now more state residents on Medi-Cal than children in the state's public school system. Spending on prisons, welfare and Medi-Cal continue to grow faster than the state budget as a whole. In the ñzero-sum gameî of the budget, this means either that these programs' costs must be controlled, all other programs must be cut or taxes must be raised.

Were these trends predictable? Should not policy makers have preferred to discuss and debate such shifts in state spending before they happened?

The cumulative costs of some state laws, particularly those associated with the criminal justice system, are not well understood. Although the debate over ñthree strikes you're outî legislation specifically addressed the measure's long-term costs, the hundreds of crime bills which pass the legislature each year are not subjected to similar fiscal scrutiny. Fiscal estimates in legislation frequently use such terms as ñpotentially significant costsî or ñunknown substantial costs,î which provide no real numbers nor link fiscal impacts to other policies.

The Budget Does Not Measure the Effectiveness of State Programs

California continues to have the largest budget of any state, despite substantial spending reductions during the past few years. Yet California has not adopted modern elements of public administration for the vast majority of its programs: clear mission statements for individual programs, definitions of priority populations to be served and measurements of budgetary success (ñperformance outcomesî), based on consumer satisfaction. California thus spends its tax dollars without either clearly defined objectives or measures of effectiveness. The state must assert programmatic and fiscal discipline in all its major programs, particularly in the state's five largest spending programs: K-12 (Kindergarten through 12th grade) education, higher education, Medi-Cal, welfare and corrections.

Longer range forecasts of state program costs can be useful tools to determine ñstructural imbalancesî (long-term differences between available revenues and demands for services or growths in costs). Identifying such imbalances prompts program re-engineering and priority setting. If new revenues are needed, clearer explanations about objectives, targets and outcome measures for existing programs must be presented for public review. Absent such information, both elected officials and the public are forced to evaluate demands for new funds without any assurance that existing money is well spent. The complexity of the state budget also aggravates the public's inability to see where its tax money is going. Simpler devices for sharing fundamental fiscal information about the state budget are needed.

Recommendations

[35] California led the nation in implementing a program to negotiate contracts with hospitals for Medi-Cal patients, beginning in 1982. While that activity has saved significant amounts of public funds—some estimate over $1 billion per year—the overall cost increases in the Medi-Cal program have nonetheless soared over the past decade, due to federal changes in eligibility, increased numbers of uninsured but employed Californians, increased number of aged and disabled in nursing homes and continuing cost increases in health care delivery.

The Commission recommends a number of reforms to provide state decision makers with better and more comprehensive budget information:

8. Tax Breaks

The Commission recommends that tax breaks be listed in a separate schedule in the governor's budget, identified as ñtax breaksî and formally included as part of budget deliberations. A balanced budget would be more easily achieved if the governor and the legislature were able to consider all of the relevant and available fiscal choices. Decision makers should not contemplate either raising general tax rates or cutting public services without being able to assess the comparative value of eliminating specific ñtax breaks.î Inclusion of tax breaks would also enable legislators to establish overall priorities for all forms of spending.

The state budget process must include all forms of state spending. If future budgets are to be balanced, then all state resources must be reviewed on a regular basis. When tax and revenue policies have been altered to forgive, exempt or otherwise reduce tax obligations, they should be classified as ñtax breaksî and discussed in the budget process with the same seriousness as direct expenditures of public monies. Policy makers can then set priorities within the context of all resources potentially available to the state.

The legislature has defined tax breaks as ñtax expenditures,î or ñthe various tax exclusions, exceptions, preferential tax rates, credits and deferrals which reduce the amount of revenue collected from the state's basic tax structure.î[36] The legislative analyst has also characterized these as expenditures because ñthe benefits they provide to individuals and businesses make them very much like regular direct governmental expenditures, except that they are paid for by reduced tax collections rather than through the normal legislative appropriation process.î[37]

In 1991, the legislature directed Legislative Analyst Elizabeth Hill to analyze and describe in detail all existing tax breaks. She found significant gaps in the information about, and purpose of, many of these tax breaks. She concluded that the legislature should review and agree upon the rationales and objectives of all tax breaks, as well as obtain evidence of their effectiveness. The legislative analyst further recommended that the legislature establish relative priorities for tax breaks as a whole to provide a context for modifying or eliminating them altogether. To date, the legislature has not followed her recommendations.

Other states place tax break information in their budgets. In Massachusetts, one volume of the governor's budget is dedicated to detailing tax breaks. Listed by major policy category, these deductions, exemptions and credits are analyzed in terms of their effects on different income groups. This listing allows the legislature to debate the effects of tax breaks on social policy.

Maryland's budget contains a summary of tax breaks by category and tax. In Montana, specific deductions, exemptions and credits are listed in an annual report, which summarizes the number of exemptions available to recipients in various income groups and calculates the total cost to the state of each. In Michigan, the governor's budget includes a tax break appendix which displays total revenues received by tax type alongside total tax revenues lost from tax breaks. In 1992, for example, Michigan's listing showed that the dollar amount associated with income tax exemptions, deductions and credits actually exceeded the total income tax revenues the state collected.

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[36] Resolution Chapter 70, Statutes of 1985 (ACR 17, Assemblymember Bates).

[37] Elizabeth Hill, *Analysis of the 1991-92 Tax Expenditure Budget: Overview and Detailed Compendium of Individual Tax Expenditure Programs*, Legislative Analyst's Office, May 1991.

In California, such information could be incorporated into the state budget in a number of ways. The governor's budget bill could include a special list of tax breaks. A control section in the state budget bill could list the exemptions, deductions and credits and summarize the total dollar volumes associated with particular tax breaks. A sunsetting device also could require explicit public policy purposes to be stated in the budget for all tax breaks prior to their future renewal.

9. Special Funds

The Commission recommends that the governor and legislature annually review, evaluate and approve all special fund financed activities in the budget process, whether or not the use of fund revenues are restricted. To be sure, earmarking funds for a specific purpose may be appropriate in some cases. But accountability for and oversight of all state spending should be a priority in the state's budget process.

The Commission also recommends that the creation of special funds be restricted, that all special funds be appropriated and reviewed through the budget, that continuous appropriations for special funds be eliminated and that the justification for special funds be clearly stated. Special funds should not be used to place certain programs beyond legislative oversight or to assure funding for programs which are wasteful, harmful or of dubious merit.

The department of finance defines ñspecial fundsî as ñfunds used to account for taxes and revenues which are restricted by law for particular functions or activities of government.î[38] Gasoline taxes, for example, are placed in a special highway fund and earmarked for transportation purposes only. Special funds are primarily created to receive revenues from businesses, professions, vocations and activities (transportation, law enforcement and capital outlays) and then use them to promote or regulate these activities. Many special funds are legally protected from normal general fund budgetary pressures. If the legislature needs additional funds to sustain public school education or welfare, for example, it cannot draw on special highway fund tax revenues to do so.

Some argue that special funds serve a critical role in the state's financing and agenda-setting. With the legislature locked in indecision over alternative ways to appropriate and spend the state's diminishing general fund revenues, special funds offer a method by which important state services—law enforcement, health, transportation—can receive dedicated and sustained funding.

The increased use of special funds, however, is not without problems. In times of fiscal crisis, important general fund programs—such as education or welfare—must be cut, while what may be less important special funds remain intact or in surplus. During the 1992 budget crisis, for example, the legislature cut a San Diego school district's $1.1 million general fund appropriation, but it approved the expenditure of $1.2 million on a San Diego-area off-road driving park because the financing was available in a special fund.[39] The relative importance of these two programs was never addressed, because special fund protections preclude such trade-offs.

General fund expenditure growth has been anemic compared to special fund spending. (See Table 12 above.) Between fiscal year 1986-87 and 1992-93, general fund

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[38] Governor's Budget Proposal, 1994-95 (released in January 1994).

[39] During the same budget deliberations, a $50,000 San Diego-area anti-gang program for inner-city youth was cut, while a $478,000 special fund financed effort to synchronize San Diego traffic lights continued uninterrupted. The money from the traffic light program came from a special account financed by proceeds from settlements of anti-trust suits brought against oil companies. The fund was created to finance energy conservation measures. Daniel C. Carson, *Some Local Programs Win, Some Lose in Budget Shuffle*, San Diego Tribune, September 21, 1992.

spending increased just 1.2% (after adjusting for inflation), while special fund spending during the same period grew 9.3% (after adjusting for inflation). In the 1990-91 fiscal year, special fund spending accounted for 16% of total state spending; by the 1992-93 fiscal year it accounted for over 22%.[40] The state department of finance estimates that by fiscal year 1994-95, *special fund expenditures will exceed one-quarter of the state budget (26%).*

This growing emphasis on special funds can be seen in revenue patterns as well. Total special fund income in fiscal year 1990-91 was $8.8 billion; in 1991-92 it was $11 billion; and in fiscal year 1992-93, it was $11.6 billion. The department of finance estimates that by the 1994-95 fiscal year, special fund income will exceed $13.7 billion.[41] (See Table 13 above.) This amount is greater than the total budgets of more than 40 states.

One of the most enticing incentives encouraging legislators and interest groups to create special fund-financed programs is their ability to provide ñcontinuous appropriations.î These are self-funding systems which do not require annual legislative appropriations and are not reviewed as part of the budget. Fees are raised, or general fund moneys are dedicated to program purposes, on a continuing basis. The statute creating the Air Pollution Control Fund, for example, uses regulatory penalties paid by manufacturers violating air pollution standards to finance the Air Resources Board. It contains the typical authorizing language, ñAll money in the Fund is continuously appropriated to the State Air Resources Board to carry out its duties and functions.î

In the early 1980s, the legislature enacted Government Code Section 13340 to curb the use of ñcontinuous appropriationsî in special fund programs and instead subject them to annual legislative review and appropriation. This legislature has since rendered this prohibition virtually meaningless, however, for numerous special fund statutes now contain the phrase, ñNotwithstanding Section 13340 of the Government Code, moneys shall be continuously appropriated for the purposes of this chapter. . . .î An informal computer search of Deering's California Codes for this phrase returned hundreds of special fund-related code sections. The ñcontinuous appropriationî is thus still alive and well in California.

Table 14

TEN LARGEST SPECIAL FUND SURPLUSES

Fiscal Year 1992-93

Fund	**Amount**
Motor Vehicle Fuel Account	$336 million
Underground Storage Tank Cleanup Fund	$132 million
Disaster Relief Fund	$87 million
Transportation Planning & Devel. Account	$62 million
Oil Spill Response Trust Fund	$53 million
Beverage Container Recycling Fund	$41 million
Agricultural Account	$37 million
Public Facilities & Local Agency Disaster Response Act	$32.3 million
Unallocated Account from Cigarette & Tobacco Products Surtax	$32 million
Prenatal Insurance Fund	$31 million

Source: Governor's Budget Proposal, 1994-95

ñContinuous appropriationsî and large sources of funding have allowed many special funds to accumulate enormous reserves. The total surplus for all special funds at the

[40]Legislative Analyst's Office, *The 1992-93 Budget: Perspectives and Issues,* at 71-72.

[41]Governor's Budget Proposal, 1994-95 (released in January 1994).

conclusion of fiscal year 1992-93 was $1.5 billion. The Motor Vehicle Fuel Account generated the largest fund reserve ($336 million) of any special fund that fiscal year. (See Table 14.) Thus, while the general fund ended the fiscal year in deficit, several special funds contained surpluses.

10. Periodic Review of Budget Constraints

The Commission recommends that at least once each decade, an independent group should review the cumulative fiscal impact of constitutional and statutory changes affecting the state budget and recommend necessary changes. The Commission believes that the government and the voters need some method to review all changes to the budget, assess the need for possible modifications and decide whether priorities have changed over time. An independent group, similar to a Constitutional Revision Commission, should be formed at least once each decade to review California fiscal policy as a whole and present to state officials and the public recommendations for modifications to meet current state needs.

Each year, the legislature enacts numerous laws dedicating revenues and mandating spending levels for specified state programs. The voters also periodically approve ballot measures which impose specific funding formulas, dedicate revenues and otherwise constrain budget decisions. These measures in the aggregate, have drastically curtailed state government's discretion to make budgeting decisions. Elected state officials and the public, however, have no opportunity to assess the cumulative impact of these piecemeal changes on the state budget.

A less desireable alternative, considered but rejected by the Commission, would be to mandate the sunsetting of all ballot measures which exerted significant fiscal impacts upon the state. Sunsetting, however, does not create the needed across-the-board analysis so lacking in California's fiscal deliberations. A state as large and diverse as California needs periodically to step back from the specifics of fiscal policy and assess the direction in which the state is heading. Mandated periodic fiscal impact reviews would provide that ñbig picture.î

11. Statement of Fiscal Condition

Most legislators today have no way of determining whether or not the particular budget proposal placed before them will improve or exacerbate the state's overall fiscal condition. Although state budgeting and debt management generally involve two different governmental functions, California's current fiscal condition illustrates the need for a single point in the decisionmaking process where the overall fiscal condition of the state is reported and understood. The Commission recommends that a new ñStatement of Fiscal Conditionî be inserted into the first section of the annual Budget Act to include estimated revenues and expenditures, short-term internal and external borrowing with associated debt service costs and long-term borrowing and associated debt service costs. The Commission believes that this summary should be a clear and essential element in all annual budget decisions. Assumptions about the state's borrowing practices—internal as well as external short-term borrowing and long-term debt—need periodic monitoring and review by the legislature and the governor.

All internal short-term borrowing, in particular, should be disclosed in the Budget Act, including the debt amounts for the closing fiscal year as well as the budget year. Such disclosure would allow closer legislative monitoring of borrowing practices. Since internal borrowing is usually the first sign of an impending deficit, it would provide an ñearly warningî of state deficit spending.

12. Capital Investment Budget and Long-Term Spending Plans

Many believe a strategy of long-term investment to meet the public needs of the state—schools, transportation, telecommunications—is critical to achieving renewed economic growth. Some states have formulated a ñcapital investment budgetî to address separately those public activities which are designed to assist or foster economic growth. The Commission recommends that California also incorporate a long-term spending and public investment plan into the Budget Act, including, for example, a five-year capital outlay plan and a clear statement of state priorities.

In 1988, for example, Oregon initiated a broad based public process which produced ñOregon Shines—an Economic Strategy for the Pacific Century.î It created an Oregon Progress Board, which in turn developed quantitative benchmarks for public investments linked to clearly stated priorities. These benchmarks are now being integrated into the state's budget process, which sets spending targets and prioritizes spending. Recent legislation in Oregon would add an investment strategy to improve the state's future work force.

California, while far larger and more diverse than Oregon, can nonetheless learn much from its approach. Throughout California's history, economic prowess has followed deliberate efforts to link state spending priorities to economic growth. California's former preeminence in water, transportation and education are examples of such strategies.

Capital outlay needs—for construction of state highways, hospitals, prisons, etc.,—are currently evaluated within the context of a particular program (e.g., CalTrans, state hospitals, Department of Corrections, etc.). A five-year capital outlay plan would link major investment goals to across-the-board priorities in state infrastructure. In past years, the state had a single capital outlay plan, and it evaluated capital outlay projects across program lines—focusing its investments on state objectives such as progressively monitored and prioritized educational, correctional, hospital and other service requirements and population growth. But as federal funding became available for specific programs—for example, environmental protection or transportation—California began to narrow its capital outlay projects to match the availability of federal funding. Today, although much of this federal funding has disappeared, the state has not reestablished its own overview program for capital funding. A five year plan would provide an opportunity to rebuild consensus on the state's economic future.

A longer-term capital investment spending plan would also provide California with a comprehensive blueprint for reviewing annual state spending. Gauging future as well as current needs will help policy makers determine program priorities. By allowing policy makers to plan in advance for capital outlay projects, a long-term spending plan would help equalize debt payments over the years. A long-term spending plan would also provide continuity in an era of term limits and rapid turnover of legislators.

13. Three-Year Program Plans

The state's existing budgetary system provides comprehensive, in-depth information about direct general fund spending, but it is usually oriented toward the budget year and lacks a longer term focus. Many of the largest programs are so complex that changes cannot be accomplished within a twelve month timetable. A short-term focus can distort true costs and fail to alert lawmakers to imbalances between revenues and spending programs before they occur. The Commission recommends that the state adopt a three-year approach to fiscal and budgetary planning.

Corrections, higher education, K-12 education, Medi-Cal and welfare cumulatively account for nearly 90% of the state's general fund budget. Each program should be required to review its primary mission, identify top priorities, predict future costs over a three-year period and produce a cost containment plan which will consolidate, modernize or otherwise make program delivery systems more cost efficient and productive. Reviewing an existing or proposed program over a three-year period will create an opportunity for the legislature to understand its full costs and benefits more accurately.

The costs of all legislation with a significant fiscal impact at either the state or local level should be analyzed by fiscal committees from a three year perspective, and a source of funding should be identified to finance those costs over time. Stating cost assumptions in legislation would create an ñinstitutional memoryî for later evaluation of continued funding needs. Final revenue assumptions would have to be negotiated by the parties and then stated explicitly, thereby giving the public a new way to measure the performance of elected officials.

14. Performance Measures

The Commission recommends that the state budget contain specific measures of program performance and effectiveness. Budget requests for each department should include mission statements, a detailed catalogue of all proposed services and programs, costs associated with each program, explicit goals for each program and specific quantifiable indicators to measure each program's successes and recipient satisfactions.

Currently the state spends large sums of money on a wide range of programs, without the self-imposed discipline of having to justify their cost effectiveness. As a result, the state and the public often do not know what the programs are designed to accomplish and whether they are effective.

Performance measures would allow the state to determine whether its resources were well spent. Analysts might compare the variety of programs purporting to provide prenatal care to high-risk pregnant women, for example, to determine which program provides the best care at the lowest cost. Many believe that California will not be able to resolve its structural deficits until it can justify the efficiency and effectiveness of current spending programs. Performance measures would help the public understand and accept the justifications for current or new programs, as well as the levels of taxation necessary to support them.

C. The Two-Thirds Vote Requirements Should Be Changed

California is the only state which requires its annual budget to be passed by a two-thirds vote of each house of the legislature, and California has imposed supermajority vote requirements on other fiscal decisions as well. The Commission has concluded that these supermajority vote requirements have not fulfilled their original intentions and have even on occasion worked to the detriment of the state's budgeting process.

Findings

The Commission has reached several conclusions concerning the procedural obstacles which promote delay and political gridlock in California's budget process.

The Two-Thirds Vote Requirement Does Not Restrain State Spending

Although some have sought to justify California's two-thirds vote requirement as a way to prevent increases in state spending, the supermajority requirement has just as often actually *increased* state spending. (See Table 15.) A small group of legislators can just as easily withhold the votes necessary for a two-thirds majority to obtain an increase in spending on favorite programs as to obtain a decrease. There is no evidence that the two-thirds vote requirement does anything to slow the increase in state spending. Instead, it allows a minority to frustrate the will of the majority.

In times of either plenty or scarcity, the two-thirds rule also encourages excessive compromise. The legislative majority frequently finds itself in the position of having to horse trade for votes—giving away programs or funding supported by a majority of Californians in order to pick up needed minority support. The more overdue the budget and the closer the vote to the needed two-thirds majority, the more costly the trading becomes.

Horse trading in the budget bill can also produce pork barrel legislation. Stories abound of legislative majorities ñbuyingî votes to reach the two-thirds majority for passage of a budget bill. In the early 1970s, for example, Senate Finance Committee Chair Randolph Collier (D-Yreka) held out for a $10 million appropriation to begin construction on a new capitol building (to be named the Collier Towers), complete with twin towers, a gymnasium and underground passages.[42] Another legislator held up budget approval until appropriations were included for restrooms at a beach in his district.[43] On one occasion, a legislator refused to give the key vote for the budget bill until the governor promised to appoint a friend as a judge.[44]

Pork barrel legislation can be a problem under any procedural rules, whether decisions are made by a supermajority or by a simple majority. But the pressure to succumb to pork barrel legislation intensifies with the level of difficulty needed to obtain the necessary votes.[45]

The supermajority vote requirement for the budget also obscures who is responsible for budget decisions. As long as a supermajority vote is required to pass and send the budget to the governor, the public has difficulty determining which legislators or political parties are responsible for either creating or resolving a fiscal imbalance.

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[42] Testimony of Walter Zelman, former Executive Director, California Common Cause, before the Assembly Committee on Constitutional Amendments, September 16, 1980, Los Angeles. The appropriation for the Collier Towers was later line item vetoed by the governor.

[43] Ron Roach, *81 Budget 'Shambles' Foretold*, San Diego Evening Tribune, July 18, 1980.

[44] *Id*.

[45] For an econometric analysis of how supermajority voting requirements affect pork barreling, see James Buchanan and Gordon Tullock, The Calculus of Consent (1962), and Brian Barry, Political Argument (1965).

Table 15

IMPACT OF BUDGET IMPASSES ON SPENDING

1969-1994

Year	Length of Budget Delay	Cause of Delay	Result
	Republican Governor/Democratic Legislature		
1994	7 days	Welfare, schools	Increase
1992	63 days	Schools, welfare	Increase
1991	16 days	Schools, tax hike	Increase
1990	31 days	COLA welfare	Increase
1983	19 days	Schools, welfare	Increase
	Democratic Governor/Democratic Legislature		
1980	16 days	COLA	Decrease
1979	13 days	Abortion	Decrease
1978	6 days	Abortion	Decrease
1976	2 days	Schools	Increase
1975	2 days	Overall budget	Decrease
	Republican Governor/Democratic Legislature		
1971	2 days	Overall budget	Decrease
1970	4 days	Schools	Increase
1969	3 days	Schools	Increase

Source: California Citizens Budget Commission 1995, based on a California newspaper search.

Trailer Bills Can Be Used to Circumvent the Legislative Process

The budget annually appropriates and spends state revenues. It cannot amend existing substantive state law. If statutory changes are necessary to implement the approved budget, therefore, the legislature and the governor must approve so-called budget ñtrailer bills.î These trailer bills accompany the budget and modify state law to conform it to budget decisions. They must currently be passed by a two-thirds vote, as must the budget bill.

In recent years, some legislators and special interests have increasingly attempted to amend substantive state law by inserting amendments into trailer bills. This practice uses the budget process as an ñend runî around the normal processes of legislative scrutiny (committee hearings, public debate, etc.). The increased tendency of the legislature to use budget trailer bills for substantive program modification reduces accountability.

Vote Requirements for Tax Decisions Are Inconsistent

The legislature can adopt tax breaks by a simple majority vote. To eliminate or alter these tax breaks, however, it must do so by a two-thirds supermajority—the same vote needed to enact a new tax. This anomalous situation makes it relatively easy to enact tax breaks but difficult to repeal them.

Recommendations

The Commission recommends several reforms to reduce or eliminate procedural obstacles to fair and efficient state budgeting.

15. Two-Thirds Vote

After considerable research and discussion, the Commission recommends that the legislature should be able to adopt the annual state budget by a simple majority vote and not the current constitutionally-mandated two-thirds supermajority vote. The Commission believes the current supermajority requirement fails to achieve its oft-stated goal of keeping budgetary spending in check, while at the same time promotes gridlock, pork barrel legislation and lack of accountability.

Very few states require a supermajority vote to resolve fiscal issues. As shown in Appendix C, California is the *only* state in the union that *automatically* requires a supermajority vote of the legislature to approve budget bills. A few other states routinely impose a supermajority requirement under certain conditions. Budget bills in Nebraska, for example, require legislative approval by a three-fifths majority if the legislature proposes appropriations that exceed the levels recommended by the governor's fiscal planning team; otherwise, a simple majority is sufficient. Maine, North Dakota and Oklahoma require an extraordinary majority vote by their legislatures to approve budget bills containing emergency clauses (which occur frequently). Most innovative, perhaps, is the State of Illinois. A simple majority vote by the legislature passes a budget bill; if the budget bill is not approved by the statutory deadline of June 30, a three-fifths vote is required.

As Table 15 indicates above, budget impasses have been reached 13 times since 1969. In eight of those deadlocked budget debates, the minority withholding budget approval principally sought to *increase* government spending—usually on schools but sometimes on welfare—or even to increase tax revenues. In five of those budget disputes, the minority demanded cuts in government spending on cost-of-living increases for welfare payments or insisted that public assistance for abortion services be eliminated.

It is apparently the political composition of the minority voting bloc and the governor's office, not the two-thirds vote requirement itself, that determines whether the supermajority rule will be used to increase or decrease state spending. Under a Republican governor in 1969, 1970, 1983 and 1990-93, for example, Democrats in the legislature formed a voting bloc which demanded increases in spending on schools and social services in exchange for the necessary votes to reach a two-thirds majority. Under a Democratic governor in 1971 and 1978-80, Republicans in the legislature formed a voting bloc that demanded cuts in spending for welfare and abortion services.[46] Rather than reducing government spending, the two-thirds vote requirement politicizes the budgetary process and, as often as not, can increase as well as decrease the size of the state budget.

A recent study that attempted to measure the impact of legislative procedures on government debt reached a similar conclusion. The authors concluded that various legislative procedures—in particular, the two-thirds rule—have no statistical significance in reducing state debt or spending. Instead, the partisan composition of the governorship and

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[46] Republicans have also formed blocs to prevent the budget's passage in California based on demands for more state spending. During Governor Earl Warren's administration, for example, a GOP bloc of legislators demanded that state revenues accumulated during the war years be used to finance a wide variety of local projects. They held up the passage of the budget until the governor agreed to create the ñChristmas Tree Fundî to support local parks, beaches, courthouses, etc., with more state funding.

legislature appears to be the primary factor determining government indebtedness and spending patterns.[47]

The experiences of other states confirm the ineffectiveness of the two-thirds rule in limiting state budgets. The vast majority of states that have simple majority requirements have weathered their budgetary crises more effectively than California.[48] In fact, there is no observable tendency for states with an supermajority requirement to spend less per capita than states in which the budget must be approved by a simple majority.

A supermajority may be legitimate in special situations, such as an override of a governor's veto. The budget bill, however, provides general support for the ordinary operations of state government, and it is hedged with numerous safeguards to prevent abuse. The governor must present the legislature with a balanced spending plan, the budget must be adopted by a date specified in the constitution and the governor has line-item veto power over each appropriation. The legislature may override any action of the governor—but only by a two-thirds supermajority. Unlike other legislation, the budget bill is in effect for only one year, and it generally does not create new programs. These attributes indicate a supermajority vote requirement is unnecessary.

The Commission believes the supermajority vote requirement is inappropriate when applied to the routine operations of state government and should be repealed. It distorts the budget process, undermines its primary purpose of distributing available revenues and converts it into a highly partisan battle in which political ñtrade offsî are required to obtain the necessary two-thirds supermajority.

16. Trailer Bills

Trailer bills are intended solely to implement the budget and must be passed by a two-thirds vote. Since the budget bill is itself a one year statute, trailer bills should not be used to make permanent changes in substantive law. The Commission recommends that trailer bills be enacted by a simple majority vote, along with the budget itself, and that trailer bills not be permitted as a substitute for substantive legislation except as needed to implement the budget. Passage of trailer bills by a simple majority would make it easier to enact a budget. Permanent changes in law should follow the normal course of legislation and be heard in policy committees, as required under the rules of both houses of the legislature.

17. Line-Item Veto Over Trailer Bills

The Commission recommends that the governor be allowed to veto specific statutory changes in trailer bills in the exact same way as the governor can now veto line-item budget bill appropriations and associated language. The legislature's power to override such vetoes by a two-thirds vote should also be retained.

Currently the governor has a line item veto over the budget. Although the governor can veto entire trailer bills, he cannot veto individual statutory changes in trailer bills. Yet the sole function of trailer bills is to make the Budget Act work as approved. Trailer bills should be subject to the same rules as the budget bill. Neither the legislature's nor the governor's powers should be different between the budget bill and any trailer bill.

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[47] Richard Kiewiet and Kristin Szakaly, *The Efficacy of Constitutional Restrictions on Borrowing, Taxing, and Spending: An Analysis of State Bonded Indebtedness, 1961-1990*, paper presented to the annual meeting of the American Political Science Association in Chicago, September 3-5, 1992. The authors concluded that a Democratic governor and a Republican-controlled legislature produced the lowest levels of bonded indebtedness.

[48] None of these states have produced deficit spending remotely close to California's.

The budget is the one document that reflects the governor's policy agenda. Allowing specific statutory language, as well as budget appropriations, to be vetoed would increase the governor's power to control overall budget policy. It would also allow the public more easily to determine who to hold accountable for the budget.

18. Tax Break Vote Requirements

The Commission has recommended that existing tax breaks—tax exemptions, credits and deductions—be incorporated into the budget process and evaluated together with all other state spending programs. In furtherance of this policy, the Commission also recommends that proposals to create new tax breaks (tantamount to authorizing government spending on those programs) be subject to the same vote requirement as needed to alter or repeal such tax breaks. The Commission believes it is important to establish the principle that tax increases and reductions should be treated consistently in the legislative process. (See Appendix B.)

D. The Budget Must Be Based on Improved Information

The Commission has reached several conclusions concerning deficiencies in information in the state budgeting process.

Findings

Elected officials are themselves often confused over the budget. When that happens, public distrust is exacerbated. Yet much of this confusion is caused by inadequate budgeting information and misleading terminology. Obscure budgeting procedures also add to the confusion. Missed budget deadlines, payment of government employees by ñvouchers,î threats of massive budget cuts (avoided at the last minute by sudden ñdiscoveriesî of funds), an inability of public service recipients to evaluate the need for or efficiency of expenditures—all isolate budget decision makers from constituent participation.

The limited time elected representatives spend in their districts also curtails their ability to discuss budgeting questions with their constituents. Since California faces difficult choices over state spending priorities—with demands for spending far exceeding available revenues—elected representatives need more time with their constituents to assess the tough choices to be made.

Inadequate Budget Information Discourages Public Participation

The public does not normally involve itself in the minutiae of government programs or spending and revenue estimates during the normal budgeting process. But when the state substantially alters specific programs, either by creating, enhancing, reducing or eliminating them, public participation in the budgeting process becomes more desireable. Obscure terminology, inadequate information or an obtuse budgeting process effectively exclude the average person—taxpayers and consumers of state services alike—leaving members of the public with little understanding of, or ability to influence, the choices that are made in Sacramento.

Other states have recognized the need to involve the public in debates over state budgetary priorities. Oregon, for example, has encouraged public participation in the budgetary process and used it to build consensus among the state's residents. As a result, the state has adopted a set of budgetary goals and approved a series of benchmarks for use in reviewing spending choices. Difficult trade-offs between specific government services and increased taxes have become clearer, and the public has been invigorated in helping set future directions for the state.

Designing such a public process in California would be a challenge, given the diversity of interests in the state. But the lack of broad based public consensus behind state budget priorities is a principal reason for indecision among government leaders. Ways to reconnect the people with their representatives in state government are needed. The budget process cannot substitute technical expertise and analysis for adequate public participation.

Local Governments Are Often Ignored in the Budget Process

The state transfers more than 70% of its budget to local governments to administer state and local programs, yet it provides local governments with little guidance to assess program objectives and local outcomes. Conversely, local resources committed to many shared state-local programs are not integrated in the state budget process. A clearer picture of intergovernmental resources is an essential missing ingredient in the state budget process.[49]

Local governments depend on timely passage of the state budget, yet the legislature and the governor frequently exceed the constitutional deadline for budget adoption. The relative power of state budget decisions on local policy is not recognized in the state budget process. Although each house of the legislature has several fiscal committees that specialize in budgetary matters, the legislature is still consistently unable to balance the budget or to conduct adequate oversight on issues of broad fiscal concern—such as debt policy, intergovernmental cost shifting and structural revenue and expenditure problems. The volume of legislation generated in the Capitol—more than 4,000 bills introduced during a two year legislative session—also obscures attention to the state's overall fiscal picture. Local governments in this atmosphere are treated as another special interest group.

The state's budget includes no information about the financial status of local governments and fails to indicate the effect state decisions will have on local governments. One of Proposition 13's many legacies has been to cast the state in the role of ñBig Daddyî over local governments. Independently elected local officials must come to Sacramento and fight, cajole and beg for their ñfair share of the revenue pie.î Not surprisingly, this allows state officials to tell local governments what to do and how to do it. Although the state budget determines the flow of state funding to local as well as state programs, the budget document does not make this clear. The local public is thus left unaware of key policy choices, local government autonomy is eroded and the long-term consequences of fiscal policy are lost among a patchwork of individual program or service decisions.

Recommendations

The Commission recommends several reforms to involve the public and local governments in the budget process.

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[49] The state's budget process also generally fails to anticipate the impact of federal budget decisions. Since the federal budget begins in October, and because federal policy is usually viewed as uncontrollable by the state—with the exception of the unusual recent interest in federal funds for illegal immigrants—state budget decision makers generally do not review total federal budget decisions or seek to influence them.

19. Comprehensive Information

Many state programs are funded through a combination of federal, state and local resources, yet aggregate information on federal and local spending is not available during the state budget process.[50] Aggregating federal, state and local funding information in the state budget would allow the governor and legislature better to assess the impact of state budget decisions on locally administered services and programs. Total resources available to fund particular activities would be known, and specific funding decisions could be made in the context of total program operations. The Commission recommends that the Governor's budget contain a section describing all federal and local resources which are part of any state program.

20. Standardized Data

The Commission recommends that the state standardize state and local budget information and timetables and write budget documents in ñplain English.î

Budget information is highly technical and confusing. Individuals who want information have a difficult time finding or understanding it. Budget information should be simplified and demystified.

The state controller gathers fiscal information from local governments, but local governments are not required to submit that information in standardized or generally accepted formats. All state and local government Budget Acts should be modified to use standardized terminology and formats.

21. Shortened Legislative Sessions

The California constitution requires the legislature to pass the annual budget bill by June 15 and the governor to sign it by June 30 of each year. The new fiscal year then begins on July 1. The primary budget-related legislative activity conducted after enactment of the budget is a one month, so-called ñveto sessionî running from July or August to September. Although this session was originally intended to allow the legislature to override any budget item vetoes by the governor, few such overrides have succeeded. Instead, the month long session is primarily used to raise campaign contributions and debate substantive legislation, much of which is hurriedly crafted and sometimes tailored to meet special interest needs.

The Commission recommends that the legislature adjourn on July 1st of each year. This would diminish its propensity to consider and enact poorly crafted or special interest-oriented legislation. It might also accelerate the legislature's action on the budget itself, cut the number of smaller bills introduced, encourage the legislature to concentrate on more important issues, diminish the connection between last minute legislation and special interest fundraising and give legislators more time to meet with constituents at home. The Commission also recommends, however, that the legislature have the authority to reconvene after July 1st to consider veto overrides of the governor's actions whenever a majority of each house signs a petition to call such a special session.

22. Joint Assembly-Senate Fiscal Subcommittee Hearings

Budget hearings before the fiscal subcommittees of each house are the only opportunity the public has to testify in the budget process. Basic budget information,

[50] The financing of public health programs is an example. Federal, state and local governments all contribute funding to pay for medical care for the indigent. While the state budget reflects state funding used for this purpose, it does not integrate all federal funds together and it fails to identify local resources altogether.

however, is duplicated in both houses, and interested persons must testify twice in order to ensure that their views are heard. The Commission recommends that the legislature conduct Joint Assembly-Senate Fiscal Subcommittee hearings on the budget. Joint hearings before the combined subcommittees of both houses would give these proceedings greater public visibility and make it easier for the public to be heard. This broadening of budget discussions would also help newer members of the legislature to gain needed expertise.

23. Final Budget Narrative

The Commission recommends that the governor direct the department of finance to issue a final narrative budget report explaining the budget's broad programs (e.g., benefits to children) in simple language and an easy-to-understand format and issue such a report within 90 days of the budget's adoption. Such budget report would provide a comprehensive description of the budget as enacted by the governor and the reasons for the principal changes made by the legislature to the governor's original proposed budget.

The governor's original budget proposal, offered in January, contains thousands of pages of detail. No narrative account is issued, however, to describe the broad programs contained in that budget. When the governor approves the final budget or vetoes particular appropriations or pieces of budget bill language associated with appropriations, he provides only the briefest explanation of his actions. No final document explains or justifies the entire final version of the budget to the public.

Displaying information about the major activities of state government could help involve the public and private organizations in budget decisionmaking. As choices about future funding become clearer, the public's advocates would be better able to represent their interests.

24. Annual Budget Primer for Taxpayers

The Commission recommends that the state direct the legislative analyst to prepare a short, easy-to-read primer (up to four pages) summarizing each year's budget and disseminate it annually to all California taxpayers. This summary should be divided into understandable categories of revenues and expenditures. It could be distributed separately with individual tax returns or with the voters' pamphlet during elections. Nineteen million Californians now file tax returns—six million more than are registered to vote. If a budget pamphlet was included with all tax returns, it would reach approximately 65% of all Californians and give over 19 million residents convenient access to basic budget information.

A budget primer could inform taxpayers how current dollars are spent—how much on K-12 education, higher education, corrections, health and welfare, etc. Taxpayers would better understand the connection between the taxes they pay and the programs their taxes fund. Citizens would become more aware of the budget process and be better able to hold their legislators responsible for spending decisions.

E. The Budget Must Give Local Governments Greater Fiscal Independence

The Commission initially assigned itself the task of reviewing California state government's major budget process policy questions. It soon became apparent, however, that issues involving the relationships between state and local governments exert a major impact on the state's fiscal affairs. While the Commission has not yet focused as directly on the fiscal relationships between the state and local governments as it has on the state's budgeting process, it offers the following preliminary recommendations as warranting further serious study and investigation.

Findings

Local governments are increasingly dependent on the state budget process, since Proposition 13 limits both the property tax rate and the rate at which property valuations for tax purposes can be increased. It provides that the maximum tax rate on real property cannot exceed one percent and that property valuations cannot be increased more than two percent a year.

At the time of Proposition 13's passage in 1978, local governments raised much of their revenue from local property taxes, and the state distributed additional revenues to local governments based primarily on their needs. After Proposition 13, local governments were increasingly forced to rely on the state to supplement their funding needs. As the recession caused the state to lose revenues beginning in 1990, however, the state began distributing its available revenue based upon the state's, and not local governments', fiscal interests.

Local governments also face procedural obstacles in preparing and implementing a budget that is responsive to their constituents. They typically face two budget decisions—one prior to the start of their fiscal year when they must prepare a budget, and the other after the state budget is determined when they must modify their budget in light of the state's decisions. Changes in the timing of local budget decisions could rationalize this process and reduce public confusion.

While the Commission has not conducted a comprehensive analysis of state-local governance and fiscal interrelationships, it has identified a number of significant problems and recommends several reforms which warrant further consideration.

Local Governments Cannot Adequately Control Local Tax Revenues

Cities and counties cannot function adequately without the ability to raise revenues to meet local needs. Historically, the single most important source of local government revenue in California has been the property tax. Proposition 13, however, substantially deprived local citizens of the power to tax themselves for purposes that might benefit the community. Moreover, even though property taxes continue to be the primary source of general purpose revenue for most local governments, state law—not local law—controls property tax exemptions. Table 16 illustrates that, despite continued dependence of local governments on the property tax, the property tax base has shrunk dramatically. Furthermore, local governments have no power to modify, repeal or even ratify property tax exemptions.

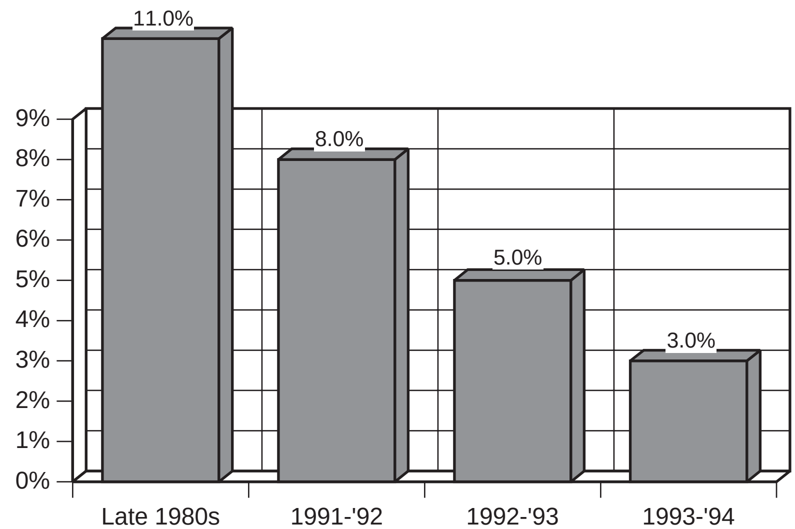
Local Governments Are Too Dependent on Volatile Revenue Sources

Local government dependence on sales tax revenues is growing. Proposition 13 forced local governments to shift their reliance away from the stable base of property taxes towards more volatile taxes—such as sales taxes which rise and fall with the economy. Sales tax revenues are shared between the state and local governments. Local governments directly receive a small portion of overall sales tax revenues (as determined by the state), but the state also gives additional portions of sales tax revenues to local governments for a variety of special purposes. The state has recently shifted one-half cent of sales tax revenues to local governments for ñrealignedî health and human service programs in 1991 and another one-half cent for general support, with emphasis on local law enforcement support through the passage of Proposition 172 in 1992.

Table 16

THE DECLINING LOCAL PROPERTY TAX BASE

Annual Percentage Change in Locally Assessed Valuation



Source: Commission on State Finance, "Quarterly General Fund Forecast," June 1993

As consumers purchase relatively fewer goods in relation to their purchases of services (which are not subject to the sales tax), California's sales tax base will shrink as a percentage of overall consumer expenditures. This will increase local government's financial instability and put pressure on state government to increase the sales tax or impose a tax on services. Tables 17 and 18 suggest that local governments will need to proceed very cautiously when using sales tax revenues to finance ongoing public services.

Relative Tax Burdens Are Inconsistent

California has dropped from being a high tax state to an average tax state (see Table 19), when taxes are measured as a percentage of personal income. This is not true, however, for all income groups. California imposes the highest personal income tax rate of any state, although the top rate (11%) only affects a few very wealthy individuals.[51] (See Table 20.) While the state's income tax is more progressive than any other state's, poor families in California have sustained the largest tax increases of any group in proportion to their incomes during the past several years, due largely to sales tax increases.

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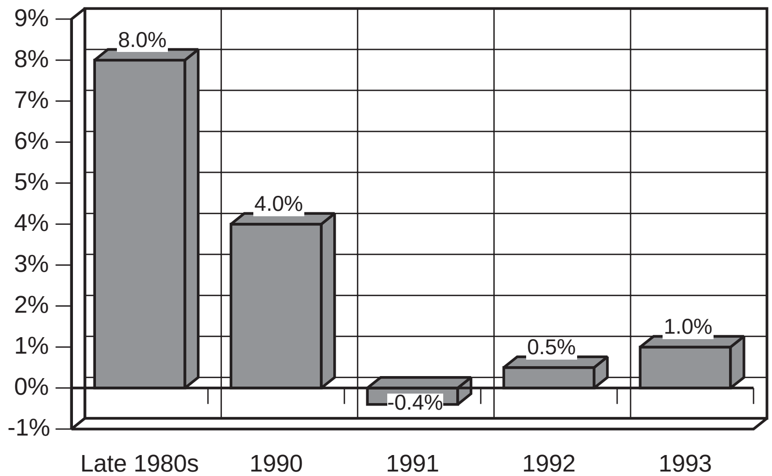
[51] Some high income taxpayers have a variety of ways to shelter income—e.g., investors may avoid taxation through tax exempt bonds.

Table 17

THE WEAKENING LOCAL SALES TAX BASE

Percentage Increases and Decreases in County Taxable Sales



Source: Commission on State Finance, "Quarterly General Fund Forecast," June 1993

The state's bank and corporations tax is high compared to other states', but some banks and corporations are able to insulate themselves from the high rates although others cannot. While the state's average property tax is very low compared to other states, it is comparatively high for new homeowners and businesses locating or expanding in California. And while the state ranks 50th in the overall amount of property taxes, the price of property remains high and new property purchasers are taxed at full market value, while other property owners enjoy tax assessments based on far less than the true market value of the property. Table 21 examines the effects of Proposition 13 on homes in Los Angeles County where 40% of real property is now assessed at 19% of market value. While current property tax policy clearly protects property owners against dramatic tax increases, California's tax structure may also inhibit some forms of economic growth, and this may in turn slow economic recovery from the recession.

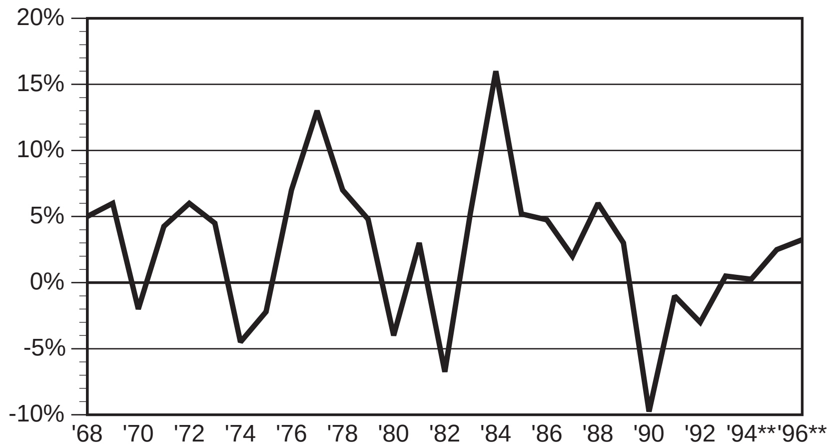
Proposition 13 Distorts Local Fiscal Decisions

California's tax decision makers have simultaneously raised tax rates and enacted numerous special ñtax breaks,î despite expert advice to make tax rates comparable with those of other states. Special tax breaks for certain businesses continue to skew business and local government land use decisions. Local governments have rapidly increased fees and assessments to replace property tax revenues lost under Proposition 13 and state revenues lost through the recession. Yet high local fees inhibit economic growth and ñfiscalizeî land use policy—causing local governments to prefer shopping malls, which provide low wage service jobs but more sales tax revenue, for example, over manufacturing plants which provide higher wage employment but less immediate revenues to local government.

Table 18

THE VOLATILITY OF SALES TAX REVENUES

Percentage Change in the State's Sales Tax Revenues,* 1968 to 1996



* Includes the impact of the "snack tax," which was in place from July 15, 1991 until November 20, 1992 (after it was repealed by the voters).

** Estimated by the State Department of Finance

Source: Governor's Budget Summary, 1994-95

Local governments seeking to finance infrastructure needs through bond measures must currently obtain a two-thirds supermajority local vote of the people. This two-thirds vote requirement was enacted in the belief that it would severely curtail the ability of local governments to incur debt. It has had the unexpected consequence, however, of encouraging local governments to raise revenues in other ways, often at greater expense to the taxpayers and without any popular vote. So-called ñcertificates of participation,î[52] for example, are not considered debt under current law. Local governments create them without a vote of the people to raise revenue by selling investors shares in lease arrangements with public properties. Since they are considered much riskier than bonds, they pay a higher rate of interest. The revenues they generate are often—but not always—used to finance capital improvements. ñCertificates of participationî can and have also been used to support on-going government programs, in effect allowing local governments to borrow money to pay for programs otherwise not supported by existing local government revenues. Taxpayers would exercise more power over, and pay less for, the accumulation of debt if local bonds were the primary means of funding local infrastructure needs.

California's state and local governments are increasingly choosing unusual financing instruments because of their political convenience, not because they provide the best terms for taxpayers. Since general obligation bonds require a majority vote of the people at the state level and a two-thirds supermajority vote at the local level, decision makers now prefer to finance their activities with other revenue-based instruments which do not require ratification by popular vote. These include lease revenue bonds or certificates of

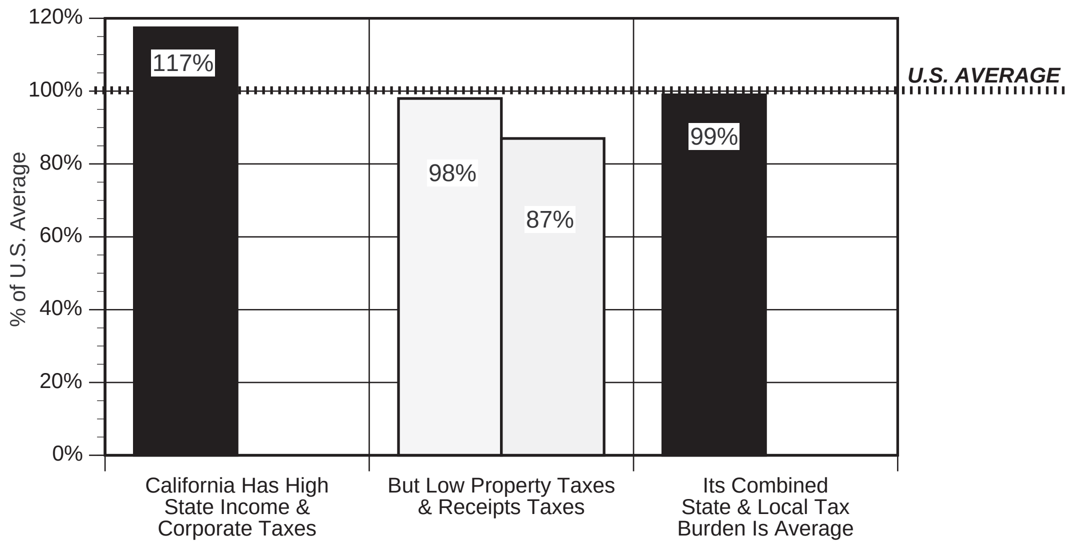
[52] *Supra* note 18.

participation—even though they may finance deficit spending or be based on repayment from the general tax base. These alternative debt instruments are more expensive and obscure the debt picture of local government.

Table 19

CALIFORNIA'S OVERALL TAX BURDENS COMPARED TO OTHER STATES

Taxes Per $1,000 of Personal Income, Fiscal 1990-91



Source: U.S. Department of Commerce, Government Finances in 1990-91

Confusion over the fiscal behavior of state and local governments is also heightened by the complicated distribution of shared revenues. The state collects income, business, corporation and sales taxes and deposits much of this revenue in special funds to finance specific programs. The state also distributes a portion of sales tax and other revenues to local governments, sometimes as a result of constitutional mandates, other times as the result of funding formulas in state law. The state constitution requires the state to distribute sales tax revenues on the basis of situs—where the tax was paid. Since the state has increasingly used sales tax revenues to finance local service programs, the situs requirement unduly constrains the state's ability to finance needed services in areas where sales tax revenues are not high. On the other hand, local voters might increase their own state sales taxes to pay for needed local services if they could retain these local sales tax funds in their own jurisdictions. The state should be given more flexibility in the future to share *its* portion of sales tax revenues with local governments on other criteria than where the tax was collected.

Recommendations

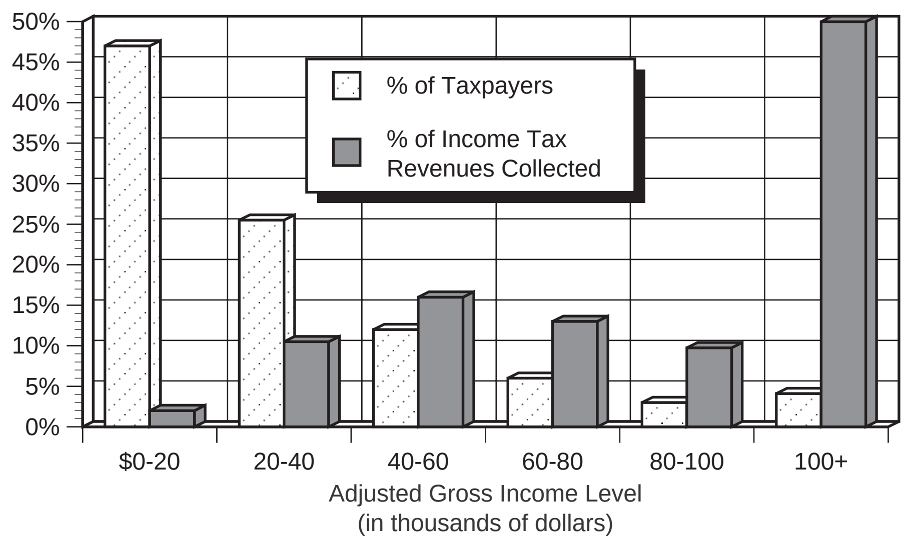
The state badly needs to restructure its relationships with local government to provide an adequate and rational financial base for local government operations. Much of the ability of local governments to raise general purpose local revenues is controlled by state law. The state's method for distribution of revenues which are shared between the state and local governments, such as sales tax revenues, has developed through a series of ad hoc decisions which have little consistency or common purpose. The public lacks a clear sense of which level of government is responsible for which services. Although tax reform and the interrelationship between state and local government fall somewhat outside this Commission's initial task of examining the state's budget process, the Commission believes that these issues must be seriously addressed if California's budgeting process is to be reformed. The Commission therefore recommends the following reforms as worthy of further study and debate.

Table 20

PERCENTAGE OF TOTAL TAXPAYERS AND PERSONAL INCOME TAX PAID

As Adjusted Gross Income Level

(Data for 1990)



Source: Governor's Budget Summary, 1994-95

25. New Local Budgeting Cycle

Local governments today, particularly counties, schools and some special districts, have essentially two budgets: the budget they adopt by July, which must guess at the revenues available from the state; and a second budget adopted shortly after the state budget is adopted and interpreted, which adjusts local budgets to the revenues actually available from the state. State funding for a local program approved in July may disappear in August or September. There is, however, no need for two sets of budget decisions. Moreover, the resulting confusion exacerbates the public's inability to participate in meaningful budget decisions before their own local governments.

The Commission recommends that local governments consider adopting an alternative budget cycle. A local government budget cycle 30, 60 or even 90 days after the state's July 1 budget deadline would create a simpler, more understandable budgeting system. Some special attention would have to be paid, of course, to transitional issues, but the Commission believes that it would serve a useful purpose for local governments to explore this option thoroughly.

The Commission believes it is inappropriate and inefficient for the state to use its budget process to determine the degree and kind of many local services—for example, how many firefighters will be employed by Placer County. Yet the state indirectly makes many such decisions today, distributing property tax revenues and directing specific funding for special purposes. Methods should be adopted—with appropriate safeguards—to allow local voters to increase their own property taxes to pay for desired community services.

26. Local Vote on Property Taxes

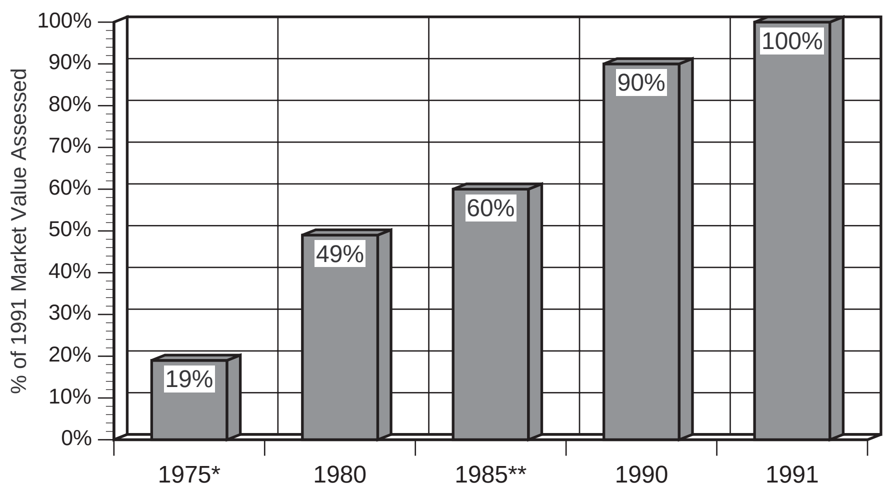
Prior to 1978, local governments had the authority to levy the property taxes they needed to meet their obligations without voter approval. When Proposition 13 capped the property tax, the state stepped in to collect and distribute property tax revenues among cities, counties, schools and special districts. Today, local voters no longer have the power under the California constitution to increase the tax rate on their own property to finance local government activities. Local autonomy, particularly for counties and schools which have few alternative sources of revenue, has been lost. State lawmakers now make the key decisions affecting local service levels, not local voters.

The Commission recommends that local voters be allowed to raise their property tax. If localities and schools are given more financial autonomy, local voters will have a greater say in resolving trade-offs between taxes and government services in their communities. This approach would rebuild the vitality and responsiveness of local government.

Table 21

PERCENTAGE OF A PROPERTY'S MARKET VALUE ASSESSED IN 1991

By Year of Property's Purchase



* 40% of all property is assessed at this level.
** The average property in Los Angeles County is assessed at this level.

Source: Commission on State Finance, July 1993

27. Majority Vote on Local Bonds

Statewide bond measures can now be approved by a simple majority vote of the people. State law, however, requires local bond measures to be approved by a two-thirds supermajority vote. These high voting requirements have forced local governments to resort to a variety of alternative financing mechanisms to finance government capital investment. Some of these mechanisms require only majority voter approval, while others require no voter approval at all.

One deficiency of these alternative financing methods is that they may impose on a small number of taxpayers the responsibility to pay for government activities that benefit a much larger number of taxpayers. Financing systems like ñbenefit assessment districtsî and Mello-Roos bonds, for example, obligate certain property owners to pay for infrastructure improvements that benefit all residents of the area. Other financing techniques, such as certificates of participation, are sometimes used to finance local government's operating costs instead of long-term capital improvements. Since they are not technically considered ñdebt,î they are not counted as part of local debt, even though they can increase local spending in excess of local revenues.

The assumption that a two-thirds vote requirement for local bonds is necessary to curb local debt is simply incorrect. Instead, the two-thirds requirement has created financial inequities between taxpayers, and in some instances it has cost taxpayers substantially more than if general obligation bonds had been used.

The Commission recommends that the issuance of local bonds be approved by the same simple majority voting standard as applies to state bonds. A simple majority vote requirement would not only enable local governments to adopt less expensive and more appropriate revenue raising techniques, but it would also generate greater public disclosure and debate over the legitimacy of local debt obligations.

An alternative approach would allow local voters, by a simple majority vote, to authorize debt up to 5% of general fund revenues. To incur debt in excess of 5%, a two-thirds supermajority vote could be required. Since the amount of debt incurred by local governments varies widely, this alternative might provide local taxpayers with greater protection than current controls.

28. State Sales Tax Allocations

California's sales tax is both a state and a local tax. The state sets the basic sales tax rate, but local governments are allowed to add additional surcharges for local purposes. The California constitution has been interpreted to require that the state disburse the portion of local sales tax revenues dedicated to local government ñby situs,î or according to where the sales tax was generated.[53]

This allocation formula is outdated and inappropriate. State income taxes and most other taxes are allocated to state programs according to population, caseload or some other measure of need. The state's share of sales tax revenues should be similarly allocated. The Commission recommends that the state allocate new state sales tax revenues to local governments on the basis of population, not ñsitus.î The local sales tax option, not the state's share of the tax, is the appropriate means to address ñsitusî concerns.

Reliance on ñsitusî for state sales tax distributions has distorting effects. Many cities, for example, have fiscalized their land use decisions and distorted their development plans to favor shopping centers and retail outlets (which generate sales and property taxes) and discourage housing (which generates only property taxes). A more appropriate distribution of state tax revenues would be based on population or need. The fiscalization of land use would diminish (but not disappear entirely), because the overall impact of sales tax revenue distribution would not create such strong incentives.

[53] The average overall sales tax in California is 7.75%. Of this total, 5% is considered a source of general fund state sales tax revenue. Another 1% is deposited into two state special fund accounts: 0.5% for counties to finance realigned health and welfare programs since 1991, and 0.5% for local governments for law enforcement services. Local governments under the Bradley-Burns Act receive another 0.75% for local purposes, including a portion dedicated to certain transportation needs. Finally, state law generally provides local governments with up to an additional 1% sales tax option if local voters approve the tax. As a separate matter, there are also in a few additional sales tax levies allowed for regional mass transit, such as the Bay Area Rapid Transit District.

Since abrupt alterations in the current tax distribution system might create hardships, the Commission recommends that any adjustments to the process of distributing state sales tax revenues be phased-in over time, allowing local governments adequate time to plan for the change. An alternative might be only to adjust future state sales tax revenues in this manner, distributing them by population rather than their situs of origin.

29. Property Tax Exemptions

Until the 1978 passage of Proposition 13, California generally gave local governments stronger powers than have most other states.[54] In the early 1900s, the property tax was a primary source of general purpose state revenue, but after 1910 it quickly became the primary source of general purpose local tax revenue.[55] Yet California state law and the constitution continue to control the variety of exemptions from local property taxes. Over the past century, these amendments and exemptions have built an incredible maze of state regulation and bureaucratic interpretation in which the simplest problem can be contorted into an expensive polyglot of government decisions that defy common sense.[56]

The Commission recommends that the constitution be amended to give counties a greater role in setting property tax exemptions. The fundamental issue that needs review and reform is local government's lack of authority over its primary source of general purpose revenue: the property tax. Local governments need to control property tax law within their jurisdictions. Just as local voters should have the authority to tax themselves to

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[54]A 1981 survey conducted by the Advisory Commission on Intergovernmental Relations, *Measuring Local Discretionary Authority*, on the period before Proposition 13, concluded that California local governments had significantly more powers than other local governments throughout the country. With a lower score indicating stronger local authority, California counties rated 3, while the average was 3.69 for counties nationally. California cities rated 2, while the national average for cities was 3.16.

[55] In the early 1900s, property taxes provided more than half of all state government revenues across the nation. Rapid industrialization, however, required states to expand and diversify their tax base. The share of state tax revenues from real property quickly declined. The Great Depression further accelerated this decline, so that by 1940 the property tax provided less than 8% of state revenues. That share fell to roughly 2% by 1980 and remained unchanged throughout the last decade. See Arthur Sullivan, Terri Sexton and Steven Sheffrin, *The Future of Proposition 13 in California,* California Policy Seminar (1993).

In California, however, the state ceased to levy and collect taxes on real property altogether as early as 1910. A ñSeparations Agreementî formulated by a 1905 Commission on Revenue and Taxation, and incorporated in part as Article XIII of the state constitution in 1910, called for separation of state and local tax sources, giving local governments jurisdiction over property taxes and counties the duty to assess and collect property tax revenues.

Today, the state board of equalization establishes the rules and procedures to be followed by county assessors. The state board, rather than the county assessor, is responsible for the assessment of ñstatewideî real property used for a common purpose. Most utilities, such as railroads, power plants and telephone companies, fall under this definition. These properties total approximately 5% of all assessments in the state. Unaffected by Proposition 13, the properties assessed by the state board of equalization continue to be assessed at market value, irrespective of their date of acquisition.

[56] Alexander H. Pope and Max E. Goodrich, *California Property Tax Exemptions, Exclusions, Immunities, and Restrictions on Fair Market Valuation—Or, Whatever Became of Full Value Assessment?,* 18 Pacific Law Journal (1987), includes a classic example of the cumulative impact of state laws and rules governing the application of property tax exemptions. It describes a state board of equalization ruling on property owned by the Crystal Cathedral in Orange County during 1979-81: ñThe state board disallowed claimed exemptions for thirty-seven rooms and part of a sanctuary in the Cathedral itself for 1982, all of the Fellowship Hall for 1982 and areas in the Hall used by a profit-making corporation for 1979-81, most of the Arboretum for 1982 and Arboretum areas used by a for-profit corporation during 1979-81, a bookstore for 1980-82, and areas used by the for-profit corporation on three floors of the Hour of Power Building in 1979-81.î The authors observe that both church officials as well as the Orange County Assessor's office have quite a challenge ahead in tracking property uses and taxation calculations in the future.

address local needs, so should local governments have some measure of authority to shape tax exemptions or credits for properties they assess to help plan their community's growth and development.

30. Overall Tax Code Revisions

The state's current mixture of taxes does not fit the state's changing economic needs and trends. State and local governments are increasingly relying on the sales tax as an important source of revenue, yet sales of durable goods on which the tax is based are shrinking. By contrast, sales of services are increasing, yet they remain largely untaxed. California ranks 42nd out of 45 states in the number of services it taxes (five states have no sales tax at all). If California continues to increase its tax credits, deductions and exemptions to relieve burdensome rates of taxation, it will shrink its overall tax base and create pressure to raise existing tax rates even higher on the revenue sources that remain. The resulting inequities and uncertainties in the state's tax structure will create impediments to economic growth.

Although California has shifted from a ñhighî tax to an ñaverageî tax state, its tax burdens are disproportionately distributed. Proposition 13 created one of the lowest property tax rates in the country, yet new home buyers and businesses pay very high property taxes compared to their neighbors and business competitors.[57] California has the highest income tax rate of any state in the country, yet the 20% lowest income families shouldered the highest increase in taxes as a share of family income of any group from 1985 to 1991. (See Table 22.) Although the state's bank and corporation tax rate is among the highest in the country, and despite more than 60% growth in the gross state product between 1987 and 1994, the state's bank and corporations tax yielded 12% less revenue in 1994 than in 1987.[58]

State and local governments are beginning to rely less on stable revenue sources (e.g., property taxes) and more on volatile revenue sources (e.g., sales taxes and fees). This leaves them vulnerable to economic fluctuations. It also makes it critical for local governments to set aside revenues as a cushion against revenue losses caused by economic downturns.

For the first time, California must worry about its competitiveness with other states in attracting investment and promoting economic growth. The nature and amount of this growth will directly affect the state's ability to fund high priority public services. Yet local governments, facing growing fiscal instability, are imposing more and higher business fees, and these in turn have an unsettling impact on business decisions.

These thorny problems suggest the need for a general overhaul of the state's tax structure. The Commission recommends that California's overall tax base and tax structure be examined, for both state and local governments, and a comprehensive package of changes be drafted to make that tax structure clearer, fairer and more broadly based.

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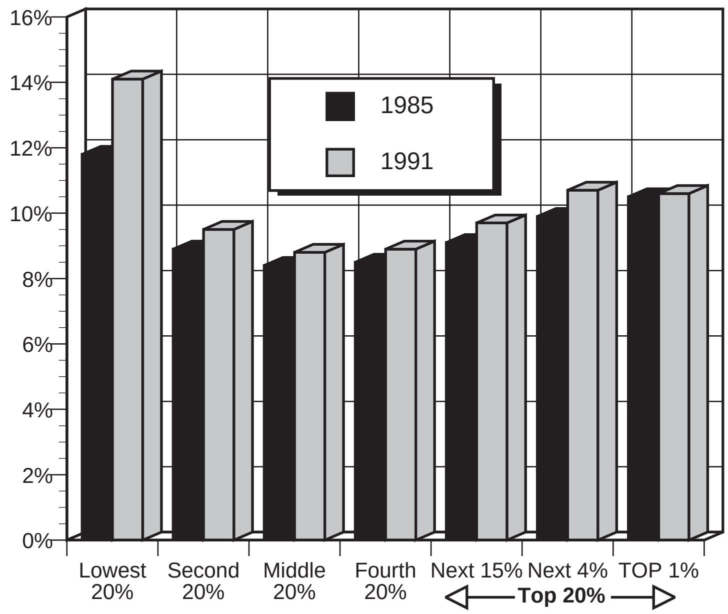
[57] See Sullivan, Sexton and Sheffrin, *supra* note 55.

[58] Statement of Kevin Scott, Goldman, Sachs & Co., at the UCLA Business Forecasting Seminar, June 22, 1994. This revenue loss is generally attributed to federal tax law changes, to which the state was forced to conform, and which provided additional tax deductions for businesses during this time.

Table 22

CALIFORNIA TAXES PAID IN 1985 AND 1991

As a Percentage of Income*



	1985	1991	Change
Lowest 20%	11.8%	14.1%	+20%
Second 20%	8.9%	9.5%	+7%
Middle 20%	8.4%	8.8%	+5%
Fourth 20%	8.5%	8.9%	+5%
Next 15%	9.1%	9.7%	+9%
Next 4%	9.9%	10.7%	+8%
Top 1%	10.5%	10.6%	+1%

*Before federal deductions. Taxes include income, sales, property and other taxes.

Source: Citizens for Tax Justice, Guide to State Tax Reform, April 1991

31. Enhanced Local Control

California has too often witnessed the following scenario: The state raises revenues and transmits them to local governments to spend on specific programs; local governments complain that the revenues are inadequate to fund those programs; the state complains the revenues are being misspent; the public, unable to determine which branch of government is responsible, turns against both.

At the heart of this debate lies an arbitrary and unworkable division of responsibility—between the state's power to tax, and local government's power to spend. Because local governments lack the power to raise revenues for their own projects, taxpayers are left uncertain as to which branch of government should be held responsible for policy successes or failures. More importantly, this division of responsibility is undermining the integrity and responsiveness of local government itself.

In February 1993, the legislative analyst proposed a set of changes to reorder and rationalize the arrangement of state and local powers and responsibilities.[59] The report, *Making Government Make Sense,* described the lack of program accountability and structural cohesion between state revenue sources and local expenditures. The governor has also proposed a variety of restructuring alternatives focused primarily on county and

[59] Elizabeth G. Hill, Legislative Analyst, *The 1993-94 Budget: Perspectives and Issues, Report to the Joint Legislative Budget Committee,* California State Legislature (February 1993).

state government relationships.[60] The interrelationships among cities, counties, schools and special districts, however, have not yet been addressed.

The Commission urges the governor and the legislature to explore further restructuring the powers and responsibilities of state and local governments to realign local governments' responsibilities more closely with their revenue bases. The objectives enumerated by the governor in his recent realignment proposal for state-county restructuring are useful guidelines: fiscal neutrality, promotion of economic development, promotion of local control and responsibility, establishment of fiscal incentives for performance and reduction of bureaucracy and administrative oversight.

F. Conclusion

Long-term solutions to California's budgeting problems will require difficult political decisions. Halfway measures and short-term answers will be insufficient to address the state's serious financial problems. Some reforms will necessitate constitutional amendments enacted by votes of the people.

Controlling California's swelling debt will be painful. Balancing the state budget will require a new sense of fiscal discipline. But both tasks can be accomplished. California's current fiscal difficulties are solvable. Without a thorough revamping of California's antiquated and incoherent budget procedures, however, they may remain beyond effective reach.

California can no longer assume that its fiscal problems will disappear with economic growth. Long-term solutions to its budget problems will require the best thinking of the state's policy makers. Without significant budgetary reform, the necessary decisions may continue to elude their grasp. California cannot make politically and financially difficult budget decisions in a strait jacket of constitutional and statutory constraints, antiquated procedures, inadequate information, insufficient public participation and unrestrained debt. The fundamental elements of the state's budget process must be reshaped to fit California's complex intergovernmental and fiscal relationships in the 1990s and beyond.

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[60] Governor's Budget Proposal, 1994-95.

PART IV

Appendices

APPENDIX A

Summary Checklist: Commission Recommendations for Reform of California's State Budget Process

The following is a Summary Checklist of the Commission's recommendations for reform of California's state budget process. A complete understanding of these summary recommendations requires a careful reading of the full text of this report. The 31 recommendations are presented as an integrated and interrelated package of reforms, not a menu of separate items.

A. California Must Balance Its Budget More Rigorously

1. Balanced Budget

Require all future state budgets—as proposed by the governor, passed by the legislature and signed by the governor—to provide sufficient revenues to cover expected expenditures in the budget year.

2. Off-Budget Loans

Prohibit ñoff-budget" loans for the operating expenses of state programs.

3. Total Cumulated Deficit

Identify the total cumulated deficit in a specially designated part of the budget.

4. Debt Repayment Plan

Adopt a specific plan to repay at least 20% of the accumulated debt in each of the next five years, so that the debt will be fully repaid by no later than December 31, 1999.

5. Short-Term Borrowing

Prohibit short-term borrowing for any purpose other than to meet the state's legitimate cash flow needs and repay such borrowing with revenues in the same fiscal year.

6. Budget Reserve Account

Create a budget reserve account for emergencies or unexpected contingencies, with specific provisions for how it should be funded, maintained, used and replenished.

7. Joint Fiscal Oversight Committee

Create a Joint Fiscal Oversight Committee to monitor the budget's implementation and recommend any changes needed to keep it balanced.

B. The Budget Must Be Honest, Accurate and Comprehensive

8. Tax Breaks

Include ñtax breaksî (sometimes called ñtax expendituresî) in a separate schedule in the governor's budget, identify them as ñtax breaksî and include them in budget deliberations.

9. Special Funds

Restrict the creation of ñspecial funds,î appropriate all special funds through the budget and eliminate continuous appropriations.

10. Periodic Review of Budget Constraints

Create an independent group to review at least once a decade, the cumulative fiscal impact of all constitutional and statutory changes affecting the state budget and recommend necessary changes.

11. Statement of Fiscal Condition

Insert a new ñStatement of Fiscal Conditionî into the first section of the annual Budget Act to include estimated revenues and expenditures; short-term internal and external borrowing, long-term borrowing and associated debt service costs.

12. Capital Investment Budget and Long-Term Spending Plan

Incorporate a capital investment budget and long-term spending plan into the Budget Act, including, for example, a five-year capital outlay plan and a clear statement of state priorities.

13. Three-Year Program Plans

Adopt a three-year approach to fiscal and budgetary planning.

14. Performance Measures

Require the state budget to contain specific measures of program performance and effectiveness.

C. Two-Thirds Vote Requirements Should Be Changed

15. Two-Thirds Vote

Allow the legislature to enact the budget by a simple majority vote, instead of a two-thirds supermajority vote.

16. Trailer Bills

Allow ñtrailer billsî to be enacted by a simple majority vote, but prohibit the use of trailer bills to make permanent changes in law.

17. Line-Item Veto Over Trailer Bills

Allow the governor to veto individual statutory changes in budget ñtrailer bills,î but continue the legislature's power to override such vetoes by a two-thirds vote.

18. Tax Break Vote Requirements

Require all ñtax breaksî to be created, modified or repealed by the same vote requirements.

D. The Budget Must Be Based on Improved Information

19. Comprehensive Information

Describe all current local, state and federal resources in the governor's budget.

20. Standardized Data

Standardize state and local budget information and timetables, and write budget documents in ñplain English.î

21. Shortened Legislative Sessions

Shorten the legislative session by requiring the legislature to adjourn by July of each year.

22. Joint Assembly-Senate Fiscal Subcommittee Hearings

Conduct Joint Assembly-Senate Fiscal Subcommittee hearings on the budget.

23. Final Budget Narrative

Direct the department of finance to issue a final narrative budget report within 90 days after the budget's adoption, summarizing all the actions taken by the governor and legislature on the governor's original budget proposal.

24. Annual Budget Primer for Taxpayers

Direct the legislative analyst to prepare and distribute a short, easy-to-read, annual primer (up to four pages) explaining the state budget to all taxpayers.

E. The Budget Must Give Local Governments Greater Fiscal Independence

25. New Local Budgeting Cycle

Establish a new budgeting cycle for local governments, allowing them to follow the state budget process rather than coincide with it.

26. Local Vote on Property Taxes

Allow local voters to raise their property tax.

27. Majority Vote on Local Bonds

Allow voters to approve local general obligation bond measures by a simple majority vote.

28. State Sales Tax Allocations

Allocate new state sales tax revenues on the basis of population, not ñsitus.î

29. Property Tax Exemptions

Amend the constitution to give counties a greater role in setting property tax exemptions.

30. Overall Tax Code Revisions

Produce a clearer, fairer and more broadly based tax system for local and state governments.

31. Enhanced Local Control

Redesign state and local programs to realign local governments' responsibilities more closely with their revenue bases.

APPENDIX B

Guide of Vote Requirements for Fiscal Matters

	To Enact	To Appropriate	To Modify	To Repeal
Expenditures				
GENERAL FUND PROGRAMS (ENACTED BY THE LEGISLATURE)	• ***2/3rds Vote:*** w/ Appropriation • ***Majority Vote:*** Education Approp. • ***Majority Vote:*** w/out Appropriation	• ***2/3rds Vote***	• ***Majority Vote***: If No Fiscal Impact	• ***Majority Vote:*** In All Cases
SPECIAL FUND PROGRAMS (ENACTED BY THE LEGISLATURE)	• ***2/3rds Vote:*** w/ New General Fund Approp. • ***Majority Vote:*** w/ Creation of New Special Fund With Non-General Fund Revenues (Dedicated Fees/Taxes) • ***Majority Vote:*** w/ Reallocation of Revenues from Existing Special Fund Programs	• ***2/3rds Vote:*** For Funds Covered by the Budget Act • ***Majority Vote:*** For Special Funds Not Containing General Fund Moneys • ***No Vote Requirement for Continuously Appropriated Funds Off-Budget***	• ***Majority Vote***: If No Fiscal Impact	• ***Majority Vote:*** In All Cases
Revenues				
INCOME/SALES TAXES (ENACTED BY THE LEGISLATURE)	• ***2/3rds Vote:*** To Create or Raise Taxes • ***Majority Vote:*** For Tax Exemption	• N/A	• ***2/3rds Vote:*** To Increase Existing Tax • ***Majority Vote:*** To Reduce Existing Tax	• ***Majority Vote:*** To Repeal Existing Tax
Additional Requirements				
Prop. 13 (Prop. Tax)	• ***Majority Vote of the People***	• N/A	• ***Majority Vote of the People***	• ***Majority Vote of the People***
Prop. 98 (Education)	• ***Majority Vote of the People***	• ***2/3rds Vote via Budget Act, However, 40% of All General Fund Revenues Are Dedicated***	• ***2/3rds Vote of the Legislature:*** To Modify Statutory Provisions that "Further Its Purposes" • ***Majority Vote of the People:*** To Modify Constitutional Provisions	• ***Majority Vote of the People***
Prop. 99 (Tobacco Tax)	• ***Majority Vote of the People***	• ***2/3rds Vote via Budget Act. However, Prescribed Amounts Dedicated***	• ***4/5ths Vote of the Legislature:*** To Modify Statutory Provisions that "Further Its Purposes" • ***Majority Vote of the People:*** To Modify Const. Provisions	• ***Majority Vote of the People***
Prop. 4 (Gann Limit)	• ***Majority Vote of the People***	• N/A	• ***Majority Vote of the People***	• ***Majority Vote of the People***

Prop. 111 (Gann Adjustment)	• ***Majority Vote of the People***	• ***Continuously Appropriated Off-Budget***	• ***Majority Vote of the People***	• ***Majority Vote of the People***
Prop. 72 (Dedicate Taxes to Trans.)	• ***Majority Vote of the People***	• ***Continuously Appropriated Off-Budget***	• ***Majority Vote of the People***	• ***Majority Vote of the People***
Prop. 74 (Trans. Bond Act)	• ***Majority Vote of the People***	• ***Continuously Appropriated Off-Budget***	• ***Majority Vote of the People***	• ***Majority Vote of the People***

APPENDIX C

Vote Requirements for States with Supermajority Budget Bill Procedures

Most states enact their budgets by simple legislative majorities. The following states, however, require various supermajority votes to enact an annual budget.

	Votes Required to Pass Revenue Increase	Votes Required to Pass Budget Bill
Arkansas	3/4 elected[1] (art. 16, §5)	Majority elected
California	2/3 elected (art. XIIIA, §3)	Mandatory 2/3 elected[2]
Delaware	3/5 elected (art. VIII, §10)	Majority elected
Hawaii	Majority elected	Majority elected[3]
Illinois	Majority elected	Majority elected[4]
Louisiana	2/3 elected (art. 7, §2)	Majority elected
Maine	Majority elected	Majority elected[5]
Massachusetts	Majority present	Majority present[6]
Mississippi	3/5 present (art. IV, §70)	Majority elected[7]
Nebraska	2/3 elected (art. III, §22)	Routinely 2/3 elected[8]
North Dakota	Majority present	Majority present[9]
Oklahoma	3/4 elected (art. V, §33(d))	Majority present[10]
South Dakota	2/3 elected[11] (art. XII, §2)	Majority elected

1 Sales tax can be raised by a simple majority.

2 California is the only state in which a supermajority vote for budget approval is constitutionally required under all circumstances. Cal. Const., art. IV, ?12.

3 If the general fund expenditure ceiling is exceeded, a two-thirds vote is required for budget approval.

4 A simple majority passes the budget bill in Illinois, unless the budget bill is not approved by the statutory deadline of June 30. Then, as an emergency measure, a three-fifths vote is required. Consequently, the legislature strives to pass the budget bill on time.

5 For emergency enactment, a two-thirds vote is required. Usually, Maine’s budget bill is approved without an emergency clause.

6 For capital budget, a two-thirds vote is required.

7 Appropriations bills require a simple majority vote for passage by the legislature (art. IV, ?64). However, the budget process in Mississippi tends to emphasize separate revenue bills, which require a three-fifths vote, rather than an omnibus budget bill.

8 While a simple majority vote is sufficient to pass the governor’s proposed budget bill in Nebraska, a three-fifths majority vote is required if the legislature exceeds the appropriations recommended by the governor’s fiscal planning team (art. IV, ?7). If budget approval is delayed, a two-thirds vote of the legislature is required for passage as an emergency bill. Routinely, the budget bill in Nebraska requires an emergency clause.

9 For emergency enactment, a two-thirds vote is required. Emergency clauses for the budget bill are invoked only occasionally.

10 Emergency clauses require a two-thirds vote for enactment. Emergency clauses for the budget bill are invoked only occasionally.

11 In South Dakota, two-thirds of both houses must approve any special appropriations bill, which is defined as any revenue and/or appropriations measure which falls outside the realm of the ñgeneral appropriations billî (i.e., budget bill).

The California Citizens Budget Commission has issued these findings and recommendations on a preliminary basis—to solicit comments and spark discussions leading toward needed reform of the state's budgeting process.

The Commission welcomes comments on these preliminary findings and recommendations. It will release its final revised report later this year.

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