THE FUTURE OF FISCAL REFORM

A CALIFORNIA 100 REPORT ON POLICIES AND FUTURE SCENARIOS

CALIFORNIA 100

VISION & STRATEGY FOR THE NEXT CENTURY

ABOUT CALIFORNIA 100

The California 100 Initiative envisions a future that is innovative, sustainable, and equitable for all. Our mission is to strengthen California's ability to collectively solve problems and shape our long-term future over the next 100 years.

California 100 is organized around 15 policy domains and driven by interrelated stages of work: research, policy innovation and engagement with Californians. California 100's work is guided by an expert and intergenerational Commission. Through various projects and activities, California 100 seeks to move California towards an aspirational vision—changing policies and practices, attitudes and mindsets, to inspire a more vibrant future.

This California 100 Report on Policies and Future Scenarios was produced as part of California 100's research stream of work, in partnership with 20 research institutions across the state. California 100 sponsored grants for data-driven and future-oriented research focused on understanding today and planning for tomorrow. This research, anchored in California 100's 15 core policy domains, forms the foundation for the initiative's subsequent work by considering how California has gotten to where it is and by exploring scenarios and policy alternatives for what California can become over the next 100 years.

The California 100 initiative is incubated through the University of California and Stanford.

CALIFORNIA 100 RESEARCH TEAM

Henry E. Brady, Ph.D., Director of Research
Lindsay Maple, M.P.P., Senior Research Analyst
Ava Calanog, M.P.P., Assistant Director of Research

THE CALIFORNIA 100 EXECUTIVE LEADERSHIP TEAM

Allison Berke, Ph.D., Director of Advanced Technology
Henry E. Brady, Ph.D., Director or Research
Amy Lerman, Ph.D., Director of Innovation
Jesse Melgar, M.P.P., Director of Engagement
Karthick Ramakrishnan, Ph.D., Executive Director

READ MORE ABOUT THE FUTURE OF FISCAL REFORM IN CALIFORNIA

For additional background information, read the related Facts-Origins-Trends report at California100.org. The Facts-Origins-Trends report contains all of the references and citations to support the content of this report.

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This Report is one of 15 reports that will be released in 2022 as part of the California 100 Initiative. We are proud to partner with the following research centers and institutes across California on our work:

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ABOUT THE OPPORTUNITY INSTITUTE

The Opportunity Institute works to increase social and economic mobility and advance racial equity. We work in partnership and collaboration with those seeking to promote systems change in education and adjacent areas of social and economic policy, both nationally and in our focus states of California, Illinois. New York, and Mississippi. Our current work focuses on whole child equity, adolescent learning and development, resource equity, and equity indicators.

THE FUTURE OF FISCAL REFORM REPORT AUTHORS:

Patrick Murphy Fellow, The Opportunity Institute

Carrie Hahnel Senior Director for Policy and Strategy, The Opportunity Institute

Maria Echaveste President/CEO, The Opportunity Institute

Alvina Jiao Research Assistant, The Opportunity Institute

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FOREWORD

"As California Goes, So Goes the Nation, Alas." That was a headline from a *Los Angeles Times* opinion column on April 30, 1989, which noted that, even though "Californians have long considered their state the cutting edge of social and political change… [it] no longer seems the vanguard of political innovation. Other states rarely look to California for policy initiatives."

Fast-forward to 2022, and few would proclaim that California lacks in policy innovation. Quite the contrary. The state has enacted a variety of policies ranging from expansions in immigrant rights and voting rights to health care and higher education, and from large-scale experiments in guaranteed income to ambitious moves towards net-zero emissions in a variety of sectors. And despite the periodic waves of "doom and gloom" reporting about the state, California's economic output over the last 25 years has grown faster than the national average, and on par with GDP growth for the state of Texas.

Even so, much remains to be done. The California Dream has always been marred by a high degree of racial exclusion, and it remains out of reach for millions in the state—whether measured by health outcomes, unaffordable housing, or massive disparities in income and wealth. California also recognizes that future progress depends on recognizing and correcting historical wrongs. Its Truth and Healing Council, for example, will provide recommendations aimed at prevention, restoration, and reparation involving California Native Americans and the State. If California's racial diversity represents America's demographic reality by 2100, our work is essential—not only for the long-term success of the state, but also for our country's innovative and equitable future.

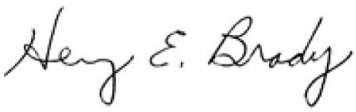
This future-focused work is especially pressing today. The COVID-19 pandemic has scrambled a state and nation already undergoing significant changes in economics, politics, and society. The harmful consequences of climate change are at our doorstep,

with forest fires and droughts that grow in frequency and intensity each year. The weakening of local media and the growth of disinformation threaten both our civic health and our public health. And staggering inequities in income and wealth, home-ownership and health, threaten the state's reputation as a haven for migrants, domestic and international alike.

In addition to immediate threats that affect our long-term future, we also see plenty of opportunity. Record increases in federal and state spending mean that billions of additional dollars are flowing to state, local, and tribal governments in California. Many jurisdictions are looking to invest in infrastructure that meets the long-term needs of their communities. Philanthropic institutions and individual donors are also looking to make transformative investments that have enduring impact. We have an opportunity to inform and enrich all of these plans and conversations.

Most institutions and organizations in California are focused on immediate challenges, and don't have the luxury of time, dedicated talent, and resources to focus on long-term futures. California 100 is grateful for the opportunity to provide added value at this critical time, with actionable research, demonstration projects, and compelling scenarios that help Californians—government agencies, stakeholder groups, and residents alike— to envision, strategize, and act collectively to build a more innovative and equitable future.

Karthick Ramakrishnan, Ph.D.
Executive Director

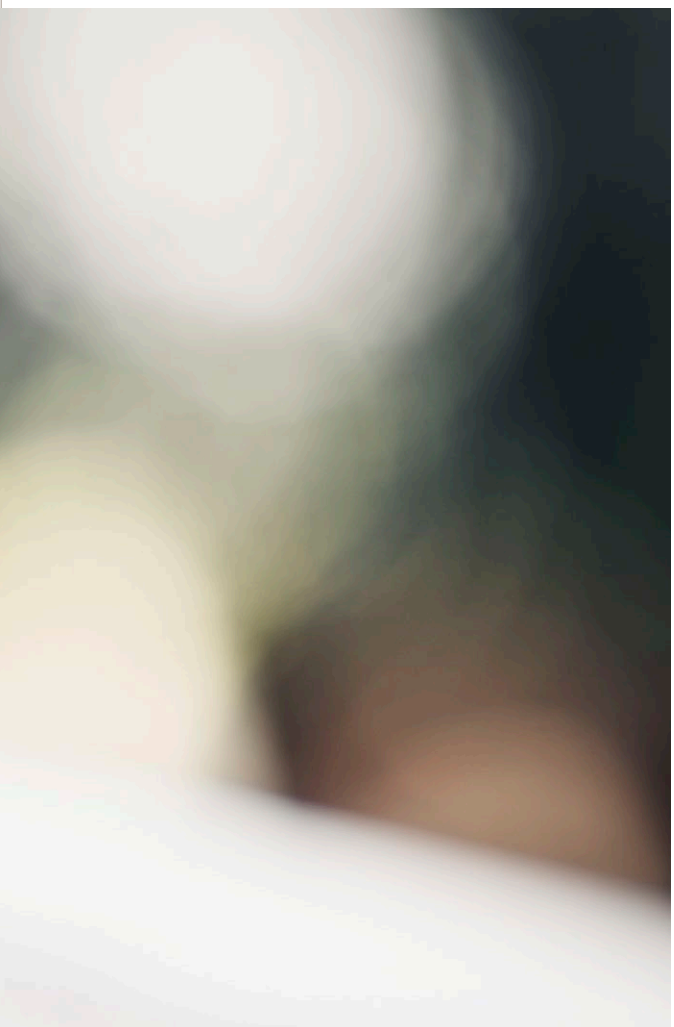


Henry E. Brady, Ph.D.
Director of Research

FISCAL REFORM IN CALIFORNIA

Fiscal policy is the set of decisions a government makes to both collect revenue (taxes) and pay for programs (spending). Both of these elements come together in the form of a budget—the collection of tables and calculations that represent the government's resource allocation plan for the coming year. It is much more than an accounting exercise, and it is easy to ignore the role of fiscal policy as the realm of spreadsheet geeks and bean counters. The reality is that fiscal policy touches nearly everything the government does if you consider that there isn't much you can do if you don't have the resources. Equally important is the fact that budgets are more than a collection of numbers; they represent a quantification of a community's values and aspirations for the future. Fiscal policy, for example, can support economic growth by investing in infrastructure. Alternatively, a community that values economic mobility can focus

Looking to the future, fiscal policy becomes a question of first defining what the state values and then figuring out how to pay for the implementation of policies guided by those values.



public funds on providing a high-quality education for students and adults to prepare them for an evolving workforce. Public resources can also provide a safety net to support vulnerable citizens during a crisis.

Looking to the future, fiscal policy becomes a question of first defining what the state values and then figuring out how to pay for the implementation of policies guided by those values. Though easily stated, this challenge is immense. Historically, state policy has ridden a fiscal roller coaster through both periods of prosperity when the economy was growing, and periods of fiscal crises during downturns. If Californians are going to continue to enjoy a golden state in the coming decades, addressing volatility and solving the fiscal sustainability puzzle will have to be part of that future.

Contemplating the future direction of California's fiscal policy requires a firm understanding of the present. Toward that end, this report first outlines the *facts* that describe the contours of the state's fiscal landscape. It then explores the major drivers – the economy, demographics, and policy – as well as landmark events that constitute the *origins* of the state's current fiscal condition. Finally, it examines how past *trends* are expected to shape the future of state fiscal policy.

The report then looks to the future, constructing possible directions the state could take given this foundation. The scenarios are designed to provide enough specificity to provoke conversation about the future Californians would like to have and what it will take from a fiscal policy perspective to get there. Toward that end, the report concludes with recommendations that address the state's challenges within the constraints of the different scenarios.

BIG INVESTMENTS MUST ADDRESS EVEN BIGGER CHALLENGES

This report focuses primarily on state government and how it collects revenue via taxes as well as distributes resources through a myriad of programs. While the focus may be on the state, California pursues fiscal policy as part of a larger system including both the federal government in Washington, D.C. and local governments throughout California. On average, federal funds have accounted for about one-third of total state spending (excluding spending for pensions and trust funds) over the past four decades. The federal dollars come to the state with strings attached, and the amount of flexibility state policy makers have in deploying the funds can be limited.

Constitutionally speaking, local governments are created by the state. They also are the unit of government closest to the people. Although most local jurisdictions have their own sources of revenue (e.g., a portion of property taxes, sales taxes, etc.), the state government passed along federal dollars and state general fund resources to more than 4,400 local government units in 2017. Similar to the relationship between the federal government and states, California can attach requirements ("strings") to the dollars it distributes.

REVENUES RISE… AND FALL

Overall, both tax revenue and spending in California have risen over the past decades in a pattern of steady growth, with sudden drops caused by economic recessions. After each recessionary cycle, the pattern of growth continues again. This repetition, in part, reflects California's reliance on a progressive income tax that predominantly derives revenue from the wealthy—when incomes of the wealthiest Californians plummet, so does state tax revenue. These sudden drops in income tax revenue leave large holes in the budget that have to be quickly remediated through budget cuts to discretionary spending items such as higher education.

California collected $189 billion in state tax revenue in FY 2020. Since the mid-1980s, California's real state tax revenues have grown at an average rate of 3.1 percent per annum.

However, as Figure 1 below shows, the growth isn't consistent, with periodic drops in revenue occurring during economic recessions such as in FY1987, 1990, 1992, 2001, and 2008.

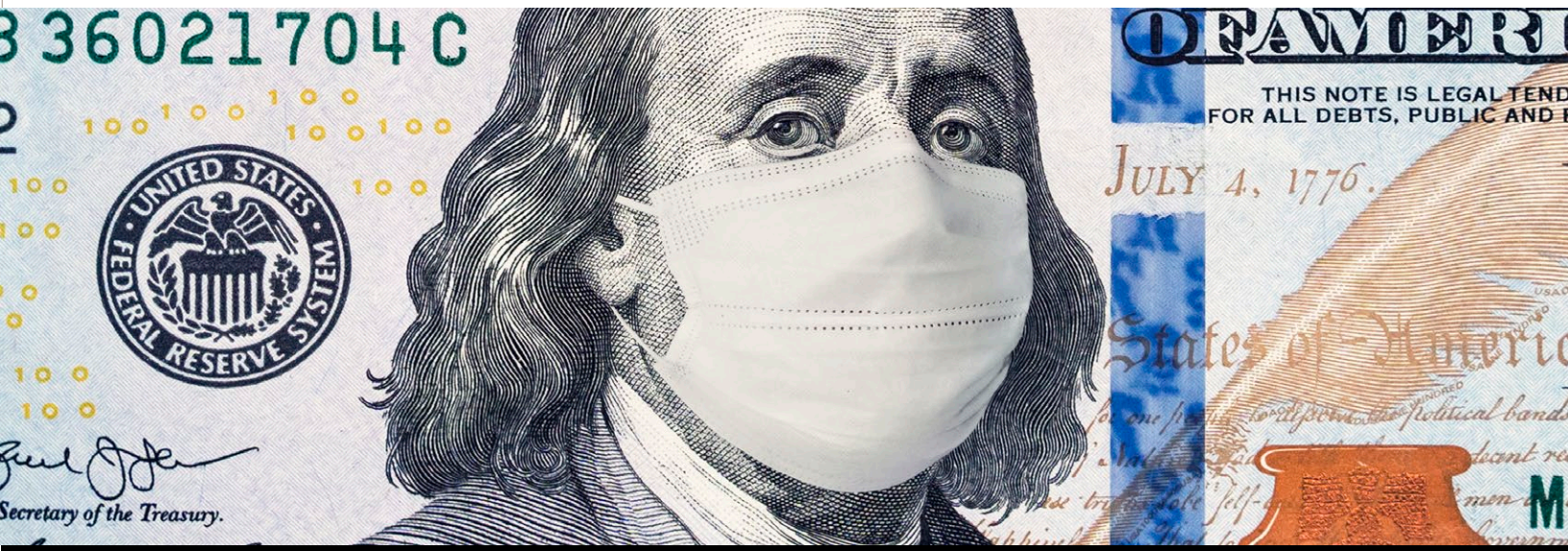
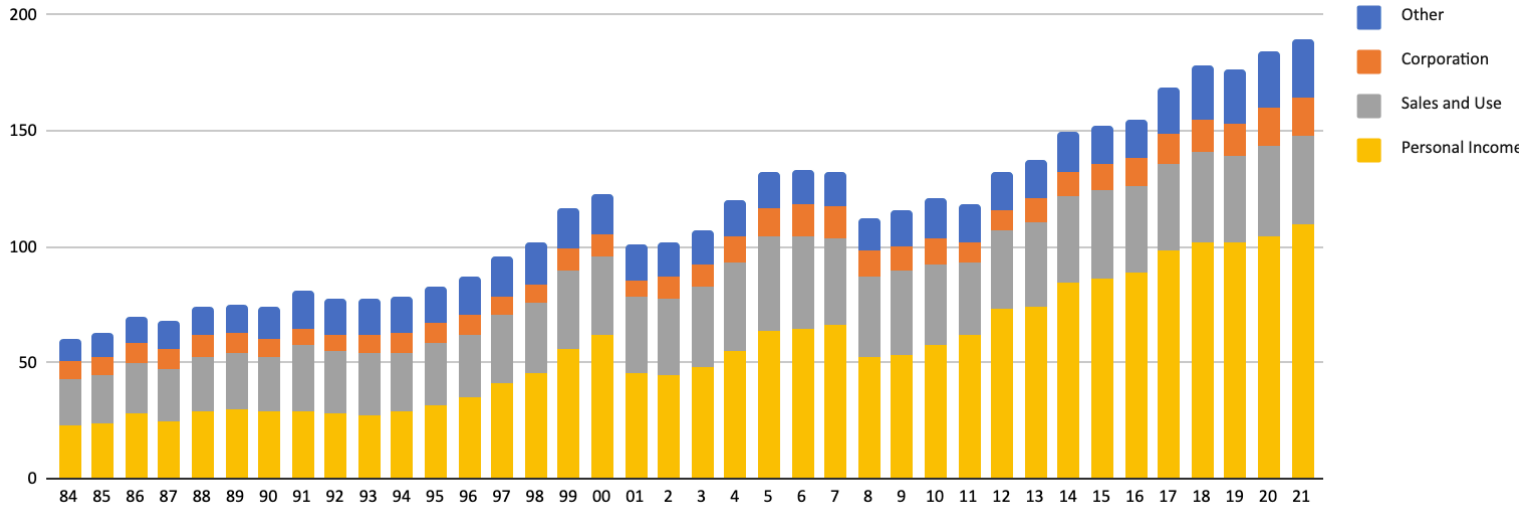


Figure 1 **California's Tax Revenues Have Not Grown Consistently, Resetting During Recessions**

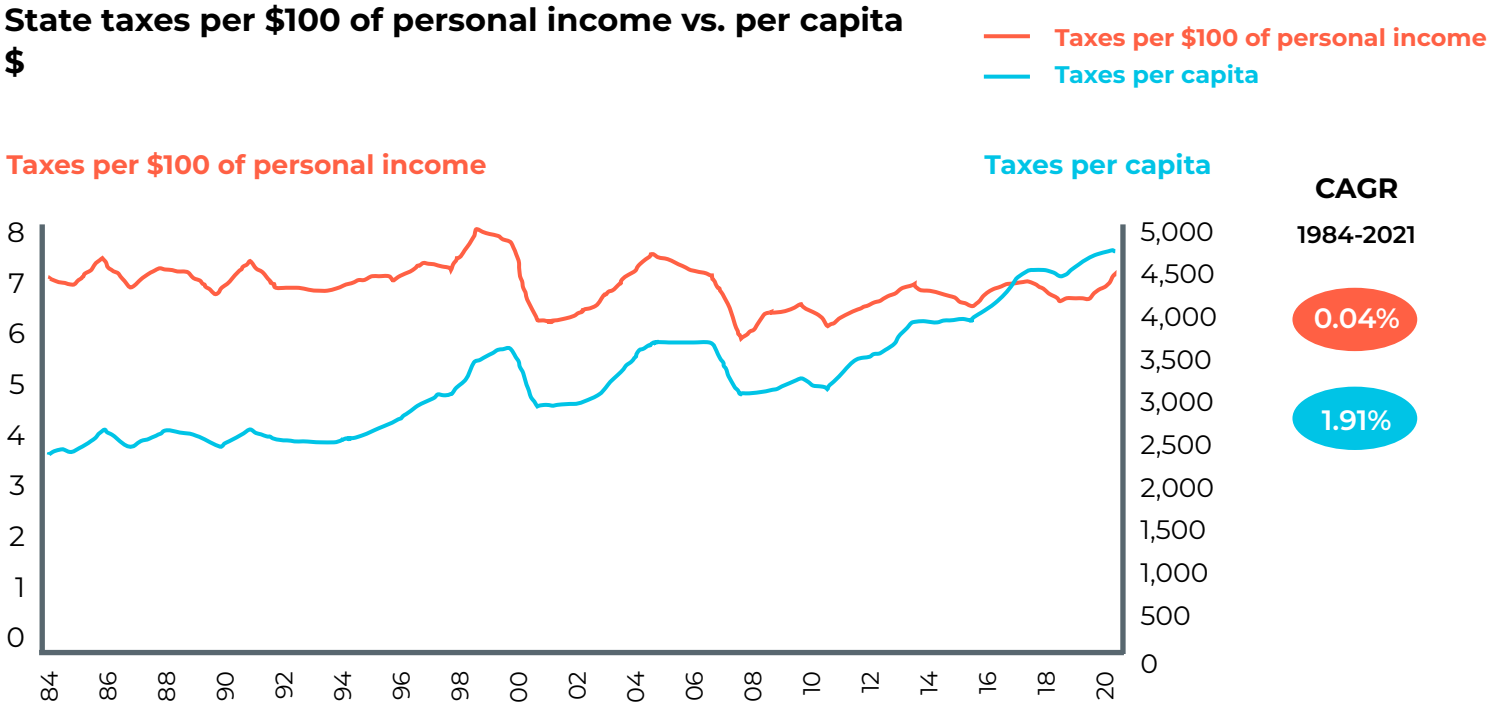


SOURCE: Authors' calculations based upon California Department of Finance Summary Schedules and Historical Charts.

To provide some sense of the impact that recessions have on California's revenues, the two sharpest contractions over the past forty years saw tax receipts decrease 18 percent from FY 2000 to FY 2001 and drop 15 percent from FY 2007 to FY 2008. Absent those sharp falls, California's state tax revenues would have grown in real terms at least an average 4 percent year over year – almost a full percentage point more than the economic growth experienced by the nation's economy overall.[1]

Figure 2 **California's Per Capita Tax Collections Have Increased Over Time While Taxes Relative to the State's Economy Have Been Constant**

State taxes per $100 of personal income vs. per capita
$



SOURCE: Authors' calculations based upon California Department of Finance Summary Schedules and Historical Charts.

1 Growth during the periods immediately following recessions was particularly impressive. California experienced 4.5 percent average annual growth from FY 1984 to FY 1999, 4.6 percent average annual growth from FY 2001 to FY 2007, and 4.1 percent average annual growth from FY 2008 to FY 2020.

State revenue in California has also grown faster than the state's population. This increase in taxes collected on a per capita basis, coupled with the size of the overall tax revenue base, probably contributes to California's reputation as a high tax state (Figure 2).

However, the idea that California is a high tax state does not capture the entire picture of state finances. California is an incredibly wealthy state, and an examination of tax revenue compared to growing incomes shows us that state taxes per $100 of personal income have actually remained flat (with 0.04 percent growth annually) in the same period that we saw such significant growth in the size of the state budget. Over the period, the sources of that revenue have changed. Proportionately, personal income tax revenues have grown while income from sales and use as well as corporate sources have decreased over the past several decades. The reliance on personal income taxes, coupled with progressive tax rates, has enabled California to leverage economic growth to fund its priorities. This dependence on wealthier individuals does make the fiscal system more volatile, however.

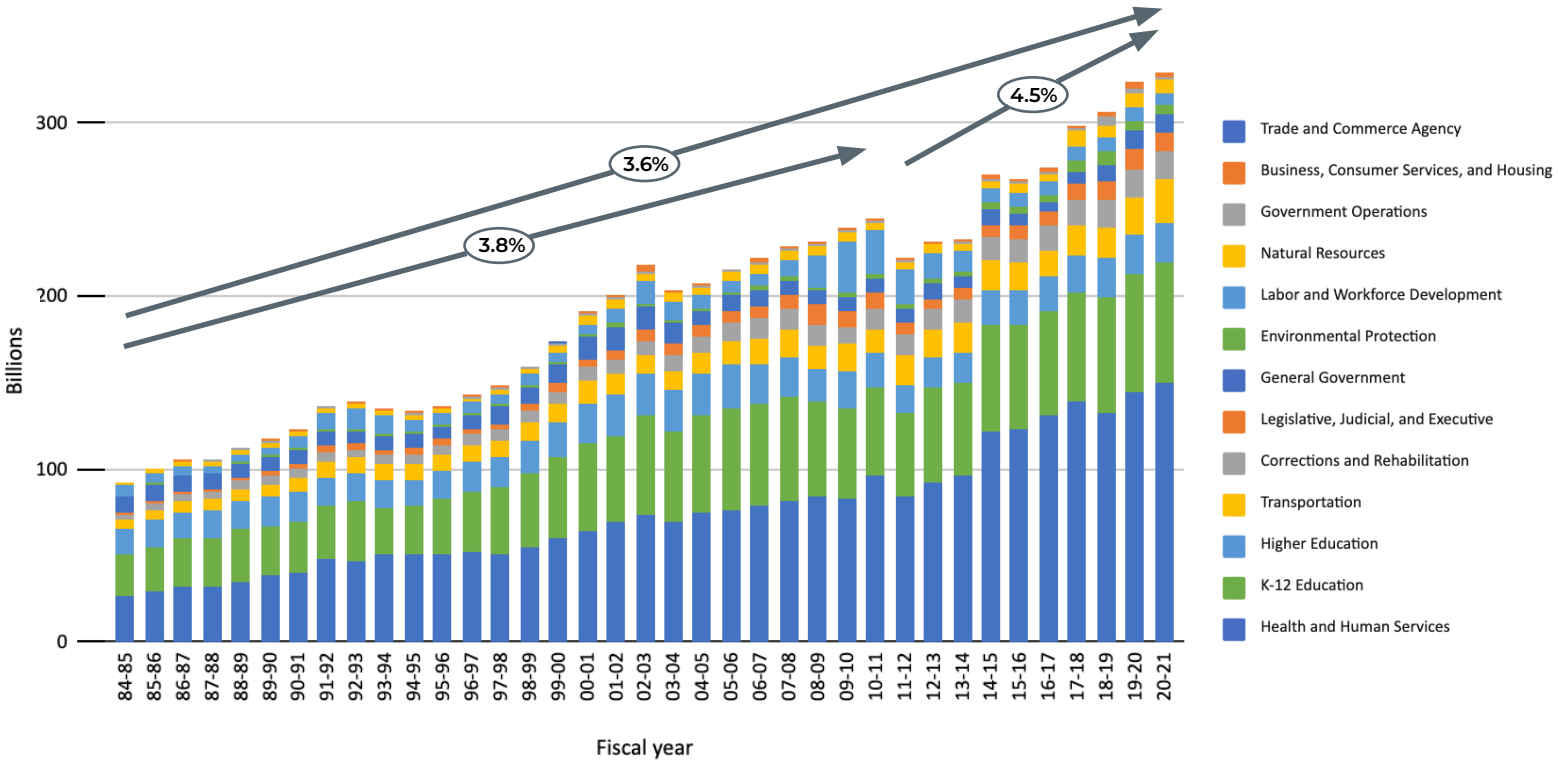
PROGRAM PRIORITIES HAVE SHIFTED

Just as the composition of the state's revenue picture has changed over time, so has its spending patterns. California's top three expenditure categories–including intergov-

ernmental transfers to local governments–are health and human services, education (including K-12 and higher education), and transportation (Figure 3). In FY 2020, California state government spent $149 billion on health and human services–45 percent of total expenditures, $94 billion on education–28 percent of total expenditures, and $24 billion on transportation–7 percent of total expenditures. Corrections, a category that many Californians assume is a large share of the state budget, accounted for $17 billion, or 5 percent of spending. As a proportion of total expenditures, healthcare and corrections spending has increased while education spending has decreased. From FY 1984 to 2020, as a percentage of total state and local expenditures:

- Healthcare expenditures increased from 29 percent to 45 percent
- Education expenditures decreased from 41 percent to 28 percent
- Corrections expenditures increased from 3 percent to 5 percent

Figure 3 **California Spends Most of Its Budget on Health and Human Services, Education, and Transportation**



SOURCE: Authors' calculations based on data from California Legislative Analyst's Office 2021. Historical Data.

Not surprisingly, California also spends more per capita relative to other states. The following table below presents the expenditure rankings for the other comparison states.

Table 1 **California Spends More Per Capita Than Many Other States**

State	Total Current Expenditures	Total Elementary Education Expenditures	Total Direct Higher Education Expenditures	Direct Health and Hospital Expenditures	Total Direct Corrections Expenditures	Total Transit Utility Expenditures
California	5	16	6	10	2	6
Florida	47	50	42	26	23	22
Illinois	16	21	35	44	29	7
New York	3	2	26	11	8	2
Pennsylvania	18	11	47	21	11	10
Texas	43	26	8	18	25	21
Washington	14	14	16	8	21	5

SOURCE: U.S. Census Bureau Annual Survey of State and Local Government Finances, 1977-2018, compiled by the Urban Institute via State and Local Finance Data: Exploring the Census of Governments.

LONG-TERM LIABILITIES THREATEN SUSTAINABILITY

The above discussion focuses on the changes in revenue and spending from one year to the next in the state's budget. However, a long-term discussion of California's fiscal situation would be incomplete without providing insight into other fiscal concerns that are present today and loom large as one looks to the future. Two areas, in particular, stand out:

- California's commitments to current and former state employees in the form of pensions and health care benefits.

- The state's historical under investment in infrastructure, which creates a significant obligation for the future to maintain its bridges, roads, and facilities.

These two long-term liabilities create different types of fiscal pressure. Public employee benefits have long included "defined benefit" pensions; this benefit is a commitment to pay a retired employee a specific amount each retired year.[2] California also promises many state employees assistance with health care costs during retirement. These commitments can lead to significant long-term cost pressures for the state. In 2018, California's state pension plans had a total liability of $640 billion but had set aside only $456 billion in assets, leaving a funding gap of $184 billion. That figure ranked California at 26th in the country (with #1 being the closest to full funding). Other post-employment benefits (OPEBs), like retiree health care, operate differently than the pension system in California. In the case of OPEBs, the state essentially pays as it goes, covering the costs of a given year as it is incurred, leaving the total liability unfunded. Pew (2018) estimated California's OPEB liability to be over $78 billion in 2016. Combined pension and OPEB commitments represent a future liability of over a quarter trillion dollars.

Putting a number on the potential liability associated with neglected infrastructure investment is more difficult. Over the years, the state has underinvested in its infrastructure – the power grid, water, roads, bridges, transit, and public buildings. The American Society of Civil Engineers estimates that nationally, the United States needs to invest an additional $2.59 trillion over the next ten years, which would entail increasing spending from 2.5 to 3.5 percent of GDP. Given these numbers, the scale of the unfunded infrastructure liability in California is likely to be large – perhaps as much as $250 to 300 billion.[3] Making the picture even bleaker, these estimates are simply to catch up on deferred maintenance and do not include the cost of new infrastructure projects that may be desired (e.g., to expand capacity at the state's colleges and universities) nor the cost of projects needed to respond to climate change.

MANY CALIFORNIANS STRUGGLE TO MAKE ENDS MEET

Given the scale of public investment California has made, one might expect the state to shine across a number of indicators. Despite the high level of spending, however, many residents struggle to afford to live in California, and the state's performance on a number of social metrics has been modest. Table 2 summarizes

2 The pension benefit is calculated using a formula that takes into consideration the individual's salary and years of service.

3 These are back-of-the-envelope estimates based on the ASCE's back-of-the-envelope estimates, so the precision is limited. The California estimates are based on about 10 percent of the national figure (of $2.59 trillion, California's share would be $259 billion) or what an additional 1 percent of state GDP ($30 billion) would be over ten years.

the state's relative position across a number of indicators. It shows that relative to other states, California's income inequality and wealth disparities loom large, its educational outcomes are middling, its housing is increasingly unaffordable, its incarceration rates are high, and its road performance is relatively poor.

For example, despite the state's progressive fiscal policies and programs (i.e., a progressive tax system and investment in the social safety net), 11.8 percent of Californians lived in poverty in 2019 based on the official poverty measure. That number climbs to 16.4 percent when accounting for the state's high cost of living and its range of family needs and resources. By this same measure, an additional 16.5 percent of Californians lived near the poverty line, which means that more than a third of Californians were poor or close to poverty in 2019.

Table 2

California Has Modest Outcomes Compared to Other States Across Various Measures of Well-Being

		State Rankings					
Indicator	**California Performance**	**CA**	**FL**	**IL**	**NY**	**PA**	**TX**
Poverty Rate Official U.S. poverty measure (USDA, 2021)	11.8%	26	32	23	37	29	41
Income Disparity Highest earners compared to lowest. A value of 0 indicates perfect equality while a value of 1 or 100 indicates perfect inequality. (Population Reference Bureau, 2021)	48.9 on Gini index	47	46	44	50	32	39
Housing Home ownership rate (Urban Institute)	54.6%	49	28	27	50	14	46
K-12 Education Spending Adjusted for regional cost differences (EdWeek, 2020)	$10,867 per pupil	38	42	13	2	10	48
High School Graduation Rate (NCES, 2020)	84.5%	31	20	27	37	25	8
Health Coverage Percentage of total population without health insurance (Kaiser Family Foundation, 2020)	7.8% uninsured	23	49	21	8	9	52
Criminal Justice State imprisonment rate (The Sentencing Project, 2020)	310 per 100,000 residents	18	40	16	9	25	42
Transportation infrastructure State ranking of overall highway performance and cost (Feigenbaum et al., 2020)	n/a	43	40	37	44	39	18
Long-term liabilities Unfunded pension liability ratio (Pew Charitable Trusts, 2020)	71% ($185 billion)	26	19	49	2	45	27

It is worth noting that it is likely that inequality in California would be considerably worse if it did not have a progressive tax system and substantial social service spending. This combination suggests Californians' value a community where individuals from a range of incomes are welcome and can afford to live. It is a goal that has yet to be realized, however. The challenge of reducing inequality, combined with threats of long-term liabilities, such as pensions and neglected infrastructure, suggest that pursuing such a vision will take considerable foresight and investment.

ORIGINS: BETTING ON A GROWING ECONOMY AND NEWCOMERS

Though they don't tell the whole story, three drivers—the economy, demographics, and policy decisions—have formed much of California's fiscal policy.

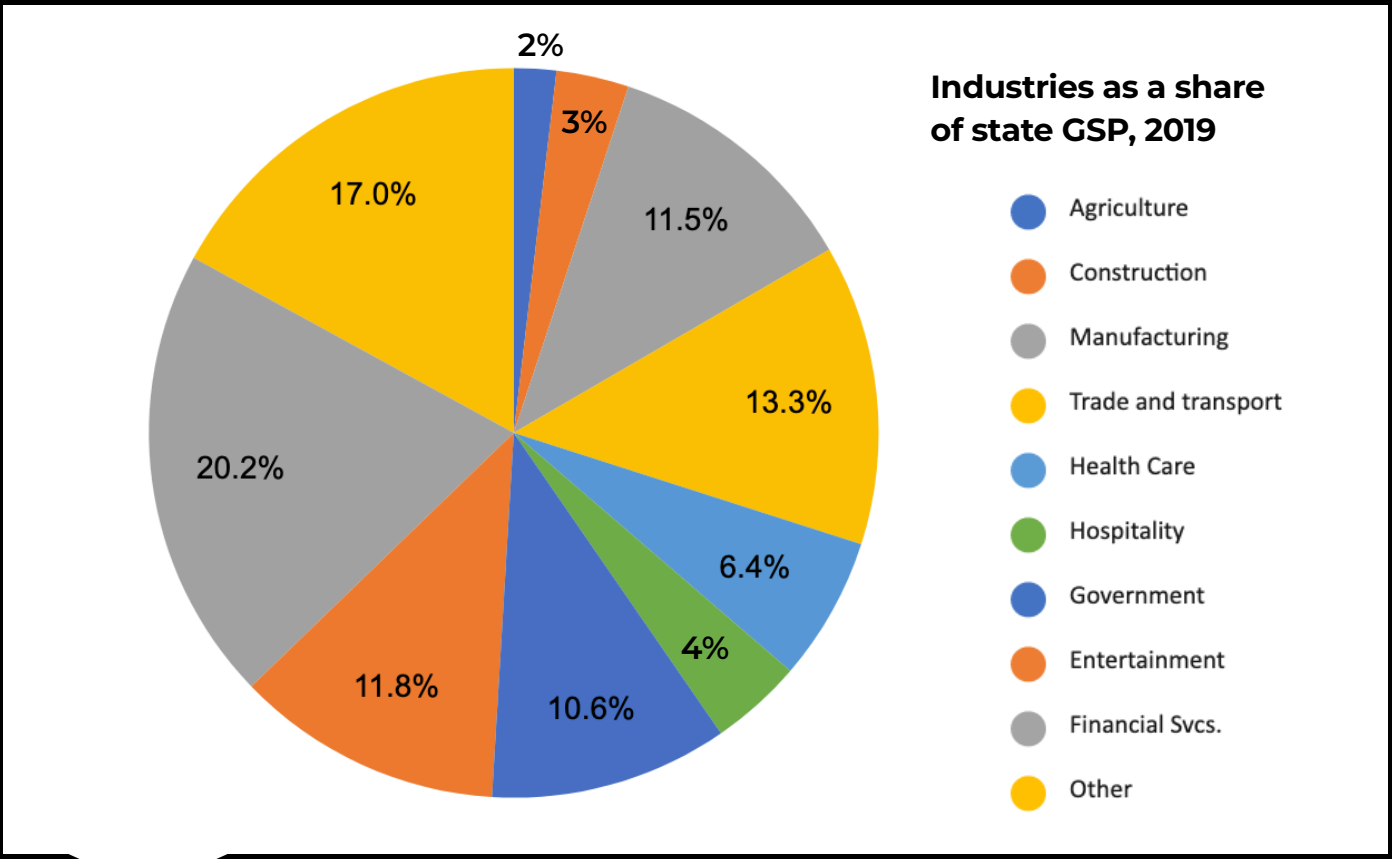
STATE REVENUES DEPEND ON A GROWING ECONOMY

The state has enjoyed an economy that has grown, often more quickly than the rest of the nation. Its capacity to innovate and diversify accounts for much of that success. That positive economic history hasn't rendered California immune to economic downturns. Recessions hit the state particularly hard and those impacts are amplified as they work their way through the state's public finance system.

California is home to 12 percent of the country's population and represents nearly 15 percent of the United States domestic output. In 2019, its $3.1 trillion gross domestic product would rank it as the 5th largest in the world behind only the rest of the United States (i.e., the other 49 states), China, Japan, and Germany. Relative to comparable states, California's economy was larger than the output of Florida, Illinois and Pennsylvania combined.

California's economy not only is large, but diverse. As Figure 4 on the following page shows, the state's economic pie is split into rather thin wedges. Financial services represent the largest single sector at one-fifth of the economy, as a percentage of gross state product (GSP) value.

Figure 4 **California's Economy is Diverse**



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis

NOTE: Other categories include utilities, mining, education services and other business services.

Other industries such as government, manufacturing, entertainment, and trade are represented nearly equally, each about one-eighth of total output. The agricultural sector, which constitutes only 2 percent of California's economy, still represents the most agricultural output by value of any state.

Over the last 75 years, the U.S. has seen 13 recessions – about one every 6 years – followed by growth periods of varying length.[4] The state's diversified economic portfolio has, at least to date, enabled it to recover from recessions. But during those downturns, the public finance system has felt the stress as govern-

4 The most recent recession associated with the pandemic was officially declared to have lasted just 2 months, the shortest on record. The pandemic recession is an outlier, where state revenues did not drop, mostly a result of the fact that those that lost their jobs were mostly low-income workers. Taxpayers with higher incomes stayed employed. That fact, combined with a strong stock market, led to higher revenues. In this case, the state's progressive tax system had a positive impact on revenues.

ment revenue in California is a function of economic activity. Taxing income, sales, and other elements of the economy generates the funds used to pay for state programs. Government revenues everywhere are sensitive to economic swings, but in California, the revenue roller coaster is extremely volatile with steeper slopes, both up and down. The state's progressive personal income tax system amplifies these effects, with its dependence on a relatively small number of high-income earners. To provide some sense of how dependent the system is on high-income households, for the 2018 tax year the California Franchise Tax Board reported that fewer than 20,000 taxpayers accounted for more than one-quarter of the personal income taxes paid that year. [5]

Because state and local governments are required to balance their budgets, the link is direct. As the economy grows, there are more resources available; if the economy slows or contracts, budget deficits emerge at a time when the need for services typically increases. During recessions, individuals lose their jobs, and their income drops. In turn, they begin to access the state's programs designed to support those in poverty. Recent research demonstrates a strong relationship between changes in California's unemployment rate and the demand for its social safety net programs.

The role of the economy in shaping California's fiscal policy is divided into two distinct branches. Along one branch, the ability of the state to innovate, adapt, and grow over the

5 There were more than 17 million tax returns filed in California in 2018. These 19,401 represent just over 0.1% of the total.

long term has been the driver of an overall growth in revenues and spending. In the short run, however, the impact of an economic downturn can precipitate a fiscal crisis. As will be discussed below, state fiscal policy often changes in the wake of recessions. Unfortunately, it is not clear that those recession-driven reforms have had a positive impact in terms of fiscal sustainability.

MIGRANTS TO CALIFORNIA ARE A BIG PART OF THE FISCAL STORY

The size and the composition of the state's population as a driver of the fiscal picture can be easy to overlook. At the most basic level, however, the relationship isn't difficult to understand. For example, if there are more people living in the state, that means more people paying taxes and therefore more revenue for the state. At the same time, a larger population also can create more residents in need of services, raising spending. From that foundational understanding, it becomes easy to imagine how shifts in California's population can have profound implications for fiscal policy that extend beyond that basic relationship. Beyond the overall size, the composition of the state's population in terms of factors such as age, skills, and educational attainment also contribute to the fiscal situation in California.

By the numbers, California is the country's largest state in terms of population, with one-in-eight U.S. residents living in the state.

A significant portion of the state's diversity has been fueled by migration into California. Migration – both from other states and other countries – has been a key contributor to California's capacity to have enough workers with the right skills to meet the needs of a rapidly innovating and growing economy. Prior to WWII, it wasn't unusual for migration to account for 80, 90, or even 100 percent of the total population growth. Over the 45 years following WWII, new residents from other states and abroad still contributed between 25 and 60 percent of the population increase each year.

Migration into California has long constituted a critical source of labor for the state's diverse economy and more recently has played a growing role in supplying workers with levels of education attainment to meet the needs of the state's innovative economic sectors such as technology. Robust migration into the state historically has been a key driver of the economy and resulting public revenue growth. In recent years, both migration and natural population growth have slowed significantly. If the population's workforce doesn't keep pace with those changes, the fiscal picture deteriorates.

POLICY DECISIONS OFTEN CONSTRAIN FUTURE CHOICES

Public policies – the constitutional provisions, state laws, and regulations that govern fiscal programs – are levers that policy makers influence directly. Voters, too, impact public policy

since they can make direct policy changes at the ballot box through the initiative process. Over the decades, policymakers and voters have made numerous changes to how the state approaches fiscal policy, sometimes in direct or indirect response to fiscal stressors, such recessions or rising costs. Often, those changes have introduced restrictions on policy makers, creating rules or formulas that leave elected officials with little discretion and have little to do with improving the sustainability of the state's finances. Proposition 13 is most notable in this regard. It is not an exaggeration to say that Proposition 13 was, and continues to this day to be, the most important change to California's fiscal landscape, reducing the revenue generated by property taxes and severely limiting the fiscal authority of local governments. Other policy changes, often motivated by the restrictive provisions of Proposition 13, further complicate the task of responding to fiscal crises. Some recent reforms, however, have contributed to a more sustainable fiscal future, particularly Proposition 25 (2010) which allowed the state budget to pass on a simple majority vote and Proposition 2 (2014) that created a workable rainy day reserve fund.

It is worth noting that the fiscal policy reforms discussed above all came about as a result of ballot initiatives, not through the regular legislative process. Given the central role that voters have in setting, and then changing, fiscal policy in California, the role that the public plays in policy making in California cannot be ignored. And, looking back at the origins of the current fiscal situation in the state, major public finance decisions began as either ballot initiatives or had to gain the voters' approval before they could take effect. Despite the fact that the public's depth of knowledge is limited and sensitive to events, the current fiscal priorities of the state reflect the collective opinions of its residents and vice versa.

TRENDS UNDERLYING CALIFORNIA'S FUTURE FISCAL REFORM SCENARIOS

When it comes to looking forward, it is difficult to imagine a situation where the key drivers that have shaped the current fiscal landscape would not continue to be central factors going forward. There are, however, other emerging (or emerged) trends that could prove to have a larger impact on California's fiscal sustainability in the future. However, major changes to policy will be needed if the state is going to be successful in confronting challenges such as persistent inequality or climate change.

THE ECONOMY, DEMOGRAPHICS, AND POLICY WILL CONTINUE TO DEFINE MUCH OF THE FISCAL LANDSCAPE

The biggest question regarding the role of the economy and state's fiscal soundness looking forward is whether California can continue to have its economy expand at a rate that outpaces the rest of the country and/or other developed countries. There is reason to be optimistic given that much of that success has been enabled by continued innovation and investment. There also are challenges and uncertainties.

On the side of optimism, much of the innovation has been accelerated by a research and development environment subsidized by public investment. The federal government invests heavily in R&D through its science and technology agencies and the state invests in its public universities. Private investment also continues to flow to the state, even after the run of media stories foretelling the demise of the Silicon Valley region during the pandemic. The pessimist would note that state spending on higher education as a share of the budget has declined in recent years, with the potential to affect the state's capacity to innovate. Other challenges to the evolution and long-term growth of the state's economy are its ability to supply workers with the necessary skills and the general changing nature of work.

The ability of California to retain an economic position that is the envy of other states is not a given. And, more important, the state already struggles with the fact that when recessions hit, some residents fare much worse than others. For example, during the Great Recession, low-income families (those in the bottom 10 percent) saw their income fall over 21 percent from 2007 to 2010. California families at the 90th percentile of income experienced only a 5 percent decline. Across race/ethnic groups, African Americans experienced the greatest loss, with income falling 25 percent compared to 10 percent overall. This uneven pattern con-

tinued across the state's regions with households on the Central Coast experiencing a drop in income of 18 percent while those in San Diego actually saw median household incomes rise about 5 percent over the period.

Beyond economic swings, three demographic trends have emerged that also will prove challenging to the state's future fiscal sustainability.

- **Migration concerns.** The number of international migrants has fallen while individuals have been leaving the state in greater numbers in recent years citing economic or family reasons for their move.

- **An aging population.** The slow rate of natural population increase, paired with the reduced migration mentioned above, presents problems that could reduce the growth of tax revenues while increasing spending.

- **Skills gap.** Concerns about a potential skills gap – the ability of the state's education system to meet the needs of the economy – have been voiced for over a decade.

Policy trends are the most difficult to predict. Many of the fiscal reforms instituted in the past have been driven by the crisis of the moment – or at least the last crisis endured. A number of these modifications have been built incrementally upon the seismic change that was Proposition 13 in 1978. As a consequence, the origin of the fiscal situation in California is a Rube-Goldberg type construction that defies any sense of coherence or simplicity.

The one feature that most of the past fiscal reforms have in common is that policy makers tend to implement changes with a short-term time horizon, and are incentivized to address the problem of the moment rather than more

pressing longer-term issues. Absent any sense of urgency, there simply hasn't been the political will to build the momentum needed to drive complex reform on such a scale. The absence of motivation to tackle large, long-term problems bodes ill for progress on issues like the outstanding pension liability or under-investment in infrastructure.

Public opinion, policy, and public finance have met frequently at the ballot box in California. As already noted, different interests have long used the state's initiative process to secure favorable tax treatment, carve out funding protection for a preferred activity, or create and then fence off a new revenue source. There is little doubt that past decisions made by voters now restrict the flexibility that is available to current policymakers. Estimates of the collective impact of these votes vary from a low of about one-third to as much as 86 percent of the state budget being locked in by propositions.

The impact that the ballot box has on future fiscal reforms also will be affected by who participates in California's electoral process. It is well documented that, at least historically, voters who take part in elections on a regular basis are not representative of the eligible voter population and the differences become even more pronounced relative to the population as a whole. The "exclusive electorate" in California is composed of voters who tend to be older, white, college educated, affluent, and homeowners. They also identify as "haves" rather than "have nots" (Baldassare, 2019). Eligible voters who, on average are less likely to participate in elections, are more likely to be renters, Latinos, less affluent, and less likely to be college educated.[6] There are also differences in turnout based on the type of election. For example, turnout in off-year elections, primary elections, and midterm elections tend to be even whiter, older, and more conservative.

Beyond the economic, demographic, and policy drivers, there are other trends that have the potential to have a significant impact on the state's fiscal future. These other trends include climate change, the changing nature of work and business, and federal policy shifts. There also is the potential for significant changes to California's fiscal policy in the event of catastrophic climate change events such as wildfires, massive shifts in how people work such as what we saw with the rise of work from home policies during the COVID-19 pandemic, or even substantial changes in the current funding from the federal government.

ADDRESSING BIG PROBLEMS WILL TAKE BIG CHANGE

Two themes run throughout the above discussion of the facts, origins, and trends that shape fiscal policy in California. The first

6 One uncertainty regarding the future of fiscal policy, should the ballot box continue to play the role it has in the past, is whether the composition of the electorate will change or remain the same. In theory, if more current nonvoters were to begin to participate, the spectrum of viable policy alternatives will shift.

theme is ***incrementalism***: the history and perhaps the future of fiscal policy is characterized by incremental decision making, with the possible exception of Proposition 13. Since 1978, fiscal policy change in California has fit one of two patterns. The first emerges after a jolt to the state's economy precipitates a fiscal crisis for the government. In response, policy makers look for a fix to fill the deficit gap they face that year, and perhaps the next. The alternative path is one where advocates seek funding for a particular program, and they head to the ballot box to carve out revenue to be set aside for their priorities. The advocates may have a long-term vision for their program, but it ignores the larger view of the other competing priorities that make up the rest of the budget and creates further fiscal limitations for the state in economic downturns. In both cases, long-term fiscal sustainability is not a consideration.

The second ongoing theme, related to the first, is that of ***inequality***. Inequality in California is a growing concern. Layered upon the state's economic inequalities are the accumulated effects of racial discrimination, which amplifies the costs borne by those who experience these inequities. Institutional racial discrimination that has limited economic opportunities and wealth creation makes it that much harder for some of the state's residents to both weather recessions or get financially ahead during economic booms. That inequality exists despite the fact that California has one of the most – if not the most – progressive tax revenue systems in the United States. It also has one of the country's most robust social safety nets and a collection of social programs. However, if the state is going to reduce inequality, it will have to pursue policy change on a very large – and costly – scale. To fund such an effort would require more than just incremental changes to existing revenue policy if the new policies are going to be fiscally sustainable.

This reality brings the discussion back to the incremental approaches of the past. In addition to economic inequality, other large problems loom ahead for the state—namely an unfolding housing crisis and the growing threat of climate change. In response, policy makers could choose to continue to muddle through, pursuing reforms that make progress at the margins, shoehorning the costs into the existing fiscal structure.

An alternative path would be to consider non-incremental solutions to these problems. Doing so, however, would require commitment to overhauling portions of the fiscal system to ensure that the solution is sustainable. The most dramatic direction to take would be to begin to unwind some of the more notable policies from the past. Given the outsized impact that Proposition 13 has had, it is worth contemplating what the probability of reforming or even getting rid of it is. Other changes such as modernizing the outdated sales and use tax, reimagining how the state invests in economic growth, and targeting new economic stimulus programs to benefit Californians who need the support the most would be the most logical starting points.

THE FUTURE OF FISCAL REFORM IN CALIFORNIA

FOUR ALTERNATIVE SCENARIOS

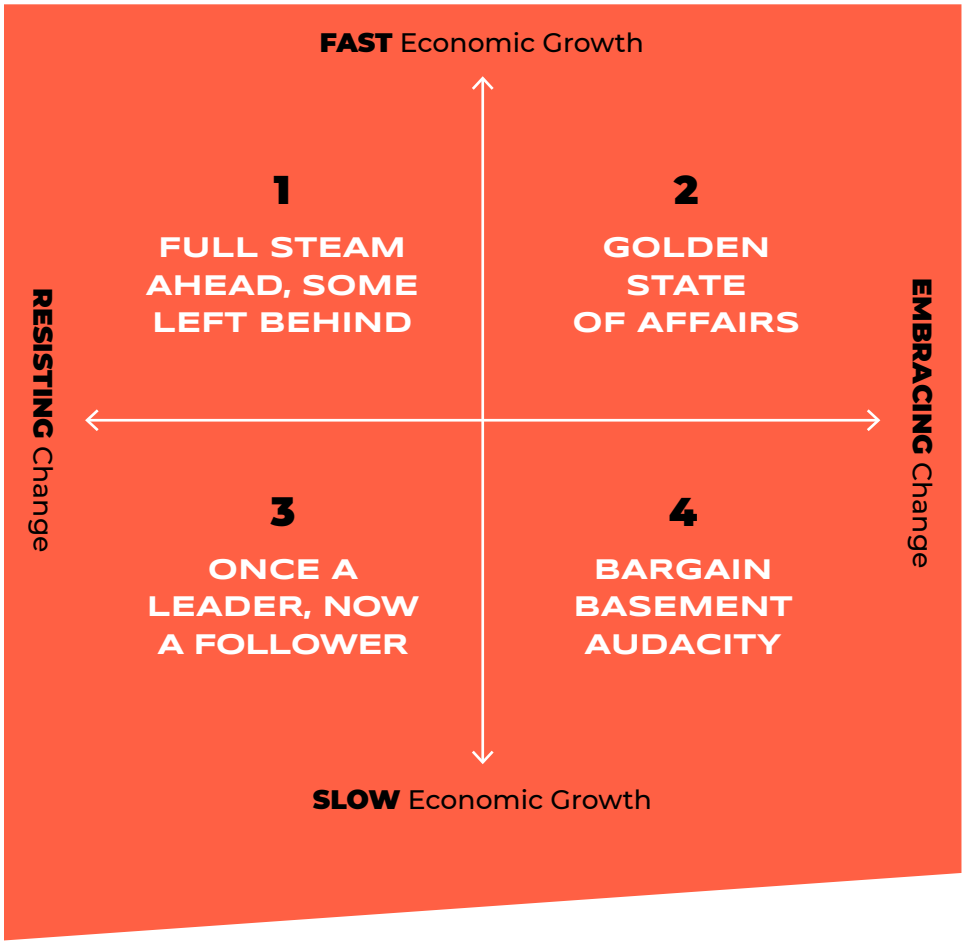
SCENARIOS FROM THE FUTURE

FISCAL REFORM

Foresight practitioners use scenarios to help make future possibilities more vivid and tangible, immersing the reader in the particular details of a future world so that they can mentally situate themselves in what it would feel like to live there. Without scenarios, the signals, trends, and other research that underlie strategic foresight work can feel distant and abstract. Scenarios can be used to center a group conversation in a positive and concrete picture of a future state so that stakeholders can pursue a shared vision for how to respond to that possibility, or mobilize action to avoid an undesirable outcome.

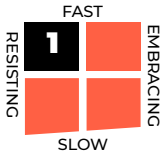
There are many uncertainties regarding the fiscal future of California, including several overlaps with other sections of the California 100 work (e.g., governance, migration, federalism, climate change, etc.). To map out possible scenarios that represent directions for the state, we settled on two critical uncertainties: the performance of the state's economy and the willingness of the public and elected leaders to accept change and embark on different policy paths.

The Y-axis recognizes that if California maintains its relative economic dominance, it will need to attract investment and an adequate supply of talent. These elements will help create businesses that will be the leaders in an evolving, rapidly growing economic environment. On the other hand, slow growth would suggest that California has lost its capacity to innovate and adapt. The X-axis of uncertainty is the degree to which Californians and their representatives are willing to explore significant, non-incremental change and policy alternatives that represent a major departure from the practices of the past few decades. This may require experimenting with new, less-tested ideas.



FULL STEAM AHEAD, SOME LEFT BEHIND

California experiences FAST economic growth despite RESISTANCE to change



California's economy stays on its current track. Thanks to diverse industries, technology-fueled innovation, and a progressive tax structure, the economy continues to grow faster than most other states and nations. California's fiscal policy remains progressive, but it stops short of demanding any real sacrifice. State leaders embrace incremental policy changes to tackle climate change, expand affordable housing, and improve education. Still, they do not press forward policies that would force people to live, work, or travel much differently than they do now. They welcome immigrants insofar as they will help fill high-demand jobs, particularly in the tech sector. The result is that California cannot eradicate poverty or the root causes of inequities.

California continues to attract new businesses, tech innovators, private investors, and skilled workers, driving economic growth. Limited government interference allows innovation to thrive. Higher-wage workers do well, but limited regulation and the high cost of living make life challenging for everyone else. Californians are progressive in theory but conservative regarding their actual behavior. Voters resist efforts to change neighborhood zoning laws, expand immigration, or increase residential property taxes. They cling to everyday conveniences, even at the expense of the environment.

HISTORICAL PRECEDENTS

1978: Proposition 13 capped property tax revenues, stifled local tax authority, and led to distortions in the housing market.

2008: The Great Recession led to record job losses, a housing market bust, and wider income inequalities.

2018: State Senator Josh Newman's vote to pass a gas tax prompted angry voters to recall him.

FUTURE DRIVERS

Economic: Total state tax revenues continue to grow at a real rate of 3%+ annually.

Demographics: Highly skilled immigrants continue to move to California, while more than 15% of Californians live in poverty.

Public Policy: Californians consistently support "taxing the rich," but NIMBYism prevails on larger issues.

Climate: Climate emergencies like wildfires put a strain on the state budget.

SIGNALS

Gig workers remain contract workers

WHAT: In 2020, California voters supported Proposition 22, allowing app-based companies like Uber and Lyft to classify workers as contractors.

SO WHAT: Tech companies may be more amenable to doing business in California if they feel safe doing so without the threat of organized labor or government interference.

brookings.edu

School funding cut by $2,000 per student

WHAT: State funding for K–12 education fell by 17 percent between 2007–08 and 2011–12.

SO WHAT: Revenue volatility will continue to affect public programs with long-tail impacts.

ppic.org

Legislature can't agree on zoning bill

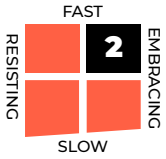
WHAT: In 2020, California's Legislature defeated SB 50, which would have forced communities to increase housing density.

SO WHAT: Subsequent legislative efforts are "light touch," suggesting incrementalism over reform.

calmatters.org

GOLDEN STATE OF AFFAIRS

California experiences FAST economic growth and EMBRACES change



Fiscal policies are regularly updated to reflect modern society, ensuring rapid recovery during economic downturns and long-term economic growth. California's thriving and diverse education and workforce development programs ensure that California has a deep bench of creative talent, entrepreneurs, and skilled workers across various industries, even as the state continues to attract high-skilled migrants from other states and countries. In combination with modern fiscal policies, a well-educated and prepared workforce ensures that California has enough revenue to address looming concerns like climate change and resource scarcity. California implements not only programs aimed at closing gaps in income, opportunity, and economic mobility — but also those intended to dismantle accumulated effects of racial hierarchy.

Californians continue to see immigrants as net-positive, welcoming both migrants who can fill high-skilled jobs and immigrants seeking safe refuge. California continues to invest in equity and quality at the postsecondary level, maintaining its status as a world higher education leader. UCs and CSUs continue to account for 7 of the nation's top 10 institutions in terms of social mobility. They also generate research and high-skilled workers that fuel the state's economy.

HISTORICAL PRECEDENTS

1960: California adopted the Master Plan for Higher Education.

2013: California passed the Local Control Funding Formula, making K-12 spending more equitable.

2014: California created the Rainy Day Fund.

FUTURE DRIVERS

Economic: California continues to reap strong income tax revenues from a large number of wealthy individuals but also broadens its tax base.

Demographic: Thanks to immigrant-friendly policies and a welcoming populace, highly skilled migrants continue to move to California.

Public Opinion: Californians vote to reform exclusionary housing policies and are willing to increase and reform taxes.

Climate: California invests in climate-resilient infrastructure and has sufficient state funds to tackle climate emergencies.

SIGNALS

Tech innovators experienced explosive growth during the pandemic

WHAT: California-based tech companies like DoorDash and Zoom reaped massive profits during the pandemic.

SO WHAT: Innovators will continue to contribute significant tax revenues to the state.

cnbc.com

Welcoming immigrants and innovation

WHAT: Nearly four in five Californians believe immigrants are a benefit to the state.

SO WHAT: A welcoming attitude toward immigrants means that employment and immigration laws make it easier for people to come and work here.

ppic.org

CSU creates new global Hispanic Innovation Hub

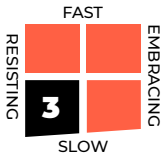
WHAT: CSU and Apple partnered to create a new center to attract Latino and underrepresented students into STEM studies.

SO WHAT: This public-private demonstrates a commitment to investing in the state's future innovation needs more equitably.

edsource.org

ONCE A LEADER, NOW A FOLLOWER

California experiences SLOW economic growth and RESISTANCE to change



California's economic growth slows as its population declines and tech innovators, lucrative corporations, and wealthy individuals leave for other states. Other nations and U.S. states benefit from the highly skilled inward migration and the innovation that once fueled California's economy. This begins a vicious cycle, with slow economic growth leading to fewer tax revenues to support existing programs and services. Meanwhile, the demand for these services grows as California's population ages, and more people struggle to find good-paying jobs and affordable housing. Rising pension debt and an unwillingness to raise taxes mean that California's costs exceed its revenues. The state cannot maintain existing programs fully and has less capacity to tackle new challenges, like climate change.

With fewer dollars to go around yet a higher demand for public services, California sees an increase in poverty, homelessness, and crime. Californians with means are increasingly unwilling to tax themselves as they see little connection between government spending and improved schools, infrastructure, or quality of life. Some blame immigrants and ineffective bureaucracy. With fewer revenues California is less able to invest in the infrastructure needed for California's future, like renewable energy, transportation, climate resilience, and water.

HISTORICAL PRECEDENTS

1980s: The decline of the "rust belt" states due to deindustrialization.

1991-2001: Japan's period of economic stagnation is known as the "lost decade."

FUTURE DRIVERS

Economic: State tax revenues slow as tech innovators, corporations, and wealthy individuals go to other states.

Demographic: The state population declines as more people leave the state than come in. Immigrants are lower-skilled and require more social services than in the past.

Public Opinion: State leaders are reluctant to reform state pension systems, even as liabilities grow, fearing public backlash.

Climate: Ongoing climate emergencies like wildfires put a major strain on the state budget, forcing reductions to other services.

SIGNALS

The nation's homeless capital

WHAT: In 2020, California was home to 28% of the nation's unhoused population.

SO WHAT: Homelessness and related problems will increase if California doesn't address its housing affordability crisis.

huduser.gov

2020 tax efforts fail at the ballot box

WHAT: In 2020, California voters rejected a slew of fiscal reform propositions.

SO WHAT: If voters are increasingly skeptical that their tax dollars will be used effectively, state revenues will fail to keep up with rising costs.

latimes.com

Deferred maintenance on power lines has led to shutdowns and fires

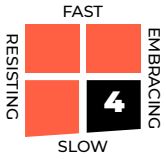
WHAT: Disasters like the 2019 Camp Fire have been linked to negligent maintenance on PG&E lines.

SO WHAT: California needs to invest more in infrastructure to mitigate future disasters.

blog.ucsusa.org

BARGAIN BASEMENT AUDACITY

California experiences SLOW economic growth but EMBRACES change



California's economy cannot evolve, and/or other states and global competitors catch up. At the same time, residents and their elected representatives are willing to push new policy ideas that make the most of limited resources. They embrace the idea that the state's chief role is to invest in people, not just to increase GDP. Consequently, the state updates its revenue structure to ensure fairness and provide support for spending priorities that keep pace with evolving needs. For instance, the state embraces progressive policies that aim to redistribute wealth, reduce poverty, and invest in education and environmental sustainability. But because economic growth has slowed, the state must try to do more with less, targeting the areas with the greatest need. With fewer resources to invest, the state must choose which regions, industries, and populations receive the greatest investment. This contributes to a slowdown in innovation and concentrates market productivity in certain sectors or regions. The economy continues to grow but at an increasingly slower rate. In the meantime, California struggles to pay down pension liabilities and retiree health care commitments amidst a constant barrage of fiscal, climate, and other emergencies. It seeks to reform these programs, but with the "boom" years fewer and farther between, it is faced with difficult trade-offs, such as should early childhood programs be expanded at the expense of support for higher education?

HISTORICAL PRECEDENTS

2006: California passes Cap and Trade policy.

2014: Affordable Care Act health care expansion.

2016: California creates CalSavers, a state-facilitated retirement program.

2016: California creates its state Earned-Income Tax Credit program.

FUTURE DRIVERS

Economic: Tax revenues decline even as the state updates its revenue structures.

Demographic: California's population growth declines as high-skilled immigrants and Californians seek jobs and economic opportunities in other states.

Public Opinion: Californians embrace progressive fiscal policies to reduce poverty and redistribute wealth.

Climate: California passes policies aimed at achieving environmental and climate sustainability, but it cannot deeply invest in infrastructure.

SIGNALS

CalSavers has increased access to retirement savings

WHAT: CalSavers works with employers to establish Roth-style retirement savings accounts for employees.

SO WHAT: Before this program, roughly 50% of workers had no access to payroll-based retirement savings.

laborcenter.berkeley.edu

Other states are actively pursuing entertainment production

WHAT: Georgia has been one of the most aggressive states in providing tax incentives for movie and TV producers.

SO WHAT: California cannot take the global status of "Hollywood" for granted.

forbes.com

Bottleneck at the state's (and country's) busiest port

WHAT: In 2022, container ships experienced record delays at the Port of LA.

SO WHAT: Transit and transportation account for one-eighth of the state's economy.

maritime-executive.com

FUTURE POLICIES FOR FISCAL REFORM IN CALIFORNIA

Choices among governmental policies depend partly upon which future scenarios seem most attractive, but they also depend upon our perspectives on the proper role of government, on the resources available to government, and on the likelihood that government will succeed in its endeavors. Doing nothing is sometimes the best policy option, but doing nothing often uncritically accepts the current mix of policies and the future they entail without considering the alternatives. At times over the past seventy-five years in California, that meant accepting discriminatory racial housing covenants, restrictive zoning laws, few restrictions on air or water pollution, "separate but equal" schooling, the dismantling of transit systems, and many more things that are now thought to have been wrong or misguided. We also have seen aggressive policy measures in California that have had unintended consequences, from the impacts of Proposition 13 on local government budgets to the way the California Environmental Quality Act has affected housing supply and manufacturing.

Because we are thinking about the future and we do not want to be hemmed in by the sta-

tus quo or a lack of imagination, we put forth an array of alternative policies tied to each of the different scenarios. Readers are certainly free to decide which ones–or combinations of them–appear to be more plausible and preferable. For many, the Golden State of Affairs projects the most attractive future path and the policy suggestions associated with it look for ways to promote that direction. Our policy recommendations associated with scenarios that embrace the status quo aim to identify policies that would mitigate the negative impact of such a direction. Readers, of course, should consider which scenario best captures the California they want to live in, and evaluate which policy recommendations in terms of their ability to get us there.

The starting point for each set of recommendations is the current situation in which the state finds itself. Though the short-run effects of the pandemic recession are still playing out, California's overall fiscal situation is relatively stable. Our review of the facts, origins, and trends reveals the following findings:

- Fiscal sustainability is dependent upon continued economic growth.
- Californians are committed to a progressive tax system and have supported a relatively expansive social safety net.
- Inequality and rates of poverty are high, though it probably would have been worse with a different policy mix.
- Past policy choices constrain policy makers and leave the fiscal system more vulnerable to economic shocks.

From this starting point, it is possible to develop a set of principles that guide policy decisions, regardless of the situation. These principles reflect California's particular situation and the values it has expressed, combined with overall responsible practices for fiscal policy. In short, they would suggest that policymakers will need to:

- Seek fiscal sustainability by addressing long-term liabilities and keeping pace with the changing economics and demographics of the state.
- Support a modern system of revenue collection that is efficient and provides adequate resources for the type of government Californians want.
- Invest in programs that seek to reduce the effects of inequality as well as support continued economic growth.
- Empower policymakers with the ability to respond to fiscal crises and restore the link between taxing, representation, and governance.

Maintaining these principles will be harder or easier depending upon what the future holds. The following discussion presents policy recommendations for each of the four scenarios that are consistent with these principals, though how they play out will be a function of the particular circumstances. Consistent with the focus of the prior discussion, the recommendations center on state government as the key actor. For each scenario, we discuss policy recommendations in terms of taxing, spending programs, and the processes and politics that drive fiscal decision making.

FULL SPEED AHEAD; SOME LEFT BEHIND

Fast Economic Growth, but California Resists Change

This scenario represents a continuation of the status quo, where California's economy continues to expand while essentially maintaining the current mix of policies and priorities. Recommendations are constrained, therefore, to build out from the margins of existing policies. The state's changing demographics put pressures on the existing fiscal structure and neglected liabilities loom large. The goal of the recommendations for this scenario focuses on making marginal policy changes that will mitigate inequality in the state while trying to introduce more fiscal sustainability.

REVENUE

Tax the Rich: Providing enough revenue to maintain the current mix of state safety-net programs, continue to support education, and keep the state's infrastructure from deteriorating further, will require an expansion of the existing revenue stream. Given past policy choices and current public opinion, policymakers look for additional ways to "tax the rich." One approach would be to institute provisions that tax the transfer of wealth either as gifts or at death. The threshold for either would be high and could conform to the federal guidelines and include protections for genuinely small businesses. The basis for taxation of the transfer would be stepped up to reflect the market value at the time. Depending upon revenue needs, marginal rates could also be raised on personal and corporate income taxes or possibly examine ways to increase the sales tax base, which is discussed in Scenario 3.

SPENDING

Pay Down Unfunded Liabilities: The goal of the spending recommendations is to increase long-term fiscal stability and mitigate the effects of poverty in the

state. The continued generation of revenue enables policymakers to contribute to paying down some portion of the state's unfunded liabilities. The state continues to make one-time payments to pensions and borrowing at low interest rates to address infrastructure needs.

Also, shoring up the state's safety net becomes a priority. For example, the pandemic recession demonstrated the deficiencies of the state's unemployment insurance program. Making the needed investments to update the systems that provide benefits would enable them to respond in crisis with the flexibility to target assistance effectively. Finally, policymakers look to continue building the state's safety net by expanding health care (Medi Cal) coverage to undocumented adult Californians.

PROCESS AND POLITICS

Expand Reserve Policies at State and Local Levels: Given that the structure of the state's revenue system is unlikely to be updated significantly under this scenario, volatility will remain an issue. Further expanding taxes to include wealth transfers would do little to decrease volatility and could actually make the swings more extreme. As a result, policymakers look for ways to hedge against dramatic economic downturns by expanding reserve policies at both the state and local level. Building off of the current rainy day fund at the state level becomes an immediate priority. Also, the state looks for ways to make it easier for the UC, CSU, CCC and K-12 districts to save in a significant way. Codifying the use of multi-year projections of state revenue and spending would also assist in the ability to respond to economic shifts.

Under this scenario the political context remains unchanged and limits the policy alternatives. While Californians express a desire to do "something" to address inequality and poverty in the state, they stop short when it bumps into reconfiguring the tax structure or changing their local zoning laws. Given this reluctance, it is difficult to imagine the fiscal changes necessary to mitigate the impact of the scale and scope of a problem such as climate change.

ONCE A LEADER, NOW A FOLLOWER

Slow Economic Growth and California Resists Change

The state has little willingness to shift from the status quo in terms of policy choices, at the same time, the ability of the state's economy to outperform competitors wanes. These circumstances combine to create a downward spiral as revenues cannot keep pace with needs of the state while increased unemployment and underemployment strains the social safety net. Simply maintaining the current level of services is unlikely and it is impossible to have the resources available to respond to additional challenges such as the unfunded liabilities and climate change. The goal of the recommendations, therefore, is to try to limit the consequences of a shrinking safety net and a sluggish economy on the state's poorest residents.

REVENUE

Seek Ways to Maximize Personal and Corporate Tax Revenues: In the absence of any support for modernizing the state's tax structure, personal income taxes continue to account for the majority of state revenue and remain volatile. A decline in the number of very wealthy individuals and the overall level of their income may both decline if California loses its position as an economic force, making it harder to look to the wealthiest to produce additional revenue. It might be possible to consider wealth transfer taxes (such as those discussed in the previous scenario), but the additional tax burden the state's economic decline, combined with the accompanying declines in quality of life, may provide the necessary incentive for mobile individuals to relocate. Therefore, policymakers look for ways to maximize personal and corporate tax revenue by leaning into the federal code— identifying the points of conformity that would advantage total revenue for the state but apply nationally. In an effort to free up some capital for infrastructure, the state's pension funds dedicate a portion of their investments for public projects.

SPENDING

Maximize Resident Participation in Federal Safety Net Programs: The general strategy with regard to spending under this scenario is damage control, emphasizing steps that try to protect the state's most vulnerable and minimize the outward migration of the state's wealthiest. With revenues declining, the state looks to maximize Californians' participation in safety net programs, removing barriers to enrollment and making modest investments in outreach programs. Specific attention becomes focused on those programs where the federal government is responsible for the majority of the funding, such as the Supplemental Nutrition Assistance Program (SNAP/food stamps), the school meals program, and Pell grants for college. All vulnerable populations are likely to feel the impact of program cuts, but legislative staff and the administration work together to try to protect the state's very poorest for as long as possible. This could be accomplished by changing eligibility requirements for benefits first before reducing the level of benefits.

PROCESS AND POLITICS

Protect the Existing Reserve Policy: Changes to the fiscal process focus on minimizing the uncertainty and disruption as much as possible. With revenue falling in real terms, it is unlikely that reserves could be expanded. In these circumstances, the legislature protects the existing reserve policy and looks to use them to slow the decline.

Use Data to Understand the Impacts of Program Cuts: Given that program cuts are likely, administrative officials establish a system where safety net program administrative data is linked. Then, when policymakers face the prospect of cutting spending for these programs, they have a clearer picture of the collective impact of how their decisions will affect vulnerable populations.

Support New Business Creation: In an attempt to attract private investment into California as a supplement or even replacement to public spending, the state looks for ways to fast-track business creation. Stopping short of tax incentives, the legislature and governor seek to remove barriers to new business by looking to waive or suspend particular regulatory requirements. This would be similar to the steps taken to fast-track the building of stadiums for professional sports teams, though the enterprises would be smaller with a much higher return on investment.

The necessary, but most difficult part of overseeing fiscal policy under this scenario would be for policymakers to adjust to the "new normal." This transition would acknowledge that it may be a long time, if ever, before California returns to a world of regularly growing tax revenues. In the past, the practice has been to look at short-term measures—deferring payments and borrowing—in anticipation of better years to come. But, if the economy flat-lines, even a relatively good year won't be enough to dig out of a deep fiscal hole. At that point, the problems will just compound.

The economic stress, combined with the inability of the government to lessen the impact, will make the politics around fiscal policy even more difficult. As the economic divide between "haves" and "have nots" widens, it will be more difficult to find areas of compromise. Avoiding a downward spiral will require leaders to convince the state's residents that there is a collective interest in reducing gaps across all groups.

SCENARIO

BARGAIN BASEMENT AUDACITY

Slow Economic Growth but California Embraces Change

The state's ability to adapt and grow more quickly than others stagnates or even declines. Californians and their elected leaders, however, are committed to re-claiming the mantle of policy innovator, pushing the envelope of fiscal change while adjusting to the new normal of modest economic growth. The new willingness opens up a wider range of possible policy options, with a chance to explore more creative ways for the state to address some of its challenges. Policymakers will have to be creative as they will be working with fewer resourc-

es than in the past. The overall goal of policy under this scenario, then, is to adjust to a new economic reality while still seeking to reduce inequality in a sustainable manner.

REVENUE

Modernize Sales and Use Tax Base: To broaden the state's tax base and reduce some of the volatility associated with revenue, the legislature acts to modernize the sales and use tax base. As consumption patterns have shifted over the decades away from goods and towards services, a significant share of potential revenue is foregone. By applying the sales tax to services (e.g., financial, legal, consulting, etc.) consumed in California, the state could offset some of the effects of the slowing economy on its total revenue. Currently, sales and use taxes apply to the smallest share of services consumed relative to the comparison states (see table 3). The gas tax also is replaced with a miles driven tax, reflecting the shift to electric vehicles.

Table 3

Tax base coverage under general sales tax, share of overall spending and major categories (%)

	Household spending	Durable Goods	Non-durable goods	Services
California	32	100	48	14
Florida	37	97	35	23
Illinois	40	100	87	11
New York	31	94	19	27
Pennsylvania	27	95	20	17
Texas	31	62	36	19
Washington	37	96	38	23

Reform Proposition 13: Finally, in an environment where the public is willing to make non-incremental policy changes, reforming Proposition 13 becomes high on the list of new revenue policies. Prop. 13 reforms would have both revenue and process effects, as we discuss further below. On the revenue side, changes to either the maximum tax rate or an adjustment of the cap on annual assessments could raise more revenue. Changes that were revenue neutral, but restructured the incentives might be more politically palatable in an era where the economy isn't growing.

SPENDING

Maintain and Expand Programs with Largest Returns on Investment: Maintaining funding support for education programs becomes paramount in an effort to provide for economic mobility, along with innovation in how those educational services are delivered. Other programs that provide a relatively large return for a small public investment by the state are expanded. These would include the state's EITC program which could be augmented by a credit for eligible taxpayers who contribute to their CalSavers retirement savings account.

Create Opportunity Accounts: The legislature creates Opportunity accounts ("baby bonds") for low-income newborn Californians which would be held in trust and invested until the child turned 18. In short, any new spending programs should focus on opportunities to help low-income Californians build wealth at a relatively low direct cost to the state.

PROCESS AND POLITICS

Challenges to Reforming Proposition 13: Possibly the biggest lift for policymakers would be to reform Proposition 13. From a process standpoint, undoing the fiscal straightjacket would help shift fiscal authority back to the local level. But, just as the institution of Proposition 13 set in motion a number of policy dominoes, unwinding it would involve more than just its repeal. The legislature

would need to negotiate with counties a realignment of fiscal responsibility once the distribution of property taxes is returned to the local level. Given that localizing property taxes again could lead to greater inequities across communities, state legislation will either need to draw upon general fund revenues to eliminate resource differences for schools and other locally funded programs or negotiate a regional or statewide redistribution scheme.

Introducing any new policy, particularly fiscal policy, is easier from a political perspective when the economy is growing. Fiscal policy changes often create winners and losers. If revenues are increasing, it is possible to structure changes in a way that some win while others win more. In a scenario where that type of growth cannot be counted upon, change presents a challenge even when the leaders and voters are supportive.

To lay the foundation for change, the shortcomings of the current structures will have to be made clear. For example, the state's sales tax, in its current form, is regressive. A proposal to expand it to include services may not completely shift the distribution of the burden, but it is possible to make it less regressive. Similarly, on the spending side, providing a benefit that is "universal" is politically more attractive as it has the potential to appeal to the largest number of supporters (think universal free preschool or low or no tuition for community colleges). Under the new economic reality of this scenario, Californians would have to acknowledge that targeted benefits are more efficient (i.e., they are capable of having a greater impact for the individuals that need the support the most) and be willing to support them.

SCENARIO

GOLDEN STATE OF AFFAIRS

Fast Economic Growth and California Embraces Change

California maintains its economic advantage relative to its competitors while embracing new policies. New policies for this scenario seek to build a California where the state actively supports both continued economic innovation and inclusive growth as well as reducing inequality among its residents.

REVENUE

Generate Broad-Based Consumption Tax: Similar to Bargain Basement Audacity, the legislature modernizes the sales and use tax to expand it to include services. However, with the economy on a positive trajectory, it may be possible to make a larger policy leap. Rather than broadening the base of the sales and use tax, California moves to a broad-based consumption tax—similar to the value added tax found in a number of European countries. Such a shift could also be combined with a carbon tax. The move to a consumption tax, depending upon the rates, could serve as a complement to the lowering of marginal personal income tax rates, adding to its political appeal. At a minimum, a consumption tax should be coupled with an expanded rebate to reduce the burden for low-earning Californians.

Create a California Reinvestment Fund from Corporate Taxes: Regarding corporate taxes, elected officials work with the business sector to develop a California Reinvestment Fund (a sovereign wealth fund). The goal of the fund is to leverage a California strength (such as innovation and business creation) as a down-payment on state support for future economic growth. The tax could be levied on a portion of business public offerings (IPOs), data collection, or repatriation of earnings abroad. Taxing wealth transfers (gifts and inheritance) from the Full Steam Ahead scenario could also be considered as a way to build the fund. Some of the state's largest family and community foundations could also contribute to the initial capital-raising effort. Conceptually, the revenue generated for the fund would be as a consequence of capital creation, where the state recoups a portion of the investment it has made to create an environment where businesses and individuals thrive and are successful.

SPENDING

Create Programs that Invest in State's Infrastructure and Human Capital: Spending recommendations under the Golden State of Affairs would draw on some of the other scenarios in terms of such policies as maximizing participa-

tion in federal programs and encouraging wealth creation through Baby Bonds and auto-IRA incentives. This scenario, however, would give state policymakers the chance to be more expansive in their thinking and look to create programs that invest in the state's infrastructure and human capital. Doing so would both encourage economic growth and, if appropriately focused, could help reduce inequality. For example, rather than simply expanding the Cal EITC, policymakers should explore whether a universal basic income (UBI) makes more sense, providing residents with a stream of income as opposed to a once-a-year annual tax refund.

Reinvest using the State Sovereign Wealth Fund: Similarly, the sovereign wealth fund would focus on re-investment in the state in a targeted manner, going beyond simply writing checks to individuals from the proceeds, as is the case in Alaska. For example, a portion of the California Reinvestment Fund (CRF) would serve as the driver for a state industrial policy. These resources would be allocated as multi-year commitments to infrastructure and emerging technologies—either via the state's public universities or private enterprise. The remainder of the CRF proceeds would be used to supplement education support for low-income residents from early-childhood to college and career. Table 4 lists the existing state sovereign wealth funds in the United States.

Table 4 **State Sovereign Wealth Funds in the United States**

Fund name	Value* ($billions)	Est.	Source	Purpose
Alabama Trust Fund	$2.6	1985	Oil & Gas	Variety of designated purposes. Including cities and counties
Alaska Permanent Fund	81.1	1976	Oil & Gas	Provide residents with dividends.
Colorado Public School Fund Endowment Board	1.3	2016	Land & Mineral Royalties	Support K12 education
Idaho Endowment Fund Investment Board	3.3	1969	Land & Mineral Royalties	Public schools plus
Louisiana Education Quality Trust Fund	1.4	1986	Oil & Gas	Education
New Mexico State Investment Council	34.5	1958	Oil & Gas	Education
North Dakota Legacy Fund	8.4	2011	Oil & Gas	Variety of designated funds
Oregon Common School Fund	1.7	1859	Land & Mineral Royalties	K12 education
Texas Permanent School Fund	48.3	1854	Land & Mineral Royalties	K12 education
Texas Permanent University Fund	24.4	1876	Land & Mineral Royalties	Higher education
Utah School and Institutional Trust Funds Office	2.5	1983	Land & Mineral Royalties	Education
West Virginia Future Fund	0.1	2014	Oil & Gas	General
West Virginia Impact Fund	**	2020	Appropriations; all sources	Economic growth
Permanent Wyoming Mineral Trust Fund	8.0	1975	Minerals	Designated

* Values are approximate and are sourced from 2018 – 2021. ** Zero balance.

PROCESS

Reform Proposition 13: The reforms of Proposition 13 also apply here. While unwinding the layers of fiscal policy will be difficult, it would be an important step in addressing the decades-long inequities that Prop. 13 has wrought. As discussed under the Bargain Basement Audacity scenario, specific laws at the state level would be needed to rebalance differences in local property wealth tax bases.

Reforming Prop. 13, along with the creation of a sovereign wealth fund and a less volatile revenue structure would fundamentally change the task of budgeting in the state. Annually, much of the budget process would be limited to adjustments at the margin of existing programs and making sure that long-term projections of spending and revenue are in balance. Beyond the annual process, a wealth fund would challenge policymakers to look at the long term, and make commitments that reflect a strategic approach to supporting the economy. The jobs of elected officials and administrators would take on the role of portfolio managers for the state, seeking to generate a positive return for all Californians.

Summary of key differences in scenario policy recommendations

Scenario / Policy Area	Full speed ahead; some left behind	Once a leader, now a follower	Bargain basement audacity	Golden state of affairs
Revenue	New gift and inheritance taxes.	Require state pensions to invest in local government infrastructure; Identify conformity opportunities to broaden income tax base	Expand sales tax to include services; Institute a "vehicle miles traveled" as an alternative to gas tax	VAT and/or carbon tax replaces sales tax
Spending	Pay down long-term liabilities; Update management of existing social support programs (e.g., EDD) Expand Medi Cal to undocumented adults	Safety net program data linkages; Maximize participation in SNAP/ CalFresh and other federally supported safety net programs	Targeted spending with high ROI: Baby bonds, Auto-IRA incentives, Expanded EITC	Sovereign wealth fund to invest in infrastructure and human capital; multi-year commitments to fuel growth and individual mobility.
Fiscal processes and institutions	Multi-year projections; Encourage reserves/ savings at both state and local level	Multi-year projections; Protect existing reserve policies	State and local tax/spending relationships are realigned via reform of Prop. 13	State and local tax/spending relationships are realigned via reform of Prop. 13; officials become fiscal stewards