



December 4, 2001

The Honorable Gray Davis
Governor, State of California
State Capitol, First Floor
Sacramento, California 95814

Subject: Taxpayer Perspectives on the State Budget Problem

Dear Governor Davis:

In the face of a multibillion-dollar general fund problem, California's state and local policy-makers have opportunities to make California more competitive for jobs and to meet priority spending needs of people of the state. The California Taxpayers' Association urges you and the Legislature, as well as local elected officials, to do the following:

- Avoid new taxes and fees – and gimmicks. Higher taxes will further destabilize the economy and slow recovery.
- Take advantage of opportunities for positive steps to steady the state's financing system. Improved financial management and planning will help protect this state from the impact of vast swings in revenue during economic turbulence.
- Review new programs and lower-priority spending in order to reallocate resources to priority needs of Californians:
 - See attached samples of spending bills signed into law in 2001 that could be candidates for deferral (in excess of \$1.3 billion).
 - See attached samples of potential management savings and new programs that are candidates for deferral (savings: at least \$1.7 billion).
 - Adopt the Franchise Tax Board protest regulation to produce substantial additional revenue (amounting to an estimated \$1 billion in revenue).
 - See attached "Accountability Files," listing more than 130 examples of governmental waste (in excess of \$6 billion). You can also access these files electronically at: www.caltax.org/final.accountability.pdf.
- Apply economic stimulus to create jobs and expand the state's economy.

- Consider performance contracting to bring competition into the public service delivery systems. This strategy has produced savings ranging from 10 percent to 40 percent in jurisdictions that have used this option.
- Beware of the “spending lobby.” Special interest spending advocates resist belt-tightening steps that are a reality for everyone else in responding to an economic downturn. Lower-priority government programs cannot be immune.

Here is a discussion of these points in greater detail:

Avoid New Taxes and Fees – and Gimmicks

Increasing taxes or fees is not the right answer. Raising taxes could balance the budget but it will not help the economy. The public does not expect to see new taxes and fees as the line of least resistance in responding to the budget deficit. In fact, raising taxes and fees simply makes it inevitable that future budget deficits occur. Another major problem with tax increases is that they sustain ineffective programs that are seldom reviewed and modified. We suggest policy-makers avoid tax-and-fee increase proposals for the above and following reasons:

- Imposing punitive taxes, fees and other exactions on isolated sectors of the economy has had embarrassing results and damaged the state’s reputation as a place to live, work and conduct business. For example, these fees and taxes were imposed to resolve earlier budget problems, but instead resulted in adverse economic effects or unintended consequences:
 - Smog impact fees on vehicles purchased in other states were ruled unconstitutional, resulting in a \$500-million refund program with adverse and costly side effects.
 - Snack foods taxation created a consumer backlash until it was rescinded.
 - A personal income tax increase produced virtually none of the expected revenue.
 - The maritime bunker fuel tax drove suppliers out of California and policy-makers were forced to rescind the levy.
- Increasing taxes during an economic downturn places on additional drag on the economy. Tax and fee increases, whether state or local, will only retard economic recovery for California. Policy-makers must be extraordinarily careful when asked to increase sales taxes to finance popular programs, such as public safety and emergency health services. Raising taxes earmarked for these services removes the incentive for legislative bodies to examine existing spending habits and focus existing tax dollars on essential services. Raising taxes for high priority public safety programs can be an easy way to insulate lower-priority or ineffective spending from budget scrutiny.

- Financing and accounting gimmicks, also known as smoke and mirrors, artificially prop up ineffective spending and postpone cost-effective measures that the public expects to see enacted. A “two-year” budget cycle could be a gimmick to blur the distinction between a balanced and an unbalanced spending plan.

Take Advantage of Opportunities for Positive Steps

Take action to stabilize the state’s financing system. Improved financial management and planning will help protect this state from vast swings in revenue resulting from the tax structure. It is vital that policy-makers work to reduce the impact of this economic cycle in the future. As predictable as rain in the winter, California’s progressive tax structure produces windfall revenue when the economy is sound, and equally predictable is the precipitous drop in revenue growth when the economy turns down. Better financial management of state spending must recognize the volatile reality of the revenue structure and the need for careful planning of spending obligations. Much the same way we try to protect communities from floods and drought, policy-makers need to provide an environment that plans public spending so that the state is not over-obligated during unstable economic periods. California must budget its resources with greater understanding of our boom-and-bust economic cycle. It is critical that California make maximum use of surplus-revenue cycles to invest in infrastructure and a competitive tax structure.

Review New Programs and Lower-Priority Spending

Policy-makers at the state level will have no better opportunity to eliminate ineffective, lower-priority and wasteful spending, and they should encourage cities and counties to do the same. Spending on ineffective programs should be reallocated to priority needs. Public opinion polls consistently show that voters have a low level of confidence in governments’ ability to match available tax dollars with essential public needs. Spending reform and fiscal discipline will be well received by voters.

Taxpayers pay for dozens if not hundreds of analysts who work for the Governor’s Department of Finance, the Legislative Analyst’s Office, legislative fiscal committees and research organizations. These analysts should immediately conduct a systematic review of the spending base to restore the public’s confidence in the way public resources are spent. Some specific suggestions include:

- **Review all new programs and spending bills passed in the last three years.** If the state muddled through without them for 150 years, many could be deferred for another year or two. As mentioned earlier, we have attached a list of spending bills approved during the 2001 legislative session (amounting to over \$1.3 billion) and a list of potential management savings and new programs (of at least \$1.7 billion) that should be reviewed as candidates for deferral for relatively brief periods of time to help the state through this difficult period.

- **Pursue revenue opportunities, such as adoption of the Franchise Tax Board protest regulation, turned down by the Davis Administration in 2000.** This regulation provided that the FTB must resolve protests within two years of the protest being filed. Former FTB Member Dean Andal of the State Board of Equalization estimates that there are \$2 billion in taxpayers' protests pending at the FTB that exceed the two-year period. Assuming the current 50-50 ratio of protests decided in favor of the state, it is reasonable to expect that \$1 billion in revenue could be produced from this change.
- **Eliminate waste in state and local government spending.** The "Accountability Files" attachment (or www.caltax.org/accountabilityfiles.html) lists more than 130 examples of wasted or misspent tax dollars over the past three years. These cases exceed \$6 billion – and this is probably the tip of the iceberg. Accountability Files are taken directly from press reports from newspapers throughout the state. These press reports identify specific examples of public spending problems, and underscore the need for comprehensive review of public spending programs. There may be answers and explanations to questions raised by these reports. However, the reports are valuable and suggest the need for additional scrutiny of the existing spending base of state and local government in California.

Apply Economic Stimulus

Private-sector job growth is California's largest revenue increase opportunity. The enormous growth in tax revenue in the 1990s directly relates to growth in jobs and the economy. Revenue to public agencies averages in excess of \$6,000 for each new job created in California.

State and local policy-makers must work to assure that California sustains a reputation as a place where business and industry can operate profitable enterprises. California needs a competitive tax structure and a hospitable business climate that attract investment. Policy-makers must continually review the costs of doing business in California. With regard to tax structure and public infrastructure, the following should be implemented:

- Exempt investment in plant and equipment from the sales tax. This would make California sales-tax law more competitive with other states and encourage investment in plants and equipment here.
- Work vigorously to improve the quality of education, public safety, and public facilities to make the state an attractive place to live, work and conduct business.
 - Approve additional bond financing for transportation, school, and housing projects.

- o Support passage of Proposition 42, the measure on the March 2002 ballot that would permanently dedicate state gasoline sales tax revenue for transportation infrastructure.
- As the federal government reduces taxes to stimulate the economy, California should move in the same direction. Conform to changes in federal laws that are designed to improve the economy.
- Foster an attitude of cooperation and assistance in tax administration and regulation. Administrators and regulators can no longer be allowed to chase jobs out of state because of hostile, adversarial attitudes that create uncertainty and unpredictability.

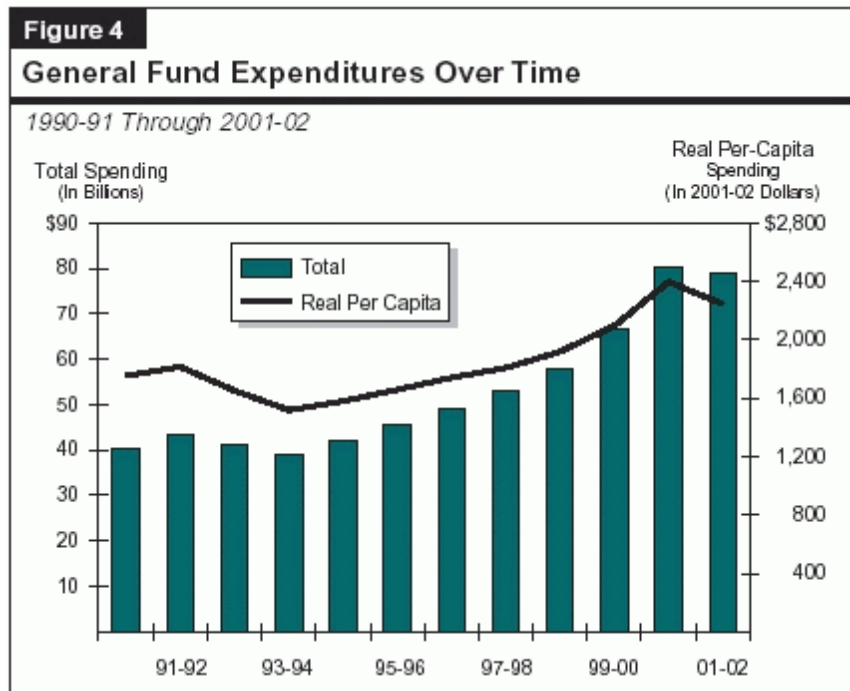
Performance Contracting is a Key Strategy

Performance contracting is a key strategy for state and local policy-makers to lower costs for the delivery of high-quality public services. Performance contracting encourages state and local governments to consider competition in the delivery of public services. Numerous opportunities exist to contract with private sector companies and other public agencies to reduce cost and increase quality. Estimates of savings range from 10 percent to 40 percent from performance contracting. A growing number of cities, counties, schools and state agencies are utilizing performance contracting for services that include fleet maintenance, parking enforcement, public transit, emergency medical services, county health care, golf courses, road maintenance and tree trimming. A 1997 report, summarized on Cal-Tax Online, describes some of the opportunities for performance contracting and competition in the delivery of public services: <http://www.caltax.org/MEMBER/digest/jul97/jul97-3.htm> .

Beware of the Spending Lobby

The largest, best-financed group of lobbyists in Sacramento is known as the spending lobby -- advocates and lobbying organizations hired by cities, counties, schools, other local agencies, public employee unions, and those who receive funding from state and local government. The job of the spending lobby is to protect the current spending base regardless of program effectiveness. Spending lobbyists primarily seek to ratchet up spending and sustain prior-year spending levels as a floor upon which to pressure for increases. Organizationally, these lobbyists generally resist spending reform efforts and support higher taxes.

As depicted in the following chart prepared by the Legislative Analyst, state general fund spending in the past eight years has more than doubled from \$38.9 billion in 1993-94 to \$80.0 billion in the current year. Keeping this extraordinary growth in mind, the objectives for policy-makers should be to achieve a balanced budget without any additional taxes or fees while protecting investments in education, transportation and public safety. Even under the most severe spending reduction, it will not be necessary to require the general fund to return to spending levels of 1999-00.



Source: California Legislative Analyst

Sincerely,

Larry McCarthy
President

LM:RWR:DRD:LAM

Attachments:

1. Sample of Spending Bills Signed by the Governor.
2. List of Other Potential Budget Cuts or Deferrals
3. Cal-Tax "Accountability Files"