CITIZENS'
Budget
2003–05

A 10-Point Plan to Balance the California Budget and Protect Quality-of-Life Priorities

Reason

The Performance Institute

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Part 9

Adopt a Biennial Budget and Limit Constitutional Revenue and Spending

"The total annual appropriations subject to limitation of the State and of each local government shall not exceed the appropriations limit of the entity of government for the prior year adjusted for the change in the cost of living and the change in population, except as otherwise provided in this article."

– California Constitution, Article XIII-B, "Government Spending Limitation," Sec. 1.

Summary of Citizen Budget Recommendations in This Section:
1. Adopt a **Biennial Budget** (2-Year Budget) where state budget is approved in year one and oversight of state government occurs in year two.
2. Adopt a **Constitutional Revenue Limit (Taxpayer Bill of Rights)** that holds increases in state revenue growth to population and inflation increases.
3. Restore a **Modified Gann Spending Limit** that allows for carry-over reserve.
4. Adopt a **Balanced Budget Trigger** that automatically makes proportional spending reductions to discretionary programs should revenue forecasts not match actual revenue collections.

In Governor Davis's 2003 State of the State Address, he stated that he would not entertain any budget that does not contain "substantial structural reform." Unfortunately, other than calling for reform, the Governor did little to propose specific steps the state could take to prevent this crisis from happening again.

As a result, the first step in addressing the state's short-term and Long-term spending challenges is to enact a biennial budget and create real Constitutional revenue and spending limits. Both of these reforms

California Budget FACTS:



$87 Billion

Reserve Surplus today had California adopted Gann-like spending limit with Spending Ratchet method

$93.9 Billion

Surplus today had California adopted 10-year moving average Revenue-based limit with Growth Freeze method

$151.4 Billion

Surplus today had California adopted population plus California CPI (inflation) spending limit with Growth Freeze method

$166.4 Billion

Surplus today had California adopted population plus California CPI spending limit with Spending Ratchet method

enacted together can provide much-needed discipline to ensure California does not find itself victim to the same scenario of inflated revenue forecasts and over-spending. Moreover, it provides an impetus for the legislature to improve its oversight of state government, while limiting the growth of government.

Moving to a Biennial Budget

Biennial budgeting is the adoption of a two-year budget rather than a one-year budget. Currently, 23 states already have a biennial budget cycle, and one more is considering it.[141] Given the complexity of the federal government's budget process, there have been numerous suggestions over the years that the federal government move to a biennial budget.

The U.S. General Accounting Office surveyed of a number of states to discover the benefits and problems of switching budget cycles. According to the survey, switching from an annual cycle to a biennial cycle afforded states the following benefits:

- More time is available in the off-year for review of program issues through effective legislative oversight; and
- Biennial budgeting requires departments and programs to consider the long-range implications of their budget requests and their program operations.[142]

Opponents of biennial budgeting note that it is sometimes hard to forecast revenues for one year, let alone doing it for two years. While biennial budget spending and revenue forecasts are necessarily less reliable for the second year of the budget cycle, off-year corrections can be made easily. In addition, should the state follow the next recommendation and adopt a revenue limit, the need for 100 percent precision in revenue forecasts will not be as great. In the end, expanding the time horizon of the budget cycle forces legislators to place greater emphasis on planning and performance evaluation, leading to more sound budget priorities and financial management.

For the short term, adopting a biennial budget allows for California to address today's fiscal crisis in a way that requires less drastic cuts. Indeed, a biennial budget for the next two years would allow time for cost savings measures to be implemented as well as provide time for the economy to recover—resulting in greater revenues.

Adopting Real Constitutional Revenue and Spending Limits

Many states have attempted to curtail spending (or, more accurately, spending *growth*) with mixed success. In fact, 45 states currently maintain some sort of spending limit, combined with rainy day funds. The effectiveness of the spending restraints and the size of the rainy day funds vary greatly, however.[143]

In fact, California has a rich history of its own in reining in tax rates and state spending. In 1978, Californians passed Proposition 13. The measure amended the state's constitution to cap property taxes at 1 percent of fair market value and prohibit valuations from growing more than 2 percent per annum unless the property was sold, effectively reducing property taxes by 57 percent. Proposition 13 did not affect the state's power to spend, however, and the government's response was predictable: raise taxes from other sources. According to Michael New of the Cato Institute, "in the years following the passage of Proposition 13, California raised the income tax, the sales tax, and taxes on beer, wine, and cigarettes."[144]

Californians followed up Proposition 13 with Proposition 4 in 1979. Proposition 4, commonly known as the Gann limit, established a state appropriations limit (SAL) that grows each year based on population and cost-of-living factors. Any tax proceeds that exceed the SAL limit over a two-year period are to be refunded to taxpayers in the form of tax rebates.[145]

Unfortunately, in 1990, the Gann limit was effectively gutted with the passage of Proposition 111. Proposition 111 altered how the Gann limit is calculated, adding K-12 public school enrollment rates in the population formula to correct a school funding inequity. Locals were provided the option of using California per capita personal income growth or the percentage of local assessed value attributable to non-residential new construction. It based cost-of-living adjustments solely on per capita income growth to recognize state economic growth and directed half of the excess revenues to be returned to taxpayers and half to go to schools. It also exempted certain state expenditures from the limit such as responding to natural disasters, "qualified" capital outlay projects (defined by the legislature) and projects funded by the gas tax and other fees. Finally, it declared the Gann limit refund would be triggered only if tax proceeds are in excess in two consecutive fiscal years.[146]

In addition, since the SAL has grown each year, even as the economic downturn has caused tax revenues and state spending to fall, the limit is presently so high that it is nowhere near binding on the state. The Legislative Analyst's Office reports that appropriations subject to the SAL will fall $14.5 billion short of the limit in FY 2001-02 and $6.3 billion below the limit in FY 2002-03.[147] In fact, the SAL has only resulted in one tax rebate, when tax revenues surged roughly 20 percent in 1987, resulting in $1.1 billion in rebates. The last time the limit was exceeded was FY 1999-00, by $702 million, although state appropriations fell well below the limit the following year and thus did not trigger a rebate due to the two-year surplus requirement.



"It's very reasonable to think that population increase and inflation should be your basis for increasing the budget. And during boom years, obviously you are going to have a surplus, (and) that surplus should not be touched, but should be put aside for rainy days."

– Esmael Adibi, author of Chapman University's semiannual economic forecast

An Alternate Solution: Colorado's Taxpayer Bill of Rights (The TABOR Model)

One of the most successful checks on government spending has been the Taxpayer Bill of Rights (TABOR), adopted by Colorado taxpayers in 1992. Although TABOR is often referred to as a spending limit, it is actually a limit on the *revenues* the state may collect, and thus serves as a *de facto* spending limit. (Although, given recent spending behavior by those in Sacramento, almost anything is possible in California!)

What It is and How It Works

TABOR caps the growth in state tax revenues at the combined growth rates of inflation and population. Any amount collected above this limit must be returned to the taxpayers through refunds, temporary tax credits, or any other "reasonable means." The state exceeded the revenue limit for the first time in FY 1997-98, and has exceeded it every year thereafter. Since 1997, Colorado has reduced taxes more

than any other state in the nation, returning over $3.2 billion to taxpayers.[148] While other states have been grappling with their financial woes, Colorado enjoyed a balanced budget and still managed to issue $927 million in tax refunds in fiscal 2001.

Increases above the tax revenue limit may only be obtained by approval of the voters in a referendum, giving the system a degree of flexibility. Since TABOR's inception, several such referenda have been offered to the voters. The only ones to pass thus far are Amendment 23, which allows for over $300 million per year to be exempted from the limit for increased public school funding, and Referendum A, which directed $44 million from the TABOR surplus toward property tax relief for qualified seniors. Both measures passed in the 2000 election.

In addition to the TABOR revenue limit, Colorado does have a spending limit as well. The Arveschoug-Bird limit, put in place in 1991, restricts General Fund appropriations growth to 6 percent per annum. Exceptions are made for federal mandates, court orders, Medicaid over-expenditures, and transfers to the state's Capital Construction Fund. According to State Treasurer Mike Coffman, "if the state collects tax revenues that exceed the Arveschoug-Bird limit but that are less than the total TABOR revenue limit … that money is normally spent on transportation and capital construction projects."[149]

Although the "6 percent limit" was merely a statute, a specific provision of TABOR prohibits the state (and local governments) from weakening any spending limitations that existed at the time of TABOR's inception, including Arveschoug-Bird. Thus, the 6 percent limit has become "constitutionalized."

Benefits of TABOR

There can be no denying the success of TABOR and its impact on the Colorado economy. In the words of University of Colorado economics professor Dr. Barry Poulson, "Colorado has achieved unprecedented growth over the past decade due to a favorable business climate."[150] By helping to keeping tax rates low and stable, TABOR has allowed taxpayers and business owners to invest more of their earnings into the economy, spurring further growth. Colorado's favorable business climate and economic growth are evidenced by the following:

- Colorado's 60 percent growth in per capita disposable income growth during the 1990s ranked first among all states.[151]
- During this period, Colorado's population grew an average of 2.3 percent per year—the third highest growth rate in the nation. The number of full-time jobs increased 43 percent, from 1,655,000 jobs in 1990 to 2,363,000 jobs in 2000. What is more, most of the jobs created during the economic expansion were not for low-skilled work, but rather for relatively high-paying positions.[152]
- Between 1995 and 2000, Colorado's 51 percent growth in gross state product was the second fastest in the nation.[153]

In addition, TABOR has made the budgeting process more transparent. This has allowed taxpayers to become more informed and have a stronger and more direct say as to what their tax dollars are buying. If taxpayers feel legislators are not adequately funding the programs that truly need funding, they can agree to set aside a special allotment for that purpose through the referendum process.
Since under the TABOR system, any funds for such a program will be taken from revenues collected over the limit—revenues that would otherwise be returned to the taxpayers—taxpayers can make the funding priority decisions that legislators are unable, or unwilling, to make. The crucial point is that, under TABOR,

excess tax collections are rightly recognized as property of the taxpayers, not the legislators. This implies that, when deciding whether or not spending (and thus, taxes) should be increased to pay for programs not covered under the TABOR limits, Colorado taxpayers can more easily factor in the costs of programs, and not simply focus on the benefits heralded by legislators or special interest groups, since the money to pay for such programs will be coming from their own tax refunds. Without such a check on the power of the purse, taxpayers might just as well kiss their tax dollars goodbye, knowing that they will all be spent, regardless of whether or not the state collected too much money in the first place.

In case the above benefits are not evidence enough of TABOR's success, its growing reputation as a model for other states should serve as proof. If, indeed, "imitation is the sincerest flattery," then TABOR has much to be proud of. Last year, State Representative Russell Pearce introduced a TABOR proposal for Arizona and Senator Curtis Person of Tennessee announced plans to sponsor a Tennessee Taxpayer Bill of Rights (TN TABOR), both built on the Colorado model.

Some Refinements Are Necessary

Despite its many attractive features, however, TABOR is not flawless. The main drawback is that Colorado lacks an effective "rainy-day fund" to resort to in times of economic hardship. While the state does maintain very limited emergency reserve funds, "it does not currently have a device in place to smooth government revenues and expenditures over the business cycle," according to Professor Poulson.[154] This is not so much a criticism of TABOR itself as it is the tax collection system as a whole, but it nonetheless deserves comment.

TABOR may be able to limit the amount that the state can collect, and thus spend, but it cannot prevent legislators from spending the maximum amount of tax dollars from the General Fund and dipping into reserves not subject to the TABOR limit. Thus, while the pot may be smaller to begin with, lack of fiscal discipline will still cause it to be depleted, leaving little or nothing in reserve for use in the event of an emergency. Indeed, this has proven to be the case in Colorado. In the words of State Treasurer Mike Coffman, "The problem is a legislature that spends to its legal limits in good times and is reluctant to set aside any of that money for the tough ones. What we need to do is ensure a balance that restrains government growth in prosperous times and permits the state to meet the needs of its citizens when times get tough."[155] To that end, Coffman has proposed the creation of a rainy-day fund.

In addition to the lack of a rainy-day fund, TABOR has been weakened by the practice of pre-spending the surplus. In 1998, legislation passed that allowed the state to recognize the TABOR surplus obligation in the year after the money is realized instead of in the year in which revenue comes in the door. Thus, the surplus is treated as an asset in the year it occurs and a liability the subsequent year. According to the Colorado Office of State Planning and Budgeting:

> *Beginning in 1998, the state did not restrict the TABOR surplus revenue in the year it occurred. Rather the legislature, through House Bill 98-1414, obligated the TABOR refund from the next year's revenues. This pre-spending of the TABOR revenues in FY 1998-99 allowed $468.3 million in spending for capital construction and highways. If the TABOR surplus had been restricted in the year it was realized, only $287 million would have been available for capital and highway expenditures in FY 1998-99.*[156]

This raises a potential cash flow problem if the TABOR surplus is less than that of the preceding year or if an economic downturn causes revenues to come in under projections. In addition, permanent tax relief in the full amount of the surplus is now much more difficult, as the prior year's TABOR surplus must be incurred in the current year. If a similar measure is to be employed in California, efforts must be made to avoid these dilutive effects and the accounting gimmicks that the legislature is so adept at using.

Alternate Models to TABOR

The TABOR model is certainly not the only means of addressing California's spending problem. Several types of spending limits have been proposed. Some of the most common include the following:

- **Gann-like.** Modeled after California's Gann limit, this measure would establish a spending limit equal to the combined growth in population and per capita personal income.
- **Revenue-based.** This method would prohibit spending from increasing more than the 10-year moving average increase in revenues, thus preventing spending splurges during short-term economic booms.
- **ACA 6.** This approach would limit spending increases to the growth in population plus the growth in the California Consumer Price Index (inflation). This proposal is similar to the Colorado TABOR model, but focuses on the spending side of the equation instead of the revenue side.

A recent analysis modeled how the above spending limits would have affected the state's fiscal situation, had they gone into effect in FY 1990-91, using historical data and Governor's Budget spending and revenue numbers.[157] Table 11 illustrates both General Fund and total budget spending, and denotes the cumulative deposits made into the rainy-day fund for each alternative. In addition, each option was analyzed using three different methods of spending limit implementation:

- **Continuous Accrual.** This approach allows spending limits to grow each year, even when actual spending falls below the limit.
- **Spending Ratchet.** This technique focuses on actual spending instead of prior spending limits by re-setting the base year at the previous year's spending level. Thus, spending limits can be reduced and, once reduced, must grow from the lower base level.
- **Growth Freeze.** This method is a combination of the two previous methods. It allows the spending limit to grow when actual spending for the previous year is restrained by the limit, but freezes the limit at the previous year's level during years in which spending falls short of the limit.

The analysis concluded that, had the above plans been put into effect beginning in FY 1990-91, all of them except for the revenue-based continuous accrual option would have resulted in significant rainy-day fund balances.[158] Moreover, these rainy-day funds would have been more than enough to balance the budget today *without tax increases or spending cuts*.

The analysis also noted that if the spending limits were allowed to accrue continuously, each would have resulted in significantly higher spending limits for 2003-04 than those proposed by the Governor's Budget, both for general funds and total funds. The spending ratchet and growth freeze methods would have resulted in much lower spending limits than proposed by the Governor's Budget. For all three methods, the revenue-based formula would have produced the highest spending limit and the ACA 6 option the lowest.[159]

Structuring California's Revenue and Spending Limits

While almost any serious revenue and spending limit would be helpful, the Citizens' Budget Plan proposes California adopt the following:

- **TABOR Revenue Limit:** California desperately needs a revenue-limit to serve as a de-facto discipline on spending, as well as on taxes.
- **Tax Rebate/Revenue Reserve Fund**: Critics of TABOR point out that should the state spend exactly to the revenue limit each year, it might be possible that a year of falling revenue would produce a deficit. As a result, we propose to modify TABOR to keep a running balance of up to 30 percent of the revenue over-collection accumulated during the previous five-year cycle. As a result, a maximum of 70 percent of over-collected revenues could be automatically rebated to the taxpayer, while provisions would be made for the retention of over-collections to meet the 30 percent reserve.
- **Restore Gann Limit, with Spending Ratchet**: California should restore its Gann spending limit and adopt the spending ratchet formula for setting the spending limit each year. While it is unlikely that Sacramento will resist spending right up to the Gann limit, a restored Gann limit along with the revenue limit outlined above will impose the right mix of restraint on Sacramento's ability to overspend.
- **"Balanced Budget Trigger":** California should adopt an Automatic Spending Reconciliation in Biennial Year Two—thus providing another way to correct for any intentional or accidental inflation of revenues. The "trigger" would adjust discretionary spending levels to achieve a balanced budget based on a program's proportion in the budget. This would make balancing the budget automatic and shield politicians from making the hard votes of reducing spending on popular programs. Now, should the legislature actually want to craft its own package of reductions and take a formal vote, it certainly could. However, to ensure gridlock doesn't prevent the balancing of the budget, an automatic "trigger" would be necessary.

Table 11: Comparison of Three Options for Spending Limits ($ in Millions)

	Continuous Accrual		Growth Freeze		Spending Ratchet	
	General Fund $	Total $	General Fund $	Total $	General Fund $	Total $
Option 1, Gann-like (Population and Per Capita Personal Income)						
▪ Spending	71,874	91,834	66,851	86,186	63,882	87,044
▪ Rainy-day Fund	11,242	59,682	57,148	109,011	83,906	98,968
Option 2, Revenue-based (10-year Moving Average Revenue Increase)						
▪ Spending	82,399	113,230	67,891	91,061	66,105	93,552
▪ Rainy-day Fund	(57,911)	(92,770)	64,857	93,899	85,372	76,398
Option 3, ACA 4 (Population and California CPI)						
▪ Spending	67,698	86,499	60,404	80,142	57,409	78,224
▪ Rainy-day Fund	38,911	92,036	108,842	151,421	134,395	166,433
For Comparison, the Governor's Budget Proposes:						
▪ General Fund Spending	$62,769 million					
▪ General Fund Reserve	$531 million					
▪ Total State Spending	$96,437 million					

Source: California State Senate Republican Caucus, "Options for Spending Limits and Rainy-Day Funds," January 15, 2003.