California in Crisis

With a dysfunctional state government unable to act, the universities, schools, and roads that were once the model for the nation are crumbling—if not collapsing.

BY DONALD COHEN AND PETER DREIER

California is broken—and broke. Its K-12 public schools, roads, levies, aqueducts, parks, and bridges; its health-care system; home health care for the elderly and disabled; and even its once-envied public universities are all crumbling from long-term neglect and underfunding. State employees have been forced to take three unpaid furlough days per month—equal to a 14 percent pay cut.

Every public service and every community across the state has taken a hit. Emily Merchant, 27, saw the number of students in her San Diego kindergarten classroom double in one year. "I love teaching, but now I'm looking at other options," she laments. "It's too exhausting to do this forever and do my best for the students." In Sacramento, the municipal fire department has slashed $2.1 million from its budget by shutting down some water-bearing trucks, a decision that could put lives and property at risk. The state adopted a budget in July that cut 585,000 children from the popular Healthy Families program. Gov. Arnold Schwarzenegger is even considering releasing 20,000 inmates from California's overcrowded prison system.

California isn't alone. Thanks to the deep recession, virtually every state is projecting a deficit for the 2010 and 2011 budget cycles as demand for public services increases while revenues decline. The National Association of State Budget Officers projects combined gaps of all state budgets of at least $250 billion over the next two fiscal years. Unable by law to run deficits, state governments have little choice but to slash public programs and eliminate thousands of public-sector jobs, which only further extends the downturn. In fact, state and local governments are shedding employees faster than the federal stimulus program can restore the cuts, exacerbating the nation's jobless figures.

California, though, is in a league of its own. According to the state's chief budget analyst, Mac Taylor, personal income and business activity hit hard by the recession have caused state tax collections to plummet further and faster than at any time since the Great Depression. State legislators and the governor made $45.9 billion in spending cuts for the 2009–2010 budget year—$30.3 billion during an extraordinary midyear special legislative session last February and another $15.6 billion during the yearly July budget agreement.

California actually has three overlapping budget problems. The first—declining revenues resulting from a long, deep recession—is shared with every other state.

The second is the result of its own irresponsible fiscal policies, which Steve Levy, head of the Center for the Continuing Study of the California Economy, calls "our special hell." In the late 1990s when the dot-com boom boosted California's economy, state lawmakers increased spending by about $10 billion, mostly to play catch-up on K-12 education and to expand health and social services. But they also foolishly cut taxes by about $10 billion. When the boom busted, revenues fell, but Sacramento neither rolled back the tax cuts nor repealed the spending increases. Desperate for revenues, Gov. Gray Davis, a Democrat, in 2003 tripled the vehicle license fee, which generated $4 billion a year by boosting fees by $130 on a typical car. Schwarzenegger, a Republican, swept into office that same year in part by promising to roll back the unpopular increase in the "car tax." He kept his pledge and plunged the state into an even deeper budget crisis.

The third and most important budget problem is the fiscal straitjacket created by Proposition 13, the original tax-revolt ballot proposition that voters approved in 1978, which capped property taxes and made it extremely difficult to raise revenues. As a result, even before the recession, California had steadily disinvested in its once world-class education system and physical infrastructure.

California now ranks at or near the bottom in many state comparisons. In 2006, the most recent year for which figures are available, it ranked 46th among states in per-student spending for public schools. Not surprisingly, its eighth-graders came in next to last (just above Mississippi) in reading and ranked 45th (tied with West Virginia) in math. The state ranks 30th in the percentage of ninth-graders who graduate from high school.

Those who do graduate from high school now face shrinking opportunities. California's three-tiered higher education system—the 10 campuses of the University of California, the 23 California State University institutions, and the 109 two-year community colleges—was once a model of high quality and low fees. Now it is imploding—both hiking its fees *and* turning away tens of thousands of students.

In September, University of California President Mark Yudof announced a plan to raise tuition and fees by 32 percent by next September, increasing the annual cost of tuition alone to over $10,300, more than double the amount just five years ago. To close a $535 million budget gap, the system laid off 1,900 workers, imposed faculty furloughs, and reduced class offerings. The CSU campuses hiked tuition and fees by 32 percent but still must reduce enrollment by a total of 40,000 students over two years.

All of this isn't because California can't afford to provide these essential public services. Its gross domestic product—$1.9 trillion in 2008—would make it the world's eighth-largest economy. Its per-capita income—$41,571—ranked seventh among the states in 2007. The state has some of the country's most productive, innovative, and profitable industries—high-tech, agriculture, tourism, entertainment, aerospace, and transportation—as well as three major ports, including the nation's largest (the Los Angeles/Long Beach), which unloads almost half of the goods entering the United States. According to the Milken Institute, a pro-business think tank, California "remains the world's center for venture capital and has the largest number of high-tech start-ups in the country" as well as a booming life-sciences sector.

POLITICS, NOT PLUMMETING prosperity, are at the root of California's dysfunction. And there is plenty of blame to go around.

Proposition 13, crafted by right-wing political operatives Howard Jarvis and Paul Gann, did more than simply limit property taxes. It created a constitutional requirement that all tax increases pass the Legislature by a two-thirds majority. (The state already had a two-thirds requirement to pass the annual budget, dating back to 1933.)

Jarvis and Gann meant to put the state in a fiscal straitjacket. They succeeded. Now, three decades later, this change has made California virtually ungovernable.

Though the Democrats now have a 51-to-28 majority in the Assembly and a 25-to-14 majority in the Senate, it isn't enough to raise taxes and pass a budget. They need three Republicans in the Assembly and two in the Senate to cooperate. Unfortunately, the GOP has lost virtually all of its moderates and is dominated by rabidly anti-tax, anti-government conservatives—giving a small minority veto power over the budget.

California is the only state that requires a supermajority for both tax increases and budget approval. As a result, each year the leaders of both parties get together and play chicken with the state budget, daring each other to bring the state to the brink of fiscal collapse. In the last two budget cycles, while the governor and the Legislature were negotiating to pass a budget, the state was forced to hand out IOUs instead of cash payments to contractors, state workers, and aid recipients.

Eventually, enough Republicans (mostly those in swing districts) agreed on a package of tax increases and spending cuts in order to pass a budget, but they have paid a political price for doing so. Senate Minority Leader Dave Cogdill was ousted from GOP leadership after supporting the budget agreement. This year, a recall was launched against freshman Republican Anthony Adams, an ardent conservative assemblyman from Hesperia, after he voted for the package. The recall failed, but Republican true believers quickly readied primary challenges against Adams—who has announced he won't run for reelection—and other GOP "turncoats."

Another obstacle the state confronts is the unintended consequences of century-old democratic reforms. In 1911, California Progressives created the state initiative process to put government directly into the hands of the people. Since then, 331 initiatives have made it to the ballot. Ironically, collecting signatures and then waging a statewide initiative campaign now costs millions of dollars, limiting the process to interest groups with deep pockets.

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Direct democracy has tied lawmakers' hands in crafting a budget. In 1988, for example, the California Teachers Association sponsored Proposition 98, which committed the state to spend 40 percent of its annual budget on K-12 education. In 2004, Californians passed a ballot initiative to increase funding for mental health by imposing a 1 percent tax on personal income over $1 million.

In 1994, Proposition 184 mandated "three strikes and you're out" sentencing requirements. From 1984 to 2008, per-capita spending on prisons increased by 126 percent, while per-capita spending on public universities declined by 12 percent.

California has also been prey to faux reforms. In 1990 voters approved a ballot initiative that imposed three two-year term limits for members of the Assembly and two four-year limits for the Senate, while cutting legislative staffing budgets. The high turnover means that lawmakers have to leave just as they are learning the ropes and developing some expertise. The shortage of policy staff means that Sacramento policy-making is dominated by the "permanent government" of professional lobbyists, who disproportionately represent business interests.

A further obstacle to restoring the state's viability is the allegation that it is anti-business. The state's Republicans, powerful business lobbies, corporate-backed think tanks, and corporate-friendly economists like the media-savvy Jack Kyser (of the Los Angeles County Economic Development Corporation) constantly complain that California's regulations and business taxes create an "unfriendly" business climate that drives away jobs and private investment.

In reality, this "crying wolf" lobby is wrong on all fronts. According to the California Budget Project, the state's tax burden is only slightly above the national average. A Public Policy Institute of California study of business relocations concluded that "the number of California jobs moving to other states due to business relocation is relatively inconsequential." A subsequent PPIC study confirmed that "rhetoric aside, California loses very few jobs to other states."

Perhaps the most damaging fallout of California's chronic budget gridlock may be public mistrust of government. A statewide survey conducted in September concluded, according to PPIC director Mark Baldassare, that the public "has now lost confidence in their leadership, and we are seeing record levels of distrust in state government." The poll found that 73 percent of all Californians—and 79 percent of frequent voters—said state government was run for the benefit of the few.

And most troubling of all for those who recognize the need for additional revenues, the PPIC polls discovered that three out of five Californians believe that state government wastes "a lot" of the money they pay in taxes. Only 5 percent said there was little waste. In fact, there is little "fat" in the state budget. California's ratio of state employees to population is the third lowest, behind only Nevada and Illinois, and is far below the national average.

Despite hostile attitudes toward state government, voters are nevertheless willing to raise local taxes to pay for the services they want. In the November 2008 election, in the depths of a worsening recession, voters in 23 local jurisdictions (including El Cajon, a solidly Republican suburb in San Diego County) adopted sales-tax increases to support local services, and in 17 school districts they passed parcel taxes—all by more than the required two-thirds margin.

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CALIFORNIA HAS HAD SOME of the nation's most progressive legislative leaders. The previous Assembly speaker, Fabian Nunez, had served as political director of the Los Angeles County AFL-CIO. The most recent speaker, Karen Bass, is a former community organizer from South Central Los Angeles. Her recently elected successor, John Perez, is a former union organizer. But the combination of supermajority vote requirements and term limits (which lead legislators to constantly maneuver to seek the next office) thwarts progressive solutions.

California's dysfunctional governance and chronic fiscal crisis have triggered a wave of blue-ribbon studies and policy proposals sponsored by various interest groups, each worried that California's budget battles are having a negative impact on the people and issues they care about. A growing number of business leaders, once opposed to any new taxes, now express concerns that the lack of investment in physical infrastructure, the future work force, and the social safety net is causing long-term damage to California's economic health and competitiveness.

Two moderate business organizations (the Bay Area Council and Joint Ventures Silicon Valley) and the centrist *Los Angeles Times* editorial board are calling for a state constitutional convention to rewrite the document all at once rather than do it piecemeal. The Bay Area Council's new coalition, Repair California, got approval from the attorney general to gather signatures to put two measures on November's ballot—one calling for a constitutional convention and one setting rules for it. They intend to make "holistic changes to our state government and wrestle our state back from special interests." But others are concerned that randomly selected citizen delegates at a constitutional convention would be no better than inexperienced term-limited legislators at fixing California's broken political system and fiscal policies.

Convention madness aside, progressive unions, consumer groups, and moderate business leaders can probably reach agreement on a set of incremental reforms that could repair the tax and budget fiascos. The solutions fall into three general categories—generating new revenues, eliminating structural gridlock, and increasing federal responsibility.

Any solution to balance revenues and expenses necessarily means tax increases. Polls show that most Californians prefer increasing taxes on profitable industries and high-income Californians over cutting education and health-care programs.

California think tanks and advocates have identified billions of dollars in potential new revenue sources. Restoring Schwarzenegger's repeal of the vehicle license fee would generate $6 billion annually. A small increase in the tax rate for high-income earners would generate $5 billion annually. Broadening the sales tax to include services (ranging from legal and engineering services to haircuts) could generate up to $8 billion per year, according to the Board of Equalization, a state tax agency. Progressives also point out that California is the only oil-producing state that doesn't tax oil at the well—a potential source of $1 billion per year in additional revenues.

Jean Ross, executive director of the California Budget Project, argues that lawmakers should "start by repealing recent tax cuts given to some of the biggest and most profitable corporations." The September 2008 and February 2009 budget agreements included $2.5 billion in corporate tax breaks that only apply to a handful of the largest California firms. State law prohibits disclosing which companies benefit, but Apple, Intel, Paramount Pictures, and Walt Disney are among the large firms that supported these tax cuts.

To chip away at Proposition 13's property-tax limits, unions, consumer and community groups, and even some businesses, advocate a "split roll" system that would increase property taxes on business but maintain the current limits on residential taxes. Because Proposition 13 locks in property-tax rates at the time of purchase, the current system typically taxes new commercial property at a much higher rate than it does older firms, putting new businesses at a competitive disadvantage. Since residential properties are sold more frequently than commercial properties, the share of state revenue from residential property taxes has steadily increased, while the proportion from commercial properties has steadily declined. In 1994–1995, business property was assessed at 87 percent of its full market value, but by 2006–2007, the rate was down to 60 percent.

In Los Angeles County, in patterns typical of a whole state, single-family residences accounted for 39.9 percent of the tax roll in 1975, before Proposition 13. This year their share is 55.8 percent. In the same period, commercial-industrial property has gone from 46.6 percent of the county's tax roll to 30.9 percent. Disneyland—which has never changed hands—pays a nickel per square foot in property taxes, while a typical home pays over $2 per square foot. The split-roll change would generate $7.5 billion in annual revenue to the state.

Every progressive and now some business organizations agree the state can't generate new revenue without structural reform that loosens the Proposition 13 straitjacket. An outright repeal of the law isn't politically possible. Instead, the most talked about incremental steps would be, first, allowing a simple legislative majority to pass a state budget and to raise taxes and, second, eliminating the supermajority requirement for raising local taxes and bonds (for schools, libraries, and other public services), since voters are more likely to support a new tax when they can see local services or construction that it finances.

California Forward, an alliance of business moderates, labor and community leaders, and former elected officials, chaired by centrist Democrat Robert Hertzberg, a former Assembly speaker, is promoting a package of reforms starting with two 2010 ballot measures. The "Best Practices Budget Accountability Act" would lower the vote requirement for adopting the state budget to a simple majority and require "pay as you go" rules for new programs or tax reductions. But revising the supermajority requirement for the budget without doing so for raising taxes makes little sense given the state's recent history of fiscal chaos. As well, adopting a pay-as-you-go plan in the depths of recession may lock in wholly inadequate levels of funding for essential programs.

In October, the Los Angeles County AFL-CIO and the Los Angeles Chamber of Commerce formed Californians for a Fresh Start. It introduced a ballot measure to modify term limits to allow legislators to serve a total of 12 years in either the Senate or Assembly. The sponsors' hope is that a more stable Legislature will develop the political and legislative maturity to earn public trust to pave the way for fiscal reform.

Even with these changes, Levy, Ross, and other experts agree that California can't entirely tax itself out of the current budget crisis. According to Ross, given the depth of the recession, "no combination of spending cuts or tax increases is sufficient on its own to remedy the current shortfall without inflicting significant harm to the poor and the state's economy."

In short, solving California's problems, like solving those of nearly every other state, requires federal help. "States can't borrow the same way the federal government can," Levy observes. In the short term, "massive federal investment to the states would be the best bang for the buck to create jobs and to stimulate economic recovery." Without significantly more federal relief, the ensuing waves of state and local employee layoffs will hamper the nation's economic recovery.

Levy warns that debates over specific taxes or rules won't resonate with voters unless they are part of a broader vision of California's future. "It's about a social contract," Levy says. "It's about whether we want great schools, and if we want every high school student to be able to go on to pursue higher education, and whether we should be building an infrastructure to secure our energy, water, and mobility needs."

"It's not about adding a penny or two to the tax rate," he adds. "It's about whether we want California to be a great place to live." TAP

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