Democratic Investments: Tax Initiatives, Public Goods, and Democratic Participation

A conference on California's public finance policies

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It is forty years since California voters approved Proposition 13. In 1978, Californians were troubled by inconsistent and rising property tax rates on homes. They sought protection against property tax policies that threatened their ability to afford their hard-earned investment in a home. Four decades later, California is a different state, demographically and economically. Four decades later, we also have a better perspective on the good and bad that have resulted from the policy and revenue implications of Proposition 13.

This report summarizes a day-long conference where experts working in the areas of government finance, public programs, political organizing, and voter mobilization convened to discuss California's fiscal policies. We present the highlights of this convening as a series of insights into what we have learned since Proposition 13. Specifically, we focus on ways California can move toward a more stable and equitable policy future that will reinvest funds into California's young people and reduce the state's high levels of poverty.

LEGACIES OF PROPOSITION 13

Proposition 13 fundamentally changed the way voters and the legislature approve new taxes. The constitutional amendment enacted by voters through Proposition 13 had the desired effect of lowering property taxes, but it also initiated a number of other policy legacies that have had long-term effects on the state's finances and fiscal options.

One legacy of Proposition 13 is a shift in who pays property taxes in the state. When voters approved Proposition 13, it changed the law governing property taxes for both commercial and residential properties by restricting the value assessment of properties. Both commercial and residential properties are only assessed at market value when they change hands, such as at the point of sale. Commercial properties change hands much less often than residential properties. As a result, commercial real estate is rarely assessed at market value. Industrial and commercial properties therefore may be taxed at much lower *effective* rates than residential property, even when the nominal tax rates are the same. In other words, the property tax burden in California has been taken away from corporations and put on people, especially homeowners.

Another legacy is reduction in revenue. Proposition 13 froze the general property tax rate in the state at one percent of assessed value. This low rate, combined with restrictions on assessment, have led to lower funding for public programs and diminished property taxes that have not been fully offset by income from other taxes. As a result, California municipalities have faced overall reductions in their budgets, which have affected the public programs local governments provide. Municipal taxing districts sometimes approve parcel taxes and bonds to make up for shortfalls in property taxes.

Perhaps the most entrenched legacy of Proposition 13 is the restriction the new law placed on the enactment of future taxes. Specifically, local governments may no longer increase *ad valorem* property taxes (taxes based on the assessed value of property); and in order to raise other local taxes, elected officials and voters have to approve measures by a two-thirds majority. This supermajority requirement means that a minority of voters can stop tax increases at the local level. Another supermajority requirement applies to state taxes: no state tax can be increased without a vote of two-thirds of each house of the state legislature. The supermajority requirements are meant to protect taxpayers from unnecessary and unwanted tax increases. However, in times when additional revenue streams are badly needed, local and state lawmakers find it difficult to overcome the two-thirds super majority requirement to enact new policy.

Proposition 13 also limits how school districts can raise revenue by banning the enactment of new *ad valorem* property taxes altogether. School district voters who want to increase local revenue can only enact a highly regressive parcel tax, which requires every property owner to pay an identical lump sum tax regardless of the size or value of their land. In general, it is mostly left-leaning, wealthy districts that approve such measures.[1]

The experience of campaign consultants suggests that between 20 and 30 percent of voters are unwilling to consider *any* tax increase when the issue is presented to them in a poll or ballot.[2] When taxes must be approved by 66.7% of voters, which leaves politicians with a very small margin of error. They essentially have to convince almost every persuadable voter—the 70 to 80 percent that are at least willing to consider a tax increase—to approve the tax.

DESIGNING FISCAL POLICY

Californians should rethink aspects of the state tax code. Our present system is decades old, and while it still meets some needs, there are improvements that could be made. Although a minority of voters may be consistently unwilling to support tax increases of almost any kind, the majority of Californians are willing to pay taxes and do vote to approve them.

A robust tax system draws revenue from a diverse set of sources. A tax system that relies too heavily on any one source may exhibit instability due to changes in political attitudes or economic shifts that affect the particular sources of revenue on which they rely. For example, since the limitations on property taxes initiated by Proposition 13, California’s reliance on progressive income taxes has increased, and is now above national averages.[3] Economic downturns heavily affect top incomes, which are the source of about half of income tax revenues in the state.[4] A broader tax base would ease the revenue shocks caused by fiscal crises.

Many Californians are resistant to the idea of adopting regressive tax tools because, in theory, a progressive tax regime, which relies heavily on income taxes, tends to redistribute income. However, when considering the redistributive character of a fiscal system, one has to look not only at how states tax their constituents, but also at how they spend the money they collect through these taxes. For example, states can tax top incomes but then spend most of this revenue on policies that redistribute toward the rich, making the overall system of public finance neutral or even regressive. As the experience of European welfare states demonstrates,[5] a fiscal system that collects most of its revenue through regressive taxes (e.g. sales taxes) can still be highly progressive if the policies it promotes benefit middle- and lower-income classes. Therefore, fiscal policy-makers should account for the source of taxation as well as expenditures.

Maintaining revenue in a “rainy day fund” during economic downturns is also a good fiscal policy, because enrollment in most social safety net programs (e.g., MediCal) and some education programs (e.g., college enrollments) are counter cyclical: demand rises when state revenues fall. California currently has a large rainy day fund, which should be largely retained given the dramatic changes in the budget due to overreliance on income taxes. However, there are cases of municipalities (e.g., San Diego County) that refuse to spend rainy day funds, even during periods of economic crisis. The decision to hoard a rainy day fund when the rainy day comes can disadvantage the most vulnerable by not patching the holes in federal and state funding that result when revenues drop.[6]

Among the biggest obstacles to updating California’s tax system are the supermajority requirements initiated by Proposition 13. Ideally, tax reforms should include a mix of expanded taxes, reduced reliance on less effective taxes like sales and corporate, and new revenue sources. There are various ways the tax system could be improved to avoid California’s boom and bust budgetary cycle, but supermajority requirements make it difficult to change and adapt. A supermajority requirement for the approval of even one kind of taxation can make the entire tax structure inflexible. This is because while supermajority requirements are in place, lawmakers are likely to rely on taxes without such supermajority requirements to replace declining revenue from other sources. California’s outdated revenue-generation system is entrenched by supermajority voting requirements, which empower the most anti-tax minority of voters to veto policy change. Only a voter referendum and two-thirds majority vote in the legislature could undo the current supermajority requirements in the state, however.

Designing fiscal policy is best done by building a diverse tax structure and removing super majority requirements. It is also most sustainable when government is transparent in the purpose for the tax and the ultimate use of the funds.

In the eyes of voters, however, not all taxes are created equal. For example, transient occupancy taxes are approved more often than other types of taxes at the municipal level, perhaps because they are perceived to be paid by out-of-town visitors. Municipal taxes that fund emergency services are especially popular. Voters also prefer tax policies that are coupled with a degree of institutionalized oversight, such as the creation of a boards of citizens to track where and how money is spent.[7] In short, California voters appear to prefer taxes paid by other people—or taxes that come with some assurance that they will be spent for particular, and particularly popular, functions of government.

SUPPORTING THE NEXT GENERATION

The effects of Proposition 13 have not been experienced evenly by all Californians. This is because many public programs are targeted at lower-income residents who feel the expansion and contraction of the social safety net most acutely. For example, MediCal covers one-third of California residents, many of them children. It is the biggest single supplier of health care coverage in the state and pays for half of all births and two-thirds of nursing home care.[8] In short, it covers the most vulnerable in the state and especially the young. But Medi-Cal pays doctors very little, often making it difficult for MediCal recipients to find doctors willing to accept their form of insurance. California could do more to supplement the program, but without additional revenue, this seems unlikely.

Another area where the effects of low funding are felt unequally is in public education. Despite efforts by the state to equalize funding across districts, California's school districts vary widely in per pupil expenditures.[9] Because some districts have extremely high real estate values while others are almost completely dependent on the state for financial support, vast inequities between districts exist. The consequences of underfunding in the most poorly resourced schools may include lower math standards, student-to-counselor ratios as high as 1,000:1, difficulty recruiting and retaining teachers in critical areas, and decreased ability to monitor student progress in key subjects.

Tax limitation relieves adults—or current taxpayers—of a higher tax burden. However, that does not mean the burden of cost is not being paid. Students may pay for this tax relief later, for example, in the form of uneven and unsustainable career pathways due to underfunded schools. Students in poorly funded and poorly performing schools tend to spend longer acquiring postsecondary credentials because they need remediation in those areas not well-taught, monitored, or developed in K-12 education.

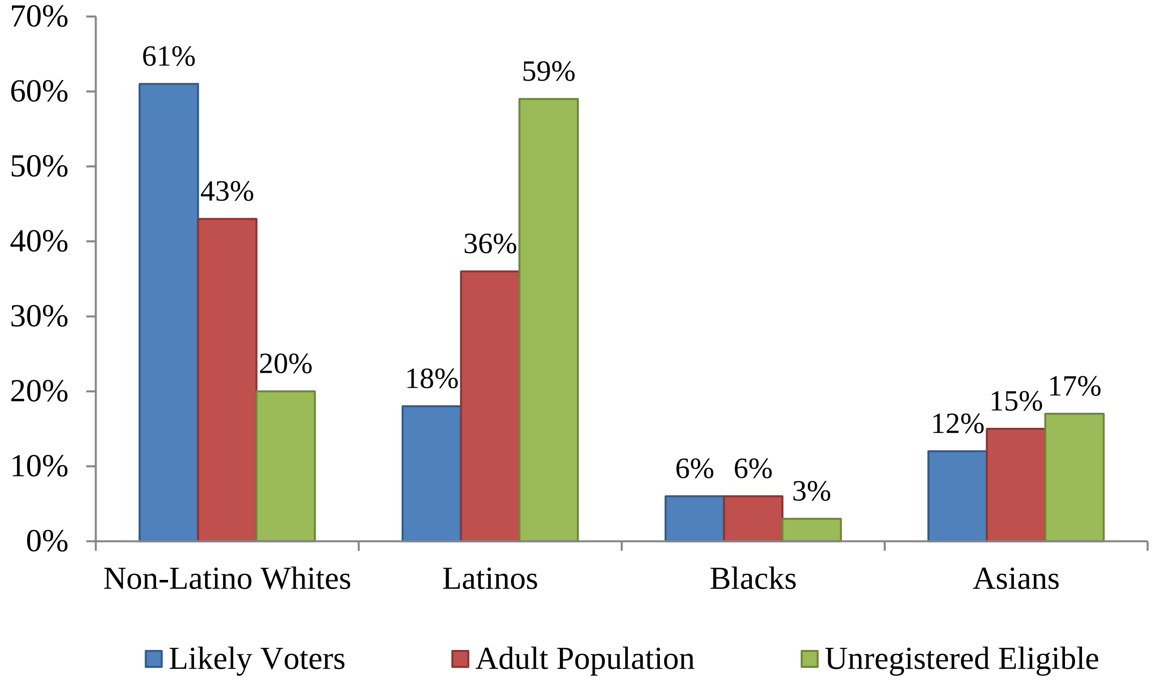
These effects may also exacerbate racial and ethnic inequality in California. Since the 1970s, Californians non-Latino Whites have gone from being the majority population to the minority. Racial and ethnic minorities in California—especially people identified as Hispanics and African Americans—are disproportionately low-income. The result is that racial and ethnic minorities disproportionately feel the effects of cutbacks to, or low support for, public programs.

When voters approved Proposition 13, a majority of the White adult population sought relief from a pressing tax burden. However, they also gained relief from funding the next generation. Beginning in the 1970s, those youth were increasingly non-White. Now, California is the most racially and ethnically diverse state in the nation, with a majority-minority youth population. California is also one of the most economically stratified. Mobility is inaccessible for many even when opportunities for education, job training, and other assistance appear within reach. The demographic turn that became apparent after the 1980 Census will not reverse course. If Californians are going to support the next generation they must be willing to fund programs that lift everyone—regardless of race and ethnicity—out of poverty and provide opportunities for upward mobility.

EQUITY IN POLITICS AND POLICYMAKING

Designing a fiscal future that includes more equitably distributed benefits will require the participation of those most affected by current public finance policies. Scholars have repeatedly shown that White voters are reluctant to pay for social and educational policies when they believe the beneficiaries are racial and ethnic minorities.[10] California's diverse population cannot advance economically if this reluctance to fund schools and a safety net persists. Enacting fiscal policies that provide better educational opportunities and improved health outcomes to all Californians is important to reduce income inequality and entrenched poverty. The challenge is overcoming racial divisions and racism, and replacing them with inclusive ideals.

Several shifts in political organizing and political participation will be key as Californians decide how much to support children and those most in need. One way to break through the supermajority barrier is to expand who votes. Nationally and in California, non-Latino White men and women register to vote and make it to the voting booth at rates far higher than their Hispanic, non-Latino Black, and Asian counterparts.[11] Political participation that is inclusive and equitable is difficult to achieve. Political parties and consultants typically focus on short-term goals of mobilizing registered and active voters for a single electoral cycle, rather than building long-term alliances. If the focus continues to be on courting those who already vote, then electoral participation rates may remain where they currently are—with only 40 percent of registered voters participating in mid-term elections.[12]



SOURCES: Likely voters/unregistered – 2017 PPIC Statewide Poll; Population – 2015 ACS

Instead, organizers and political institutions might think about "changing the electorate"—by bringing new voters to the polls—rather than "chasing the electorate" by pandering to the shrinking White minority.[13] Some recent campaigns have found that values-based organizing is an effective way to build bridges among racial and ethnic groups, and thereby to bring a diverse group of voters to the polls.[14] When candidates or other groups rely on multi-ethnic, multi-racial, and multi-issue organizing, they can increase voter participation.

Another way to improve citizen participation is to improve voters' understanding of political institutions and fiscal policy. There is more that could be done to inform people about the services government provides—and what services it *could* provide, with adequate public revenues.

CONCLUSIONS AND RECOMMENDATIONS

The legacies of Proposition 13 are felt by everyone in the state. Some of those legacies are popular. But others have been harmful for the state's social and economic programs. There are many specific policies that might address the problems. The following general principles may provide guidance.

- Aim to have a broader, more diversified tax portfolio. A broader tax base decreases the risk of revenue shortages present in systems that are too over-reliant on few sources (as the current California tax system, which relies heavily on progressive income taxes).

- Consider policies that look at both the tax and expenditure sides of the budget. Looking at redistribution from only one of these points of view gives an insufficient picture of the redistributive character of a fiscal system.

- Maintain rainy day funds but also develop efficient institutional tools to *employ* rainy day funds: saving when economic times are good, but also spending in an economic downturn.

- Consider relaxing supermajority requirements, which, their name notwithstanding, empower a minority of the most tax averse people to exercise a veto over public policy. Supermajority requirements can lead to a rigid public budget that should be capable of adapting to economic fluctuations and social changes.

- Create more transparency in the fiscal system overall. This can be done by creating communication tools to inform citizens on the services governments provide, on where the taxes they pay are invested, and on how new services could be provided in case new taxes were to be implemented.

- Invest in programs that foster the development of next generations and that lift needed populations out of poverty, thereby creating more upward mobility.

- Engage and mobilize the future voters of California, including youth of all racial and ethnic groups; these are the Californians who register and vote at the lowest rates, but who bear the greatest burdens as a result of the legacies of Prop 13.

As these recommended future actions suggest, the work needed to achieve stability and equity in California public finance and spending must be approached on several fronts. And these fronts are necessarily dynamic: a more robust system of public finance would better support low-income youth, thereby helping to remove barriers to their political participation, and more demographically-representative political engagement could mobilize efforts to reform current supermajority requirements.

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[2] Democratic Investments presentation by Tom Shepard.
[3] https://taxfoundation.org/state-individual-income-tax-rates-brackets-2018/; Democratic Investments presentation by Kirk Stark and Darien Shanske.
[4] https://www.ftb.ca.gov/Archive/aboutFTB/Tax_Statistics/Reports/Revenue_Estimating_Exhibits/05022014.pdf, see Exhibit A-10 page 4 of 4; Democratic Investments presentation by Kirk Stark and Darien Shanske.
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[11] Democratic Investments presentations by Marissa Abrajano, Lisa Garcia Bedolla, and Thad Kousser.
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[13] Pastor, Manuel. 2018. *State of Resistance: What California’s Dizzying Descent and Remarkable Resurgence Means for America’s Future*. New York: The New Press.; Democratic Investments presentation by Manuel Pastor.
[14] Democratic Investments presentation by Jennifer Ito.

Democratic Investments

Tax initiatives, public goods, and democratic participation

A Conference on California's Finance Policies

9:00-10:30 am TAXATION AND PUBLIC SERVICES

- Kirk J. Stark, *UCLA Law*
- Shannon McConville, *Public Policy Institute of California*
- Susan Yonezawa, *CREATE at UCSD*
- Darien Shanske, *UC Davis Law*

10:45 am-12:15 pm THE POLITICS OF SUPPORT

- Jennifer Ito, *USC*
- Thad Kousser, *UCSD*
- Tom Shepard, *Tom Shepard & Associates*
- Marisa Abrajano, *UCSD*

1:50-3:30 pm MOVING FORWARD

- Isaac Martin, *UCSD*
- Peter Brownell, *Center on Policy Initiatives*
- Manuel Pastor, *USC*
- Lisa García Bedolla, *UC Berkeley*

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YANKELOVICH CENTER FOR SOCIAL SCIENCE RESEARCH

Friday, June 1st, 2018
8:30 am - 3:30 pm

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