California Fiscal Federalism: 
A School Finance Perspective

INTRODUCTION

California's system of public finance has undergone a radical change over the past 20 years. This change was brought about by the actions of a wide group of interested political actors—by citizens, through the initiative process; by the legislature, through the passage of a variety of fiscal measures; by the executive, through the administration of a California finance system that became more centralized over time; and by the judiciary, through decisions that have substantially restricted the funding options available to local school districts.

This paper provides a critical review of the important actions that have altered California's fiscal federalist system. I begin with a brief review of the constitutional limits that existed in California's federalist system prior to the 1970s. Next, I focus on California school finance; schooling is not only the most important budgetary item for California governments, it has also been affected fundamentally by both the initiative process and the judiciary. The following section extends the discussion beyond school finance to the general fiscal budget. Finally, I comment on the implications of the analysis for California Constitutional federalism.

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CALIFORNIA FEDERALISM IN PERSPECTIVE

Prior to 1970 the California state constitution provided a relatively clear assignment of spending and taxation functions to the three most important levels of government: local, county, and state. Specifically, the constitution gave to the state the exclusive right to tax franchises, banks, and public utilities. The income tax, retail sales tax, and federal grants were, and are, the primary sources of state revenues. While the property tax was reserved explicitly as a local source of revenue, local jurisdictions could in principle use any tax instrument that had not been exclusively allocated to the state. The property tax, federal grants, state grants, and service charges were the primary sources of county revenues, while the property tax, state and federal grants, local sales taxes, and service charges provided the bulk of local revenues.

In California as in most states, local governments have the power to control land use, and the authority to provide sanitation, police, and fire services, as well as services relating to community development, transportation, utilities, culture, and recreation. Counties administer state programs, including health and welfare, courts, jails, elections, and property tax collections. They are also responsible for parks, museums, libraries, and roads.

1 The California personal income tax is highly progressive, with rates ranging from 0 to 11 percent. There is also a 9.3 percent tax on corporate net income.
2 The tax is currently levied at 4.75 percent of value.
3 For example, the Supplemental Security Income Program is fully funded by the federal government, but administered by the state, along with its own State Supplemental Program. Other major programs include the Community Block Grant program, Aid to Families with Dependent Children, Medi-Cal, Indigent Health Care, and Special Education.
4 Grant programs from the state include sales tax revenues, highway user fees, vehicle license fees, trial court funding, AFDC, mental health programs, and indigent health care.
5 State grants include sales tax revenue, highway user fees, vehicle license fees, school aid, special education, desegregation funding, and state mandate reimbursements.
6 The permanent rate is 1.25 percent for most localities.

During the 1950s and 1960s the California Constitutional restrictions on revenue sources were the only constraints that affected California's hierarchical system of governments. However, as the initiative process evolved during the 1970s and the 1980s, and two constitutional amendments, Proposition 13 and Proposition 4, were passed, all levels of government began to face additional restrictive constraints.

Interestingly, prior to June 1978, the property tax had been the primary funding source for the California public sector generally, and for primary and secondary education in particular. The enactment of Proposition 13 as a California Constitutional amendment on June 6, 1978 drastically changed the fiscal environment of local and state governments. Property tax rates were limited to a maximum of one percent of assessed value, and the property tax base was limited to a maximum increase of two percent per year. Proposition 13 did allow for additional nonproperty tax revenues to be raised, but only by a minimum two-thirds vote of cities, counties, or special districts.

The fiscal effects of Proposition 13 were felt almost immediately. The proposition's limitations on the use of the property tax and on the local taxing authority generally led to a substantial budgetary shortfall—for primary and secondary education alone this amounted to $2.8 billion. Proposition 4 (the Gann Amendment), which followed on Proposition 13, established an appropriations limit based on the 1978-79 budget. Increases in this limit were restricted to the lower of (a) the rate of inflation as measured by the change in the U.S. Consumer Price Index, or (b) the percentage change in California personal income. The proposition also contained an "unfunded mandates" provision that required the state to reimburse local governments for the costs of new and increasing require-

7 Superior Court of California, Memorandum of Decision, SCHOOL FINANCE CASES, Coordinated Actions, April 28, 1983.
8 The rates were limited to 1 percent of the full cash value of real property subject to taxation (Cal. Const. Art. 13A, Para. 1).
9 Because property taxes are deductible on the federal personal income tax, not all of the reduction in taxes benefited California citizens. Moreover, a portion of the lost revenues was eventually replaced by increased sales taxes, which have had limited federal personal income tax deductibility.
10 Half of all revenues in excess of the limit are to be returned to the taxpayers within two years in the form of lower taxes.
number of pupils in a school district, the local share of the assessment cost (1191), is calculated by the formula

\[ \text{Local Share} = \frac{\text{Number of Pupils}}{\text{Total Number of Pupils in District}} \times \text{Assessment Cost} \]

where the assessment cost is the total assessed value in the district. This formula is based on the premise that local taxpayers should bear the cost of education proportionate to the number of students they educate. The goal is to ensure that each district's share of the assessment cost is directly related to the number of pupils it serves, reflecting the principle of educational equity.

California's School Finance Reform

School Finance in California

The growth of government in California has been accompanied by significant increases in property taxes to fund educational services. The California Constitution, Article IX, section 5, outlines that the state shall provide for a system of free and uniform public schools. However, the current system of school finance is not entirely equitable. The current system of school finance is based on a complex formula that takes into account factors such as property values, student enrollment, and district demographics. This system was designed to ensure that schools in high-property-value areas receive more funding than schools in low-property-value areas, which can lead to a disparate distribution of educational resources.

Proposition 13, passed in 1978, significantly reduced property taxes and shifted the burden of education costs to the state and local governments. This led to an increased focus on property tax reform and the development of a more equitable system of school finance.

In 1978, Proposition 13 was passed, which limited property tax increases and required school districts to develop a new funding mechanism. This led to the development of Proposition 98, which established a minimum funding guarantee for public schools, based on a formula that considers student enrollment, inflation, and other factors.

Proposition 98, passed in 1988, established a base level of funding for public schools, which must be funded by the state. This base funding is adjusted for inflation and increases in student enrollment. The state is required to provide at least $1 billion per year in additional funding to ensure that school districts have the resources to provide a quality education.

In 1996, Proposition 209, also known as the anti-affirmative action initiative, was passed. This initiative prohibited state and local government entities from using race, sex, national origin, ethnicity, or language as a basis for hiring, contractual, financial assistance, and educational opportunities. This prohibition has significant implications for school finance, as it affects the ability of school districts to address disparities in educational outcomes based on race, gender, and other factors.

Despite the recent changes in school finance, California remains a leader in educational equity, with ongoing efforts to improve the system. The state continues to evaluate and adjust its funding mechanisms to ensure that all students have access to a high-quality education, regardless of their background or the resources available to their school district.
sufficiently rapid pace. Specifically, in Serrano II, the court stated that the system of finance still violated the state's constitution; the court further allowed only an additional six years for the state to bring the system into compliance. The court ruled in particular that "wealth-related disparities in funds should be reduced to insignificant differences, which means amounts considerably less than $100 per pupil" by 1980-81. In effect, the court argued that the school system must be financed in such a way that there was no correlation between the per-pupil wealth of the district and per-pupil expenditures.

This Serrano decision moved the state much further towards equality of spending than a number of the original supporters of the Serrano litigation had expected. More importantly, it questioned whether local school districts could control their own school finances by using local revenues to supplement state funded spending levels. According to Serrano II, any attempt to increase local spending that was "wealth-based" could be seen as inconsistent with the Serrano mandate.

In response to the court's ruling in Serrano II, the legislature continued to modify and improve its own tax base equalization program. In 1977, AB 65 was passed; it would have expanded the power equalization program associated with SB 90 by putting into effect a guaranteed yield program, and by providing aid to low wealth districts that wanted to spend above their foundation level.

With the passage of Proposition 13, however, property taxes were limited to one percent of assessed value, and AB 65 was superseded. The most obvious means of increasing local school spending—the local property tax—was no longer a viable option, even if some or all of the property tax increases were not wealth-based (as would occur, for example, under a power equalization scheme). Proposition 13, in combination with Serrano II, had effectively cut the link between taxing and spending at the

local school district level. What had once been essentially a locally controlled K-12 public school system with some state financial support, had been transformed in relatively few years into a state controlled and state funded system. Whereas 53.75 percent of public school income in 1977-78 was from local sources, only 24.18 percent was local in 1979-80 immediately following the passage of Proposition 13.

There remains substantial disagreement in the academic community as to the "cause" of Proposition 13. William Oakland (1979) suggests that excess state spending in general, and a large state surplus in particular, was the source, while Geoffrey Brennan and James Buchanan (1979), supported by Thomas Downes (1988), emphasize the inefficiency of a "Leviathan" government. William Fischel (1989), however, puts the blame squarely on the court's prior Serrano decisions. He argues that Serrano equalization meant that voters could no longer use the property tax as an effective means of increasing their own local spending. As a result, it was much easier to make the next step with Proposition 13—to eliminate local control over property taxes entirely.

Whatever its true cause, it is clear that Proposition 13 created an almost immediate crisis for many public school districts, simply by reducing the available property tax revenues. After the passage of Proposition 13 in 1978, the state legislature introduced SB 154 as a stopgap solution to the short-run funding problem. The bill introduced a system of block grants from the state to the school districts, which effectively transferred state budgetary surplus funds to local districts. Moreover, the bill allowed for some local control, through certain overrides and additional funds for adult education and "emergencies." However, once the state surpluses disappeared and a recession hit in 1982-83, the state was no longer willing or able to fund the inflation adjustment that had been previously available to the local districts.

18The court also ruled that, because education is a fundamental interest and wealth is a highly suspect classification, the state of California was required to devise a valid financing system.
20Serrano v. Priest, Judgment, August 30, 1974, at paragraph 3(c).
22It was to have gone into effect on July 1, 1978.
23The local property tax remains a source of financial support for schools, but there is no local control over those funds, and they are therefore best seen as state-controlled monies.
24Downes (1992), Table 1, p. 407.
25None of these authors point to the inability of the legislature and the governor to put forth a more moderate alternative to Proposition 13.
26Ch. 292, 1978, as amended by SB 2212 (Ch. 332, 1978).
California Fiscal Federalism

A further Proposition 13-related change accelerated the movement of control from the local districts to the state. Prior to Proposition 13 and after Serrano II, each school district could determine its local property tax revenues by subtracting its allotted state aid from its state-determined base revenue limit (which, apart from grandfathering, was a function of the district's assessed property value per pupil). Because of Proposition 13, however, each district’s property tax revenue—a portion of all property taxes raised by the county—was limited. In response to Proposition 13, therefore, each district determined its share of the one percent of property tax revenues first (with the remaining portion allocated to other local and county functions), and state aid was supplied until the district’s revenue limit was reached. The result was that the state became the marginal funding source for all school district funds, and the move from local to state control had more or less been completed.

The continuing saga of Serrano litigation did not end with the passage of Proposition 13. While Serrano III was a post-Proposition 13 appellate decision of relatively little fiscal consequence, Serrano IV raised issues concerning the meaning of fiscal equity in school finance that could conceivably have led to a substantial further change in California’s school funding arrangements. In fact, however, there was little change. On May 15, 1986, the Serrano IV court decided that the appropriate equity standard implicit in Serrano II was whether the vast majority of districts fell within a $100 per ADA (average daily attendance) band in real (inflation-adjusted) 1971 dollars. In 1982-83, 93.2 percent of all districts’ pupils fell within that band (which had increased to $198 nominal 1982 dollars per ADA). By 1990-91, the equalization process had continued further, with only 4.9 percent of the pupils in districts being outside the allowable range, which had increased nominally to $268 per ADA.

The Serrano case court also confronted the difficult conceptual question of how to separate the portion of local school spending that is wealth-based from the portion that is not. (Recall that differences in tax-base per ADA that result in differences in the “price” of local education will, other things equal, lead to spending differences. But demand differences, even with no difference in tax base per ADA, can also lead to spending differences. The conceptual problem is how to sort out the two.) The court found that no more than 10 to 30 percent of the difference in base revenue limits (the measure of per-pupil spending) was due to property wealth. Had Proposition 13 not been in effect, the court’s decision in Serrano IV would have effectively re-empowered local school districts with spending authority. However, with Proposition 13, school districts could not levy additional property taxes, even if such levies were consistent with the Serrano mandate.

Did Serrano, in fact, achieve the desired goals of the court? Downes (1992) provides one answer. He utilized data from unified school districts to estimate that 36.1 percent of the school districts’ 1975-76 revenue limits fell within a $100 band centered around the median. At the same time, the correlation between revenue limit funding and assessed valuation per pupil was .78. By 1985-86, substantial equalization, although certainly not complete equality, had occurred. At that time approximately 65 percent of school districts fell within the same $100 per pupil (inflation adjusted) band, and the correlation between revenue limit funds and wealth had fallen to .52. This equalization continued beyond the middle 1980s. By the 1992-93 school year, approximately 92.6 percent of unified school districts were within the $100 per pupil band, and in 1993-94 96.1 percent of all districts were within the band.

While Serrano effectively required near spending equality in education, and Proposition 13 limited the use of property tax revenues to fund schools, California was not statutorily limited in the amount of funding from sources other than the property tax that could be allocated to K-12 public education.

27In the Court of Appeal of the State of California, Second Appellate District, Division Two, School Finance Cases, May 15, 1986.
28Had the nominal band been $100 per ADA, a substantial further equalization of spending would have been required.
29Goldfinger (1992), 11.
30Downes (1992), 409.
31Ibid., 418 (fn.12) and 410.
32The comparable number was smaller for high school districts and elementary school districts. The data are from the California State Department of Education. Note also that the growth of categorical state aid raises additional questions concerning the equalization of school spending. While categorical spending is in many cases equalizing, it is not included in the Court’s equalization requirements. Moreover, it is quite possible that substantial categorical assistance can lead to less rather than greater equalization.
33California Department of Education.
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districts through a two-thirds vote in support of a parcel tax, which is exempt from the Proposition 13 limitation because it is not an *ad valorem* property tax.34

While centrally financed schools are not unusual outside the U.S., California's state-dominated educational system is quite distinctive within the U.S. fiscal federal system. In 1991, for example, 66.4 percent of all California school district revenues came from the state, whereas the comparable national average was only 47.7 percent.35 Such a state-dominated system has the potential to be highly sensitive to the whims of the state budgetary process generally, and to the business cycle in particular.

Moreover, *Serrano* and Proposition 13 effectively separated the taxing and spending decisions of local school districts. The result is that individual households have little incentive to participate in the local political process as it relates to school funding, and local school officials have less reason to be accountable to individual households in performing their management activities. It is not surprising, therefore, that the overall effect of limitations on financing and the removal of state control was to reduce public support for school funding. During the time period under study, California school funding fell substantially in its relative ranking among states. As Table 1 shows, while California had been 19th in spending per ADA in 1971-72, it had fallen to 36th by 1991-92.

Perhaps more troubling is the fact that California's support for K-12 schools lies substantially below the support levels of most other relatively high income, industrialized states. Table 2 shows that California's spending was 88 percent of the national average in 1990-91, while the spending of New York, Pennsylvania, and Massachusetts were 162 percent, 124 percent, and 121 percent of average, respectively.

While spending per ADA in California has fallen substantially in relative terms, teacher salaries have declined only slightly. In 1991-92, California's average salary was $40,192 compared to the national average of $34,148.36 It should not be surprising therefore, that when one focuses

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34The minimum amount of funding provided to K-14 education is based on three separate tests: the greater of (1) the same share of the General Fund as the 1986-87 base year, or (2) the prior years' funding from state and property taxes adjusted for inflation (measured by the growth in per capita personal income) and enrollment increases. Further, (3) in low growth years, inflation in test (2) will be measured by the growth in per capita General Fund revenues plus ½ percent. The shortfall will be restored in years of higher revenue growth. See EdSource (1992).

35If not, the funds must come from reductions in other programs.

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Note: The text continues with further discussion and analysis on the impact of Proposition 13 on state school finance and policy, followed by additional references to various studies and sources.
on the most important determinant of educational output (other than the students' abilities), the picture looks particularly gloomy. California ranks second highest nationally in the number of pupils enrolled per teacher (23.1). Only Utah, with 24.8, ranks higher, while the national average is only 17.3.39

This decline in relative spending and increase in absolute class size is, in my view, directly related to the overall trend toward equalization within California. Prior to Serrano and Proposition 13, there was substantial variation in per-pupil spending. Yet, by the early 1990s, spending had been

39Ibid.
ing additional initiatives has to one extent or another constrained the choices that California governments face in making their fiscal decisions.40

- Propositions 5 and 6 (1982)—state gift and inheritance taxes were abolished
- Proposition 7 (1982)—the state income tax was indexed for inflation
- Proposition 37 (1984)—43 percent of state lottery revenues were earmarked for education
- Proposition 46 (1986)—two-thirds vote was required to increase the property tax to finance bonds
- Proposition 62 (1986)—two-thirds governing board approval and majority voter approval was required for any measure that increases local taxes
- Proposition 163 (1992)—the state sales tax on snacks and bottled water was repealed

The dynamics of California fiscal federalism have been shaped by external forces (federal grants) as well as internal ones (state propositions). Federal grants to California actually peaked in 1977 in real dollars, declined until 1980, and remained relatively constant thereafter.41 Partly as a replacement for lost federal aid, and partly as a response to various state propositions, state aid to local governments increased substantially over the same period.

Table 3 provides a brief summary of the relevant information.42 Over the period from 1974 to 1988, there was a slight decline in the portion of state and local government expenditures funded by the federal government. A more notable change, however, was the substantial increase in the fraction of expenditures funded by the state—from 39 percent to 48 percent. As we have seen specifically in the case of education, the passage of Propositions 13 and 4 was responsible for much of this change.

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40Two initiatives, Proposition 37 (lotteries) and Proposition 99 (cigarette tax), actually increased the revenue options of the state of California.

41Federal grants to the states actually increased somewhat (through programs such as AFDC and Medi-Cal), while federal payments to counties and cities declined.

42The Bureau of Census data do not accurately account for specific revenue items such as the revenues of county transportation commissions. However, accounting for these and other differences would not change the broad generalizations made in this paper. For further details, see Kirlin, et al. (1994).
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Table 4. The Revenue Mix of California State Government

<table>
<thead>
<tr>
<th>Year</th>
<th>Federal Grants</th>
<th>Income Taxes</th>
<th>Sales Taxes</th>
<th>Other Taxes</th>
<th>Pension Contributions</th>
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</thead>
<tbody>
<tr>
<td>1974</td>
<td>22%</td>
<td>20%</td>
<td>26</td>
<td>13</td>
<td>17%</td>
</tr>
<tr>
<td>1977</td>
<td>20</td>
<td>23</td>
<td>23</td>
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<td>17</td>
<td>24</td>
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<td>22</td>
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<tr>
<td>1989</td>
<td>18</td>
<td>25</td>
<td>19</td>
<td>16</td>
<td>22</td>
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</table>


Table 5 The Revenue Mix of County Governments

<table>
<thead>
<tr>
<th>Year</th>
<th>Federal Grants</th>
<th>State Grants</th>
<th>Property Taxes</th>
<th>Service Charges</th>
<th>Other</th>
</tr>
</thead>
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<tr>
<td>1974</td>
<td>22%</td>
<td>24%</td>
<td>34%</td>
<td>12%</td>
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<tr>
<td>1977</td>
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<td>1989</td>
<td>16</td>
<td>33</td>
<td>21</td>
<td>20</td>
<td>10</td>
</tr>
</tbody>
</table>


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the stricter criminal sanctions of governors deukmejian and wilson, and the california legislature, which led to a substantial growth in the california prison population.

Table 6 completes the picture. It shows an expected decline in both the use of the property tax and in state aid. As explained previously, localities have responded by increasing their use of whatever alternative sources of finance may be constitutionally appropriate and politically feasible.

IMPLICATIONS FOR CALIFORNIA CONSTITUTIONAL FEDERALISM

My brief review of California federalism has highlighted a number of fundamental changes in the way California governments are financed. Perhaps the most remarkable have been those changes affecting K-12 public school funding. In brief, the following represent the significant changes in California fiscal federalism.

School Finance

1. Proposition 13 has substantially limited the ability of local and county governments to make independent fiscal choices. These limitations were especially severe with respect to K-12 school funding, where the California Supreme Court had effectively turned a decentralized local school system into a centralized state system. While the school system has become more equalized, it has also become less flexible. Further, because this lack of local control reduced local political support for public schools, it may be a major cause of the substantial decline in per-pupil school spending. This is particularly troubling in light of the fact that public opinion polls continually show strong citizen support for K-12 public education.

2. By separating the taxing and spending decisions of local school districts, Serrano and Proposition 13 together have weakened incentives for political and economic accountability on the part of local school officials. In the current environment, those who benefit from K-12 state school support—school districts and the parents of public school children—are not directly accountable for the costs involved in the educational program.
in rare cases have localities been able to get the political and constitutional support to raise additional revenues.

5. Initiatives in California have substantially limited the ability of all California governments to raise revenues and to provide goods and services. Proposition 13 has been particularly constraining.

6. The growth in entitlement programs and other spending demands has greatly increased the pressure on the state to fund its activities while balancing the budget. The state has responded occasionally by raising revenues (e.g., a one-half cent sales tax increase in 1991), and in part by shifting additional program responsibilities to the counties. The net effect has been to squeeze California counties severely.

7. Proposition 4 served as a binding constraint on selected local governments only in 1987, but it could severely limit the future options of at least a minority of California’s local jurisdictions. It is not surprising, therefore, that without the traditional source of local funding, the property and sales tax, localities have resorted to user fees (service charges) and to other more esoteric revenue sources, such as the parcel tax.

8. Despite the historical precedent in California, there appears to be little conceptual support for counties taking primary responsibility for health and welfare programs. Such programs have typically been seen as under the purview of the state.

While the fiscal changes in California federalism made governmental units less accountable and reduced policy flexibility, I believe these results were largely unintended. But, whether they were intended or not, these changes have proven contrary to the interests of the California electorate. I believe, therefore, that constitutional reform should be directed towards making the same political entity responsible for both spending and taxing decisions.

While this could, in theory, be resolved by further centralization of the system, I believe that the benefits of decentralization, which include the added flexibility given to local school districts, are substantial. The following policy suggestions are consistent with this latter view.

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3 While Proposition 98 has benefited K-12 schools, it has created additional fiscal problems for other state and local governments. In recessionary periods such as 1993, the state has been unable to meet its Proposition 98 requirement. The state’s response—shifting $2.6 billion in property tax revenues from counties and cities to the public schools—temporarily resolved the state’s fiscal problem, but put even further pressure on the counties.41

City and County Finances

4 Along with the counties, California cities have also felt the increased fiscal pressure created in part by the state. For example, cities lost approximately $300 million with the property tax reallocation from other spending items to public school funding that was needed to support schools in light of Proposition 98. Further, cities are severely constrained in their revenue choices because of Proposition 13. Only

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41The state did remove some county statutory responsibilities and earmarked a temporary one-half cent sales tax for public safety programs.
Proposition 13 should be repealed or amended. One of its original goals—to limit the size of state and local governments—is explicitly accounted for by Proposition 4. Another major goal, to reduce the level of residential property taxation can be achieved through other means.

a. If local governments are allowed to levy additional property taxes to finance education, the link between local taxation and spending will be reattached. This, in itself, should increase local support for public schools, which could lead to a substantial improvement in K-12 funding.

b. Requiring a 50 percent majority vote to increase funding for public schools is inherently more democratic than is a two-thirds requirement. The latter allows a substantial minority to oppose fundamental positive changes in the educational system.

c. On equity grounds, the property tax should be preferred as a source of public school funding to many of the sources of finance that have replaced it. To the extent that the tax is applied broadly across all jurisdictions, it is in substantial part a tax on capital, which is progressive. The parcel tax, however, is somewhat regressive, since all units, whether rental or owner-occupied, are taxed the same amount.\(^4\)

d. If additional property tax revenues are to be raised, while maintaining a cap on residential property taxes, the introduction of a split role whereby businesses are assessed on a market value basis, while residential assessments continue to be limited as directed by Proposition 13, should be seriously considered.\(^4\)

2. The California Constitution should be amended to require that disparities in the provision of education not be wealth-based, consistent with the *Serrano* I decision. However,

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\(^4\)The volume of parcel tax revenue has been sufficiently small so as to have little effect on the overall distribution of tax burdens in California.

\(^4\)Alternatively, all current assessments could be grandfathered, with future assessment increases (for residential, commercial, and industrial property) indexed to market values. If a split role approach is used, the state will need to consider the broader question of whether businesses ought otherwise to be compensated for the increased cost of operating in the state of California.
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REFERENCES


Daniel L. Rubinfeld