Statement of Principles

California Budget and Tax Reform Initiative

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SILICON VALLEY JOINT VENTURE

BAY AREA ECONOMIC FORUM

A Partnership of the Association of Bay Area Governments and the Bay Area Council

ABOUT THIS PAPER

The California Budget and Tax Reform Initiative is led by Joint Venture: Silicon Valley Network and the Bay Area Economic Forum. The Initiative is an outgrowth of strong sentiment coming from labor, business, education, local government, and the community about the crucial role the state plays in our efforts safeguarding this region's economic environment. The goal is to reach out to organizations throughout California, and work in partnership with state officials to rebuild California's fiscal foundation – ensuring long-term investments in education, infrastructure, people, and the quality of living.

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BACKGROUND

California faces an unprecedented budget shortfall. While it is not alone in this predicament—40 other states also have faced significant budget shortfalls — the magnitude of its problem stands out. California's deficit is larger than the combined total of all other states, which on average face gaps about half as large.

The state's budget shortfall is attributable to two factors: (1) large declines in state tax receipts, and (2) escalating government costs. Analysis by the Legislative Analyst shows unprecedented declines in revenues that have not been met by commensurate adjustments in spending growth.

On the revenue side, receipts from California's three major taxes—personal income tax (PIT), sales and use tax (SUT), and corporation tax (CT)—declined by about 18% ($13 billion) between FY2000-01 and FY2001-02, driven by a 26% decline in PIT revenues. Excessive reliance on unstable components of the personal income tax has contributed to volatility. Although the deterioration in PIT revenues was due both to the recession and the declining stock market, the drop in revenues from capital gains and stock options, which totaled $17 billion and represented about 25% of total General Fund revenue in FY2000-01, was particularly steep. These revenues fell by 66% to $6.5 billion, or just 9% of General Fund revenues in FY2001-02. On balance, excessive reliance by the state on the personal income tax has significantly contributed to budget volatility.

On the spending side, state expenditures as a percent of personal income rose rapidly between FY1993-94 and FY2001-02, from 7.1% to 8.5%.[1] Some of the largest increases in spending were on programs such as education and health and human services. Once enacted, these increases, either from popularity or state mandate, have proven difficult to roll back as the economy has slowed. As a result, the state has found itself with major spending liabilities it cannot fund from current revenues.

[1] California was not alone in increasing the state's role in the economy; nearly every state in the nation expanded the role of state government during the 1990s, especially in education, corrections, and more recently in homeland security. States also expanded spending on Medicaid in compliance with federal mandates.

At the same time, the state has been under-investing in key infrastructure such as roads, water, utilities, and schools. This ultimately threatens business investment in the state and the creation of the jobs needed to let all Californians share a brighter future.

The magnitude of the state budget shortfall and the barriers to resolving it have exposed major structural problems in the underlying budget process. Two key issues that must be addressed are budget volatility, and the need to reform state and local finance so as to better align taxing authority and spending responsibility. The failure of the governor and the Legislature to adequately constrain spending as revenues fell exacerbated the magnitude of the deficit and its social and economic consequences. The flexibility of the governor and the Legislature to deal with the subsequent crisis has been limited by Propositions that predetermine how more than half of the budget must be spent.

Meanwhile, the ability of county and city officials to pay for services with locally raised taxes is hampered, as they have come to increasingly depend on allocations from Sacramento that are too often not sustained in difficult times.

A broad coalition of business, labor, education and local government leaders has come together to articulate a set of foundational principles that we believe should guide reform. Based on sound economic and management principles and a commitment to improve fiscal responsibility, the coalition will review legislative proposals and ballot initiatives, undertake new initiatives where necessary, and facilitate a public consensus in favor of a more effective tax and budget system.

NEAR TERM AND LONG-TERM CONSIDERATIONS

California must come to agreement on the level of spending desired and on the sources of revenue required to meet these goals. This is critical to fiscal balance. Near term solutions that merely defer those decisions can be expected to exacerbate the state's long-term fiscal position.

California's long-run fiscal health depends on the sustained strength of the state economy. Thus, resolutions to the near-term crisis must reflect the ultimate goal of maintaining and increasing the performance of the state economy and its ability to generate jobs, personal income, and taxes. Even at the margin, taxes that increase the cost of doing business in the state risk making California a less competitive environment in which to invest, thereby accelerating the loss of businesses and employment that constitute both California's future tax base and the opportunity for working men and women to raise their standard of living. To the maximum extent possible, therefore, measures that would discourage or impede economic growth must be avoided.

In addition to ensuring long-run economic health, any short-term adjustments to spending and revenues must be consistent with structural changes to the budget process intended to limit the state's vulnerability to future economic cycles. Any resolution to the current shortfall should also connect to a long-term strategy for a more balanced devolution of spending responsibilities and funding authority to local governments.

STRUCTURAL REFORMS TO CALIFORNIA'S STATE BUDGET PROCESS

Structural reforms in the wake of the current budget crisis must address the high degree of cyclical volatility in the state budget. Further adjustments are required to realign local governments' spending responsibilities with their revenue sources. Also critically important to the long-run well-being of the state is a commitment to ensuring adequate investment in infrastructure. Finally, given the constraints on resources, emphasis on increased productivity in both state and local government is an essential complement to the reform of spending and taxation policies.

Dealing with budget volatility

Revenues (taxes and fees) and spending must be restructured to: reduce the vulnerability of California's budget to cyclical swings (volatility); simplify compliance and reduce the distorting effects of tax policy on land use and investment decisions (efficiency); and to maintain the progressivity of the tax system (fairness).

- More stable revenue

  To reduce volatility, dependence on the most volatile components of the personal income tax, e.g., capital gains, should be reduced. Volatility in personal income tax revenue stems in part from the state's heavy reliance on revenues from the highest marginal tax brackets. Increasing reliance on the upper brackets may exacerbate volatility, while broadening the base and increasing revenues from other sources will enhance stability.

- Budget reserves

  The state can mitigate the need to raise taxes or cut spending due to cyclical variation in revenues by setting appropriately high targets (expressed as a share of state spending) for budget reserves. The budget reserve should be built up over time using revenues received in excess of designated spending levels.

  Revenue in excess of the budget ceiling should be used for one-time expenditures on infrastructure, education or other long-term investments, or returned to taxpayers as one-time rebates. Such revenues should not be allocated to multi-year purposes or included in the permanent spending base.

- Legislate discipline on spending growth

  To reduce budget volatility, revenue stabilization must be matched by restraint on budget growth, where the budget encompasses both spending and allocations to reserves. A baseline should be set for budget growth, with a year-on-year limit. Such a baseline could be established, for example, at a fixed level based on pre-bubble spending levels for current services, with budget growth equal to population growth plus inflation, or personal income less capital gains. Implementation of this framework would require more flexibility regarding mandated spending for some programs than is allowed under current state law.

- A process should be established under which cyclical budget shortfalls can be resolved over multi-year timeframes. On those occasions when economic downturns are especially large, the state should have the flexibility to use its debt-issuing authority to spread some part of the shortfall over time. Fiscal discipline is still required, however, with the requirement that debt is paid down within a period of not more than two years.

State and local government spending and revenue

Spending responsibilities should be better aligned with revenue-raising authority, to leave a larger share of revenues in the communities where they are raised. To this end:

- Local governments should be assured of revenue streams when responsibilities are devolved to them by the state, at levels adequate to meet both present and future program costs. Cities and counties should be allowed to retain greater control over revenues that are raised locally.

- The requirements for voter approval of tax initiatives should be changed so that a reduced majority of votes is needed to pass initiatives for local bond measures, and an increased majority is required for general-purpose tax initiatives.

- In light of changing mechanisms for retail sales, consideration could be given to revising the sales tax base to capture in-state internet sales by out-of-state commercial entities

Ensuring adequate investment in infrastructure

California's long-run economic health depends on improving the state's infrastructure. This includes transportation, housing, education, water and the environment and requires an assessment of spending priorities.

- Increased investment by state and local government is needed.

- Wherever possible, state and local infrastructure projects should be financed through a combination of fees on users who directly benefit and public funding reflecting the projects' social benefit.

- Fees for use of both new and existing infrastructure should be structured so as to enhance their efficient use.

Increase efficiency in state and local government

Another issue is the performance/accountability of state and local governments. A hallmark of the 1990s expansion and even the recent recession and recovery has been rapid productivity growth. Businesses have used these productivity gains to increase output without increasing costs. State and local governments should be expected to achieve increases in productivity as well.

- Subject to the requirements of a balanced budget as determined by the Governor and the Legislature, state agencies and local governments should be allowed to retain and use a portion of the revenue saved from improved efficiency and innovative approaches.

- Measures also should be considered that encourage more efficient expenditure by local governments by leveraging city and county resources across jurisdictions.

- The management of state programs should be reformed by enacting a five-year lifespan on new programs and regulations, and sunsetting them unless they are reauthorized by both houses of the legislature and signed by the governor. By adopting this measure, the state process would mirror the current procedures of the federal government. The same provisions should apply to new budgetary allocations adopted through initiatives.

- State expenditures should be based on performance-based budgeting. Quality-of-service goals and cost targets should be set and year-to-year improvement expected. Performance standards (such as cost per unit of service) should be developed to evaluate the efficiency and effectiveness of state services. Where appropriate, these should be benchmarked against comparable private-sector standards. Efforts at increased quality, improved efficiency and cost savings should be documented in annual budget submittals of state agencies. Based on these criteria the governor and the Legislature should take those budgetary measures that are in the best fiscal interests of the state and its taxpayers.

- Effectiveness, measured against performance standards, should be assessed by a state Performance Review Panel that draws on qualified auditors, analysts and professionals from within and outside state government, and representatives of the public, in periodic reviews of state agencies and programs. The panel should be required to make recommendations to the governor and the Legislature on program maintenance, redesign, restructuring, elimination or outsourcing. Creation of such a panel will produce more accountability in state programs and a more systematized basis for achieving budget savings and efficiencies.

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