California’s State and Local Revenue System

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On November 3, 2020, Californians will vote on Proposition 15, also known as the California Schools and Local Communities Funding Act of 2020. The proposition would require commercial and industrial properties to be taxed based on their market value rather than on their purchase price.

Under current law, a property’s assessed taxable value is generally set at its purchase price, and annual increases are limited to 2 percent or the rate of inflation (whichever is lower). The assessed value resets to market value only when the property is sold. As a result, for most properties, assessed values are well below market values.

Proposition 15 is often referred to as “split roll” because, if enacted, it would introduce different taxation based on a property’s use or “class.” The proposition would not change how residential property is taxed in California. Agricultural properties would also be exempt, as would properties owned by individuals or businesses with less than $3 million in total California property holdings.

Another provision of the proposition would eliminate personal property taxes for small businesses (those with 50 or fewer employees). All other businesses would be exempt from taxes on the first $500,000 in value of their personal property.

The proposition would generate an additional $6.5 billion to $11.5 billion in revenue for most years. For context, California collects more than $60 billion in property taxes annually. Revenue from the proposition would be split among K–12 public schools and community colleges (40 percent) and other local government services (60 percent) such as infrastructure, police protection, and hospitals.
The new commercial property tax revenue would also shift California’s state and local revenue mix. Since voters passed Proposition 13 and thus limited California’s local property taxes, California has increasingly relied on state income tax revenue.² Although income taxes have benefits, such as making the overall tax system more progressive, they also make the revenue system more volatile.³

To help inform policy debates about Proposition 15, the Urban Institute is making available the following three briefs:

1. **California’s State and Local Revenue System.** This brief compares California’s revenue system with national trends. We detail how Proposition 13 shifted revenue collection away from local property taxes toward state income taxes and the fiscal consequences of this change.

2. **California’s K–12 Education Needs.** This brief compares California’s elementary and secondary education system with other states’ systems. Although California’s funding per pupil has increased in recent years, California’s cost of living is higher than many other states’, and its large, diverse population of students, including many living in poverty, requires additional resources and more local control of resources.

3. **California’s Infrastructure Challenges.** This brief describes California’s infrastructure spending and relates how, despite recent infusions of funds, the state still lacks a stable, predictable, adequate revenue source. This creates problems addressing deferred maintenance backlogs, regional inequities, and challenges preparing for climate change.

Each brief helps readers better understand the proposition and how California’s finances and government services could change if it passes.

**Characteristics of a Good Revenue System**

Foremost, a high-quality revenue system must raise sufficient funds to support public goods and services. Revenue systems should also be reliable, predictable, and grow with both the economy and demands for public programs.

More challenging, a high-quality revenue system should be equitable. It should balance differences among taxpayers in their ability to pay and it should treat similarly situated taxpayers the same. Adding to the design complexity, a high-quality revenue system should also be as economically neutral as possible, meaning it should not distort economic decisions that individuals and businesses would have otherwise made. Finally, taxes should be simple, easy to administer, and transparent to the public.

These consensus principles often conflict with each other. But the tensions represent the trade-offs that officials must navigate when constructing a revenue system that reflects their values.⁴ This is why public finance experts support balanced revenue systems consisting of different revenue sources that complement each other.
Many economists refer to the "three-legged stool" of income, sales, and property taxes, because when working in tandem, each tax offsets the flaws of the others. Sales taxes generally burden low-income households more than high-income households because consumption is a larger share of low-income household budgets. Income taxes work the opposite way, falling more heavily on high-income taxpayers because of tax rates that rise with incomes plus various tax credits and exemptions that benefit low-income taxpayers.

Property taxes generally fall somewhere in between, depending on how state and local governments design and restrict the tax. For example, does the government offer credits for low-income earners, particularly renters? And does the government tax residential and commercial property the same way? In general, the property tax is seen as proportional to income but in large part falls on wealthier residents and businesses who own more and more high-value property (e.g., Fisher 2016).

A diverse tax mix can also make revenues less susceptible to economic cycles and the ebbs and flows of specific industries. Income taxes typically rise and fall with the economy, while property taxes are steadier over time (e.g., Liu and Mikesell 2013). Sales taxes are somewhere in between, with purchases on durable goods first to fall in an economic downturn but overall revenues remaining less volatile than income taxes (e.g., Chernick and Reimers 2015).

Thus, when working together, the three tax revenue streams complement one another and achieve a more balanced and equitable system.

Split-Roll: The Argument for a More Balanced Revenue System in California

Proponents of Proposition 15 make two main arguments for why California needs a split-roll property tax system. First, the resulting revenue would improve the state's public services, including education and infrastructure, which could use additional funding to better meet the specific needs of California's residents and businesses. The other two briefs focus on those services.

The second argument is that California's revenue system is volatile and unbalanced, and specifically that the state's income tax is overburdened because of an underperforming property tax. Proponents argue that the split-roll proposition (and resulting revenue from higher commercial property taxes) would both give California more stability and restore the connection between local tax and spending decisions. This second argument is the focus of this brief.

Indeed, California uses all major state and local revenue sources but relies heavily on individual income taxes levied by the state government. This is in large part because of Proposition 13, which severely restricts local governments' ability to levy property taxes.

Passed by voters in 1978, Proposition 13 amended the California constitution to cap a property's overall tax rate at 1 percent. It also made a property's assessed taxable value its purchase price (not
market value) with annual increases limited to 2 percent. (Some exemptions for bond measures are allowed.)

Although these restrictions benefit all people who pay property taxes, they particularly keep commercial property taxes low relative to taxes in other states. A study of local property taxes in all 50 states found California’s effective tax rates (that is, the tax paid as a percentage of the property value) on residential homes were average while effective tax rates on commercial properties were relatively low (Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence 2019).

Proposition 13 led to an immediate drop in property tax revenue. As a share of state and local general revenue, property taxes fell from 27 percent in 1978 (well above the national average) to just 14 percent in 1980 (below the national average). In 2017 (the most recent year for which we have comparable data), property taxes provided 14 percent of California’s state and local general revenue and 17 percent of the nation’s. Meanwhile, individual income taxes as a share of state and local general revenue in California grew from 10 percent in 1977 to 19 percent in 2017. The share from income taxes was mostly unchanged nationally over the same period (increasing slightly from 10 percent to 12 percent).

As a result, over the past 40 years, tax and spending authority and decisions largely shifted from localities to Sacramento.\(^8\)

The state’s progressive income tax has benefits. Specifically, it helps make California’s system more equitable than most state and local revenue systems. However, the income tax is also inherently volatile, rising and falling with the economy, and California’s reliance on it leaves its finances vulnerable to unexpected financial swings.

This volatility could prove especially troubling amid the economic and fiscal crisis triggered by the COVID-19 pandemic.

**California and the COVID-19 Pandemic**

In a typical year, California’s state and local revenue system collects more than $450 billion (including federal transfers). These funds allow its governments to provide a range of valued public goods and services such as schools, infrastructure, and health care.

However, 2020 is anything but a typical year. On March 19, Governor Gavin Newsom issued a statewide stay-at-home order in response to the outbreak of COVID-19—the first statewide order in the nation.

Most states and localities soon followed with similar restrictions. As a result, over 46 million Americans filed for unemployment between March 21 and July 9 (including more than 6 million in California), and retail sales in April declined 15 percent from the previous month. (Retail sales rebounded in May but are still down over the year.)
This economic shutdown is having an unprecedented effect on state and local revenue across the nation. Although data are still preliminary, projections based on historical relationships between economic growth, employment, and state revenues show state and local governments losing hundreds of billions of dollars in revenue over the next few years. Simultaneously, demands for services such as health care and unemployment relief are growing, and thus state and local spending will increase.

In his May 2020 revised budget proposal, Governor Newsom reported the state’s updated revenue forecast is $41 billion lower than the forecast used for the January budget. Further, when the revenue shortfall is combined with the expected increase in spending on public health and related programs, the projected budget deficit is $54 billion (State of California 2020).

A preliminary report from the California Legislative Analyst’s Office (LAO) says the state’s “budget picture will evolve over the next few months as data become available,” but state Legislative Analyst Gabe Petek told lawmakers the state’s budget deficits will completely overwhelm the state’s reserve funds. California’s localities will similarly see unprecedented budget gaps. In April, the League of California Cities estimated a combined shortfall of $7 billion over the next two years.

Assistance from the federal government could significantly mitigate this fiscal emergency. As of this writing, however, federal relief has been inadequate: Congress allocated funds for state and local governments, but these were mainly to address the public health emergency and not pandemic-induced revenue shortfalls.

Unlike the federal government, state and local governments are generally required to balance their annual budgets, so if they face a shortfall they will be forced to cut spending on essential services and eliminate public jobs, raise new revenue, or pursue a combination of both.

Further, although the recession caused by the pandemic is clearly an immediate emergency, it is not just a short-term problem: the shifts in revenues and need for additional public health spending are likely to continue over the next few years. If the downturn and recovery are similar to prior recessions, the recovery and restoration of revenues to spending programs will likely continue well into this decade. During the Great Recession, for example, both the nation’s and California’s state and local general revenue did not reach their 2007 prerecession peak until 2014 (in inflation-adjusted dollars). Thus, the fiscal damage from this recession is likely to continue for many years.

This brief relies heavily on data from before the COVID-19 pandemic had spread to the US because little data that account for the pandemic’s effects—let alone comprehensive, 50-state data—are yet available. Further, although the immediate crisis is correctly at the forefront of current policy discussions, past data are the best predictor of longer-term future revenue performance.
How California’s Revenue System Compares

California’s per capita combined state and local general revenues were $11,521 in 2017. National per capita general revenues were $9,573. California’s largest own sources of per capita revenue were charges ($2,171) individual income taxes ($2,137), and property taxes ($1,607).

FIGURE 1
Per Capita State and Local General Revenue
By sources, 2017

Compared with other states, California’s state and local governments rely more on individual income taxes and less on property taxes. California collected 19 percent of its general revenue (including federal transfers) from individual income taxes and 14 percent from property taxes in 2017. The national averages that year were 12 percent from individual income taxes and 17 percent from property taxes. California’s other major revenue sources were generally in line with national averages.
California’s share of state and local revenue from individual income taxes ranks seventh in the country after Connecticut, Maryland, Massachusetts, Minnesota, New York, and Oregon. Its share of state and local revenue from property tax ranks 33rd, trailing Arizona, Oregon, Texas, and Washington.

FIGURE 2

The Three-Legged Stool

Taxes as a share of state and local general revenue, 2017

The diversity of state and local revenue systems reflects economics and demographics as well as policy choices. For example, Vermont’s individual income tax is far more progressive (having multiple marginal tax rates on higher levels of income) than Massachusetts’s individual income tax (having one flat tax rate), but Massachusetts collects more per capita individual income tax revenue because its residents earn more income.

This is why it’s important to look at both economic metrics and policy choices when comparing governments. California’s relatively high per capita income tax revenue is in part a reflection of its relatively affluent residents. The state ranks in the top 10 in both per capita income and median household income. But policy choices have also played a large role in driving up the state’s income tax revenue.
California’s individual income tax has multiple progressive tax rates, with a top rate of 13.3 percent on taxable incomes over $1 million. Its top rate is the highest in the country. Hawaii and New Jersey also have top rates above 10 percent, and six additional states have rates above 8 percent.

However, it’s also important to note why the state made these policy choices. In 2012, for example, California voters approved Proposition 30, which increased income taxes on higher earners (including establishing the 13.3 percent top rate). The tax hikes generated billions of dollars in revenue that were used in large part to prevent spending cuts to education programs (which were vulnerable at the time because of revenue losses from the Great Recession). With Proposition 13 restricting property tax revenue, it’s not surprising California’s policymakers turned to the income tax to support education funding.

This was not the first time California had replaced property tax revenue with income tax revenue; rather, it was the culmination of a decades-long trend. In 1977, California collected nearly three times as much per capita property tax revenue as individual income tax revenue. In the 1980s through the 2000s, the two revenue sources were roughly equal. Since the 2012 changes, per capita income tax revenue has been roughly 25 percent to 35 percent larger than per capita property tax revenue.

Meanwhile, when looking at national aggregate data, per capita state and local individual income tax revenue has never surpassed per capita state and local property tax revenue.

California’s general sales tax rate is 7.25 percent. This is the highest state sales tax rate in the nation. Localities can also levy a general sales tax in California. The highest local sales tax rate in the state is 3 percent in Los Angeles, but most Californians live in a locality with a local rate of 1 percent or less (LAO 2018). When comparing combined state and local tax rates, some states (such as Washington) have higher combined sales tax rates than California (depending on which localities are compared). Although the state general sales tax rate has only increased 1.25 percentage points since 1974, many localities have increased their rates over this period.

Comparing property tax rates is more challenging because rates differ widely both across and often within states. Further, local governments across the country use different methods to calculate their real property tax bases and assessment levels. For example, 45 states limit property tax rates, 25 states use classification systems that tax different types of property at different effective tax rates, and 19 states limit the rate of growth of a property’s assessed value.¹⁶

Currently, California’s property tax rules and rates apply the same to both residential and commercial property. By contrast, half the states allow localities to tax different properties at different effective tax rates, a policy known as “classification” (if there are multiple types of properties) or “split roll” (if there are only two).¹⁷ Governments in some states use classification to set lower assessment ratios (i.e., assessed value relative to market value) for residential properties and higher ratios for commercial properties (as well as different ratios for other types of properties, such as farms). Governments in other states let local governments levy lower tax rates on residential properties than on commercial properties.
An analysis from the Lincoln Institute of Land Policy finds that effective tax rates on residential homes in Californian cities are typically in the middle of the pack while effective tax rates on commercial properties are generally in the lowest quintile (Lincoln Institute of Land Policy and Minnesota Institute for Fiscal Excellence 2019). California’s relatively low effective tax rate on commercial properties is in part the result of other states and localities using classification systems (such as split roll) to increase their effective tax rates on commercial properties.

Determining an “average” property tax rate is always challenging because of the exemptions, deductions, and restrictions used in every state. But doing so is particularly difficult in California. Among the many consequences of Proposition 13 is that because property taxes are based on purchase price rather than market price, neighbors who own identical houses could face very different tax bills based on when the house was purchased.

Viewed over time, the trends are clear: Since 1977, inflation-adjusted local property tax revenues are roughly flat (down 12 percent since that year), and as a result the state has turned to state income tax revenue (up 226 percent) and local general sales tax revenue (up 107 percent) to compensate.

**FIGURE 3**
California Revenue Trends: 1977 to 2017

*Real per capital revenue ($2017), indexed*

Source: US Census.
The Consequences of California’s Dependence on Income Taxes

California’s high and increasing reliance on individual income tax revenue makes the state’s revenue base among the more volatile in the nation. Income tax revenue grows and falls with the economy. And this is particularly true for capital gains income: the LAO reports revenue from capital gains were more than 10 times as volatile as those from salaries and wages from 1990 to 2014.¹⁸

**FIGURE 4**
Revenue Volatility, 1997 to 2017
Per capita revenue, $2017

Source: US Census.
Notes: Census does not provide state-level data for 2001 and 2003.

Thus, California’s per capita own-source general revenue declined faster than the national average during the Great Recession but also recovered quicker than most states’.
California has in part addressed revenue instability by expanding its reliance on rainy-day funds.\textsuperscript{19} The state had over $20 billion in reserves before the COVID-19 pandemic hit the US, and a November 2019 LAO report concluded California was in "good shape to weather" a typical recession (Petek 2019).

However, the 2020 recession is not a typical recession. The state expected to collect $18.4 billion in individual income tax revenue in April 2020. Instead, it collected $5.1 billion.\textsuperscript{20} Some of that unprecedented shortfall was because the state extended the tax filing deadline from April 15 to July 15. So the state will eventually recover some of those funds when returns are filed. But the revenue gap also reflects job losses and stock market declines.

Beyond revenue volatility, California’s property tax restrictions also led to less local control over how revenues are raised and spent. Local governments still collect property taxes in California, as in other states. However, the state determines how property tax dollars are distributed across multiple local governments, including counties, cities, school districts, and special districts within each county based on a formula that, although it has changed somewhat over time, is still roughly based on the share of each local government’s property tax revenues before passage of Proposition 13.\textsuperscript{21}

Moreover, because localities cannot adjust their property tax rates, and assessed value growth is limited to 2 percent, property tax revenue growth is driven mostly by property turnover and development.\textsuperscript{22}

Property tax restrictions and low property tax collections relative to other states are part of why California transfers a comparatively large amount of state revenue to local governments. In 2017, state transfers accounted for 39 percent of local government general revenue in California; nationally, they accounted for 32 percent. And because state and local finances are so intertwined in California, state budget cuts will become local budget cuts.

**California’s Fiscal Challenges and Reform Options**

California’s revenue system is volatile. To create more revenue stability, California could simply reduce its reliance on individual income taxes. However, doing so in isolation would have several negative consequences.

First, although the income tax is volatile, it has several benefits. California’s progressive income tax rates and its tax deductions and credits (such as its earned income tax credit) shift the tax burden from lower-income residents to higher-income residents.\textsuperscript{23} States without an income tax or with a low flat tax rely more on sales taxes, property taxes, or charges such as highway tolls and sewerage fees. All of these options ask low-income residents to shoulder a larger share of the state revenue system.

Second, reducing the income tax without offsetting tax increases would require large spending cuts. This is particularly true in the wake of the current recession, when the state faces large budget deficits. The state could certainly consider tax relief options, particularly targeted tax relief policies, to address
the current economic crisis. But any significant reduction in income tax revenue would exacerbate an already dire fiscal situation.

Third, the income tax performs well in good economic times, and the state’s recent investments in its rainy-day funds and savings mechanisms will help mitigate the tax’s underlying volatility. And when the state’s economy eventually recovers from the current recession, the income tax will be an effective and progressive way to raise revenue for the state.

Another option is to increase sales taxes. However, California already has some of the highest state and local sales tax rates in the nation. Further, increasing the general sales tax (without other offsetting tax changes) would make the state’s revenue system more regressive.

Expanding the state’s sales tax base to include more services would make the state’s tax more equitable and bring in more revenue. However, this change is always politically challenging. Only a handful of states have successfully expanded their sales tax base over the past decade, and they typically expand it to only a few previously untaxed purchases with limited resultant revenue.

Alternative sources of revenue, such as marijuana taxes, sports betting taxes, and severance taxes, are all relatively small. For example, even if California collected $1 billion in annual tax revenue from marijuana (as some optimistic forecasts predicted), that would represent well less than 1 percent of its state and local general fund revenues. Taxes on legal sports betting, a new source of revenue in many states, provide only tens of millions each year even in the most populous states (Auxier 2019). Severance taxes provide less than 1 percent of revenue in most states with the tax. Worse, all three of these revenue sources are also volatile. And changing any of these taxes would not restore local revenue and spending authority.

That leaves property taxes. If California policymakers want to find additional revenue during the COVID-19 pandemic and stabilize its revenue system, they should consider collecting more revenue from local property taxes. Allowing localities to tax a commercial property’s market value rather than its purchase price, as proposed in Proposition 15, is one way to achieve this.

Allowing for property tax classification (different tax treatment for commercial and residential properties) in California could increase property tax revenue and better balance the state’s revenue system. Further, the additional revenue would restore some local control and allow communities to align their taxes with their spending preferences.

And although raising taxes in the midst of a recession is often as challenging as cutting spending and government jobs, provisions in Proposition 15 plus others available to policymakers could mitigate this problem. Notably, if Proposition 15 were to pass, the first market-rate assessments are not set to take place until fiscal year 2023. Further, the corresponding tax relief for small businesses are significant.

Still, if economic conditions have not improved by then, the state could also consider additional delays for any tax increases resulting from split-roll. Alternatively (or additionally), California could
enact targeted tax relief for struggling businesses until economic growth resumes. Policymakers could also design ways to better phase in tax increases caused by the switch to market-based assessments.

However, these options, and other targeted tax changes, are only available to policymakers if California treats commercial and residential properties differently and increases its revenue flexibility.

Given California’s volatile revenue streams and the likelihood of fiscal challenges for the foreseeable future, increasing revenue from commercial property taxes would provide much-needed support and balance for California’s state and local fiscal systems.

Notes

1 The property tax changes would raise between $7.5 billion and $12 billion depending on real estate market conditions. However, these revenues would be offset by decreased personal property and income taxes and increased county administrative costs. See “A.G. File No. 2019-008,” California Legislative Analyst’s Office, October 2, 2019, https://lao.ca.gov/BallotAnalysis/Initiative/2019-008.

2 As described in this brief, Proposition 13 amended the California constitution to roll back assessed property values to 1976 levels, cap property tax rates at 1 percent, and limit growth in assessed values to 2 percent a year unless a property was sold. It also established a concept of “special taxes” and required cities, counties, and special districts to obtain two-thirds voter approval to impose them. Proposition 218, another landmark measure passed in 1996, further limited local governments’ ability to impose certain taxes, fees, and assessments. Proposition 26 later broadened the definition of taxes to include some fees and charges. In general, fees may not exceed the reasonable cost of the proportional special benefit conferred to those charged. See League of California Cities (2017).

3 For example, as described in this brief, California’s per capita own-source general revenue declined faster than the national average during the Great Recession but also recovered quicker than most states.


5 Compared with their high-income counterparts, low-income households also consume more goods (which are generally taxed) than services (which are generally not).


8 There are no local individual income taxes in California.


13 Charges include tuition paid to public universities, payments to public hospitals, tolls on highways, sewerage and parking meter fees collected by a city, and other public payments connected with specific government services.

14 Revenue systems vary greatly by state. Property taxes as a share of state and local general revenue in 2017 ranged from 7 percent in Alabama to 39 percent in New Hampshire (a state that does not use an individual income tax or general sales tax). General sales taxes as a share of general revenue ranged from 6 percent in Vermont to 24 percent in Washington (omitting the five states that do not levy a general sales tax). Individual income taxes as a share of general revenue ranged from 3 percent in North Dakota to 23 percent in Maryland (omitting the nine states that do not levy a broad-based individual income tax).

15 California collections from charges (19 percent), general sales taxes (11 percent), selective sales taxes (4 percent), corporate income tax (2 percent), and transfers from the federal government (22 percent) were roughly the same as the US average.


17 For example, Arizona has 11 property tax classes, Illinois has 15, and New York has four. Arizona’s property tax classification system is statewide, but Illinois’s and New York’s only exist in certain localities. Other jurisdictions, such as the District of Columbia, use classification to levy different tax rates on residential and commercial properties (as well as vacant and blighted properties). The District levies a relatively high rate on its valuable commercial property. As a result, taxes on commercial property account for roughly two-thirds of the District’s property tax revenue. See Lincoln Institute of Land Policy, “State-by-State Property Tax at a Glance.”


19 The Rainy Day Budget Stabilization Fund Act of 2014 requires the state to deposit 1.5 percent of general fund revenue plus a portion of “excess” capital gains tax revenue (determined by a formula based on how much revenue is collected) into the state’s debt payments and budget stabilization account.


21 Thus, if a city grew in population or an area became more dense and changed its economic base over the past 40 years, it was still left with its prior allocation. This is especially acute for governments that formed after 1978. See “Understanding California's Property Taxes,” Legislative Analyst’s Office, November 29, 2012. https://lao.ca.gov/reports/2012/tax/property-tax-primer-112912.aspx. See also Michael Coleman, “The State-City Fiscal Relationship Since Proposition 13: Is the AB8 Bailout Still Alive?” California City Finance, January 5, 2011.

22 For example, a jurisdiction with dense, high-value homes and businesses has a larger tax base and thus more tax revenue than a community with fewer and less-valuable properties. A jurisdiction with particularly high-value properties, such as a power plant or oil refinery, can also collect relatively high amounts of tax revenue, while a jurisdiction with many tax-exempt properties, such as governments and university properties, might collect limited tax revenue. See Legislative Analyst’s Office, “Understanding California's Property Taxes.”

References


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