EXECUTIVE SUMMARY

California’s health care reform effort may have been one of the first casualties of the national economic downturn. Yet the conditions that gave rise to the initiative did not disappear when the plan failed, and other states are pushing ahead with proposals to expand health coverage. So it remains useful to reflect on the California experience. In particular, it will be helpful to understand the proposed funding sources, how they would have interacted with California’s revenue system, and what alternative funding streams might have withstood the politics of reform.

In this policy brief, we analyze the options for financing expanded health insurance coverage in California and offer our own preferred solution in light of the state’s fiscal and political constraints. Regardless of what the future holds for California’s health care reforms and its budget situation, policymakers and the public should keep a few basic principles in mind. In particular, any new funding for health care (or for other new programs) should be:

- **Robust to the business cycle.** The need for state-supported health insurance peaks when the economy is declining. Therefore, revenues should not come from recession-sensitive sources, such as an income tax surcharge on high earners. Such revenues tend to fall during downturns because the returns on capital gains and exercised stock options also fall when the economy weakens.

- **Minimally disruptive to productive economic activity.** In general, the best taxes are those that are hard to avoid by altering individual behavior or by employing creative accounting methods. Of course, policymakers occasionally want to encourage behavioral change through taxation. If they wish to curb teen smoking, for example, a cigarette tax might produce the desired response. However, revenues will tend to decline as behavior is affected.

- **Borne by those who benefit.** Many groups will benefit from expanded health insurance coverage, and they should share in its cost. However, workers whose employers do not currently provide health insurance will benefit most. This principle argues in favor of an expanded payroll tax on workers whose firms do not provide health insurance coverage.

- **Equitable.** California has a tradition of progressivity, exempting many low-income individuals from income taxation and maintaining relatively generous expenditure programs. To this end, the state may want to provide subsidies to offset the costs of health insurance for low-income workers.

*Tracy M. Gordon is an Assistant Professor at the School of Public Policy at the University of Maryland and Kim Rueben is a Senior Research Associate, The Urban Institute and Joint Brookings Institution/Urban Institute Tax Policy Center.*
• **Reliable.** A dedicated source of funds will be essential to ensure that annual revenues match program costs. To the extent possible, funds should also be insulated from other spending requirements such as those under Proposition 98, which guarantees that roughly 40 percent of California’s General Fund goes to public schools and community colleges.

There is no single revenue source that can fulfill all of these criteria. Moreover, the principles listed above can be contradictory in practice. We would therefore prefer to fund expanded coverage through a combination of new revenues, including a small universal payroll tax and higher cigarette and alcohol taxes. The payroll tax could be similar to the current funding system for the State Disability Insurance (SDI) program. If it were limited to firms that did not offer health insurance or to employees who did not participate in employer plans, it would be equivalent to the “in-lieu” fee or “pay or play” aspect of the Nunez-Schwarzenegger plan that was rejected in January. The universal payroll tax would act as a backstop against the fluctuations in other funding sources and could be reduced as projected cost savings were realized.

While these funding options would decrease the progressivity of California’s tax system, we think the trade-offs in terms of benefits to low-income workers would offset the additional tax costs. As economists, we would prefer to keep revenue sources fungible, or available for many uses. However, given California’s recurring budget crises and segmented spending rules, protecting the funding for expanded health care coverage—or for any other new programs—from encroachment by other government programs is essential. For example, if the new revenues intended to fund expanded coverage were included in the General Fund this would automatically increase education funding under Proposition 98, which would in turn mean less funding for the new health program.

Nearly 20 percent of Californians lack health insurance coverage at any given time. Reforming the state’s health care system and expanding coverage would improve the well-being of Californians and the overall economic health of the state. However, if California is to provide universal health care coverage, policymakers will have to be up front about the program’s costs and provide adequate and protected funds to pay for it.

**INTRODUCTION**

California’s health care reform effort, ultimately the ABX1 1 plan put forward by Gov. Arnold Schwarzenegger and Assembly Speaker Fabian Najnez, failed to survive a critical Senate Health Committee vote in January. A key intervening event was the release of the governor’s budget, which projected a $14.5 billion shortfall in revenues through FY 2009. More recently, the state’s Legislative Analyst projected the shortfall to be $16 billion.

Several lawmakers cited concerns about the state budget as the main reason they rejected the health measure. The Legislative Analyst’s Office also raised questions about funding sources for the plan. Tax increases would have required voter approval, a long shot in the best of times and a near impossibility in a slowing economy.

Yet the underlying conditions that made health care reform important to Californians persist. California is home to a disproportionate share of the nation’s uninsured. In 2006, 6.7 million Californians, or 18.5 percent of the state’s population, lacked health insurance at any given time, well above the national average of 15.3 percent. In a study by the Commonwealth Fund, California ranked 39th among the 50 states in health system performance. The state had especially low rankings regarding access, quality, and equity, in large part because of the number of uninsured. With worsening economic conditions, the number of uninsured is likely to rise.
Moreover, Californians continue to support health care reform despite the darkening fiscal environment. A statewide survey conducted in January 2008 found that a majority of state residents (60 percent) as well as a majority of likely voters (53 percent) would support a plan requiring all Californians to have health insurance, with costs shared by employers, hospitals, individuals, and government through a variety of fees and a cigarette tax.\(^3\)

In light of this ongoing support and other states’ coverage initiatives, it is useful to reflect on the California experience. In particular, it will be helpful to understand how California’s specific fiscal and political circumstances affected the prospects for reform, how proposed funding sources would have interacted with California’s current revenue system, and what alternative funding mechanisms would look like.

In this policy brief, we examine the advantages and disadvantages of a broad range of potential funding sources. In particular, we address the following questions:

- What does California’s current revenue system look like? Are there state-specific characteristics that will affect current and future sources of revenue?
- What options for additional revenues are available and how will they interact with current revenue streams? Are there political or economic reasons to prefer some revenue sources over others?
- What principles should be considered when designing changes to state and local revenue systems?
- What are the best options for funding health care, either in addition to or in place of the revenue streams proposed by the governor and the legislature?

**CALIFORNIA’S REVENUE SYSTEM**

Assessing proposed sources of revenue for expanded health insurance coverage requires an understanding of California’s current revenue system. Two analyses, one by the Public Policy Institute of California and another by the Tax Policy Center and the Boston Federal Reserve Bank, compared California’s revenue and expenditure systems to those of the rest of the country. The studies asked different questions and used different analytical methods but reached similar conclusions.\(^4\)

According to these studies, California’s state and local governments took in roughly $7,470 per capita in general revenues in 2005.\(^5\) About 20 percent of these general revenues came from federal grants for specific purposes, such as for building or maintaining highways and mass transit systems, or as payments for administering federal and joint federal-state programs, such as Medicaid. The remainder came from state- and locally-imposed taxes, fees, charges, and other miscellaneous revenues; roughly 70 percent of these “own-source” general revenues came from taxes.

In 2005, California’s own-source general revenues, about $5,960 per capita, were approximately 14 percent higher than those for the rest of the nation. This is to be expected because California is a high-income state. (In 2000, median household income in California was $50,220, compared to $43,564 in the United States as a whole.) Adjusting for personal income alters the picture of California’s general revenues. In 2005, California’s own-source revenues, at $170 per $1,000 of personal income, were just 4.3 percent higher—or $7–than the national average of $163 per $1,000.
Adjusting for income also puts historical trends in perspective. In 1978, California’s general own-source revenues per $1,000 of personal income were 15 percent higher than the average for all other states; by 1979, they were 5 percent below the average. The intervening event was the passage of Proposition 13, a constitutional initiative that had the immediate effect of cutting property taxes in half. The measure rolled back assessed property values to 1976 levels, capped property tax rates at 1 percent, and limited the growth in assessed values to 2 percent a year unless a property is sold and its market value becomes its new assessed value. Under Proposition 13, all new state taxes and local special taxes must be approved by two-thirds of the electorate in a popular vote.

Another way to see the effect of income on California’s revenues is to consider “revenue capacity,” or what California’s revenues would be if the state levied taxes and charged fees at the average rates for the nation as a whole. In 2002, for example, the state’s revenue capacity was $5,059 per capita, while its actual revenues were $5,099 per capita. Thus, California’s “revenue effort” was slightly higher than average relative to its capacity.

California differs even more markedly from other states in its tax mix. In 2002, the average state relied on property taxes for roughly a third of tax revenues and on income taxes for another quarter. In California, these proportions were reversed, with 32 percent of tax revenues coming from income taxes and 26 percent from property taxes.

This difference stems from both Proposition 13 and California’s highly progressive personal income tax. In 2001, the top 1 percent of California’s taxpayers accounted for 34 percent of all income tax receipts, whereas the bottom 40 percent provided 1 percent of these revenues. By comparison, in New York the top 1 percent of tax filers paid 30 percent of all individual income taxes and the bottom 40 percent paid 7 percent.

Another way to see the effects of California’s tax mix is to consider revenue capacity and effort for each major tax type. For example, what would California have raised in income and property taxes in any given year with tax rates equal to the national average? In 2002, California raised $864 per capita from the property tax, but it would have raised $1,254 with tax rates set at the U.S average rate applied to its own assessed valuations of property. By contrast, it raised $945 per capita from the personal income tax, compared to the $763 per capita it would have raised if it had applied national average income tax rates. The only area besides the property tax where California’s revenue collections lagged behind capacity was the selective sales tax (taxes on particular goods, such as alcohol and cigarettes). Here the difference between actual and potential was $274 versus $278 per capita.
California also has different expenditure needs than the nation in general. It has a large, diverse population, a substantial portion of which is school-aged or living in poverty. The share of California’s population that is school-aged is 11 percent higher than rest of the nation. Its percentage of school-aged children is even higher in comparison to other large states like New York, Illinois, and Florida. California must also pay higher than average compensation to compete in the national labor market; in 2002 college graduates working in California were paid about 15 percent more than the national average. In addition, California has made policy decisions in areas such as welfare to expand access or provide higher levels of benefits than in other states.

One way of distinguishing the overall effect of background conditions from policy choices is to analyze what California would have spent if it had provided an average level of services compared to the nation as a whole given its demographic characteristics. In 2002, if it had done so, its expenditures on services per capita would have been $6,211. (This figure is slightly higher than the national average spending level of $6,007, due to differences in California’s population and economic characteristics.) California actually spent $6,732 per capita, or 8 percent more than the average of all other states. Thus, California has a “high expenditure effort.”

California’s revenue system usually receives positive reviews for conforming to generally accepted principles of taxation regarding reliability, balance, and equity, and for putting minimal burdens on low-income individuals. However, there is room for improvement. The state’s reliance on a highly progressive income tax means that its revenues are subject to volatility, increasing quickly during economic booms and plummeting in downturns. For example, revenues from capital gains and the value of exercised stock options grew strongly through the end of the 1990s but tumbled by between $6 billion and $8 billion in fiscal 2001.
Finally, California’s state-local fiscal relationship is complicated by several voter-approved measures, most notably Proposition 13, that limit local property taxes and heighten dependence on the state to raise funds to pay for government services. These measures have made instituting new taxes or changing California’s revenue mix more complicated than in other states due to the need for a supermajority vote in the legislature to institute new taxes or direct voter approval for most additional local taxes.

**Potential New Revenue Options**

In light of these considerations, what are California’s options for raising additional funds for health care reform? In an attempt to answer this question, we first examine tax changes that have been instituted or proposed in recent years. We then look at how some of these alternatives would affect funding sources in the proposals put forward last year. We also consider how best to augment each plan if specific funding sources are found to be politically infeasible.

**Tobacco Taxes**

A frequently proposed source of funds for health care is a tax on cigarettes and tobacco. In 1988, voters approved a tax increase of 25 cents per pack of cigarettes and comparable amounts on other tobacco products to support tobacco-use education and prevention efforts, health care services for low-income uninsured persons, and other programs. Similarly, in 1998 voters passed Proposition 10, a ballot initiative adding a 50-cent per pack tax to support early childhood development programs. More recently, in November 2006, voters rejected Proposition 86, which would have increased taxes by an additional $2.60 per pack to provide funding for hospital emergency services and programs to increase access to health insurance for children.

California’s current tax on cigarettes is 87 cents per pack, slightly above the national average of 80 cents and 24th in a ranking of state tobacco taxes. If California were to double its current tax rate to $1.74 per pack, an increase well below the proposed $2.60 rate hike rejected in November 2006, it would still rank behind 17 other states.

Current California tobacco taxes generate $1.1 billion annually. However, doubling the tax would not automatically lead to a doubling of tax revenues. A tax increase of this magnitude (which would increase the price of a pack of cigarettes by about 20 percent) would likely result in a 5 to 10 percent decline in demand for tobacco products. Thus, the state could expect to raise slightly under $1 billion annually in new revenue once some of the existing programs funded by cigarette taxes were “backfilled” to make up for declining sales.

An advantage to increasing cigarette taxes would be any resulting decline in smoking and the related improvement in the health of Californians. However, if consumers were to shift their cigarette purchases to other states the hoped-for decline in smoking might not occur. Also, it is important to bear in mind is that cigarette taxes are regressive. Lower-income individuals are more likely than others to smoke and to spend a greater share of their income on cigarettes, so taxing cigarettes increases the revenue burden on lower-income households. However, lower-income households would also disproportionately benefit from expanded health coverage, offsetting the increase in the tax burden.

**A Surcharge on High-Income Earners**

A surcharge on high-income earners may be among the more politically popular options. For example, in an April 2007 statewide survey more than two-thirds of respondents favored raising taxes on the wealthiest Californians. In November 2004, voters approved a 1 percent tax surcharge on individuals earning at least $1 million a year in order to fund mental health programs.
The existing “millionaire’s tax” is estimated to raise slightly less than $1 billion annually. Doubling this tax would likely have behavioral effects; taxpayers might leave the state or shift their income elsewhere. Moreover, because California’s current income tax is highly progressive, imposing an additional millionaire’s tax would exacerbate the volatility problem. As a result, the state would be left with less revenue during economic downturns, when the need for state support for public health care funding is likely to be highest.

**A Payroll Tax**

Alternatively, California could institute a dedicated, adjustable-rate payroll tax to fund health care. The rate would fluctuate, depending on the availability of other sources of revenue, in order to keep the underlying fund solvent. (The state’s disability insurance program is funded in this manner.) If the rate was set at 0.6 percent (the 2007 rate for the SDI program), we would expect the tax to produce $3.1 billion annually.

This estimate is based on the assumption that the tax would be paid by all employers and employees regardless of their health-coverage status. A disadvantage of this proposal is that the payroll tax, as a flat tax, would place a disproportionate burden on low-income workers.

If the payroll tax were limited to firms that did not offer health insurance and/or to employees who did not participate in employer-offered coverage, it would be equivalent to the purchasing pools and “in-lieu” fees of other major health reform proposals. There might be less political support for such a broad-based tax than for either “sin” taxes or taxes on high-income households. However, this revenue source would be more stable during economic downturns than a revenue stream achieved by increasing the top marginal tax rates and would not be hostage to falling revenues as a result of declining purchases.

**Sales Taxes**

Currently, California has a state sales tax rate of 6.25 cents per dollar, with local governments collecting up to an additional 2.5 cents per dollar. The local addition varies depending on voter approved option taxes for transportation programs and other purposes.

California could try to broaden its sales tax base by reducing the number of exemptions (it currently exempts both grocery purchases and utilities from the sales tax for reasons of equity or fairness) or expanding the tax to cover more services (the state currently taxes only 8 of 164 service categories). Analysts have estimated that broadening the sales tax base could produce between $2 billion and $8 billion in additional revenues. However, the amount of revenue raised would depend on politically weighted decisions about which services to tax.

Support for applying the sales tax to services appears weak. According to a May 2007 statewide survey, 65 percent of respondents opposed extending the sales tax to services. In a June 2007 survey, a similar percentage of voters opposed increasing the sales tax rate to expand education services.

Finally, the state could increase all selective sales taxes to the national average. If Californians paid the same share of their income in selective sales taxes as the residents of other states, revenues would increase by $3.3 billion annually. This calculation does not take into account any change in revenues due to offsetting behavior, but we would expect an increase in such taxes to lower consumption. If demand for alcohol and other goods subject to selective sales taxes were to have the same demand elasticity as for cigarettes, revenues would likely increase by the somewhat smaller sum of $3 billion annually.
Expanding the Vehicle License Fee

California could also raise its Vehicle License Fee. The VLF is a tax on the ownership of a registered vehicle rather than a tax on a vehicle as personal property. From 1948 through 2001, the VLF rate was 2 percent of the value of the vehicle. Since the passage of Proposition 47 in 1986, VLF proceeds have been allocated to cities and counties by mandate. However, the state legislature may alter the tax rate and the allocation of revenues among localities.

In 2001, the rate was cut by two-thirds to 0.65 percent. By law, if state funds were insufficient to make up for lost revenues, the rate would revert to 2 percent. This occurred in June 2003 and was a contributing factor in the recall of former Gov. Gray Davis. Governor Schwarzenegger repealed the “VLF trigger,” restoring the rate to 0.65 percent and allocating the necessary backfill funds. In subsequent years, the restored rate has been maintained with some “swapping” of property tax revenues for the lost VLF funds.13

Although increasing the VLF may be politically unpopular, doubling the current rate to 1.34 percent would raise an estimated $2 billion annually. This revenue could be allocated to cities and counties, potentially simplifying California’s tax system, which currently requires the swapping of funds between the state and local governments.

Reforming the Property Tax

Given the current tax mix in California compared to the rest of the United States, an obvious candidate for additional funding would be an increase in property taxes. As a result of Proposition 13, California raises a much smaller share of state and local revenues from property taxes than does the rest of the country. If California’s property taxes were raised to the average for the rest of the United States per $1,000 of personal income, state and local governments would realize more than $6 billion in additional revenues. However, this change would require amending the state constitution by popular vote, an unlikely proposition.

More feasible politically may be recent proposals to “split” the property tax roll, with different assessment practices or tax rates applied to residential and commercial properties. Again, this change would require a popularly approved constitutional amendment. About half of all states allow for different rates for residential and commercial property. According to one estimate, splitting the property roll and allowing higher rates on commercial property could increase annual revenues by between $2 billion and $3 billion.14 As with the VLF, property tax increases could be used to boost local revenues, in turn freeing up state revenues for health coverage purposes.

PREFERRED REVENUE CHOICES AND GUIDING PRINCIPLES

If access to health care is to be extended to the nearly 20 percent of Californians who are uninsured, it is essential that reforms be paired with adequate funds to cover the costs of expanded coverage.

Most of the revenue sources described above have both pluses and minuses. Those that are perhaps more politically feasible (increased cigarette taxes or an additional “millionaire’s tax”) are the most narrow and would affect a minority of taxpayers. Additionally, another tax on high-income households would exacerbate the volatility in California’s income tax receipts. Higher cigarette taxes would disproportionately affect low-income households, and the revenues from this source could erode if the higher taxes induced consumers to stop smoking or to buy their cigarettes elsewhere.
A dedicated payroll tax would spread the burden more widely and could produce a given level of revenue with lower rates than an in-lieu fee for nonparticipating businesses alone. However, a flat payroll tax would place a greater burden on low-income households. On the other hand, a small payroll tax could be useful in light of the uncertainty surrounding other proposed funding sources. It might be constructed as a “stop gap” tax that could be lowered or eliminated depending on cost savings or if alternative revenue sources materialized. As we have seen, the state has a history of adjusting payroll tax rates with respect to its disability insurance program.

In general, economists prefer to keep funding sources fungible—allowing governments the flexibility to apply revenues to those areas most in need of funding. However, given California’s history of earmarking revenues for specific programs constitutionally and shifting other promised funds as economic conditions change, it would be wise to protect the revenues for any new health care initiative. No matter what reforms are instituted, the state and local governments will remain California’s health care insurers and providers of last resort. We therefore believe that the state should introduce a dedicated fund for health insurance coverage with specific revenue streams attached.

These revenue sources should be:

- **Robust to the business cycle.** Revenues will be most necessary during economic downturns, due to lower alternative revenues and an increased number of unemployed individuals and possibly uninsured households.

- **Minimally disruptive to economic activity.** The tax or taxes should not be avoidable through changes in economic behavior (such as where cigarettes are purchased) and ideally should not change behavior unless there are social benefits arising from this change (such as reductions in smoking).

- **Borne by those who benefit.** Many groups will benefit from expanded health insurance coverage, though lower-income households are most likely to benefit, therefore many groups should share in the cost. This principle argues in favor of an expanded payroll tax on workers whose firms do not provide health insurance coverage.

- **Equitable.** Policymakers should be mindful of California’s tradition of revenue progressivity and protecting the least advantaged. This may call for subsidies to low-income workers or adjustments to the tax rate, depending on the availability of other funds.

- **Reliable, or capable of providing annual funding to match program costs.** Maintaining revenues or, alternatively, setting up a reserve fund will be critical to a sustainable program.

- **Insulated from other spending requirements and budget rules.** Proposition 98, for example, requires that roughly 40 percent of California’s General Fund revenues go to schools and community colleges. A dedicated revenue source for health care spending would prevent funds from being automatically siphoned off for other government programs.

- **Close to the level of government where services are provided.** Thus, for example, we would suggest freeing up some city or county funds by increasing the vehicle license fee, rather than increasing this fee for the specific purpose of funding health care.
It is unlikely that a single revenue source can meet all these criteria. We would therefore recommend a combination of new revenue sources, including a small payroll tax and higher cigarette and alcohol taxes or general sales taxes, depending on political support.

While the recent reform efforts have failed, the underlying conditions that make health care reform important to Californians persist. Reforming the state’s health care system and expanding coverage would improve the well-being of Californians and the overall economic health of the state. However, if California is to provide universal health care coverage, policymakers will have to be up front about the program’s costs and provide adequate and protected funds to pay for it.

ENDNOTES

3 Mark Baldassare, Dean Bonner, Jennifer Paluch, and Sonja Petek, PPIC Statewide Survey: Californians and Education (San Francisco: Public Policy Institute of California, January 2008).
4 Tracy M. Gordon, Jaime Calleja Alderete, Patrick J. Murphy, Jon Sonstelie, and Ping Zhang, Fiscal Realities: Budget Tradeoffs in California Government (San Francisco: Public Policy Institute of California, 2007; Yesim Yilmaz, Sonya Hoo, Matthew Nagowski, Kim Rueben, and Robert Tannenwald, “Measuring Fiscal Disparities Across the U.S. States: A Representative Revenue System/Representative Expenditure System Approach, Fiscal Year 2002,” Assessing the New Federalism, Occasional Paper No. 74, Urban Institute and Federal Reserve Bank of Boston (Washington, DC, 2006). Both studies used fiscal year 2001–02 data for their analyses, reflecting the latest available data at the time of the studies. In some parts of this paper, we use more up to date information from fiscal year 2004–05. In most cases, the overall patterns described have not changed.
5 General revenues exclude payments to publicly owned utilities, contributions to insurance trusts such as public employee retirement plans, and receipts from publicly owned liquor stores, which do not exist in California and provide a small share of revenues in other states.
6 Gordon, Alderete, Murphy, Sonstelie, and Zhang, Fiscal Realities.
8 See, for example, Michael F. Lovenheim, “How Far to the Border? The Extent and Impact of Cross-Border Casual Cigarette Smuggling” (working paper, University of Michigan, March 2007).
9 Mark Baldasarre, Dean Bonner, Jennifer Paluch, and Sonja Petek, PPIC Statewide Survey: Californians and Education (San Francisco: Public Policy Institute of California, April 2007).
12 Mark Baldassare, Dean Bonner, Jennifer Paluch, and Sonja Petek, PPIC Statewide Survey: Californians and Education (San Francisco: Public Policy Institute of California, June 2007).
13 See Coleman Advisory Services, “VLF Facts: A Primer on the Motor Vehicle In-Lieu Tax, the Car Tax Cut and Backfill” (Sacramento, CA, 2006).
14 Sheffrin, “The Tax System in California.”