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Proposition 55: Should California Maintain Higher Taxes on the Wealthiest to Fund Education, Health Care, and Other Services?

Proposition 30, approved by voters in 2012, provided critical revenues to California at a time when the state faced daunting budgetary challenges. Prop. 30's tax rate increases are scheduled to fully expire at the end of 2018. Prop. 55, which will appear on the November 8, 2016 statewide ballot, would extend for 12 years the Prop. 30 tax rate increases that affect very-high-income Californians. Revenues generated by Prop. 55 – a projected \$4 billion to \$9 billion per year from 2019 through 2030 – would go to K-12 public schools, community colleges, health care for low-income Californians, the state's rainy day fund, state debt payments, and other state services. This *Issue Brief* provides an overview of Prop. 55 and the policy issues it raises. The California Budget & Policy Center neither supports nor opposes Prop. 55.

What Would Proposition 55 Do?

Prop. 55, "The California Children's Education and Health Care Protection Act of 2016," would amend the California Constitution to (1) extend Prop. 30's personal income tax provisions for 12 years beyond their scheduled expiration at the end of 2018 and (2) create a formula to provide additional funding for Medi-Cal from the revenues raised by the measure. Moreover, existing provisions of the state Constitution would require Prop. 55 revenues to go to K-12 public schools, community colleges, the state's rainy-day fund, and state debt payments. Specifically, Prop. 55 would:

- **Extend Prop. 30's personal income tax rate increases on very-high-income Californians.**¹ Prop. 55 would extend – from 2019 through 2030 – personal income tax rates enacted by Prop. 30.² Extending these rates would raise between \$4 billion and \$9 billion each year (in today's dollars), according to the Legislative

Analyst's Office (LAO).³ Prop. 55 would allow Prop. 30's one-quarter cent increase in the state sales tax rate to expire at the end of 2016 as scheduled.

- **Create a new constitutional formula to increase funding for Medi-Cal, which provides health care services to Californians with low incomes.** For each fiscal year from 2018-19 through 2030-31, the Governor's Department of Finance would be required to estimate the amount of General Fund revenues – including those raised by Prop. 55 – that are needed to:
 - Meet the annual Prop. 98 minimum funding guarantee for K-12 schools and community colleges.⁴
 - Fund the cost of services that were authorized as of January 1, 2016 (excluding Prop. 98 spending), as adjusted for

population changes, statutory cost-of-living increases, federal mandates, and other factors.⁵

If any Prop. 55 revenues are estimated to remain after meeting these combined expenditures, Medi-Cal would receive 50 percent of the excess, up to a maximum of \$2 billion in any fiscal year.⁶ Revenues allocated to Medi-Cal under this provision would have to add to – rather than replace – existing General Fund support for the program.

- Increase funding for K-12 schools and community colleges as compared to current law.** The vast majority of funding for California’s K-12 schools and community colleges is provided by the Prop. 98 minimum funding guarantee. This guarantee is based on varying economic and fiscal conditions, including state General Fund revenue collections. Other things being equal, General Fund revenues from 2018-19 to 2030-31 would be *higher* if voters approve Prop. 55 than if the measure is rejected. This is because Prop. 55 would extend income tax rate increases that otherwise would expire at the end of 2018 under the provisions of Prop. 30. By increasing General Fund revenues relative to current law – which assumes the expiration of Prop. 30’s income tax rates – Prop. 55 would boost the amount of Prop. 98 funding that K-12 schools and community colleges would otherwise be expected to receive during the period that Prop. 55 is in effect. About half of the revenue raised by Prop. 55 would go to K-14 education, according to the LAO.⁷
- Increase deposits into the state’s rainy day fund and repayments of state budgetary debt as compared to current law.** Under Prop. 2, which voters approved in 2014, California is required to set aside a certain share of General Fund revenues each year in order to build the state’s rainy day fund (the Budget Stabilization Account) and pay down state budgetary debts, including unfunded state pension liabilities.⁸ Because Prop. 55 would increase General Fund

revenues relative to current law – as explained above – the measure would result in larger debt payments and bigger deposits into the rainy day fund compared to what would be expected if voters rejected Prop 55. The LAO estimates that Prop. 55 would provide an additional \$60 million to approximately \$1.5 billion each year for Prop. 2 purposes.⁹

- Allow state policymakers to use any remaining revenues raised by Prop. 55 for any budget priorities.** Prop. 55 revenues that remain after (1) meeting the constitutional spending obligations described above and (2) helping to maintain state services that were in place as of January 1, 2016 could be used for any public systems and services funded through the state budget. For example, these excess Prop. 55 revenues could be used to raise the number of subsidized child care slots, increase cash assistance for low-income seniors and people with disabilities, and boost state support for the California State University (CSU) and the University of California (UC).

Whose Taxes Would Proposition 55 Affect?

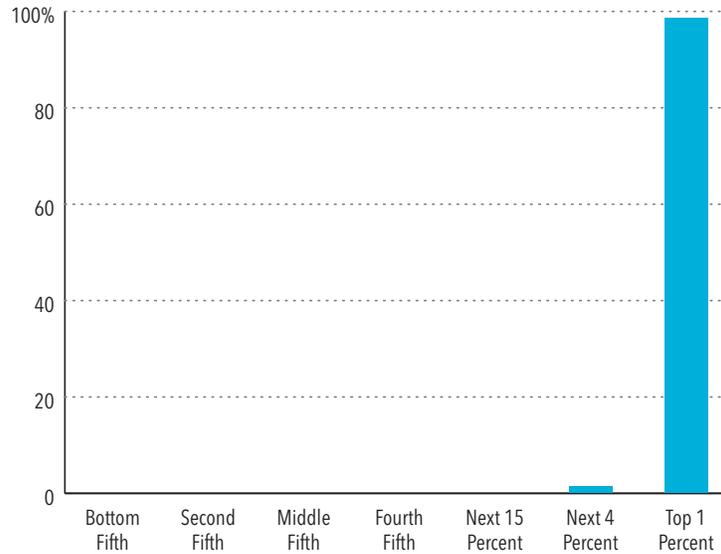
As noted above, Prop. 55 would extend the personal income tax rate increases of Prop. 30, but not the sales tax rate increase. Prop. 30’s *income tax rate* increases are aimed specifically at the highest-income households. Of the total dollar increase in income taxes brought about by Prop. 30, the top 1 percent of households pay 98.6 percent, and the next 4 percent of households pay the remaining 1.4 percent, according to the Institute on Taxation and Economic Policy (Figure 1). Prop. 55’s income tax rate increases could be expected to have a similar effect.

Compared to those of Prop. 30, Prop. 55’s overall tax-rate changes would be even more progressive. This is because Prop. 55 would not extend Prop. 30’s quarter-cent sales tax increase, which has a disproportionate impact on households with lower incomes.¹⁰ Prop. 55 follows the equity principle of taxation, by which taxes are levied fairly and based on the ability to pay.¹¹

FIGURE 1

Proposition 30's Income Tax Rates Mainly Affect the Top 1 Percent – Proposition 55 Would Have a Similar Effect

Share of Total Tax Increase Paid by Income Group



Note: Based on 2012 income distribution.
Source: Institute on Taxation and Economic Policy

Currently, California’s lowest-income families pay the largest share of their incomes in state and local taxes, while the wealthiest, who substantially benefit from public investments and have the greatest ability to contribute, pay much smaller portions of their incomes in state and local taxes. In other words, California’s tax system as a whole is regressive, even with Prop. 30’s income tax increases on the wealthiest households. If voters reject Prop. 55, California’s tax system would become even more regressive because the highest-income households would contribute a smaller share of their income in taxes than if Prop. 55 were approved (Figure 2).

Furthermore, the top 1 percent of California households – those who would be most affected by Prop. 55’s tax rate increases – have seen their average income more than double since the late 1980s, after adjusting for inflation (Figure 3). In contrast, average inflation-adjusted incomes for the bottom 80 percent of California households have *declined*.

What Would Rejection of Proposition 55 Mean for Public Services?

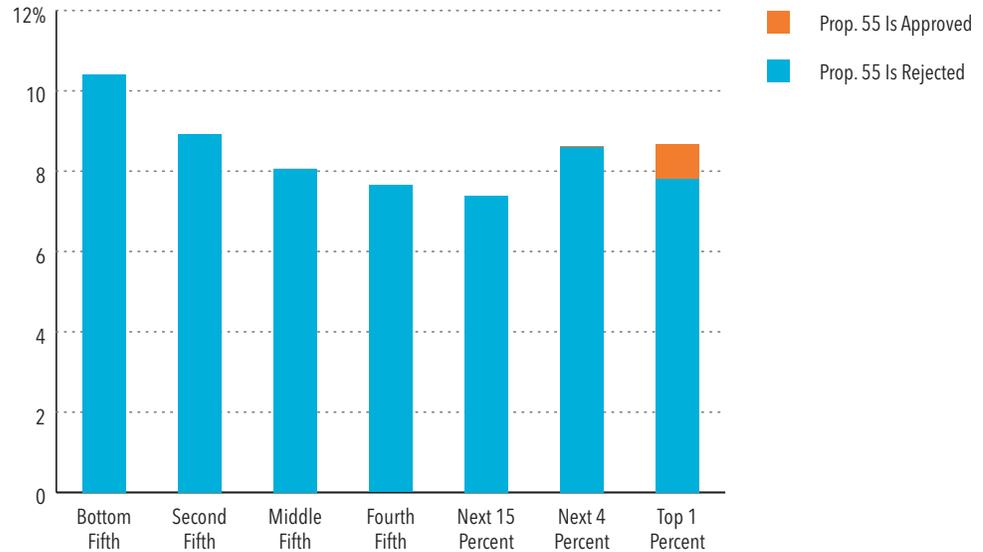
If California voters do not approve Prop. 55, the personal income tax rate increases on very-high-income Californians enacted by Prop. 30 will expire at the end of 2018. The expiration of Prop. 30’s income tax rates would:

- **Result in a significant loss of General Fund revenues.** Fiscal year 2018-19 would lose half a year of higher personal income tax revenues and 2019-20 would lose a full year of higher revenues – a projected \$4.5 billion in 2018-19 and \$7.7 billion in 2019-20, with annual revenue losses continuing thereafter (Figure 4).¹²
- **Create a multi-billion dollar budget deficit that would likely result in cuts to state services.** With the expiration of Prop. 30’s income tax rates, the loss of billions of dollars in General Fund revenues

FIGURE 2

California's Tax System Would Be More Regressive if Proposition 30's Income Tax Rates Were Allowed to Expire

Average Percentage of Family Income Paid in State and Local Taxes

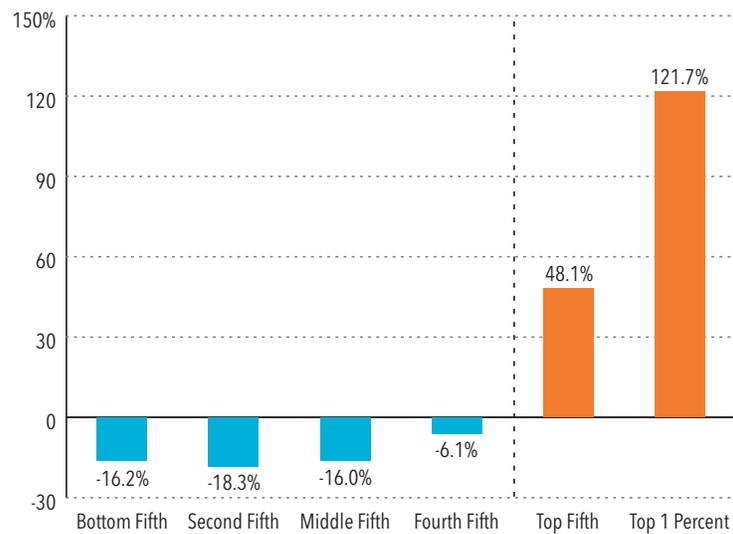


Note: Based on 2012 income distribution.
Source: Institute on Taxation and Economic Policy

FIGURE 3

Only California's Wealthiest Saw Increases in Average Income Over the Last Generation

Percent Change in Average Adjusted Gross Income (AGI), 1987-2014, Inflation-Adjusted



Source: Franchise Tax Board

would lead to annual multi-billion dollar state budget deficits. Under such a scenario, state policymakers would likely need to reduce spending for critical services in order to help to help balance the budget.

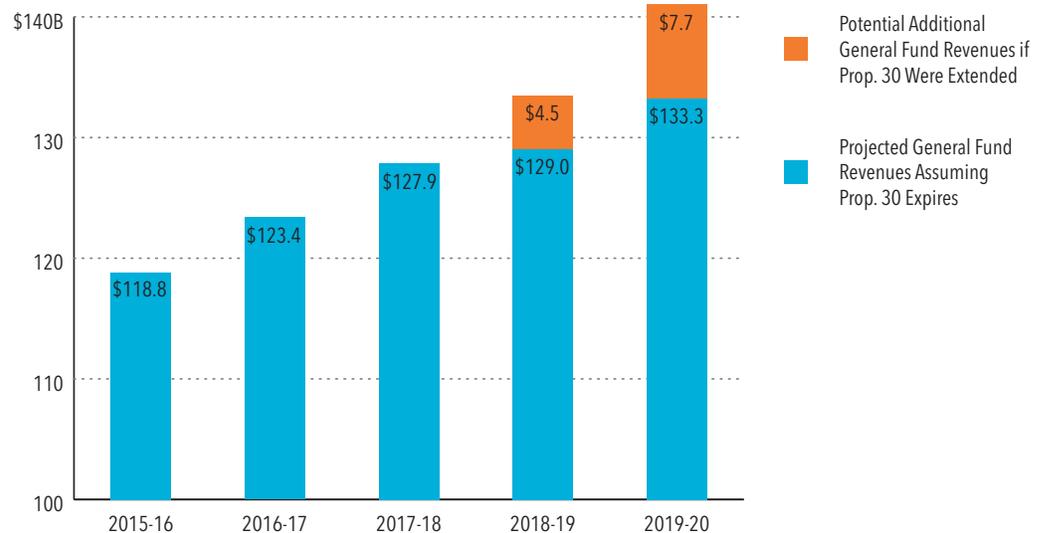
- Reduce the Prop. 98 funding guarantee for schools and community colleges.** Changes in annual General Fund revenues tend to affect the Prop. 98 guarantee. If Prop. 30's income tax rates are allowed to expire, the projected decline in annual General Fund revenue growth would reduce Prop. 98 funding for K-14 education compared to the funding that would be required if Prop. 30's tax rates were extended. Specifically, the Prop. 98 funding level could fall by roughly \$2 billion in 2018-19 and by roughly \$4 billion in 2019-20 if voters reject Prop. 55.¹³

- Restrict the state's ability to boost investments in a broad range of critical services and systems.** These include:
 - The state's child care and development system, which continues to provide tens of thousands fewer subsidized "slots" than in 2007-08, the year the Great Recession began.
 - The state's higher education system – the CSU and UC – for which direct state General Fund support per student is down substantially since the early 2000s, after adjusting for inflation.¹⁴
 - The CalWORKs welfare-to-work program, which provides a level of support that leaves families, including 1 million children, unable to afford even low-cost housing.¹⁵

FIGURE 4

Expiration of Proposition 30's Personal Income Tax Rate Increases Would Leave Permanent Gap in State Revenues

General Fund Revenues Before Transfers to the Budget Stabilization Account, in Billions



Note: 2015-16 is estimated; 2016-17 onward are projected. Additional revenues for 2018-19 and 2019-20 assume that personal income tax (PIT) revenue growth under an extended Prop. 30 would reflect the Administration's projected underlying PIT growth rate absent Prop. 30 taxes. Source: Department of Finance (DOF); Budget Center calculations based on DOF data

- SSI/SSP cash assistance for seniors and people with disabilities, which leaves individuals living below the poverty line and struggling to afford housing, food, and other necessities.¹⁶
- **Result in smaller deposits into the state’s rainy day fund and lower debt payments, leaving the state less prepared for the next economic downturn.** Building up reserves and paying down budgetary debt gives state policymakers additional options – beyond spending cuts – for balancing the budget and maintaining services during an economic downturn. However, the expiration of Prop. 30’s income tax rates would reduce the amount of revenues that are available for deposit into the Budget Stabilization Account and to pay down budgetary debt. As a result, critical services would likely face larger cuts if a recession significantly reduced state revenues.

In summary, allowing Prop. 30’s income tax rate increases on very-high-income Californians to expire would eliminate billions of dollars from California’s revenue system. This would leave the state with less funding to invest in schools, community colleges, and other vital public services and systems as well as reduce the state’s ability to pay down debts and save for a rainy day.

Policy Issues Raised by Proposition 55

Prop. 55 raises key policy issues, including whether to add a new funding formula for Medi-Cal to the state Constitution and whether to use temporary revenues to support ongoing services.

Adding a New Funding Formula for Medi-Cal to the State Constitution Reflects “Ballot-Box Budgeting”

By creating a new constitutional spending requirement for Medi-Cal, Prop. 55 is an example of what is commonly called “ballot-box budgeting.” On the one hand, critics of ballot-box budgeting argue that the initiative process limits voters to an up-or-down choice in isolation from other potential uses

of funds. They argue that earmarking the proceeds from a certain revenue source constrains the ability of the Governor and lawmakers to use the same source for other spending priorities, to make programmatic changes, or to modify spending in response to economic, budget, and demographic shifts.

On the other hand, proponents of initiative-based spending argue that the two-thirds vote requirement for legislative approval of tax increases makes it difficult, if not impossible, to raise revenues through the legislative process to support public services and systems. As a result, they maintain that it is appropriate to offer voters the ability to raise taxes to fund specific state budget priorities.

Proposition 55 Provides Temporary Funds for Ongoing Spending

Prop. 55 extends Prop. 30’s personal income tax rate increases through 2030, but does not make those higher rates permanent. In other words, the revenues raised by Prop. 55 would eventually disappear. Given the temporary nature of these revenues, relying on them to fund permanent, ongoing services – such as K-14 education and Medi-Cal – would mean that state policymakers (and possibly the voters) would again face the question of whether to extend these tax rates, make them permanent, or find a different source of funding. If such efforts failed, state budget shortfalls would likely emerge, meaning that state policymakers would face the prospect of reducing spending on vital public services and systems.

What Do Proponents Argue?

Proponents of Prop. 55, including the California State PTA, the California Teachers Association, and State Superintendent of Public Instruction Tom Torlakson, argue that the measure will prevent “billions in budget cuts without raising taxes by ensuring the wealthiest Californians continue to pay their share.” They state that money from the measure “goes to local schools” with strict accountability requirements that “ensure funds designated for education go to classrooms,” and further that the measure “expands health care access for children.”¹⁷

What Do Opponents Argue?

Opponents of Prop. 55, including the Howard Jarvis Taxpayers Association, the National Federation of Independent Business/California, and retired Superior Court Judge Quentin L. Kopp, argue that voters supported Prop. 30's tax rate increases only "because we were promised they'd be temporary." They assert that funding for schools and other requirements is adequate, and state that "we can't trust the politicians and special interests."¹⁸

Conclusion

Prop. 55 would extend – from 2019 to 2030 – the personal income tax rate increases on very-high-income Californians that voters approved by passing Prop. 30 in 2012. Prop. 55 would not extend Prop. 30's quarter-cent increase in the state sales tax rate, which would be allowed to expire at the end of 2016 as scheduled. Prop. 55 is projected to generate between \$4 billion and \$9 billion per year, a range that brackets the roughly \$7 billion to \$8 billion per year that Prop. 30 has raised to date. Prop. 55's revenues would be used to meet various constitutional spending obligations, such as for K-14 education and for Medi-Cal, as well as

to help maintain services that were in place as of January 1, 2016. After meeting these spending requirements, any Prop. 55 revenues that remained could be used for any budget priorities, including boosting working families' access to subsidized child care, making higher education more affordable, and improving safety-net services for low-income families with children.

With Prop. 55, voters have a choice to maintain a level of funding that has allowed California to begin reinvesting in its schools and other public services after years of disinvestment during and following the Great Recession. Rejecting Prop. 55, and thus allowing Prop. 30's income tax rate increases to expire at the end of 2018, would result in reduced state revenues, less funding for schools and community colleges, smaller deposits to the state's rainy day fund, less repayment of budgetary debt, and – quite possibly – cuts to vital public services and systems. Moreover, California's state and local tax system would become even more regressive because the wealthiest households – primarily the top 1 percent – would receive a substantial tax cut and thereby contribute less toward strengthening services that can promote economic security and opportunity for all Californians.

Scott Graves, William Chen, Chris Hoene, and Jonathan Kaplan prepared this *Issue Brief*. The California Budget & Policy Center neither supports nor opposes Proposition 55. This *Issue Brief* is designed to help voters reach an informed decision based on the merits of the issues. The Budget Center was established in 1995 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The Budget Center engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the Budget Center is provided by foundation grants, subscriptions, and individual contributions. Please visit the Budget Center's website at calbudgetcenter.org.

ENDNOTES

- ¹ For an overview of Prop. 30 and its impact, see William Chen, *What Has Proposition 30 Meant for California?* (California Budget & Policy Center: September 2016).
- ² Prop. 30 added three new personal income tax rates for very-high-income Californians through 2018: A 10.3 percent tax bracket for single filers' taxable income between \$250,001 and \$300,000 and joint filers' taxable income between \$500,001 and \$600,000; an 11.3

percent tax bracket for single filers' taxable income between \$300,001 and \$500,000 and joint filers' taxable income between \$600,001 and \$1 million; and a 12.3 percent tax bracket for single filers' taxable income above \$500,000 and joint filers' taxable income above \$1 million. These income ranges applied to tax year 2012 and are adjusted annually for inflation.

- ³ Legislative Analyst's Office, "Proposition 55: Tax Extension to Fund Education and Healthcare. Initiative Constitutional Amendment. Analysis by the Legislative Analyst," in Secretary of State's Office, *California General Election Tuesday November 8, 2016: Official Voter Information Guide*, p. 40.
- ⁴ The Prop. 98 guarantee, which voters approved in 1988, is funded with both local property tax revenues and state General Fund revenues. For an overview of the Prop. 98 guarantee, see Nirupama Jayaraman, *School Finance in California and the Proposition 98 Guarantee* (California Budget & Policy Center: April 2006).
- ⁵ For a complete list of adjustments that would be allowed by Prop. 55, see California Government Code, Section 13308.05.
- ⁶ This allocation to Medi-Cal could be reduced during a fiscal year in which the Governor declares a budget emergency as allowed by Prop. 2 of 2014. However, any reduction could not be greater than the proportional reduction in overall General Fund expenditures for that fiscal year.
- ⁷ Legislative Analyst's Office, "Proposition 55: Tax Extension to Fund Education and Healthcare. Initiative Constitutional Amendment. Analysis by the Legislative Analyst," in Secretary of State's Office, *California General Election Tuesday November 8, 2016: Official Voter Information Guide*, p. 43.
- ⁸ For a discussion of Prop. 2, see Scott Graves and Jonathan Kaplan, *Proposition 2: Should California Prioritize Paying Down Debt and Significantly Change State Budget Reserve Policies?* (California Budget & Policy Center: September 2014).
- ⁹ Legislative Analyst's Office, "Proposition 55: Tax Extension to Fund Education and Healthcare. Initiative Constitutional Amendment. Analysis by the Legislative Analyst," in Secretary of State's Office, *California General Election Tuesday November 8, 2016: Official Voter Information Guide*, p. 43.
- ¹⁰ All Californians pay the same state sales tax rate regardless of their household income. As a result, low-income households pay a larger share of their incomes in sales taxes than do higher-income households, other things being equal.
- ¹¹ For a discussion of how to evaluate tax proposals, see William Chen and Chris Hoene, *Asking the Right Questions About Emerging Tax Proposals in California* (California Budget & Policy Center: November 4, 2015).
- ¹² This estimate of lost personal income tax revenues in 2019-20 is dependent in part on the projection of that revenue stream in the preceding fiscal years. The latest publicly available estimate is from the Department of Finance's May 2016 projection. For comparison, as noted above, an LAO analysis of the fiscal effects of Prop. 55 concluded that the measure could generate from \$4 billion to \$9 billion per year.
- ¹³ These estimates assume that the Prop. 98 guarantee would be reduced by roughly *half* of the projected General Fund revenue losses in 2018-19 and 2019-20 if Prop. 30's income tax rates are allowed to expire.
- ¹⁴ Phaelen Parker, *State Spending Per Student at CSU and UC Remains Near the Lowest Point in More Than 30 Years* (California Budget & Policy Center: March 2015).
- ¹⁵ Alissa Anderson, *CalWORKs Grants Fall Short as Rents Continue to Rise* (California Budget & Policy Center: March 2016).
- ¹⁶ Scott Graves, *Cost of Rent and Food Highlights Inadequacy of SSI/SSP Grants for Seniors and People With Disabilities in California* (California Budget & Policy Center: March 2016).
- ¹⁷ "Argument in Favor of Proposition 55," in Secretary of State's Office, *California General Election Tuesday November 8, 2016: Official Voter Information Guide*, p. 44. See also "Rebuttal to Argument Against Proposition 55," p. 45.
- ¹⁸ "Argument Against Proposition 55," in Secretary of State's Office, *California General Election Tuesday November 8, 2016: Official Voter Information Guide*, p. 45.