



FINANCING THE FUTURE: How will California pay for tomorrow?

CHAPTER 1:

What about Prop 30?

FINANCING THE FUTURE

California is at a crossroads. Changes and challenges—in community demographics, environmental conditions and regional economies—require smart and innovative approaches to achieve sustainable growth.

CA Fwd, in partnership with the California Economic Summit, is encouraging a statewide conversation about where to make these investments and how to pay for them—two elements of the Summit's **Roadmap to Shared Prosperity**.

This is the first in a series of reports exploring the state's choices. The first chapter focuses on Proposition 30, the temporary taxes approved by voters in 2012. In the next two chapters, CA Fwd will examine where and how additional investment could be made—and the options for making California's revenue system stable, adequate, and equitable.

Prepared by California Forward
for consideration by the
California Economic Summit



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HOW WILL CALIFORNIA PAY FOR TOMORROW?

→ CALIFORNIA—AND ITS TAX SYSTEM—ARE AT A CROSSROADS.

After more than a decade of red ink, the state's annual operating budget is finally in balance. With thoughtful fiscal discipline, state policymakers are paying down the "Wall of Debt." A strong economy is employing more Californians and generating more revenue, especially from the temporary taxes created by Proposition 30. Roughly \$8 billion of the \$113 billion in state General Fund revenue is attributable to the measure's sales and income tax increases—funds that have bolstered reserves, paid down debts, and supported education and social services following the severe cuts during the Great Recession.

But the bloom may soon be off this rosy scenario.

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While the recovery is expanding, it also is growing old. And while Prop 30 has provided significant benefits, its higher tax rates will begin to phase out in 2016.

At the same time this revenue source is expiring, a diverse chorus of leaders is pointing to the need for more strategic investments in education and infrastructure to increase economic opportunity for young Californians and to support more efficient and environmentally sustainable growth.

In 2015, elected officials, stakeholders and civic leaders have a political window to determine what to do next—and how to balance the need for a stable revenue system with the equally important need to equitably distribute the tax burden.

One option is to extend the higher tax rates in Prop 30, but policymakers eager to provide adequate and reliable funding for essential state investments may need to consider a mix of revenue sources.

This is because many fiscal analysts believe a tax structure focused on high income-earners is inherently unstable—a troublesome feature of the State's revenue system that has been amplified by Prop 30's taxes on the wealthiest Californians. The State has taken steps to deal with volatility by capturing a portion of revenues before they are spent on ongoing programs. In November 2014, voters approved a more robust rainy day fund in Proposition 2, which captures "spikes" in revenue from a surging economy and smooths out the "boom and bust" budgeting of the past.



But even with this new fiscal backstop, essential public programs would benefit from a tax system that produces more stable revenues—funds that grow with the broader economy and are more resilient in economic downturns. To maintain the system's progressivity, policymakers also may need to consider revenue sources outside the state General Fund, including options that link revenue to specific investments, regional economies, or community-level governments.

This is the task—and the opportunity—facing state leaders, who will have to assess these ideas, weigh them against economic, political and social considerations, and identify the best possible and politically viable solution.

ENCOURAGING A THOUGHTFUL DIALOGUE ON REVENUE



→ TAXES ARE THE NEXT TEST OF CALIFORNIA'S NEW POLITICS.

Taxes are inherently controversial. But California's policymakers in 2014 demonstrated an increasing capacity to deal with politically difficult fiscal and policy issues. In addition to the budget reserve created by Prop 2, lawmakers reached bipartisan—and nearly unanimous—agreement on a more disciplined \$7.5 billion water bond, which also was endorsed by voters in November.

While consensus on a tax and investment strategy may be more difficult to achieve, California's elected officials, as well as the leaders of major interest groups, should be encouraged to have a fact-based and thoughtful public discussion on the level of resources that will be needed to pay for California's future.

CA Fwd, in consultation with the California Economic Summit, strives to inform and catalyze this conversation—encouraging a dialogue about what investments will be needed to prepare the next generation of Californians to contribute to a dynamic economy, while building the water systems, transportation networks and educational facilities to support a growing population in a time of climate change.

California is on the policy frontier on many of these challenges. But to achieve lasting prosperity, the state's tax structure must provide adequate and stable revenue under changing and uncertain conditions. CA Fwd, while not proposing a particular solution, believes the best possible answer will emerge and gain support if public and private sector leaders have a common understanding of the needs, the options and the benefits of strategic investments.

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To begin this conversation, this paper summarizes Prop 30's impact on revenues and expenditures. It also describes how the higher tax rates can be expected to perform in the future, in a growing economy as well as a recession.

PROP 30: IMPACT ON REVENUES

- ➔ Powered by a growing economy and growing personal income, Prop 30 has had a substantial and positive impact on state revenues. With higher tax rates on the state's highest income earners, the measure also has contributed to the state's shift over the last 30 years toward a more progressive income tax.

By raising rates on the wealthiest Californians, Prop 30 also contributed to revenue volatility—putting more weight at the end of a revenue system increasingly dependent on the highest income-earners (*Figure 1*). In the 2012 tax year, for example, the 4 percent of California taxpayers affected by Prop 30 were responsible for 34 percent of the state's \$1.104 trillion in adjusted gross income—or just over \$370 billion. In the year prior to the passage of Prop 30, this group of taxpayers paid 50 percent of state income tax. In the first year of Prop 30, their contribution jumped to 60 percent.

In some ways, the timing of Prop 30 could not have been better. The Prop 30 income tax rates will be in effect for seven years. They began boosting revenues in 2012 just as the economic recovery picked up steam and are likely to generate healthy revenue before they expire in 2018. The measure's quarter-cent sales rate has performed similarly ahead of its expiration in 2016.

With the slow economic recovery gaining steam just as these two rates went into effect, Prop 30 has provided an annual boost to the state budget of over \$7 billion. This revenue growth can be seen in *Figure 2*.

During this period, all of the state's major sources of revenue have been growing, as well—including corporate, sales, and personal income taxes. *Figure 3* shows the impact of the Great Recession and the recovery on the state's revenues. Prop 30 has reinforced revenue gains associated with the improving economy, showing an overall revenue gain of about 26 percent from 2011 to 2014.

Figure 1

WHO PAYS MORE INCOME TAX UNDER PROP 30?

(Current marginal tax rate is 9.3 percent)

SINGLE FILERS	JOINT FILERS	ADD'L TAX RATE
\$250k-300k	\$500k-600k	1%
\$300k-500k	\$600k-1,000k	2%
>\$500k	>\$1,000k	3%

Data source: Department of Finance

Figure 2

HOW MUCH HAS PROP 30 RAISED?

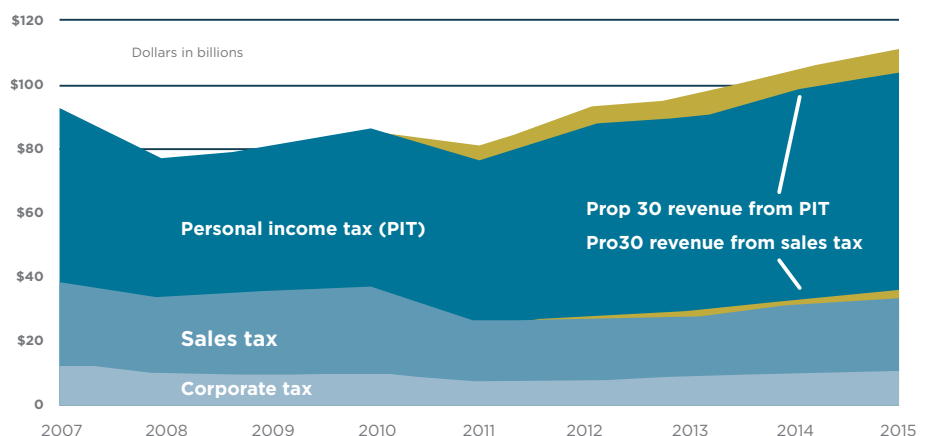
(Revenue estimates from 2015-16, in millions)

FISCAL YEAR	SALES TAX	INCOME TAX	TOTAL
2011/12	\$0	\$3,356	\$3,356
2012/13	\$640	\$5,417	\$6,058
2013/14	\$1,371	\$6,025	\$7,396
2014/15	\$1,409	\$6,458	\$7,867
2015/16	\$1,529	\$6,489	\$8,018
2016/17	\$804	\$6,765	\$7,569
2017/18	\$0	\$7,132	\$7,132
2018/19	\$0	\$2,912	\$2,912
2019/20	\$0	\$0	\$0

Data source: Department of Finance

Figure 3

HOW PROP 30 HAS AFFECTED MAJOR GENERAL FUND REVENUE



Data source: Legislative Analyst's Office

PROP 30: IMPACT ON EXPENDITURES

➔ Prop 30 eased fiscal pressures after the Great Recession and allowed the state to boost educational spending and reduce the Wall of Debt.

Even though the economy was recovering prior to Prop 30, General Fund revenues were not growing fast enough to meet the growing demands and costs of programs. Nor were they helping the state adequately reduce the enormous budget-related debt—let alone restore some of the most painful program cuts, particularly in education.

Prop 30 led to increases in K-14 education funding, more debt payments, and has freed up funds for health and human services.

Prop 30 changed that, and the benefits were immediate. Between 2011 and 2012, revenues grew by \$12.7 billion—about \$6 billion of which was attributable to Prop 30. As shown in *Figure 4*, this has allowed overall expenditures to surpass their pre-recession levels.

K-12 education, in particular, has seen a dramatic increase in support from the General Fund, with school funding climbing from \$34.6 billion in 2011 to \$42 billion in 2012. This increase translates to roughly \$1,000 more spending per student.

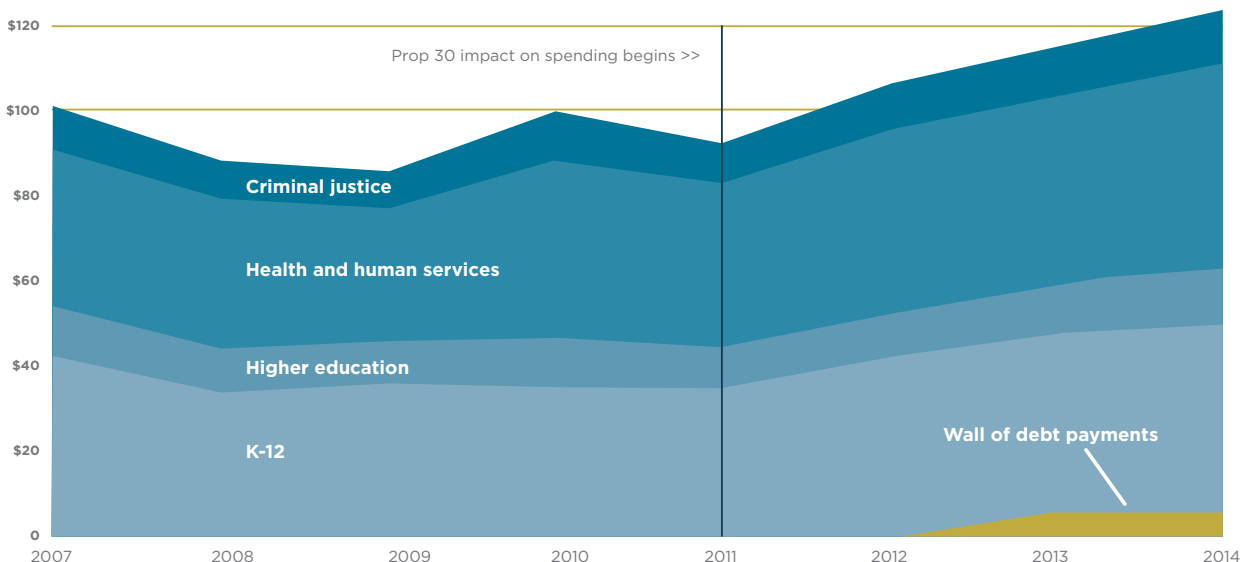
California's community colleges also benefited from Prop 30. According to the State Controller, higher income and sales taxes were responsible for roughly 11 percent of the system's total revenue of \$7.1 billion in 2012—or about \$770 million.

While K-14 education received the largest share of the additional revenue, other programs benefited, as well. Health and human services spending, for example, has benefited from resources freed up by Prop 30 revenues.

Figure 4

MAJOR STATE SPENDING DURING THE RECOVERY

(General and special funds, in billions)



Data source: Legislative Analyst's Office

PROP 30: IN THE FUTURE



➡ In determining whether to extend Prop 30's higher rates—or allow them to expire—it is worth considering how these revenue streams will perform in the future. Prop 30's impacts on General Fund revenue during an economic recovery are becoming clear. But how will these same tax rates support state services during a recession?

According to CA Fwd analysis, Prop 30 has effectively boosted the state General Fund by capturing revenues created by the most dynamic parts of California's recovery. For the same reason, however, these same taxes are likely to stumble when the economy slows again. (In recent recessions, income tax revenues from the wealthiest Californians declined by 50 percent.) The new budget reserve created by Proposition 2 will cushion some of the

budget volatility by setting aside resources that are usually available for expenditure. Still, the same tax rates that produce \$6 billion in personal income taxes in good times may produce less than half of that amount in a recession—which could lead to budget cuts and fiscal uncertainty.

If the goal is to craft a revenue stream that increases reliability in good times and bad, it may be worth considering revenue options beyond Prop 30.

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PROP 30: PROJECTED PERFORMANCE

→ SUMMARY OF PROP 30 IMPACTS IN DIFFERENT ECONOMIC CONDITIONS

IF THE ECONOMY IS GROWING AND:	PROP 30 EXPIRES	PROP 30 IS EXTENDED
	<p>As the Prop 30 rates expire, the Governor and Legislature could fill a portion of the gap with a combination of revenue from a still-growing economy and several billion dollars per year that is currently being allocated to pay off the Wall of Debt. Under the Administration's 2015 forecast, most of the Wall of Debt will be paid off in 2018, freeing up these funds for other purposes. Many of these resources would go to maintaining health and social services spending, while a significant share of the growth in the K-14 guarantee could come from the property tax. The budget reserve would grow more slowly.</p>	<p>Higher income taxes on wealthy Californians during a strong economy would dramatically increase resources for education and health and human services, especially after the Wall of Debt is paid down. Prop 98 would guarantee a portion of this growth for schools, although growth in the property tax may reduce the amount of General Fund growth that is applied to the guarantee (<i>Figure 5</i>). The budget reserve also would grow significantly.</p>
IF THE ECONOMY IS DECLINING AND:	PROP 30 EXPIRES	PROP 30 IS EXTENDED
	<p>Most state-supported services would be negatively impacted by the fiscal pressures of a recession. The budget reserve would be used to backfill a portion of the lost revenue. If the Wall of Debt has been eliminated, the State would also have more flexibility to sustain funding for high-priority programs since each dollar previously allocated to debt reduction would be available for education and other services.</p>	<p>Because of California's dependence on high-income earners—who pay fewer taxes during recessions—Prop 30 would produce fewer funds during a downturn. The upper-income tax rates that produce \$6 billion in good times may only yield half that much in a recession. This could limit the benefit of extending Prop 30 in a declining economy.</p>

PROP 30: IN A GROWING ECONOMY

➔ Projections show steady growth in California's economy through the end of the decade, and both the 2014 Fiscal Outlook from the Legislative Analyst's Office (LAO) and the Department of Finance's 2015 forecast estimate annual growth in personal income of over 4 percent through 2018.

Even without Prop 30's high rates, this will cause most of state's overall revenue growth to come from the income tax (already a source of 66 percent of the State's General Fund revenue).

Given these assumptions about economic growth, how would decisions about Prop 30 impact the State's fiscal condition?

WHAT HAPPENS IF PROP 30 TAX RATES ARE ALLOWED TO EXPIRE?

The Brown Administration 5-year budget forecast projects that a growing economy will help the State maintain a positive fiscal balance until late in the decade even with the phase out of Prop 30. The absence of Prop 30 will reduce revenues by \$7 billion every year. Nevertheless, the Administration estimates that with growing income tax revenue and lower debt payments, more money will be available to General Fund programs.

These increases are not expected to be large enough to allow for significant program expansion or payments toward pension and other post-employment benefit obligations. But as the Wall of Debt is paid off, funding would likely be maintained, if not dramatically increased, on the non-Prop 98 side of the budget—health and social services programs, as well as higher education.

It is difficult to make blanket generalizations about how changes to Prop 30 will affect school funding, since the Prop 98 minimum guarantee calculation changes based on various fiscal and demographic inputs. Increases in revenue often do not increase the Prop 98 guarantee, while decreases in revenue usually reduce the guarantee.

Depending on the situation, the state General Fund share of the guarantee may remain flat—with or without the expiration of Prop 30. Since the school funding guarantee is supported by a combination of local property taxes and the General Fund, when property tax revenues grow, the State's share of the funding guarantee is usually offset by an equal amount of property tax. *Figure 5* highlights how this would lead to continued—but only incremental—increases in school funding.

WHAT HAPPENS IF PROP 30 TAX RATES ARE EXTENDED?

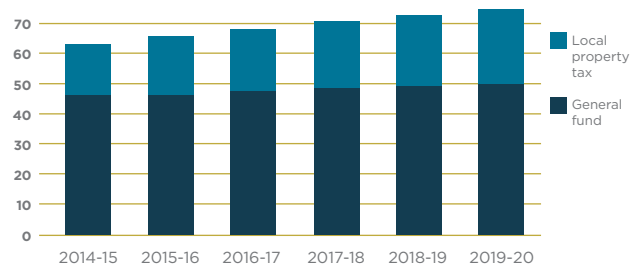
Extending the Prop 30 tax rates in a growing economy will provide substantially more resources to the state budget—especially if the State has paid off the Wall of Debt. With the higher income and sales contributing over \$7 billion annually, and with budgetary debt paid off, the state would have additional resources for budgetary purposes.

Depending on how the underlying guarantee is calculated, revenue from the extension of Prop 30 could increase the size of the Prop 98 guarantee. Because of the complexities of how the K-14 guarantee is funded, though, rising property tax revenue may also offset much of the General Fund share of increased school funding, even with more Prop 30 revenue. Prop 30 dollars, meanwhile, would be available to be used to support higher education, criminal justice, and health and social services.

A growing economy also would lead to more transfers to the Budget Stabilization Account.

Figure 5

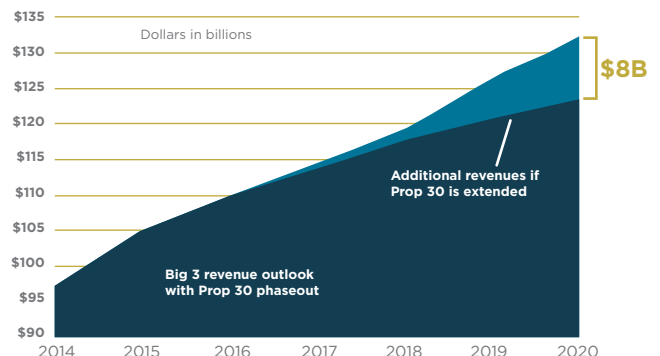
FORECAST OF REVENUE SOURCES SUPPORTING PROP 98



Data Source: California State University Fullerton Center for Demographic Research

Figure 6

HOW PROP 30 WOULD PERFORM IN GROWING ECONOMY



Data source: Legislative Analyst's Office

PROP 30: IN A DECLINING ECONOMY

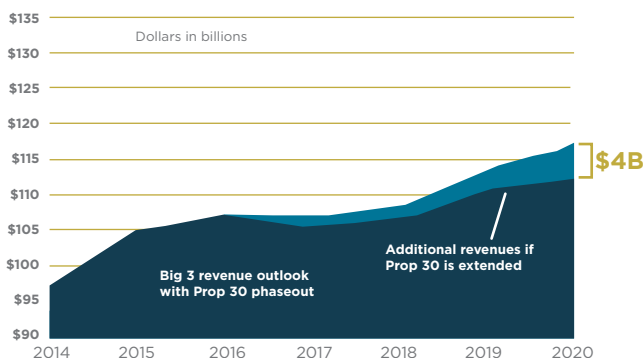
➔ Though the LAO and the Brown Administration are not forecasting an economic slowdown, a recession is inevitable. The average time between the last five recessions in California was 68 months. January 2015 was the 67th month of the current economic recovery.

So how will California's revenue system perform in a declining economy—with and without the Prop 30 tax rates? For this analysis, a declining economy is defined as one with less than 3 percent personal income growth and negative growth in General Fund revenue. With 65 percent of California's revenue coming from the income tax, and over half of income taxes coming from high-income earners, modest changes in the stock market often have significant fiscal impacts. In the dot.com recession, for example, high income earners' share of income tax revenues dropped by 50 percent—most of it due to drops in investment income.



Figure 7

HOW PROP 30 WOULD PERFORM IN DECLINING ECONOMY



Data source: Legislative Analyst's Office
Analysis: CA Fwd

WHAT HAPPENS IF PROP 30 TAX RATES ARE ALLOWED TO EXPIRE?

With the expiration of the Prop 30 tax rates, two conditions are likely to occur. First, revenues from Prop 30 would be phased out, reducing revenue by \$3 billion to \$4 billion since high income earners have less capital gains income and are likely to have a smaller tax liability. Second, other revenues like the sales tax, which fluctuates with disposable income, would likely fall quickly. Meanwhile, spending pressure will increase, particularly for health and social services programs that are the safety net for economically fragile residents.

According to the Administration, even with the expiration of Prop 30, the state's new Budget Stabilization Account should exceed \$6 billion by 2019, after accounting for required debt payments and assuming no withdrawals in the meantime. A robust budget reserve will soften the impact and reduce the operating deficit, but likely not enough to achieve fiscal balance without reducing some spending or increasing revenues.

Without Prop 30 revenues and with additional declines in income tax revenues of, for example, 25 percent, a prolonged recession could cause budget shortfalls exceeding \$10 billion.

WHAT HAPPENS IF PROP 30 TAX RATES ARE EXTENDED?

Extending Prop 30 during a recession also presents a conundrum, since revenue from high income tax rates on the wealthy are likely to drop faster than other groups of taxpayers. The \$7 billion generated in a strong economy will shrink considerably.

In past recessions, a stock market decline of 30 percent off its peak resulted in capital gains revenue falling 75 percent. According to the LAO, a stock decline of 20 percent—with the Prop 30 rates in place—could reduce capital gains revenue by 50 to 60 percent. These assumptions are used in Figure 7, which projects how Prop 30's high rates would perform in a recent "slowdown scenario" developed by the LAO. While sales tax revenue could be expected to flatten in a recession, income tax revenue from the Prop 30 tax brackets might only produce 40 to 50 percent of the peak.

CONCLUSION: CRITICAL CHOICES



➡ The emerging revenue debate begins with the approaching expiration of Prop 30. This paper charts the various scenarios of a future with and without an extension of Prop 30 to initiate a thoughtful discussion about the first of many choices that should be considered.

For starters, the contemporary rationale is much different than the need for a temporary tax to repair the State's fiscal condition and rescue essential programs dependent on the state General Fund. While the debate that rallied public's support for Prop 30 focused on staving off deeper budget cuts, the current conversation is how to finance California's future.

If the economy remains strong through the end of the decade, California will be better prepared for the next downturn—with a stronger budget reserve and a significantly reduced Wall of Debt, thanks to both to the temporary taxes in Prop 30 and the reserve requirement in Prop 2. But even through the ups and downs of the economic cycle, Californians need

and want adequate public resources targeted at public priorities. Some of those priorities—including education and infrastructure—go beyond the General Fund's responsibilities.

For some taxpayer advocates and business interests, the case has not yet been made that additional revenue is needed to adequately pay for priority public services. This can motivate a smart and challenging conversation on how to improve the performance of programs and increase the return on the public investment.

For some advocates of low-income Californians, stability in revenue is not a high priority if it means increasing the tax burden on lower and middle-income taxpayers. A number of options can be explored for diversifying tax bases and reaching agreement on the fairness factor.

CONCLUSION: HOW TO PAY FOR TOMORROW?

➔ In many venues, including the California Economic Summit, a broad cross section of public and private sector leaders are recognizing the need for additional investment, particularly in infrastructure and human capital. This investment is needed to close the educational gap, the employment gap, and the opportunity gap. It is needed to adapt to climate change and make California's communities more livable and regional economies more efficient consumers of water, energy, and land. The investment is needed to prepare and provide for the next generation of Californians.

While all taxes are controversial, some are even more so. Still California's leaders—in government, in business, in labor and the civic sector—should encourage and take part in an open-minded and respectful exploration of the obvious and important needs and options.

CA Fwd, for its part, will strive to explore and describe the elements of an investment structure, distilling analysis to inform the conversation. CA Fwd will work with its allies—in business, government and community organizations—to capture ideas for the best possible strategy.

CA Fwd also will work with partners, including Next 10 with its annual "Budget Challenge," to engage Californians in this discussion online and in-person. CA Fwd will encourage regional and community groups to use the analysis—including Next 10's interactive presentation—in regional convenings.

Having made significant progress in paying off yesterday's debt, now is the time for leaders in California to answer the question: How should we pay for tomorrow?



FIVE QUESTIONS TO CONSIDER

1	Are additional resources needed to invest in human capital?
2	How should California's tax structure be revised to grow with the dynamic economy, yet provide the stability public programs require?
3	What additional resources—at the state and local levels—are needed to support investments in human capital and infrastructure and how can they be targeted to improve results?
4	Should the tax structure be changed to reflect the evolution toward greater authority of local governments, greater public support for local taxes and the clear distinctions of California's regional economies?
5	How should California balance contrasting values—such as stability versus progressivity and encourage both adequacy and efficiency?

WHERE TO GO NEXT: FROM EXPERTS/ADVOCATES

➔ As this report was in development, CA Fwd shared drafts with an informal group of fiscal experts who offered their perspectives, as well as members of business, education, labor, and other organizations.

Most experts and advocates share the report's underlying conclusion: California's increasing reliance on personal income taxes over the last 30 years has made the State's General Fund revenue system more progressive, but also more volatile. Because Prop 30 relies on these same rates, it may not be the State's best option as a primary financing tool over the long term.

Because Prop 30 relies on the same volatile revenues that have contributed to California's fiscal problems, the state should explore other options.

REVIEWERS' GUIDANCE ON FINANCING CALIFORNIA'S FUTURE.

Stability and progressivity

California's revenue system was volatile before Prop 30, but raising rates on the wealthiest Californians has only contributed to this problem. The challenge lies in finding alternatives that increase stability without shifting the tax burden onto those who can least afford it.

Adequacy of existing revenue

While many advocates argue that more resources are needed to finance needed projects and provide adequate services, that case still must be made to voters. Business groups, in particular, urged CA Fwd to provide information on whether there are enough resources in the public sector—especially to meet the needs in human capital and infrastructure. Only after this need is firmly established will many groups be willing to explore how additional revenue could be spent in ways that improve results.



Expanding the list of options

If extending Prop 30 won't provide California with a stable and adequate source of revenue, many reviewers said all other options should be considered, especially sources of revenue outside the state General Fund.

In its next paper, CA Fwd will explore both the state's human capital and infrastructure needs and its ability to fund these investments, as well as the broad categories of revenue that could provide this support—including wealth, income, and transactions. Mindful of the admonition that voters should also be given more control over how these dollars are spent, the paper also will explore options that link revenue to specific investments, regional economies, and community-level governments.

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