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FRBSF Weekly Letter

After Three Rounds: 2-1

On Tuesday, a third round came to a close in the California Tax Movement, but this time the opponents won for a change. Proposition 9—Jarvis II, or Jaws II as it was also known—was defeated in the statewide popular vote by a 62-38 percent margin. Had it won, Prop. 9 would have been the third recent government-limitation amendment to the state constitution. Earlier rounds resulted in the June 1978 passage of Proposition 13 (the Jarvis-Gann amendment) and the November 1979 passage of Proposition 4 (the Gann amendment).

The erstwhile coauthors, Howard Jarvis and Paul Gann, were divided on the next step after passage of their pathbreaking Proposition 13, which rolled back local property taxes 57 percent statewide. Gann (Prop. 4) preferred a patient strategy of opting for a long-term spending limitation rather than an immediate cutback, while Jarvis (Prop. 9) argued for an immediate reduction of state income taxes by 50 percent. Perhaps voters preferred the Gann to the Jarvis strategy—or perhaps the former option won out only because it reached the voters first. Despite the defeat of Jarvis II, voter pressure had already persuaded the California legislature to adopt some of its features, so it is not clear that Proposition 9's message was actually repudiated.

The latest tax-reduction amendment contained three basic provisions. First, it would have required state personal-income tax rates not to exceed 50 percent of the rates in effect in the 1978 tax year. Second, it stipulated that the legislature provide a system of adjusting income-tax brackets to reflect annual changes in the California consumer-price index, and finally, it exempted business inventories from property taxation. To fend off the 50-percent reduction, however, legislators moved early to pre-empt the other two issues. As early as 1977, they changed the tax law so that personal-income tax brackets would be adjusted annually for changes in the California consumer-price index in excess of 3 percent. Then, in response to the Proposition-9 movement, they removed the 3-percent floor so that brackets would be fully indexed—but only through 1981, after which time the 3-percent floor would be reinstated. Also, the legislature exempted business inventories by statute in 1979, effective in the 1980-81 property-tax year.

Discourse via the Constitution

Like its predecessors, Jarvis II grew out of the grassroots initiative process that has come to characterize California politics. It qualified easily for the June statewide ballot after Mr. Jarvis obtained 820,000 signatures—a quarter-million more than needed. Long ago, voters found the state constitution to be an effective medium through which to talk to the politicians. The constitutional initiative process has been the focal point of many controversial issues in California—anti-busing, anti-pay TV, political reform, anti-open housing, the death penalty, as well as earlier attempts in 1968, 1972, and 1973 to limit taxes and spending.

The overwhelming votes in favor of Propositions 13 and 4 carried an especially strong message to government. Proposition 13 rolled back taxes on all property to one percent of 1975-76 market value, resulting in a $7-billion (57 percent) reduction in California property taxes. Under that initiative, assessed market values can rise no more than two percent per year from the 1975-76 base. (All new construction or transfers are reassessed at current market value.) The amendment locked these restrictions permanently into the constitution, and stipulated further that other taxes can be increased only by a two-thirds vote of the legislature (state taxes) or "qualified electors" (local taxes).

Proposition 4 carried the movement considerably further by placing permanent

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spending limits on all governments and most special districts in California. It limited annual government appropriations (spending) to the 1978-79 fiscal-year level with annual adjustments only for consumer-price increases and local population growth. The ceiling applied *individually* to the state, every county, city and school district, and most large special districts. The Gann amendment also included added stipulations to prevent circumvention: surpluses are returned to the taxpayers; direct fees for government services are free of the limitation only to the extent they reflect the cost of providing each service; adjustments are made to account for changes in government boundaries or transferrals of functions to private enterprise; and voter-approved increases in the appropriations ceiling extend no more than three years without voter reconfirmation.

Given the apparent stringency of Propositions 13 and 4, what prompted Mr. Jarvis to pursue a third round? The answer seems to lie in the failure of the earlier amendments to bring about major reductions in public expenditures within California. Specifically, Proposition 13's drastic reduction of property taxes lost much of its punch when the state used its rapidly accumulating surplus to "bail out" local governments to the tune of $4.4 billion and $4.9 billion, respectively, in the first two years of operation. Moreover, Proposition 4's spending ceiling is unlikely to bite until several years from now, because governments inflated their 1978-79 appropriations bases in anticipation of its passage.

The voter thus has not yet seen much tangible evidence of reduced government spending in California. Although the growth rate of spending has declined, many voters have seen only the significant shift in taxes from the local to the state level —particularly to state income taxes which have been rising recently at a 33-percent annual rate according to some analysts. Although Proposition 4's spending ceiling will limit government spending to the 1978-79 real per capita level (resulting in a sharp curtailment of past trends and a gradual *reduction* in California governments' share of real income), Proposition 9 proponents want hard evidence of cuts now, particularly in light of the escalating state income tax.

Effects of tax cuts

Like Proposition 13, the new amendment would have resulted in an immediate rollback in taxes of dramatic proportions. Hence a heated debate arose over the amendment's potential effects on the level of the state's economic activity and the provision of government services.

Proponents argued that a 50-percent reduction in (and permanent restriction on) state income taxes would have greatly stimulated private income and spending while eliminating government waste. The result, they said, would have been a magnified positive stimulus to statewide employment, production, and real incomes —as was demonstrated earlier in the wake of Proposition 13.

It is true that Proposition 13 stimulated the state's economy. But the short-run stimulation came not so much from the reduction in the size of the public sector as from the fact that taxes were reduced far more than expenditures. In the first year alone, the state funded $4.9 billion (70 percent) of the $7.0-billion cut in local tax revenue, by sharing its rapidly accumulating budget surplus with local governments through a complicated "bail out" formula. Hence, some short-run stimulus occurred because Californians received large tax cuts with a *much smaller reduction in public expenditures*.

But the present state surplus is much smaller —on the order of $2.1 billion, according to the most recent state estimate. Furthermore, with the prospect of a deep recession in 1980, little or no increase in the surplus may be expected in the next fiscal year. A surplus of this size would have only partly offset the $4.9 billion and $4.2 billion income-tax cuts officially forecast for the next two fiscal years under Proposition 9. Thus, Proposition 9 would have come closer than Proposition 13 to a matched reduction in government receipts *and* expenditures —and its one-time stimulus accordingly would have been smaller.

Tax experts are divided over whether or not a permanent reduction in tax receipts *with a matching reduction in expenditures* would provide a lasting stimulus to economic activity. At its simplest level, the answer depends on the extent to which our current tax structure deters incentives to work and invest within the private sector. Proponents of Proposition 9 have carried this argument to its extreme, utilizing the widely-touted "Laffer curve" devised by Professor Arthur Laffer of the University of Southern California. Given the burdensome level of taxes, in Laffer's view, a reduction in statutory tax *rates* would so stimulate the economy (and reduce tax avoidance/evasion) that tax *revenues* would actually increase. Laffer's argument has been used also in support of the Kemp-Roth tax-cut movement at the national level. Although his thesis has more merit when applied to states and localities (where migration is sensitive to tax rates), many supporters of the government-limitation movement argue that Laffer's claims are overstated.

In contrast, California's Legislative Analyst took the opposite extreme in his official estimate of Proposition 9's effect on state-tax receipts by assuming no stimulus at all—even with a complete drawdown of the state budget surplus. In other words, he estimated the decline in state income-tax receipts— $4.9 billion and $4.2 billion in the next two fiscal years—by assuming that receipts would decline exactly in tandem with the 50-percent reduction in rates. The truth probably lies somewhere in between this estimate and the "Laffer curve" estimate.

Size of government

Proponents of the tax-limitation movement argue that to focus only on the sensitivity of tax revenues to statutory rates is to miss the underlying issues of the tax-limitation movement—the choices between public and private decision-making in the economic, political, and social arena. To these individuals, a redistribution of production (even of the same goods) from public to private enterprise would enhance productivity, and ultimately, total real income. Moreover, the private sector would likely produce goods more highly valued by society. But the controversy also deals with other issues: whether government expenditures should be directed toward current consumption (for example, transfer payments) or toward activities that enhance our future capacity to produce (such as effective education or highways), and whether government intervention leads to a more or less equitable (or efficient) distribution of income.

By most estimates (except, of course, Mr. Laffer's), Propositon 9 would have led to a reduction of 10-percent or more in state-and-local government expenditures after drawdown of the state surplus. As the election date approached, Californians saw the main issues as these: Who would gain and lose most from the tax and expenditure reductions? What public services or transfer payments might be cut? Might the state merely replace the lost income-tax revenues with a less-desirable combination of higher sales and business taxes. And finally, might Proposition 4 by itself provide an adequate control on the size of government? In answering these questions, voters were willing to settle at this time for the already legislated portions of Proposition 9, and to reject the proposal for a massive income-tax cut. But further rounds in the tax revolt may yet be fought in California, as well as in other states and the nation's capital.

Jack Beebe

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/21/80	Change from 5/14/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	136,745	− 582	+ 10,423	+ 8.3
Loans (gross, adjusted) — total#	115,105	− 559	+ 11,702	+ 11.3
Commercial and industrial	32,839	− 309	+ 2,079	+ 6.8
Real estate	46,322	+ 79	+ 8,811	+ 23.5
Loans to individuals	23,902	− 117	+ 1,998	+ 9.1
Securities loans	1,135	− 38	− 472	− 29.4
U.S. Treasury securities*	6,352	+ 9	− 1,396	− 18.0
Other securities*	15,288	− 32	+ 117	+ 0.8
Demand deposits — total#	41,166	− 1,054	+ 687	+ 1.7
Demand deposits — adjusted	29,703	− 751	+ 110	+ 0.4
Savings deposits — total	26,398	+ 207	− 3,473	− 11.6
Time deposits — total#	64,185	− 289	+ 13,602	+ 26.9
Individuals, part. & corp.	55,334	− 231	+ 14,083	+ 34.1
(Large negotiable CD's)	22,853	− 165	+ 5,491	+ 31.6

Weekly Averages of Daily Figures	Week ended 5/21/80	Week ended 5/14/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	199	285	31
Borrowings	2	4	218
Net free reserves (+)/Net borrowed(−)	197	281	− 187

* Excludes trading account securities.
# Includes items not shown separately.

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