Tax Shift Funds State Debt

The irresistible force of California's budget crisis met the immovable object of partisan political differences in Sacramento this summer. One result of the wreckage is an unusual $10.7 billion debt financing scheme in the 2003-2004 state budget. It has features that have been advocated for both fiscal and land use reform; the state will market bonds it says are not really bonds; and the maneuver has already been challenged in court.

Democratic legislators' distaste for program cuts ran up against their Republican counterparts' refusal to accept tax increases until an increasingly frustrated and angry Legislature agreed that the state would issue $10.7 billion in deficit retirement bonds. The bonds would be repaid by a three-way shift of existing taxes that some call the "triple flip," and others have called a "shell game."

The state would market the bonds to investors and deposit the money in the General Fund. Wall Street, which would be providing the financing, wanted a reliable source of dedicated funds for repayment. So to repay the bondholders, ½ cent of the sales tax now going to local governments would be redefined as a "new" state tax. An equal amount of property tax money would shift from K-14 schools to cities and counties, and finally state General Fund money would shift to reimburse schools.

State law requires bond measures to be approved by the voters and to be used only for a "single object or work," such as a dam or a building. Some state attorneys have concluded that paying off debts for multiple purposes with bonds might not pass judicial scrutiny. The Pacific Legal Foundation has in fact filed a suit challenging this move, and was encouraged by a recent ruling against a $2 billion bond issue the state hopes to sell to cover state pension funds.

Ordinary bond borrowing is repaid through a continuing appropriation which is not reapproved by the Legislature each year. This measure will need an annual legislative okay, which future Legislatures are expected to give because otherwise the consequences to the state's credit rating would be unacceptable.

A lot of fingers are being crossed in Sacramento about how this will work, because of the novelty and complexity of the legal questions. Even if this Legislature is prepared to stick to the deal, it cannot be guaranteed that future Legislatures will do so. Local government representatives, such as the League of California Cities, are understandably nervous that the promised pea may not continue to be there when they pick up their shell. The two parts of the shift designed to keep local government and school revenues constant are not dedicated funds, and local government has no protection like Proposition 98.

This bond money only covers the funding gap in this year's budget. If the two parties have no better luck next year in agreeing on further spending cuts or new revenues, there will be another very big budget gap next year, and it is unlikely that the state will be able to continue borrowing at the necessary level to fill the gap.

The idea of swapping local sales tax money for property tax money has been a regular feature of various calls for reform. Local property tax money is a more stable source of funding, and tends to increase more over time, than sales tax funds. Moving away from dependence on sales taxes has also been advocated as a departure from the "fiscalization of land use" in which local jurisdictions compete for those projects expected to bring in the most sales tax dollars, whether they make land use sense or not. Some insiders believe this piece of the tax swap might stay in place after the bond holders have been repaid.

Any Governor and future legislators will still have to face the same hard fiscal and political facts that brought us to this strange exercise in budget management and will have to deal with a voting public that apparently believes it can have government services without the inconvenience of paying for them.