THE CALIFORNIA *Journal of*

Politics & Policy

Volume 2, Issue 3 2010

Lessons for California from the History of Fiscal Constitutions

Isabel Rodriguez-Tejedo
University of Navarra

John Joseph Wallis
University of Maryland

Abstract

California continues to undergo a series of budget crises. This paper examines the evolution of fiscal provisions in state constitutions over time, as well as in California. The evolution of fiscal provisions across the states shows an evolution from debt restrictions to balanced budget amendments to rainy day funds and tax and expenditure limits. California shows the same pattern. We suggest that many of the constitutional changes are responses to the previous constitutional change, which is why a definite pattern emerges. We end by suggesting that California return to the intent of the original 1849 debt restriction and require voters to actually raise taxes when they authorize new borrowing.

Keywords: constitutions, state government, fiscal constitutions, debt limitations, balanced budget, rainy day funds, TELs

THE CALIFORNIA
Journal of
Politics
& Policy

Lessons for California from the History of Fiscal Constitutions*

Isabel Rodriguez-Tejedo
University of Navarra
John Joseph Wallis
University of Maryland

I. The Constitutional Problem

California faces a fiscal crisis in 2010. It isn't the first fiscal crisis the state has faced, nor will it be the last. The first California constitution, written in 1849, did not contain the word "budget," but Article VIII was concerned exclusively with state debts. The article restricted the state legislature to a state debt of $300,000, which it could incur on its own initiative. Any debt larger than $300,000 required the approval of the voters through what eventually came to be known as a bond referendum.[1] The referendum provision was invoked in 2004 when Governor Schwarzenegger proposed to issue $15 billion in state bonds without a referendum, and was quickly reminded by the state supreme court that such an action was unconstitutional. If a sitting governor can "forget" what the constitution says about government borrowing, perhaps it is not surprising that regular citizens have trouble with what the state constitution says and how it works in practice. For over 150 years the voters of California have approved constitutional changes that were apparently directed at preventing the accumulation of state debts. Why haven't the provisions prevented the accumulation of debt and what should the voters try next?

This short essay draws on the history of provisions of state constitutions that deal with fiscal matters—taxing, spending, and borrowing—to explain why American state and local governments have, by and large, been very successful at using government debt to finance valuable infrastructure investments in roads, schools, and public utilities, but nonetheless still experience periodic crises in their finances. The explanation has two parts. First, the problem of taxing, spending, and borrowing recurs every year and is not, by its nature, a problem that can be permanently

* This paper was prepared in response to the "Too Big to Fail Conference" held at the USC Law School in February, 2010. We would like to acknowledge Roger Noll for insisting that this be a paper rather than a note, Mat McCubbins and Bruce Cain for the opportunity and encouragement to make our argument.

solved. Whatever rules guide the process of deciding what taxes, spending, and borrowing will be, it is impossible ahead of time to construct a set of rules that will always be "enforceable" in a political sense.

The persistent reoccurrence of budget questions is like the problems of cooking dinner and taking out the garbage in any household. The rule that Mom cooks and Dad takes out the garbage may be clear and workable in principle, but there are inevitably days when the rule doesn't work because either Mom or Dad isn't home. Even a clear and simple rule like "no borrowing" may not work because situations arise in which a majority of the legislators and voters prefer borrowing to raising taxes and/or cutting spending. They respond to the unusual circumstance by devising new ways to authorize borrowing. Remember, constitutions can always be amended.

Whether the response to unusual circumstances should be thought of negatively as evading the original rule or positively as a creative institutional response to a crisis depends on your point of view. The second element to understand is that sometimes constitutions are changed in response to an earlier change in the constitution. That is, rather than addressing the underlying problem of taxing, spending, and borrowing, a constitutional change may be a response to an earlier attempt to regulate taxing, spending, and borrowing.

For example, many states in the 1840s enacted procedural debt restrictions that increased the political cost of borrowing at the state level. As a result, government borrowing shifted to the local level. When local governments got in fiscal trouble in the 1870s and 1880s, states extended procedural restrictions to local governments, making it harder for local governments to borrow. This led to the proliferation of special purpose districts whose primary purpose was taxing, spending, and borrowing for a specific purpose.[2]

These are examples of truly unintended consequences of a constitutional change leading to later rounds of constitutional change. The reforms in the 1840s and 1870s were not intended to move government borrowing from the state to local governments, or from local to special purpose governments. In the 1870s, the new constitutional provisions about local borrowing were a response to unanticipated changes brought about by constitutional changes in state borrowing in the 1840s. Over the last 30 years, California has had a series of constitutional changes that were responses to the unintended consequences of earlier changes.

Those who see the purposes of these debt restrictions as a way to limit government borrowing by constitutional provision feel that the system is, at best, unresponsive. At worst, they feel that politicians successfully evade any and all attempts by citizens to limit the behavior of legislatures and governors. This may be another case of Pogo's famous dictum: "We have met the enemy… and he is us."[3] We may be trying to permanently solve a problem that cannot be permanently solved

DOI: 10.2202/1944-4370.1113

because it is impossible to construct a constitutional rule that people will find in their interest to follow in all situations. As a result, when citizens are dissatisfied with fiscal arrangements, political leaders suggest new constitutional provisions that voters approve. The new provisions, however, may end up creating another set of unanticipated problems at a later point in time. The system appears to become more broken over time, while the breakdowns are, in fact, the cumulative effect of past fixes.

California has gone through this sort of process over the last century and a half, but California is by no means unique. States across the country have tried a number of provisions in their fiscal constitutions to address the problem of government debt. The next section describes those briefly. The adoption of these provisions has followed a consistent pattern over time, a pattern laid out in the third section. The final section returns to the history of constitutional change in California to show that it too is involved in the same ongoing process of constitutional adjustment.

II. The Provisions of Fiscal Constitutions

States developed four main types of constitutional provisions governing fiscal processes over the last two centuries. The first and most widespread are restrictions or limitations on government borrowing. The second, also widespread, are procedures that require a balanced budget, and sometimes stipulate that the budget be passed following certain procedures. The third are rainy day funds, which require or allow a state to save funds in good years to be available to meet deficits in lean years. The fourth are tax and expenditure limits that cap the level of taxes, expenditures, or both in absolute or relative terms. The actual terms of these provisions vary widely, and keeping track of all the differences in state constitutions over time can get complicated, but we focus on the main outlines.

Debt restrictions were the first fiscal provisions inserted into state constitutions in the 1840s. Debt restrictions and debt limitations are often confused. To be clear, a debt “limitation” is a limit on the total amount of debt a state (or local) government can issue. The limit can be absolute, say $300,000, or relative, say, 1 percent of assessed property valuation. A debt “restriction,” sometimes called a procedural debt restriction, allows a state (or local) government to create new debt as long as a particular procedure is followed.

The most common kind of debt restriction requires the state legislature to identify the purpose for which the debt will be issued and calculate the annual cost to service the debt. The legislature must raise taxes by that amount and voters must approve the debt and any new taxes in a special bond referendum. Other procedural restrictions require a legislative supermajority approval, two-thirds or three-quarters of both houses of the state legislature, or approval in two consecutive sessions of the legislature.

The difference between procedural restrictions and limitations cannot be over emphasized. State constitutions typically are concerned with procedural restrictions that shape the incentives of political actors, both officeholders and voters. The point of debt restrictions is not to make it impossible for states to borrow, but to put procedural hurdles in the way of borrowing so that legislatures and voters must be more conscious of the decisions that they make. Many states combine a debt limitation with a debt restriction. The 1849 California constitution, for example, allowed the legislature to borrow up to $300,000 without voter approval (a limitation), but allowed the state to borrow unlimited amounts with voter approval (a restriction). This type of debt limitation is a "casual" limit, since it only limits the amount of debt the legislature is allowed without invoking the debt procedure. The California constitution still has the 1849 limit of $300,000 on casual debt and a procedural restriction on the issue of other debt.

Procedural debt restrictions do not limit debt; they change the procedures for approving debt issue. As advocates of less government borrowing learned that debt restrictions would not eliminate borrowing, they began pressing for balanced budget provisions. Balanced budget provisions require state governments to adopt budgets that raise enough revenue to cover expenditures. Balanced budget provisions are quite variable. Some simply state the principle of a balanced budget. One of the first was Nevada's 1864 constitution, Article 9 section 2:

> the Legislature shall provide by law for an annual tax, sufficient to defray the estimated expenses of the State for each fiscal year; and whenever the expenses of any year shall exceed the income, the Legislature shall provide for levying a tax sufficient, with other sources of income, to pay the deficiency, as well as the estimated expenses of such ensuing year or two years.

The Nevada provision enunciated the idea of a balanced budget and required the legislature to balance the budget over a period of two years following a shortfall.

More recent balanced budget provisions are more forward looking and apply more formal guidelines. In 1938, New York adopted a constitutional provision that required the governor to submit a balanced budget to the state legislature every year. Article 7, section 2:

> Annually, on or before the first day of February, the governor shall submit to the legislature a budget containing a complete plan of expenditures proposed to be made before the close of the ensuing fiscal year and all moneys and revenues estimated to be available therefor, together with an explanation of the basis of such estimates and recommendations as to proposed legislation, if any, which he may deem necessary to provide moneys and revenues sufficient to meet such proposed expenditures. It shall also contain such other recommendations and information as he may deem proper and such additional information as may be required by law.

DOI: 10.2202/1944-4370.1113

Section 2 was followed by 14 more sections that specified legislative procedures for implementing a balanced budget and a complicated set of debt limitations and restrictions. In the 1930s and later, the balanced budget provision in many states became increasingly strict, limiting the ability of the state to run casual deficits that they could eventually make up.

Formal procedures for creating the budget were aimed at the budgeting process as much as balancing the budget. Because budgets had to be in balance *ex ante*, the ability of state legislatures to make informal adjustments without resort to long-term borrowing was significantly reduced. Even states with sound fiscal practices occasionally would find themselves in a situation where their forward looking budgets were out of balance. Legislatures were then required either to raise taxes, lower spending or to ask voters for borrowing approval.

In order to ease the constraints of balanced budget provisions, the third fiscal provision, the rainy day fund, appeared in the 1940s. A rainy day fund required legislatures to put away money in good years that would be available to supplement tax revenues in lean years. There was a technical effect as well. Money put into the rainy day fund was counted as an expenditure in the year the contribution was made, but withdrawals from the funds and the expenditures based on those withdrawals were not counted as expenditures in the later year.[4]

Rainy day funds could be drawn on when conditions warranted. This gave states more flexibility in managing finances over time while allowing them to meet the letter of the balanced budget rules. Rather than borrowing to meet temporary shortfalls, the state could draw down its rainy day fund. Rainy day funds were adopted on a widespread basis in the 1980s and 1990s. Again, the terms of the rainy day fund provisions varied widely from state to state.

Like debt restrictions, the combination of balanced budget rules and rainy day funds did not stop the growth of state governments in the mid-20th century. The most recent type of constitutional provision is a direct limitation on taxes and expenditures, sometimes called a TEL. Famously in California, Proposition 13 limits the property tax rate to 1 percent of the assessed value of the property (it has other provisions as well).

Tax and expenditure limits are attempts to fix the size of government budgets, sometimes in absolute terms, but more often as a percentage of a relevant economic measure like per capita income or assessed property value, or as a percentage of the previous year's budget (limiting budget growth). In the next section we draw a distinction between property tax limitations (PTLs), which have been around since the late 19th century, and TELs which are more comprehensive attempts to limit revenues and expenditures and only became common after 1980.

There are two ways to view this progression of fiscal institutions. In one perspective, the intention of fiscal restrictions is to make government financing responsible, enabling borrowing when it is useful but requiring governments to commit to higher taxes or setting aside revenue to service the debt. From this perspective, it appears that fiscal restrictions have worked. State and local governments in the United States are the primary providers of public infrastructure and in fiscal year 2007 had outstanding debts of about $2.4 trillion. In the same year they issued $384 billion in new long-term debt and retired $228 billion in old long term debt. State and local governments rarely default on their debts, and when they do it is usually big news.

According to the second perspective, the intention of fiscal restrictions is to limit the size of government in general, and specifically to limit government borrowing. From this perspective, fiscal restrictions have failed and the governing process is broken.

We subscribe to both perspectives, with a twist. The purpose of the first procedural debt restrictions was to improve the quality of political decisions when states borrowed by requiring the costs of borrowing to be transparent and subject to voter approval. In the process of doing so, it became politically more costly for states to borrow. The economic effect of the debt restrictions was positive. Indeed, one can argue that these provisions made it more likely that states would make sound economic decisions when they borrowed and, as a result, lowered the cost to further state borrowing because both the capital markets and voters came to believe the system worked.

At the same time, the waves of constitutional restrictions raised the political cost of borrowing at each step along the way, particularly borrowing through general obligation bonds backed by the general revenues of the state. As a result, when the economy turns down, as it has over the last three years, states find themselves faced with enormous political battles over rather small economic magnitudes. The budget shortfall in California this year is less than 1 percent of state income, so why can't the politicians (and voters) solve such a small crisis? They can't because of the accumulation of fiscal provisions over the last century or so.

III. The Pattern of Fiscal Constitutions over Time

That states adopted constitutional provisions sequentially is easily demonstrated by looking at the timing of constitutional changes across states. Figure 1 shows the number of states that adopted their first debt restriction or limitation in each decade between the 1830s and the 1950s and after. Figure 2 shows the cumulative total number of states that have a debt restriction or limitation in place over the same period. States began requiring debt restrictions in the 1840s when 10 states changed their constitutions. By 1900 most states had a debt restriction of some type.

DOI: 10.2202/1944-4370.1113

Figure 1. Adoption of first constitutional debt restrictions, by decade

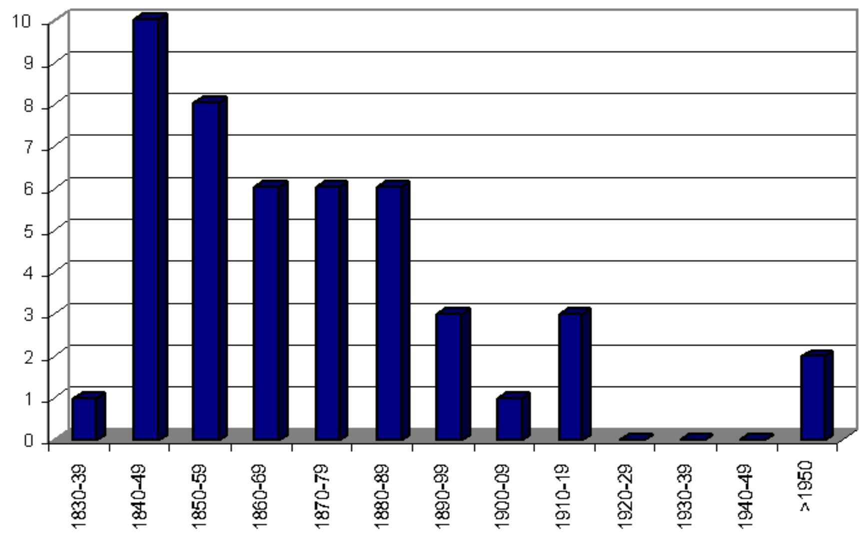
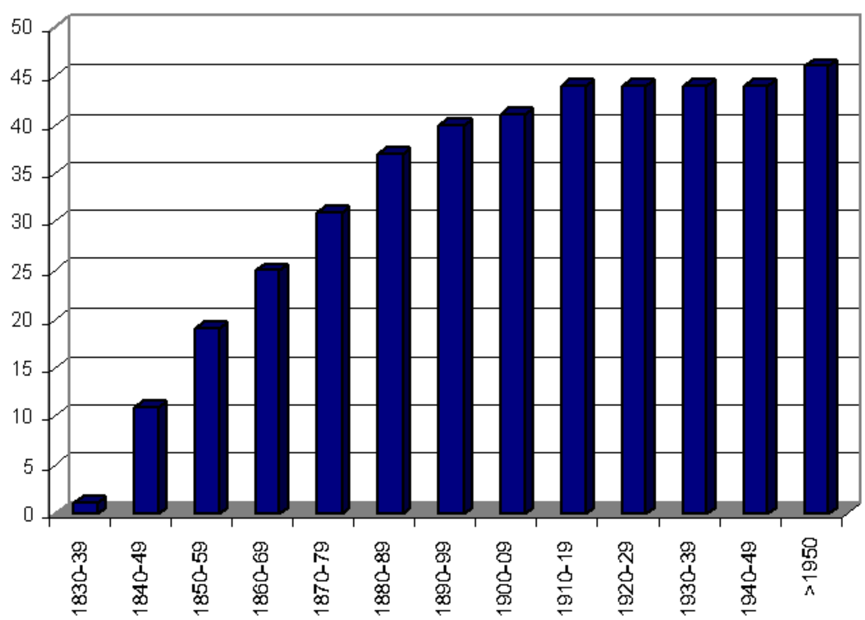


Figure 2. Number of states that have a constitutional debt restriction, by decade



Balanced budget restrictions (BBRs) were also adopted in the 19th century but less widely. Figure 3 shows the number of BBRs adopted in each decade from the 1840s to the 1990s. Figure 4 shows the cumulative total of states with BBRs. The first waves of BBRs occurred in the 1860s and 1880s. These early BBRs required the legislature to ensure that total revenues were at least as great as total expenditures (like Nevada). The second wave of BBRs occurred in the 20th century. These restrictions were more likely to require that the governor submit a balanced budget to the legislature and that the legislature pass a balanced budget.

Although the first debt restrictions and BBRs were put in place in the 1840s, debt restrictions were adopted much more rapidly than BBRs. The average date of adopting a state's first debt restriction was 1872, while the average date of adopting a state's BBR was 1919, 47 years later.[5] In total, 46 states have some form of debt restriction and 42 some form of BBR. Only two states, Connecticut and Tennessee have a BBR but not a debt restriction. Of the 40 states with both measures, the average debt restriction was adopted 40 years before the adoption of a BBR. Only one state, West Virginia, adopted a BBR (1863) before they adopted a debt restriction (1872). In every other state debt restrictions either preceded the adoption of a BBR, or the two were adopted simultaneously.[6]

Similarly, rainy day funds were adopted later than BBRs. Figure 5 gives the number of states that put rainy day funds in place in each decade from the 1940s to the 2000s, and Figure 6 gives the cumulative number of states with rainy day funds by decade. Rainy day funds were often adopted by statute rather than constitutional amendment, so the graphs distinguish statutory rainy day funds from constitutional funds. By 1979, 32 states had adopted a BBR, while only 6 states had rainy day funds.

In the 1980s, however, 21 states adopted rainy day funds: 16 by statute and 5 by constitutional amendment. On average, states first adopted RDFs in 1984 (of states who adopted) and BBRs in 1919. Of the states that adopted both measures, the average difference in years between adopting a BBR and a rainy day fund was 59 years. Three states, Connecticut, Vermont, and Mississippi, adopted a rainy day fund without adopting a BBR. Four states adopted rainy day funds before they adopted a BBR.

Limits to taxes and expenditure came at roughly the same time as rainy day funds. The first of these limits were not TELs in the comprehensive sense, since they regulated only one particular aspect of taxation: property taxes. Property tax limits (PTLs) first appear in the 1860s and '70s. They were not as widely adopted as BBRs as only 23 states enacted PTLs. The average date of adoption was 1913, but there were two distinct waves of adoption.

Several states adopted property tax restrictions in the 1870s, and then the rate of adoption fell until the end of the century, to pick up again in the 1930s and '40s. Of

DOI: 10.2202/1944-4370.1113

Figure 3. Adoption of first constitutional BBR, by decade

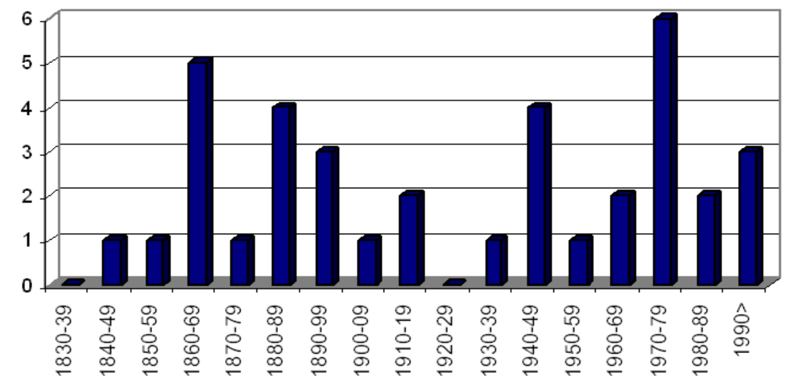
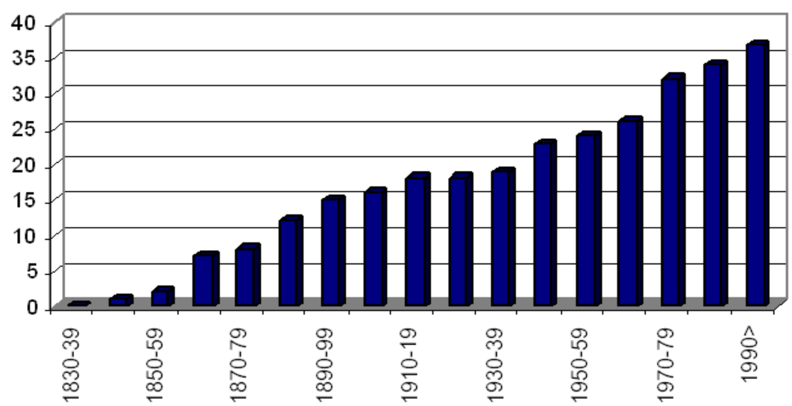


Figure 4. Number of states that have a constitutional BBR, by decade



the 23 states with PTLs, 20 also have a BBR, and although sometimes they were incorporated far apart in time, about a third of the states with a property tax limit and a BBR adopted them at approximately the same time. Only one state (Alabama) has a PTL but not a rainy day fund. In all the other cases, the tax limit was enacted before (often much before, with an average of nearly 69 years) than the rainy day fund.

Figure 5. Number of adoptions of RDFs, by decade

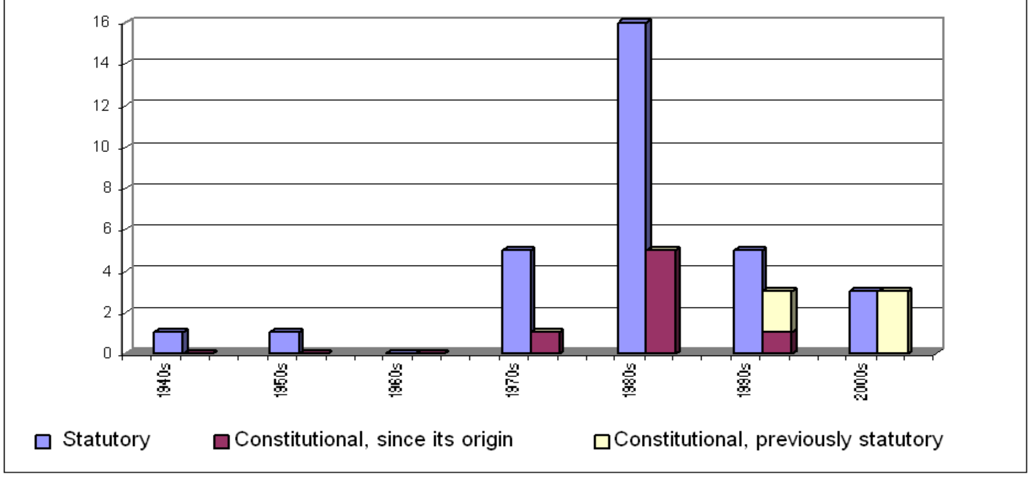
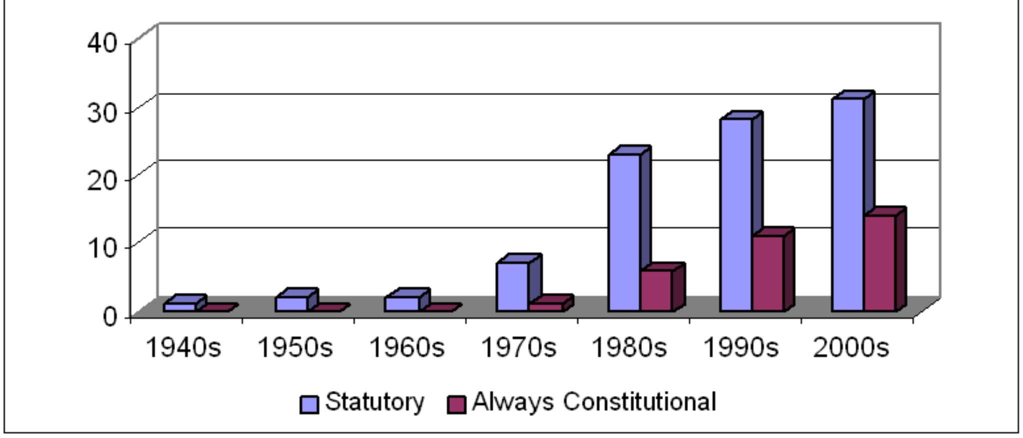


Figure 6. Number of state rainy day funds, by decade and type



In most states rainy day funds and comprehensive TELs (that is, not dealing with property taxation or with balancing the budget) were adopted at about the same time. The average date that states first adopted a comprehensive TEL was 1983, compared to 1985 for rainy day funds. Of the states that adopted both measures, the difference in first adoption was only 12.5 years. In comparison to BBRs, of the 15 states with both a BBR and a comprehensive TEL, the difference in the date of adoption is 63 years. Only one state, South Carolina, adopted a comprehensive TEL before a BBR. Rainy day funds are more common than TELs: 45 states

DOI: 10.2202/1944-4370.1113

have rainy day funds while only 18 have comprehensive TELs. Figure 7 shows the number of states that adopted their first TELs or PTLs in each decade between the 1830s and the 1990s and after. Figure 8 shows the cumulative total number of states that have each type of limitation in place over the same period.

The historical record reveals a broadly common pattern in the timing of the adoption of fiscal measures. Debt restrictions were adopted in the mid-19th century. Weak balanced budget restrictions were adopted in the late 19th century, and stronger restrictions in the late 20th century. The first debt restrictions preceded the first BBRs by roughly 40 years and only one state adopted a BBR before they adopted a debt restriction.

A similar pattern appears when we compare BBRs and the adoption of rainy day funds and TELs. The first rainy day fund appeared in the 1940s, but it was in the 1980s and 1990s that rainy day funds became widespread. The same is true with TELs. On average, rainy day funds were adopted 60 years after BBRs were adopted, while the average restriction on property tax was adopted 69 years after the first BBRs (comparing states that adopted both measures) and the comprehensive TELs were adopted over a century later. More states have adopted rainy day funds, 45, than have adopted any sort of TEL, 35. Figure 9 shows the distribution of adoptions over time, while Figure 10 presents the total number of states that have adopted each type of institution by decade.

There is a definite pattern in the evolution of fiscal measures in state constitutions. What about California?

IV. California

California's process of constitutional adaptation over the last century and half mirrors the national history. The first California constitution in 1849 contained a debt restriction for state borrowing. The second constitution in 1879 contained the same debt restriction and added a more stringent restriction for county and municipal governments (they had to have approval of a tax increase of two-thirds of their voters before bonds could be issued). The first balanced budget procedure was introduced in 1922 and strengthened in 1946. Tax and expenditure limitations were implemented in 1979, limiting property taxes to 1 percent of assessed valuation and limiting expenditures to the previous year's budget plus an allowance for population growth and income growth. A rainy day fund was also introduced in 1979.

California regularly reevaluates its fiscal institutions. In that respect, the current debate over revising budget provisions in the state constitution is no different than prior debates during most of California's history. Constitutional provisions restricting state debts were amended in 1908, 1934, 1956, 1960, 1962, 1964, 1970, 1979, 2000, and 2004. During the same period, constitutional provisions restricting

Figure 7. Limits on "traditional" TELs and property tax limitations, by decade of first adoption

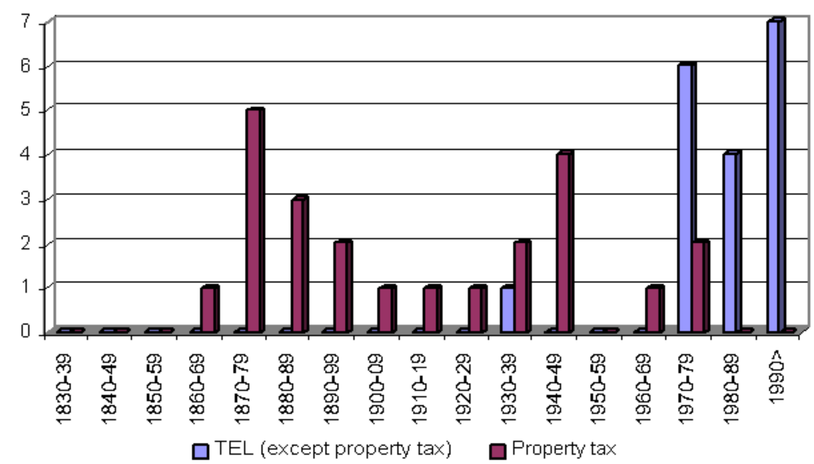
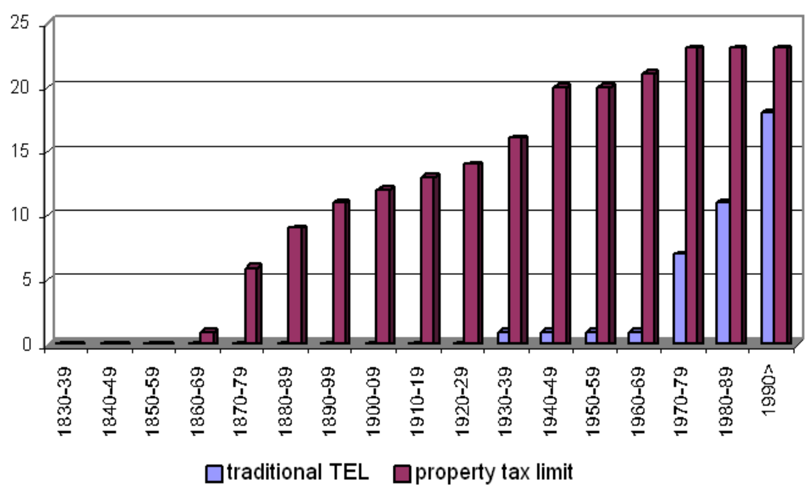


Figure 8. Number of states that have a traditional TELs and property tax limits, by decade



local debts (county and/or municipal governments) were amended in 1892, 1900, 1906, 1910, 1911, 1914, 1918, 1926, 1940, 1949, 1952, 1954, 1970, 1964, 1974, 1979, and 2000. Constitutional provisions regulating the state budget process were established in 1922 and amended in 1946, 1949, 1966, 1970, 1972, 1976, 1990, and 1998. Similarly, constitutional provisions limiting taxes and expenditures were first

Figure 9. Adoption of constitutional fiscal institutions

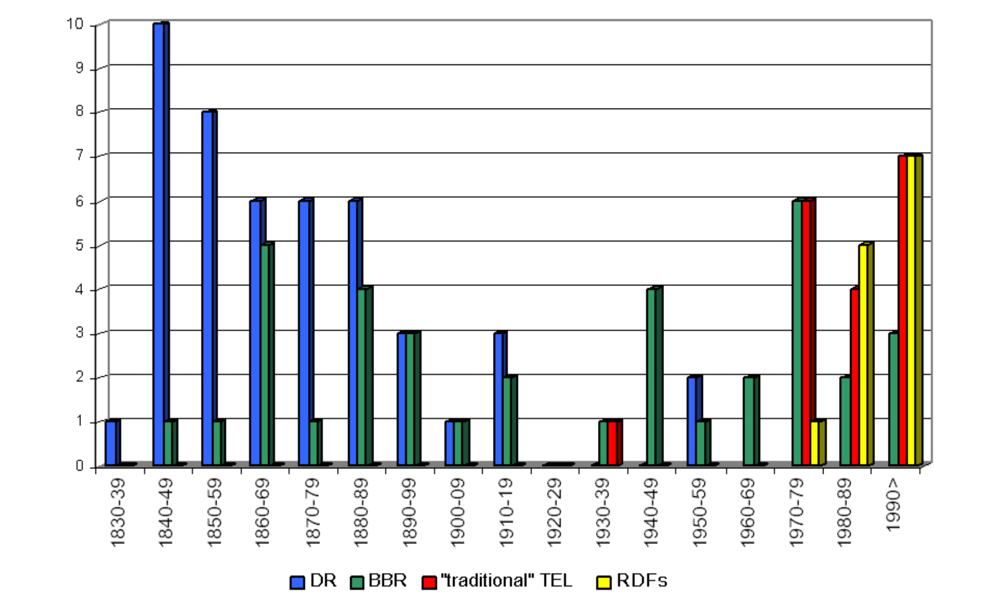
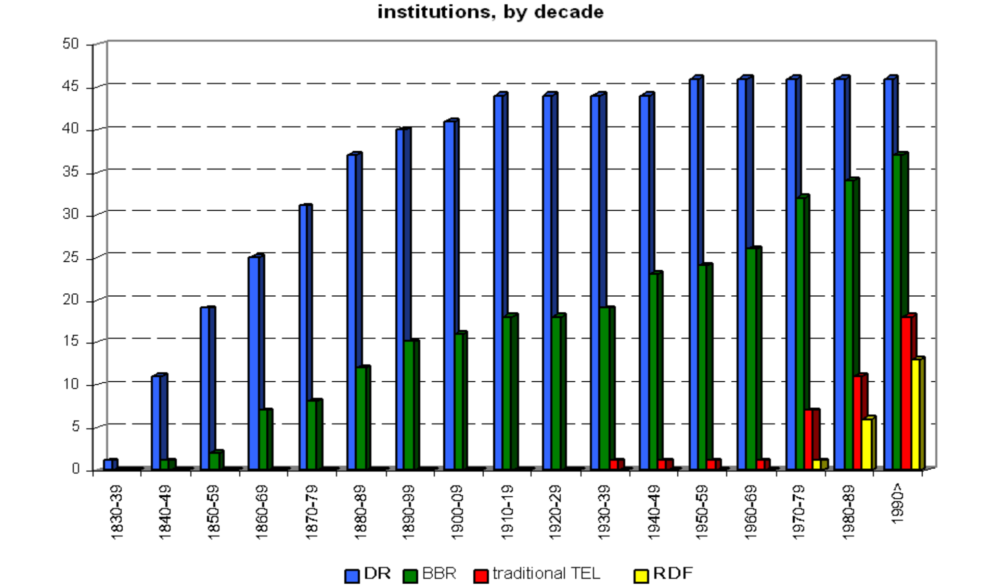


Figure 10. Number of states that had adopted each type constitutional fiscal institutions, by decade



put in place in 1979 and amended in 1990, 1998, and 2000. Rainy day funds were first authorized in the same year and amended in 1988.[7]

Sometime in the late 19th century, California changed the way debt restrictions were interpreted. This occurred through a process that we have yet to understand completely, because it was not done through amending the text of the constitution.

The intent of the debt restriction is to force voters to raise current taxes when they approve a bond issue. By the early 20th century, however, California bond issues began including something like the following language (which is taken from section 16724 of the California Government code: the "General Obligation Bond Law"):

> (d) An appropriation from the General Fund in the State Treasury of the sum annually as shall be necessary to pay the principal and interest on the bonds as they become due and payable.
> (e) A requirement that there be collected annually in the same manner and at the same time as other state revenue is collected the sum, in addition to the ordinary revenues of the state, as is required to pay the principal and interest on the bonds; and a provision making it the duty of all officers charged by law with any duty in regard to the collections of the revenue to do and perform each and every act which is necessary to collect that additional sum.

Language like this has been included in every state bond referendum in the 20th century. The effect of this provision is to require the state legislature to set aside money in the general fund to meet the obligations of the bond issue (both interest payments and repayment of principle). But, if we are reading the provision and the history right, it does not require the state legislature to actually increase taxes, merely to set aside revenue (despite the 'additional sum' language). In one sense this meets the letter of the original California constitutional provision restricting the issue of debt to laws:

> which law shall provide ways and means, exclusive of loans, for the payment of the interest of such debt or liability, as it falls due, and also pay and discharge the principal of such debt or liability within twenty years from the time of the contracting thereof, and shall be irrepealable until the principal and interest thereon shall be paid and discharged; but no such law shall take effect until, at a general election, it shall have been submitted to the people, and have received a majority of all the votes cast for and against it at such election; (Article 8, section 1, California Constitution, 1849).

In another sense, however, California does not require voters to approve a new tax increase whenever they issue bonds. We don't know of anyone who has noted this feature of California borrowing, but it has important implications that we return to later.

Changes in California's fiscal constitution since 1979 (including changes mandated by Proposition 13) have followed the pattern of constitutional changes that produce unintended consequences, followed by another constitutional change. In 1979 property taxes were capped at 1 percent of assessed value, and assessments on some property were rolled back to their 1975 level. Property taxes were limited statewide by a change in the state constitution, but property taxes were and are primarily levied by counties, municipalities, and school districts.

The cap on property tax rates and assessments affected local governments directly. Local governments were now not only effectively limited in their ability to raise property taxes, they were crippled in their ability to use proposed property tax increases to secure new bond issues. As a result of constraints on school district revenues, some of the burden of elementary and secondary school expenditures shifted to the state level. It is safe to say that this was a consequence that the promoters of Proposition 13 did not anticipate or intend.

Shifting education expenditures to the state level caused another unexpected set of problems. People are much more willing to tax themselves to pay for public education in their own local communities, in part because the benefits of higher taxes accrue to their own children, and in part because the costs of higher taxes for schools is partially offset by higher property values in communities with better schools. Once education funding shifted to the state level, these incentives disappeared. Voters and taxpayers were less willing to fund school expenditures (and the associated higher taxes) for students living in other communities.

The constitutional response, in 1988, was to mandate a minimum level of state expenditures for education (Proposition 98). Mandating state expenditures, however, only addressed part of the problem, since local school districts no longer had access to the property tax to finance incremental increases in school funding. In 2000, a constitutional amendment was approved that allowed local governments to approve exceptions to the 1 percent property tax limit to fund local bond issues for schools. These bond issues had to be approved by 55 percent of the voters. Since 1879, local governments had been required to secure two-thirds voter approval for any bond issues. The result of the 1979 limits on property taxation was, 21 years later, to make it easier for local governments to raise property taxes to finance school bond issues than at any earlier time in California history—a truly unintended and unanticipated consequence of an earlier constitutional change!

A general effect of the property tax limitation was to shift financial responsibility to the state government, as was apparent in the case of education. But the property tax initiative also created a higher bar for tax increases at the state level, requiring a two-thirds majority in both houses of the state legislature to pass any tax increase. In effect, the property tax initiative increased the political demand for greater state expenditures and at the same time increased the political costs of raising state taxes. Not surprisingly, political pressure on the state to finance expenditures through borrowing increased as well. Two outcomes followed.

Voters continued to approve bond issues for specific purposes. Between 2000 and 2004 voters approved $54 billion in state bond issues for water, reading, veterans' homes, elections, transportation, and education. The legislature also managed effectively to borrow without going to the voters through a series of accounting stratagems (like moving the expenditures from the last day of one fiscal year to the first day of the next), until a budget deficit of roughly $15 billion has built up (this in a state with balanced budget procedures). In 2004, the constitution was amended to allow "budget shortfalls" to be classified as a single purpose for borrowing, and the voters approved a bond issue of $15 billion to balance the state's general fund.

The 2004 debacle followed years of fiscal crisis that brought down a sitting governor through a recall election. The fiscal crisis did not slow borrowing, however, as voters approved an additional $55 billion in state bond issues between 2005 and 2009. The 2010 crisis is, in an important way, a political rather than an economic crisis. The legislature cannot agree on a proposed budget that is in balance. The deficit amount is roughly $15 billion, less than 10 percent of California state government general fund revenues; 5 percent of total state revenues (which include grants from the federal government and insurance fund revenues); 3 percent of combined state and local revenue;[8] and well less than 1 percent of personal income in California. So it is not a matter of inability to pay, but instead it is a matter of unwillingness to pay.

Why? We do not have a definitive answer, but suspect that it is a function of three factors in California history that go back to the 19th century. First, California, like most other states, has always been concerned about the size of government and the amount of government borrowing, but has also been concerned about using government to promote economic and individual development. As a result, California government has been active in building physical infrastructure (roads, transportation, water supplies, and utilities) as well as education.

Debt financing has been an integral part of that process and, for a century and a half, voters have regularly approved bond issues (they have also rejected bond issues regularly; the system is sensitive to voter preferences). Rather than imposing limits on debt issue and the size of governments, California has placed restrictions on the process of government that have imposed political and procedural hurdles to taxing, spending, and borrowing. The outcome has probably been a government that is smaller than it would have been in the absence of the restrictions, but also a government that has grown larger with the explicit approval of the voters.

Nonetheless, Californians have continued to pass constitutional measures to regulate the process of borrowing, setting budgets, and determining fiscal parameters. This second aspect of continuing constitutional change can be interpreted as a well functioning set of institutional adjustments that have served California well. They can also be interpreted as a series of attempts by opponents of deficits and larger government to rein in the size of government at all levels, attempts that have largely failed to accomplish their aims. Both interpretations probably capture the intentions of two sub-sets of the supporters of constitutional changes. Part of the current confusion about whether constitutional changes are effective is grounded in the fact that the same constitutional change can appeal to two very different groups with different intentions.

DOI: 10.2202/1944-4370.1113

In a period of fiscal abundance at the end of the 1970s, the opponents of larger government seized an opportunity to limit the size of government through limits on property tax rates and higher procedural hurdles for the state government for raising taxes. Whether you believe that the limitations worked depends on what you believe would have happened in the absence of the limitations. California government has grown since 1979, but probably more slowly than it otherwise would have. The evidence seems pretty clear that, relative to other states, California government provides a lower level of services than it did in the past. Whether you think this is a good or bad thing will not be influenced by anything we have to say, so we will say no more.

The unusual way that California interprets its constitutional debt restriction (currently Article 16, section 1), which does not require the state to raise new taxes by increasing tax rates when voters approve a new bond issue, but only to set aside and segregate revenues to repay the debt in the general fund, may interact with the tax limitations and the procedural tax restrictions in a way that exacerbates the current political crisis. Voters in California approved $110 billion in new state bond issues between 2000 and 2009. At a 5 percent interest rate those bonds would require interest payments of $5.5 billion a year.[9] The state legislature is required to sequester funds in a separate account, the General Obligation Bond Fund, to pay interest on those loans. The state legislature is not required by the bond referendum to raise taxes (unlike a local level bond referendum in California, which is a referendum on higher taxes).

New bond issues require the approval of only a majority of the voters voting in the election, but new taxes require a two-thirds majority in both houses of the state legislatures. When voters approve new bond issues, but legislators do not approve higher taxes, then principle and interest payments on the new bond issues gradually squeeze general revenue funds for other purposes.

The current crisis is a political crisis, attributable to the positions of the two political parties and exacerbated by the constitutional provisions governing the budgeting process. California is not close to going bankrupt, nor has it gone on a debt binge. But California, like most states, has over the last two centuries changed its constitution to restrict the procedures by which new debts are issued and taxes raised (or not raised) for that purpose. If we interpret those restrictions as attempts to limit the size of government or the size of government debt outstanding, then we come to the conclusion that the system is not only broken, but attempts to fix the system have just made it worse.

We do not subscribe to that way of thinking, largely because the history of fiscal provisions in constitutions in California and other states has been to restrict debt issue, not limit it. The intention of most fiscal provisions is to ensure that governments make reasonable decisions about what to spend and have set aside sufficient revenues to service the debt. The exception, of course, is tax and expenditure limitations that are intended to strictly limit the size of government.

Quietly, however, California disconnected one of the major ways that debt restrictions create incentives for responsible decision-making. California voters no longer vote to raise their taxes directly when they approve a bond issue. Perhaps, as a result, they have approved more bond issues than they might otherwise have, or, more likely, the budgeting process has been skewed so that new spending is authorized through debt issue and is not associated with new taxes. This is actually a relatively easy problem to fix with a constitutional amendment. We propose that California amend Article 16, section 1, to require that any new state debt issue that obligates the general fund, be for a single purpose and financed by bonds of certain duration. Before the bonds can be issued, a majority of voters must also approve an increase in the state income tax rate sufficient to service the bonds. Such tax increases shall be "irrepealable" as long as the bonds are outstanding and shall be accounted for separately in the state budget.

The proposed constitutional amendment is not a panacea, but it will restore some of the incentives that shape the interests of voters and politicians that have been eroded over the last century in California.

DOI: 10.2202/1944-4370.1113

Notes

[1] The text of Article VIII section 1 reads: "The legislature shall not in any manner create any debt or debts, liability or liabilities, which shall singly, or in the aggregate, with any previous debts or liabilities, exceed the sum of three hundred thousand dollars, except in case of war, to repel invasion or suppress insurrection, unless the same shall be authorized by some law or some single object or work, to be distinctly specified therein, which law shall provide ways and means, exclusive of loans, for the payment of the interest of such debt or liability, as it falls due, and also pay and discharge the principal of such debt or liability within twenty years from the time of the contracting thereof, and shall be irrepealable until the principal and interest thereon shall be paid and discharged; but no such law shall take effect until, at a general election, it shall have been submitted to the people, and have received a majority of all the votes cast for and against it at such election; and all money raised by authority of such law shall be applied only to the specific object therein stated, or to the payment of the debt thereby created; and such law shall be published in at least one newspaper in each judicial district, if one be published therein, throughout the State, for three months next preceding the election at which it is submitted to the people." All quotations from constitutional texts from Wallis, NBER/UMD State Constitution Project, <www.stateconstitutions.umd.edu>.

[2] See Wallis, John Joseph and Barry R. Weingast. "Dysfunctional or Optimal Institutions: State Debt Limitations, the Structure of State and Local Governments, and the Finance of American Infrastructure," in *Fiscal Challenges*: *An Interdisciplinary Approach to Budget Policy*, ed. Garrett, Grady, and Jackson (New York: Cambridge University Press), 2008.

[3] <http://www.igopogo.com/we_have_met.htm>.

[4] The California constitution authorized rainy day funds in 1979 (along with an expenditure limitation). The language of Article 13.B, section 5, reads: "Each entity of government may establish such contingency, emergency, unemployment, reserve, retirement, sinking fund, trust, or similar funds as it shall deem reasonable and proper. Contributions to any such fund, to the extent that such contributions are derived from the proceeds of taxes, shall for purposes of this Article constitute appropriations subject to limitation in the year of contribution. Neither withdrawals from any such fund, nor expenditures of (or authorizations to expend) such withdrawals, nor transfers between or among such funds, shall for purposes of this Article constitute appropriations subject to limitation."

[5] This is the average date that the first debt restriction or BBR was adopted, excluding the states that never adopted a measure.

[6] States that entered the Union in the 1840s, beginning with Wisconsin in 1848, were very likely to adopt both measures in their first constitution.

[7] Both the TEL and the rainy day fund are in article 13B of the constitution of 1879, as amended in 1979.

[8] This is based on state general fund revenue of $189 billion, state total revenue of $299 billion, and combined state and local total revenues of $467 billion in the 2007 Census of Governments

[9] In 2007 the outstanding state debt was $114 billion and interest payments were $5.4 billion, so these numbers are in the right ballpark.