

## **State Budget Deficit Dynamics and the California Debacle**

Steven M. Sheffrin

**N**ational recessions are bad news for state budgets. Virtually all states face some form of balanced budget requirement, which at a minimum requires that they adopt budget plans that avoid deficits in their general funds or basic operating budgets. With the onset of a recession, falling tax revenues and increasing transfer payments force governors and legislators to make difficult choices.

However, the recession of 2001 appeared to have created more than the usual chaos in state governments. Consider these examples reported in mid-2003. In Alabama, a Republican governor facing a \$675 million budget deficit proposed a tax increase of \$1.2 billion both to eradicate the deficit and to improve educational opportunities. Voters overwhelmingly rejected this proposal, resulting in sharp cuts in spending (Rawls, 2003). In Nevada, the state constitution requires both a two-thirds supermajority provision to raise taxes and also includes a requirement to provide adequate educational funding. The Republican governor brought a lawsuit to overturn the two-thirds majority and raise taxes for education, and the state Supreme Court agreed. Eventually, a tax increase was passed with a two-thirds vote, but irate voters initiated an (ultimately unsuccessful) recall attempt against the governor (Riley, 2003). Connecticut and Oregon both witnessed prolonged and bitter budgetary stalemates. Oregon broke its record for the length of the legislative session; Connecticut came within six days of breaking its record (Dixon, 2003; Har and Hogan, 2003). In New York, the legislature overrode a governor's veto of its spending plan for the first time in two decades. Also, it was the first time in memory that the legislature had enacted tax increases over a governor's veto (Baker, 2003).

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One episode in the saga of state budget problems was widely covered in the national and world media—the case of California. Not long after Governor Gray Davis signed a budget bill that featured a combination of tax increases, spending cuts and borrowing, enough signatures were gathered to place a recall of the governor on the ballot. In only the second successful gubernatorial recall in U.S. history—after North Dakota’s recall of Governor Lynn J. Frazier in 1921—Davis was recalled and replaced by an Austrian-born bodybuilder, actor and political novice, Arnold Schwarzenegger.

These dramatic events for state budgets occurred in 2003, about 18 months after the recession’s trough in November 2001. By postwar standards, the 2001 recession was relatively mild both in terms of its duration and depth—more like the mild recession of the early 1990s than the deep recessions of the early 1980s. The contrast between the extreme political and budgetary angst at the state level and the relatively mild national recession is striking.

This paper explores the dynamics of the recent state budget problems from several angles. We begin with a broad national look at recent state fiscal crises and contrast them to the experiences of the early 1990s, when the U.S. economy suffered its last recession. The initial magnitude of the decline in state budgetary fortunes was similar in these last two recessions, but the policy responses differed sharply. Policymakers throughout the states, and in California, initially responded much less aggressively to budgetary shortfalls in the 2001 recession than in 1990–1991. We then review the empirical and theoretical literature on the role that state institutions, such as differing balanced budget requirements, play in determining state responses to potential fiscal crises. Finally, we make an in-depth examination of California’s experience as it coped with record budgetary shortfalls. Were California’s fiscal difficulties just a larger version of the problems facing other states, or did California face unique factors not found elsewhere—like an interaction between California’s large number of technology companies, income from stock options and the stock market decline that started in 2000? In California and elsewhere, postponement of hard choices and delays in budget information and analysis made difficult budget problems even worse.

## **The State Budget Experience in Perspective**

All states except Vermont have some rules governing balances in their general fund accounts, but the rules differ (Bohn and Inman, 1996). The weakest rules require only that the governor submit a balanced budget plan or that the legislature pass a plan in which the budget is balanced. In these cases, the budget balance rules are *prospective* only; that is, there are no provisions that actual expenditures and revenues be balanced by the end of the appropriate fiscal year. States with such requirements include Illinois, Louisiana, Massachusetts, New Hampshire, New York and Nevada. The next category includes those states that may run a deficit at the end of the year, but must budget explicitly for the deficit in the next fiscal year. The

states that can *carry over* deficits from one year to the next include Alaska, California, Connecticut, Maryland, Michigan, Pennsylvania and Wisconsin. The Advisory Commission on Intergovernmental Relations (ACIR, 1987) developed a numerical index of stringency of balanced budget requirements that distinguished between the prospective and carry-over states, with the latter being deemed to have more stringent rules. However, in practice, there is reason to doubt whether the budget differences in these systems will be large, since the prospective states will also typically incorporate current fiscal year deficits into planning for the next fiscal year. The remaining category is states that *cannot carry over* deficits from one fiscal year to the next. In these states, adjustments to taxes or spending must be made during the current fiscal year.

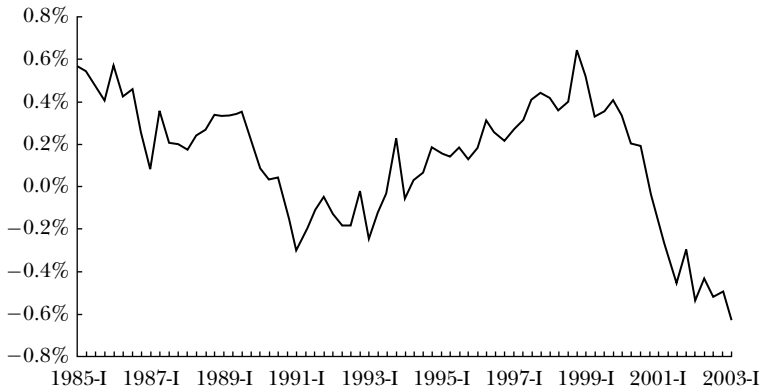
This section discusses the recent state budget experience from a number of different perspectives: the overall national trends in state budgets; the economic causes behind those budget trends in terms of taxes and spending; a disaggregated view looking at which states have the largest budget problems; and a discussion of how state budgets are affected by institutional factors like specific balanced budget requirements or political setting of the state government.

### **National Trends in Aggregate State Budgets**

There are two traditional ways to measure the fiscal health of state, or state and local, governments. The most comprehensive method is the surplus/deficit measures of the National Income and Product Accounts (NIPA). The NIPA accounts include the state and local sector for the United States and also include depreciation of the existing stock of capital, although for present purposes we exclude balances in social insurance funds. The second traditional measure is produced by the National Conference of State Legislatures (NCSL) and the National Association of State Budget Officers (NASBO). These organizations measure the balances held by the states in their general funds, which are the states' core operating funds. Thus, the latter measure only applies to state governments—not local governments—and does not include “special accounts” like funds dedicated to transportation or other special purposes. General fund balances are probably most tied to traditional measures of fiscal distress; however, state governments can and do alter their net fiscal positions with respect to local governments and may sometimes be able (at least temporarily) to tap into special accounts.

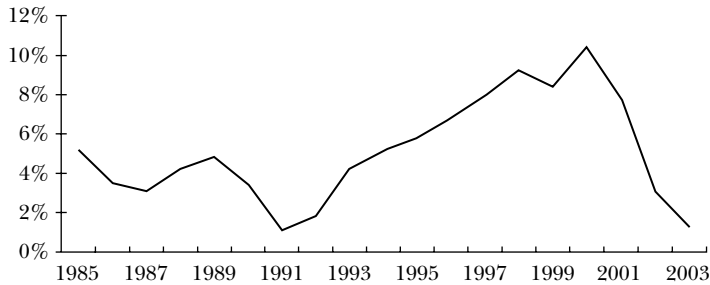
Both data series tell approximately the same story. Figure 1 plots the NIPA surplus/deficit as a percentage of gross domestic product (GDP) from 1985:1 to 2003:1 on a quarterly basis. Figure 2 plots total general funds balances as a percentage of total state expenditures for fiscal year 1985 through fiscal year 2003. Both measures show a decrease during the recession of the early 1990s followed by sharp increases in the last part of the decade. Beginning in approximately 2000, both fiscal measures deteriorated. By 2003, general fund balances were 1.3 percent of expenditures, just slightly above the 1991 value of 1.1 percent. The deficit on the NIPA account in 2003 exceeded the deficit in the early 1990s. In 2003:1, the current balance reached  $-0.62$  percent of GDP, whereas its previous low in the prior

*Figure 1*  
**Current Surplus or Deficit as Percentage of GDP**



*Note:* Excludes social insurance funds.  
*Source:* U.S. Bureau of Economic Analysis (2003).

*Figure 2*  
**Total General Funds Balances as Percentage of Total Expenditures**



*Source:* National Association of State Budget Officers and National Governors Association (2003).

recession was  $-0.30$  percent in 1991:1. The surplus of the late 1990s reached as high as 0.64 percent of GDP. While the precise numbers differ, the patterns look similar using either the NIPA or NCSL/NASBO measures.

### **Decomposing the Aggregate State Budget Numbers**

What were the causes of the latest deterioration of the fiscal health of the states? Knight, Kusko and Rubin (2003) decompose movements in the NIPA measure of state budget balance into three components.

First, they use the high-employment budget concept, which estimates what the budget surplus would be if the economy were operating at full employment and, thus, effectively holds the business cycle constant.

Second, they use a capital gains component reflecting the collapse of the stock

market and its effects on state revenues. Recent revisions of federal budget projections by the Congressional Budget Office reflect large “technical corrections” to their budget estimates, which is the CBO term for saying that the slowdown in the economy produced a larger-than-usual decline in tax revenue (Auerbach, 2003). In turn, these revisions appear to be connected to stock market related income. To address this issue, Knight, Kusko and Rubin include estimates of capital gains realizations at the national level as an independent factor in their analysis and calculate the implied state revenue changes using an average state capital gains rate. Other observers have also highlighted the relatively sharp decreases in revenues during the last recession and the key role that capital gains likely played in the decline. For example, Boyd and Jenny (2003) point out that the 7.4 percent decline in real per capita tax revenues in fiscal year 2002 was more than twice the size of the declines in the 1990–1991 recession (3.5 percent) and 1980–1982 recession (3.0 percent).

Third, Knight, Kusko and Rubin (2003) find a residual that they label as “policy and other” factors that measures actions taken (or not taken) by state and local governments with respect to spending and taxation as well as exogenous cost pressures from, for example, increases in the relative price of health care or from federal mandates.

Knight, Kusko and Rubin’s (2003) decomposition of the sources of change in state budget balances is provocative. Looking first at the deficit in 2002, they conclude (p. 435) that “neither the cyclical weakness in the economy, nor the direct effects of capital gains realizations, when measured relative to their longer run trend, account for very much of the deficit in 2002. The implication is that the current deficit is largely structural . . . .” Cyclical weakness and capital gains do account for approximately one-third of the swing (or decline) in the current state budget balance from 1998 to 2002, but even by this accounting, the analysis implies that “policy and other related” factors were the principal causes of the most recent state fiscal crises.

Knight, Kusko and Rubin (2003) compare the most recent state fiscal crisis to the two prior crises during 1989–1991 and 1978–1982. In both the prior periods, cyclical factors dominated the causes of decline in state budget balances as measured by the National Income and Product Accounts. The 1980s recession had roughly the same impact on the state budget deficits as a percentage of GDP as the most recent recession. Policy and other changes accounted for only approximately 25 percent of the deterioration in the state and local fiscal position in the early 1980s, whereas they accounted for 75 percent during the most recent period.

What are some of the common state-level policy changes that can help to explain the deterioration of the states’ underlying budget position from 1998 to 2002? First, many states cut taxes during the late 1990s. Second, states expanded eligibility for Medicaid at precisely the same time that they began facing increases in the relative price of health care. Third, state and local government spending generally increased. While state general fund spending increased in real terms by approximately 2.7 percent per year from fiscal years 1985–2003, it increased by

5.2 percent in 1999 and 4.0 percent in the three subsequent years (NASBO, 2003, p. 4).<sup>1</sup>

It also appears that state legislators were slower to respond to the fiscal stress of the early 2000s than they were during the previous recessions. Maag and Merriman (2003) use NASBO data on legislated state-level tax changes to examine the responses of policymakers during the last two economic downturns. They find that policymakers during the 1990 recession “quickly increased taxes to bring budgets into balance,” but in the 2001 recession “shunned significant policy changes.” In fiscal year 1991, state tax policy changes increased revenues by 3.43 percent, and for fiscal year 1992 revenues were increased by 4.62 percent. The largest tax increases stemmed from increases in personal income taxes. In contrast, for fiscal years 2002 and 2003, that revenue increased by only 0.2 percent and 1.64 percent, respectively. Maag and Merriman calculate that if states had been as aggressive in raising taxes during fiscal years 2003 and 2002 as they were during fiscal years 1991 and 1992, they would have raised an additional \$33 billion in revenues and closed approximately two-thirds of the gaps in their fiscal 2003 budgets.

The National Association of State Budget Officers also provides data on budget cuts made during the current fiscal year. Measured as a percentage of expenditures, budget cuts during fiscal years 1991 and 1992 were 2.68 percent and 1.51 percent, respectively. In fiscal year 2001, the cuts were only 0.4 percent, although the cuts did increase to 2.68 percent in fiscal year 2002. These data also show that policymakers were less aggressive in making rapid adjustments to spending in the 2001 recession than in the 1990–1991 recession.

States that are not willing to raise taxes or reduce spending can use a variety of short-run strategies. One example was the frequent practice of securitizing revenues from the legal settlement that the tobacco companies made with the states in 1998; that is, states sold bonds based on the future revenues and used the proceeds to offset current budget shortfalls. Petersen (2003) provides a recent review of time-honored (and some relatively new) strategies that states can use to disguise or offset fiscal deficits. These methods include optimistic budget projections, sales of assets, capitalizing new income streams or even current costs, borrowing from other state funds, accelerating revenues and postponing spending without changing programs, or restructuring debt. Of course, strategies that provide temporary relief are not appropriate for structural problems in states’ operating budgets and can exacerbate long-run problems.

### **Identifying the Worst State Budget Problems**

The decline in measures of national fiscal health during recessionary periods is highly concentrated in a few states. Table 1 presents the percentage of total

<sup>1</sup> It is true that real state spending per capita grew more rapidly during the 1980s than the 1990s, but nonetheless, there was a clear escalation in spending growth during the last part of the 1990s (Snell, Eckl and Williams, 2003, p. 914).

*Table 1*  
**Top Five States With Declines in General Fund Balances**  
*(in million \$)*

1990	State	Change in balance	As % of total decline	1991	State	Change in balance	As % of total decline
	Massachusetts	-837	26.9%		Connecticut	-809	12.9%
	New Jersey	-410	13.2%		Pennsylvania	-715	11.4%
	Michigan	-405	13.0%		Ohio	-373	5.9%
	Georgia	-376	12.1%		California	-3,424	54.5%
	California	-564	18.1%		Washington	-468	7.4%
Subtotal		-2,592	83.3%	Subtotal		-5,789	92.1%
Total balance change		-3,113		Total balance change		-6,284	
2001 <sup>a</sup>	State	Change in balance	As % of total decline	2002 <sup>a</sup>	State	Change in balance	As % of total decline
	Indiana	-828	9.4%		Massachusetts	-1,880	8.7%
	Wisconsin	-628	7.1%		New Jersey	-1,718	8.0%
	Minnesota	-551	6.2%		Pennsylvania	-1,319	6.1%
	Virginia	-512	5.8%		California	-5,170	24.0%
	California	-6,102	69.0%		Oregon	-1,493	6.9%
Subtotal		-8,621	97.5%	Subtotal		-11,580	53.7%
Total balance change		-8,842		Total balance change		-21,553	

<sup>a</sup> Excludes Florida.

Source: Fiscal Survey of the States, Fall 1985 through Spring 2003, NASBO.

national decline in state general fund balances from the prior fiscal year accounted for by the five states with the largest declines for fiscal years ending in 1990, 1991, 2001 and 2002. The top five states accounted for over 80 percent of the decline in three of the four periods examined and over 50 percent in the other period. California is among the top five states in all four periods. It dominates the list in three of the four periods.

Boyd and Jenny (2003) point out that the decline in tax revenues varied across the states, with the west (dominated by California) facing the largest declines followed by New England. Aside from Alaska (a state in which revenue is tied closely to oil prices), the states with double-digit declines include California, Colorado, Connecticut, Massachusetts, New Jersey, New York, Oregon and Vermont. Boyd and Jenny (p. 4) characterize these states as “generally states with progressive income taxes and many taxpayers who were paying taxes on capital gains.” These reasons help to explain why California’s fiscal situation was particularly vulnerable.

As noted earlier, taxes that are related to the stock market fluctuations—like capital gains and stock options—played an important role in the state budget problems of the early 2000s. These issues loomed especially large in California. Using state-level data on capital gains from the *Statistics of Income* of the Internal

Revenue Service coupled with detailed data on state tax systems, Sjoquist and Wallace (2003) document that states differ widely in the importance that capital gains play in their tax bases. In general, capital gains are a more important source of revenues in states with higher per capita personal income, large numbers of retirees and higher tax rates on income from capital gains. For 1999, the following states had the highest concentration of capital gains as a fraction of income tax collection: Montana (27.2 percent), California (26.1 percent), Arizona (19.6 percent), New Jersey (19.4 percent), Nebraska (16.7 percent) and New York (16.2 percent). The interaction of capital gains income with state tax rates is important; Florida and Nevada have among the higher shares of capital gains as a percentage of federal adjusted gross income, but these states do not have personal income taxes.

In addition, the value of stock options is obviously related to stock prices. However, income from the exercise of “nonqualified” stock options (which in California accounted for 95 percent of option income) is reported as wage and salary income and taxed as ordinary income, not at a preferred capital gains rate.<sup>2</sup> Since this type of income is reported along with wage and salary income on income tax returns, it must be estimated based on deviations from past trends in wage and salary income for employers offering options. In California, firms in Silicon Valley offered stock options as a key component of employee compensation. The California Legislative Analyst’s Office (2001, Chapter 3, p. 4) estimated that income from options accounted for between 35 and 40 percent of total stock market related income in fiscal year 2000. California’s fiscal issues are discussed in greater detail below.

### **Changes in Legal and Political Constraints**

A considerable literature has developed to discuss how legal and political factors affect state budget decisions. This literature has generally reached three conclusions. First, a state’s constitutional or statutory constraints that affect spending, taxes or borrowing can definitely have an effect, especially when the balanced budget rules prohibit carrying over a deficit to the following year. Second, when political control is divided so that two houses of the state legislature are held by different parties or the state governor is from a different party than is the legislature, political adjustments to fiscal shocks will often take longer than if political control is unified in one party. For example, the two states mentioned in the introduction with especially protracted budget negotiations, Oregon and Connecticut, had governments where control of the two legislative chambers was split

<sup>2</sup> Phil Spilberg of the California Franchise Tax Board provided this estimate to me. A nonqualified stock option is treated as income to the recipient when the option is exercised, and it constitutes a compensation related deduction at that time to the company offering the option. The alternative is a “qualified stock option,” also known as an “incentive stock option,” which is not treated as income when the option is exercised, but is taxed as capital gains when eventually sold (if the stock is held for at least a minimum time). A company cannot deduct the gain on a qualified stock option as a compensation related expense.

between the parties. Third, state governments dominated by Democrats tend to spend more than state governments dominated by Republicans. For example, these three points sum up the general findings of Alt and Lowry. Alt and Lowry (1994) use data on total state government spending and taxes (not general fund data) from 1968 to 1997, and Alt and Lowry (2000) examine the effect of changes in state government for 33 states from 1952–1995 on real per capita general fund revenues.

Bohn and Inman (1996) use general fund budget data from 1970–1991 to examine the effects of balanced budget rules and alternative political configurations on the general fund surplus in a panel study of 47 states. While they generally confirm the Alt and Lowry (1994, 2000) findings, their work also raises two analytical issues that apply across this literature. One warning is that state balanced budget rules apply only to the general funds accounts of the states and not their total balances over all accounts, which leaves room for states to move funds between accounts. They find strong evidence that balanced budget rules matter, but *only* for the states with the strictest “no-carry-over” balanced budget provisions. A second warning is that it may be difficult to separate out the impact on spending of constitutional or statutory provisions from the political climate of a state itself. When Bohn and Inman included state fixed effects in their analysis, they did not find any response of general fund surpluses to government divided by party, but without the fixed effects they report results similar to Alt and Lowry.

Poterba (1994) tackled these issues using NASBO data on the actual revenues and expenditures from the prior year, forecasts of revenues and expenditures for the current fiscal year and any budget cuts or tax changes enacted during the fiscal year. He used this data to construct measures of *unexpected* fiscal deficits that transpired during the year, relative to the tax and expenditure system that was in effect at the beginning of the year. He then examined how states changed spending and taxes with respect to “fiscal news” and how institutional features affected these adjustments. Using this approach, Poterba finds for the period 1988–1992 that states with weak antideficit rules adjust spending less than states with strong antideficit rules, although he does not find similar effects for taxes. Poterba also finds that states with unified governments adjust to fiscal deficits more rapidly than states with divided government.<sup>3</sup>

Poterba and Rueben (2001) built on the measure of unexpected fiscal deficits from Poterba’s earlier work and use it to explore the role of state institutions as

<sup>3</sup> Poterba’s (1994) empirical work differs in several respects from other authors. First, because he looks at within-year adjustments, he excludes those states with two-year budgeting cycles. Second, his “weak antideficit rule” states include only those states with prospective balanced budget rules, and not those with carry-over rules. In a footnote in the paper, he indicates that the results are similar when he uses the Alt-Lowry classification. However, this finding stands contrary to results reported by other authors that only the no-carry-over deficit rules matter. At the minimum, this ambiguity puts large and important states such as California, Michigan, Maryland, Pennsylvania and Wisconsin into an empirical “fiscal limbo.”

perceived through the bond market. For example, they find that unexpected deficits are associated with higher general obligation bond yields. Moreover, this effect, although small, is more pronounced in states with weak antideficit rules, which suggests that financial markets take fiscal institutions into account as they evaluate states' creditworthiness. Poterba and Rueben also find that other fiscal institutions matter, such as binding revenue limits or supermajority provisions for increasing taxes, which consistently exacerbate the effects of deficit shocks on bond yields. They also consider the effects of other fiscal institutions such as limits on the legislature's ability to issue long-term debt, binding expenditure limits, limits on local revenues (such as Proposition 13 in California) and supermajorities to pass local bonds. Fiscal institutions may also interact with each other in important ways. For example, limits on state revenues may not matter very much unless there are also local limits. If a state has supermajority provisions to pass a state budget, like California, then even if one party controls more than half of the legislature along with governorship, state government may not be "unified," in the sense that the majority party cannot pass a budget by itself.

Do changes in states' legal and political constraints over the decade of the 1990s help explain their markedly different responses to the fiscal crises at the close of the decade? Perhaps. Looking at Alt and Lowry's (1994, 2000) measures of divided government reveals no obvious explanatory factors. In fact, the number of unified state governments rose from 18 to 24 from 1989 to 2000, with a distinct trend toward unified Republican governments, from four in 1989 to 15 in 2000. Further, the number of split legislative states (potentially the most divisive political split) held constant at 12; while split branch governments declined from 19 to 13. On the other hand, legal constraints may provide a possible explanation for states' inability to close their budget deficits. Over the decade of the 1990s, nine states enacted or expanded measures that raise the requirements to pass taxes (Rafool, 1998; Ferrara, undated). Some enacted legislative supermajority requirements; others required voter approval of new taxes.

The increase in legal restraints to raise taxes, however, may also simply be a manifestation of the voting public's increasing reluctance to support tax increases. There certainly is a perception that raising taxes has become more costly for politicians in recent years, as exemplified by the defeat of politicians who raised taxes, such as Governor James Florio in New Jersey in 1994 and Governor Gray Davis in California in 2003. However, taxes have been a high-voltage political issue in U.S. states and in California for quite some time, and it is debatable whether it was politically harder to raise taxes in 2001 than in 1991 or in 1982.

It is difficult to study the impact of state fiscal institutions and political configurations on spending. Different rules and institutions interact with each other. They tend to exhibit only infrequent changes. It can be difficult to untangle the impact on spending and taxes of state fixed effects (which may reflect underlying political tastes for spending and taxation) from the institutional structures

that are in place.<sup>4</sup> However, the evidence does suggest that rules creating a greater degree of inflexibility in state taxes, spending and borrowing may help to explain why state governments were slow to react to the budget trauma of the early 2000s.

## Untangling California's Fiscal Crisis

California's fiscal crisis was a major part of the overall budget crisis of all 50 U.S. states in 2001–2002. On November 17, 2003, Governor Arnold Schwarzenegger was inaugurated in a modest ceremony in Sacramento. He came into power following the voters' recall of Governor Gray Davis. Governor Davis's reputation was already weakened by his delayed response to the electricity crisis in California,<sup>5</sup> but California's budget deficit and Davis's response were what fueled the recall. Governor Davis and the legislature passed a budget that the governor claimed closed a \$38 billion dollar deficit. But closing the budget in one year was accomplished with over \$16 billion in explicit borrowing, only \$9.2 billion in program cuts and with the general knowledge that an \$8 billion deficit would emerge at the beginning of the next fiscal year (Legislative Analyst's Office, 2003a, p. 5). Much to the voters' dismay, the budget also reversed prior reductions in the Vehicle License Fee, popularly known as the "car tax."

The financial markets made negative judgments on the final Gray Davis budget. In July 2003, Standard & Poor's downgraded California's bond ratings from A to BBB, the lowest of any state. Moody's followed in August with a downgrade in their rating. The state had already had to pay "credit enhancements" of \$84 million to financial institutions to guarantee placements of an \$11 billion bond sale in June. Following the downgrading in credit, the state had to pay an additional \$34 million in credit enhancements—a cumulative total of over 1 percent of the face values of the bonds. The financial markets were pointing out that, whatever the wording of the state's constitution and laws, California did not in fact have "strong antideficit rules."

### The Genesis of California's Crisis

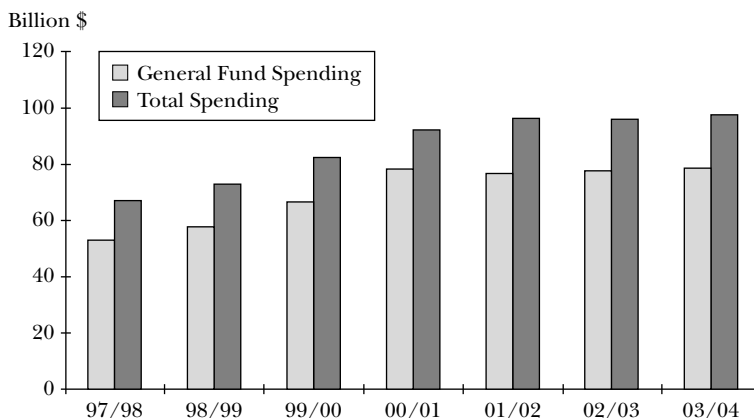
How did the California's budget crisis originate? Contrary to one common belief, the 2001 electricity crisis was not the cause of California's fiscal difficulties. In 2001, the state of California did have to buy electricity on behalf of the public because the major utilities that customarily bought the electricity were bankrupt.<sup>6</sup> The state tapped into its general fund to pay these bills. However, the state then repaid the general fund after selling \$6.2 billion in electricity bonds, which were

<sup>4</sup> Besley and Case (2003) provide an extensive review of the literature on political institutions and policy choices and present their own evidence, typically with state fixed effects, and often find a significant role for political factors in determining policy outcomes.

<sup>5</sup> For an analysis of the California electricity crisis in this journal, see Borenstein (2002).

<sup>6</sup> Sexton and Sheffrin (2002) provide an institutional perspective on the electricity crisis.

Figure 3

**California General Fund and Total Spending from 1997–1998 to 2003–2004**

Note: Total spending in 2001–2002 was 7.08 percent of gross state product in 2001.

Source: Legislative Analyst's Office (2003d).

financed by ratepayers, not taxpayers. Thus, the electricity crisis in California only had a temporary effect on the state's general fund cash flow.

At the broadest level, the origins of California's fiscal problems are clear. Beginning in fiscal year 2000–2001, the state began to run an operating deficit, with revenues falling short of expenditures. The operating deficit widened and continued for the next three fiscal years, with the result that a budget surplus of approximately \$7 billion at the beginning of 2000–2001 was transformed into a projected deficit of \$38 billion at the beginning of fiscal year 2003–2004 (Legislative Analyst's Office, 2003a, p. 3). To put these numbers into some perspective, Figure 3 plots California's general fund and total spending for fiscal years 1997–1998 through 2003–2004.

How did the state create this multiyear operating deficit? Again, at a broad level the answer is straightforward. Starting in the late 1990s, general fund tax revenues began to grow sharply, particularly from the personal income tax. In fiscal year 1997–1998, total general fund revenues were \$53.9 billion. By fiscal year 2000–2001, they had increased to \$75.7 billion. Personal income tax revenues grew during that same period (with no changes in tax rates) from \$27.9 billion to \$44.6 billion, thus accounting for the lion's share of the rise in revenues. State spending grew in tandem with these revenue increases. But then revenues began to collapse. Personal income tax revenues fell back to \$32.1 billion in 2002–2003, and total state revenues fell to \$64.2 billion. Policymakers failed to adjust spending levels to these reduced revenues or to find significant sources of new revenue.

In retrospect, we now understand the genesis of the surge in revenue that began in the late 1990s. According to California's Legislative Analyst Office (2002b, p. 2), revenue from capital gains and stock options peaked in fiscal year 2000–2001 at \$17 billion—or 38 percent of the revenue from the personal income tax. By

the next fiscal year, following the stock market decline, these revenues were only \$6 billion. Once the stock market bubble burst, this drop in tax collections became permanent. As a result, the earlier increase in spending was unsustainable, and the state began to face ongoing operating deficits.

This explanation of California's budget crisis raises several questions. What were the extra revenues spent on during the boom period? The answer to that question will help with the other natural question—why were policymakers slow to react to changing economic circumstances?

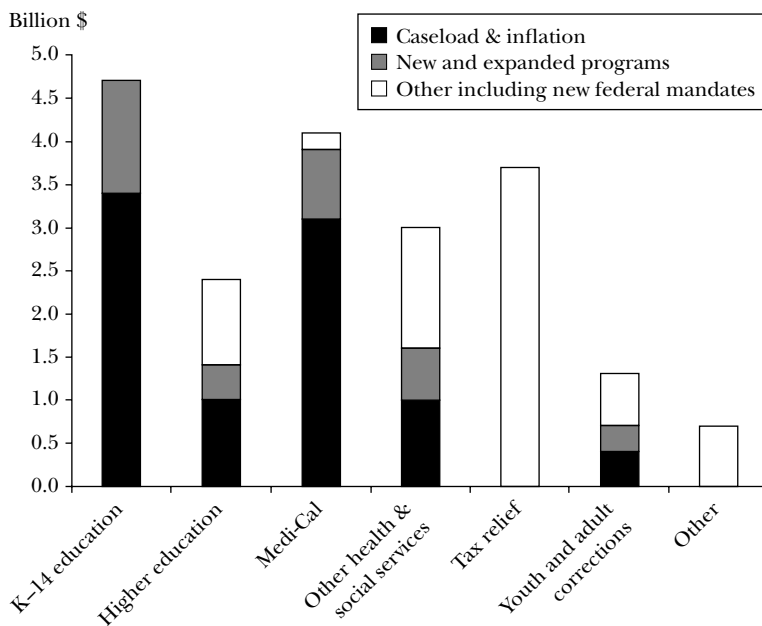
From fiscal year 1998–1999 to 2002–2003, general fund spending in California grew from \$57.8 billion to \$77.7 billion, a total increase of \$19.9 billion. The governor and the legislature took advantage of what they deemed to be a new, expansive fiscal environment by creating new programs and increasing allocations to ongoing programs. The increase in total spending reflected the preferences of a Democratic governor and legislature consistent with the general pattern found by Alt and Lowry (1994) that showed that states controlled by Democrats had higher levels of spending.

Figure 4 shows a breakdown of the spending into some major categories: K–14 education, higher education, Medi-Cal (California's Medicaid program), other health and social services, "tax relief" (to be explained in a moment), youth and adult corrections and other (Legislative Analyst's Office, 2003b, p. 4). It also depicts the decomposition of the spending increases into increases attributable to caseload and inflation, new and expanded programs and other factors including federal mandates. Of the \$19.9 billion dollar increase in spending, \$8.9 can be accounted for by increased caseload and inflation, \$3.4 billion by new and expanded programs and \$7.6 billion in other increases including federal mandates.

Education accounted for \$7.1 billion of the \$19.9 billion total increase in spending over the four years leading up to 2002–2003. Over this time, total education spending increased by 23 percent. For example, in K–12 education, the state provided additional funds beyond constitutional mandates and added or supplemented new programs in child care, teacher recruitment and retention, testing, summer school and after-school programs. In 1997–1998, California ranked 30<sup>th</sup> in instructional spending in elementary-secondary public schools on a per pupil basis at \$3,452 per pupil. By 2000–2001, instructional spending in elementary-secondary public schools had risen to \$4,325 per pupil, with California's rank rising to 26<sup>th</sup> (U.S. Census Bureau, 2001, 2003). In higher education, the state provided increases in base support, offsets for fee increases, outreach to K–12 students and professional development funds for K–12 teachers.

Health and social services together also increased by \$7.1 billion from 1998–1999 to 2002–2003, which was a 44 percent increase. Three-fourths of the \$4.1 billion increase in Medi-Cal was due to increased caseload and higher costs of service delivery, while one-fifth of the increase was a result of expanded program eligibility. Other health and social services programs increased by about \$3 billion. California has a long history of providing one of the most generous Medicaid benefit packages of all the states, covering 32 of 34 categories of services deemed as optional by the

Figure 4

**Where Did Increased California Spending Go?**

Source: Legislative Analyst's Office (2003b,c).

federal government. These optional services range from dental care and emergency services to chiropractic and personal care services. Governor Davis and the legislature also continued to expand health programs, including the popular Healthy Families program, even as the budget worsened. Healthy Families provides health, dental and vision benefits to children in low-income households. While the program is funded in part by federal funds, about half of the cost the program comes from state sources. In 2001–2002, Healthy Families expenditures totaled \$556.3 million, with \$55.3 million coming from state Tobacco Settlement funds and \$148.7 from general funds (Legislative Analyst's Office, 2002c).

In the calculations of the Legislative Analyst's Office, the "tax relief" from the decrease in the Vehicle License Tax is also treated as a spending program. Since the proceeds of that tax had been allocated to local government, the state provided funds to local governments to offset the decrease in Vehicle License Tax revenues. This rise in state spending to compensate for the lower vehicle tax revenues shows up as "tax relief" on the spending side of the state budget. Tax relief increased by \$3.7 billion from 1999–1999 to 2002–2003. Youth and adult corrections increased by \$1.3 billion. This category included increased costs for providing health care to inmates (often court mandated) and overtime for prison workers. "Other" increases account for \$700 million of the overall increase.

Most of California's increased spending went into broad areas that were

generally viewed as providing positive value, such as increased funding for education and health care. Without detailed audits of these increased spending programs, it is impossible to say how much of the higher spending was a reasonable and well-targeted response to public policy problems by a state that found itself with more revenue and how much of the extra spending was dubious or wasteful. In some cases, the extra revenues made it easier to enact spending programs that almost certainly would not have been increased in this way in a time of tighter budget revenues. Here are some examples of what seem like excessive budgetary enthusiasm. Based on standardized tests scores in the 9<sup>th</sup>, 10<sup>th</sup> and 11<sup>th</sup> grades, students were eligible for up to \$1,000 per year in college scholarships as Governor's Scholars. Students who scored very high on tests in mathematics and science were eligible for a \$2,500 college scholarship. Neither of these programs was means tested. Teachers and schools were given cash awards ranging from \$5,000 to \$25,000 based on changes in school test scores. In September 2001, the legislature increased the maximum weekly benefit for unemployment insurance from \$230 per week to \$330 per week, with scheduled increases to \$410 per week by 2004. As a final example, the state operated 12 foreign trade offices (expanding over time to include Johannesburg and Taipei) that traditionally were not subject to careful scrutiny.

In other cases, the spending increases crossed from the gray areas of being extravagant into waste or even fraud. A variety of such examples have been put forward from the Legislative Analyst's Office, newspapers, and taxpayer groups like the Citizens Against Government Waste and the Howard Jarvis Taxpayers Association. Here are a few examples, the first two drawn from the *Red Ink Diaries*—accounts of wasteful spending published by State Senator Ross Johnson, a Republican from Irvine—and the others drawn from newspaper accounts. Caltrans, the California transportation agency, proceeded with a costly plan to add numbers to freeway exit signs at a time when other transportation projects were being reduced. A state audit found that the Department of Motor Vehicles ordered \$125,000 worth of teddy bears to induce people to fill out their census forms. Moreover, the teddies were ordered on a no-bid “emergency” contract because of a tight deadline. A “boot camp” for troubled youth, one of Governor Davis's pet projects, cost \$12 million to run and housed only 25 students (St. John, 2002). A Low-Income Repair Assistance Program designed to help the poor cope with the California smog check program cost millions to run and served only 25 motorists (Willis, 1999). The *Piglet Book* published by the Howard Jarvis Taxpayers Association also highlights the politicians and other political patrons who earn high salaries from government commissions, some which have relatively low workloads.

Of course, any state budget will have some examples of unjustified, wasteful or fraudulent spending, and it is impossible to draw general conclusions from a few anecdotes. But the sheer number and proliferation of anecdotes about wasteful spending in California in the late 1990s and early 2000s as its revenues and spending increased certainly suggests some reason for skepticism over whether the

additional spending in big-ticket areas like health and education was all well targeted.

### **The Political Response to Budget Crisis: Davis versus Wilson**

Why was California slow to respond to the emerging fiscal crisis? In general, as discussed earlier, states were more aggressive in closing budget gaps through changes in spending and taxes in the early 1990s than they were in the recent crisis. This pattern also holds in California if we compare the solutions adopted under Governor Davis with those adopted by Governor Pete Wilson in the early 1990s.

California first began to receive bad budgetary news during the passage of the 2001–2002 budget. By April 2001, it was clear that revenues were falling below projections, and the May Revision (the official time at which the state reassesses the budget) showed a deterioration of \$5.7 billion from the January budget. The decisions made by Governor Davis at this time set the tone for future years. He adopted a budgetary strategy that relied heavily on one-time solutions, such as shifting funds from transportation accounts into the general fund. These one-time shifts were occurring as the budget continued to expand social programs, such as increased spending in K–12 and increased eligibility for health insurance.

By November 2001, the Legislative Analyst's Office forecast that the 2001–2002 budget would end with a \$4.5 billion deficit, rather than the \$2.6 billion reserve as originally projected. Moreover, they forecast a \$12.4 billion deficit for the following fiscal year and an ongoing structural deficit. After the May Revision, Governor Davis faced a 2002–2003 budget deficit of \$23.6 billion—and an upcoming fall election. After a record impasse of 67 days, the governor signed the budget on September 4, 2002. Of the \$23.6 billion gap, only \$7.5 billion was accounted for by program cuts and only \$2.9 billion in revenue increases. The remaining \$13.2 billion was comprised of borrowing, interfund shifts or loans, deferrals of expenditures and assumed increases in federal funding. As the Legislative Analyst's Office (2002a, p. 4) commented, "Because of the relatively limited amount of ongoing savings incorporated in the 2002–2003 budget package, the state will continue to face large multibillion shortfalls in 2003–2004 and beyond, absent corrective actions." This forecast proved accurate, so that Governor Davis then faced a disastrous budget deficit of \$38 billion in 2003–2004.

Governor Pete Wilson reacted rather differently when he faced his first major fiscal crisis in developing the budget for fiscal year 1991–1992. After the May Revision, he projected a budget gap of \$14.3 billion, approximately one-third of total general fund expenditures. He closed this gap with \$8.4 billion in revenue increases, \$3.4 billion in expenditure cuts and \$2.5 billion in cost shifts, transfers from special funds or reductions in reserves. Therefore, 82 percent of the adjustment was made in changes in taxes and spending.

Governor Wilson then faced two more difficult budget years. For fiscal year 1992–1993, he closed an \$11.2 billion dollar deficit by relatively large budget reductions (\$5.1 billion), modest tax increases (\$0.6 billion) and the remainder in cost deferrals and revenue accelerations (\$1.9 billion), shifting costs to local

government (\$2.3 billion) and other actions. Finally, in fiscal year 1993–1994, he faced an \$8.0 billion gap, which he closed with shifts to local government (\$3.7 billion), deferral and revenue accelerations (\$2.4 billion), program reductions (\$1.1 billion) and modest revenue increases (\$0.8 billion). Governor Wilson’s aggressive initial response helped to limit the problems that emerged in the next two years.

What political factors can account for the much less aggressive stance that Governor Davis took to the California budget in the early 2000s than did Governor Wilson in the early 1990s? At first glance, we would expect, based on previously cited research, that Governor Davis would have the easier time making adjustments since California at that time had a unified government under the Democrats, while the Republican Governor Wilson faced a Democratic legislature. However, California is one of just three states that requires a supermajority (two-thirds) to pass a budget. Tax increases also require a supermajority. As all California governors discover, these restrictions sharply limit their apparent power and decrease the apparent advantage of a “unified government.”

Political observers in California have pointed to three factors that made budget adjustments more difficult during this crisis. First, term limits for the legislature originally enacted in 1990 had taken full effect. When Governor Wilson was brokering his budget deals, he could rely on long-term Republican and Democratic legislators who were accustomed to negotiating with one another. During the recent crisis, fewer long-term legislators remained, and animosity across the aisles was greater. A second factor was that the September 2001 legislative reapportionment reflected a deal struck by incumbents, which meant that most legislators had secure seats and decreased incentives to bargain. Finally, rather than trying to bargain with the Republicans, Governor Davis had previously put together governing majorities by enticing legislators to desert the Republicans through various perks, including the apparent promise of an appointment in his cabinet to a termed-out state senator.<sup>7</sup> Thus, when the Republicans were able to hold ranks during the budget negotiations, there was no history of past negotiations to build upon.

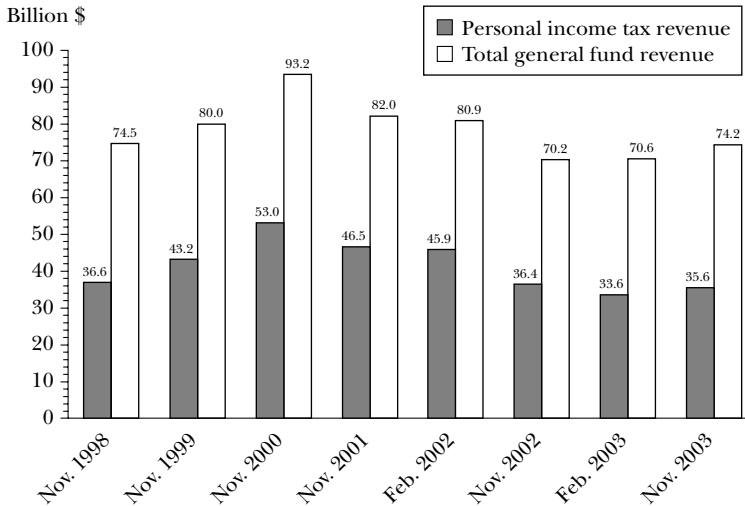
### **When Did They Know It?**

During the 2003 recall vote on Governor Davis, one common accusation was that Davis had deliberately minimized the extent of California’s budget problems when he was reelected in 2002. This accusation is at best only partly true, since even California’s nonpartisan Legislative Analyst’s Office underestimated the severity of the problems that Governor Davis would face.

Figure 5 plots the Legislative Analyst’s Office forecasts for fiscal year 2003–2004 starting in November 1998 and ending in September 2003. As of November 2000, the official predictions did not show a bursting of the revenue bubble. A year later,

<sup>7</sup> Republican Senator Maurice Johannessen was appointed head of Veteran Affairs by Governor Davis in December 2002, after he sided with the Democrats in earlier budget negotiations.

Figure 5

**Forecasts for 2003–2004 Fiscal Year**

Source: Legislative Analyst's Office, various reports and documents, 1998 to 2003.

the Legislative Analyst's Office reduced its forecast. But even by February 2002, when Governor Davis had just announced his plans for the critical 2002–2003 budget, the Legislative Analyst forecasts still called for personal income tax revenue to be nearly \$46 billion and total revenue \$81 billion. In November 2002, the Legislative Analyst lowered its forecasts again, bringing personal income tax revenue down to \$34 billion and total revenue to \$71 billion. Clearly, there was a two-step drop in the forecasts, as new information changed the Legislative Analyst's Office assessment during 2002. This change complicated the underlying budget process during fiscal year 2002–2003 and exacerbated the budgetary woes caused by Governor Davis's reliance on borrowings and deferrals—a strategy that is predicated upon a recovering, not a declining, economy.

The Legislative Analyst's Office recognized that capital gains and stock options initially caused personal income tax revenues to increase above prevailing levels and discussed this point in their November 2001 *Fiscal Outlook*. Nonetheless, their forecasters were still hampered by a lack of full information. In November 2001, the Legislative Analyst's Office would have had access to state tax data for the 1999 calendar tax year, which would have details on capital gains.<sup>8</sup> Capital gains realizations are notoriously difficult to forecast in any case. Moreover, as we discussed above, options that accounted for between 35 and 40 percent of stock market related income in California in 2000 need to be estimated separately from payroll data from specific companies.

<sup>8</sup> Phil Spilberg of the Franchise Tax Board points out that tax returns for 1999 can be filed, with an extension, as late as October 15, 2000, and the FTB would conduct its analysis in April 2001.

In contrast, similar data from the early 1990s do *not* show a steep two-step drop in forecasted revenues. Adjusting for legislated tax changes, it appears that in the early 1990s, the bulk of California's bad fiscal news occurred all at once. Once the 1991–1992 budget was passed, revenue increases that were originally estimated to be \$9.1 billion were later re-estimated to account for \$7.5 billion, reflecting a mild deterioration in the economy. But this problem was relatively manageable. Governor Wilson faced the worst news in his first year, and the news did not get much worse over time.

In many ways, the California experience mirrored the experiences of other states during the most recent state fiscal crisis, but California's political environment was a fun-house mirror that exaggerated fiscal features. The surge in temporary capital gains revenue was spent, which is consistent with the literature on the "flypaper effect" that finds that lump sum grants (or their equivalent) are largely spent by state and local governments (Hines and Thaler, 1995). Like other states, California was slower to make permanent adjustments to alleviate its fiscal plight during the current crisis as compared to the earlier crisis. The drop in stock market related income caused additional difficulties, both because of its magnitude and the delay in information as to its full impact on revenues. A variety of political factors led California politicians to temporize and avoid difficult adjustments to taxes and spending. By postponing hard budget solutions, California became especially vulnerable to a second wave of bad news as the full impact of the stock market decline on tax revenues became evident.

After he was inaugurated, Governor Schwarzenegger fulfilled a campaign promise by reversing the increase in the car tax, which exacerbated the financial difficulties of the state. His January 2004 budget plan called for a public vote on a \$15 billion dollar bond (slightly larger borrowing than what the legislature had passed) and relied substantially on program cuts, shifts in funding from local governments and one-time solutions. Although the Legislative Analyst Office (2004, p. 3) called the proposed budget a "solid starting point for budget deliberations," it would still leave an ongoing structural deficit of approximately \$6 billion. Voters approved the bond in March 2004, but California's budget woes are still not over.

## Conclusions

During the recent economic downturn, the reluctance of states to cut spending and raise taxes led to protracted fiscal difficulties. Politicians, responding to public sentiment that sought both to protect programs and avoid tax increases, were led to the increasing use of one-time solutions that postponed the resolution of their underlying fiscal problems. In many cases, they were constrained by legal or constitutional restrictions on tax increases, as well as court mandates that protected some spending programs. While restraints on taxation may be useful at some times, they do limit the ability of the political system to respond to fiscal shocks and raise borrowing costs. Moreover, restrictions on the ability to raise taxes

may also make politicians less inclined to decrease them during boom times, leading to excessive state spending.

States clearly need to be more careful in assessing whether increases in tax revenue are permanent or temporary. The temporary bulge in tax revenues from stock market related income in California led to unsustainable spending increases in core programs, such as education and health care, as well as increases in a variety of other less essential spending. Cutting back on the latter is relatively easy, but cutting back on the former is more difficult politically and causes disruptions in expectations and program delivery.

Finally, as the California experience highlights, failure to come to grips early with budget difficulties sharply increases the risks of truly severe fiscal problems. Investors and financial institutions do give the states some leeway in finding their way through budget crises, but a prolonged failure to balance the budget may ultimately lead to a loss of state sovereignty to financial institutions.

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