



Stabilizing the California State Budget for Economic Growth

In 2007, California's state and local policymakers have opportunities to make the state more competitive for jobs and at the same time meet priority spending needs of residents. Unfortunately, the budget process, which allocates more than \$140 billion for the total operating budget, is inadequate to meet the needs of Californians who depend on public services and for taxpayers who pay high taxes. An improved budget process would bolster financial management and help focus resources to provide quality public services.

The California Taxpayers' Association urges state legislators, the governor and local elected officials to take these actions:

- Avoid new taxes and fees, while keeping in mind that the largest and most dramatic revenue opportunity for the state is revenue growth from an improved economy.
- Solve budget shortfalls by reviewing ineffective, mismanaged, low-priority spending. In light of California's structural deficit problem, review of questionable spending is critical.
- Act immediately on press reports of waste, fraud and mismanagement of public funds.
- California must do a better job of managing its boom-and-bust revenue system. In the past, revenue surges have been allowed to damage the budget when policymakers over-committed one-time revenue to ongoing spending programs.
- California must apply economic stimulus to create jobs and expand the state's economy. Private-sector jobs and investment result in increased revenue to state and local agencies.
- Consider performance contracting to bring competition and performance measurements into public service delivery systems – a strategy that has produced savings ranging from 10 percent to 40 percent.
- Beware of the influence of spending advocates. The Legislature must be prepared to say “no” when necessary. Special-interest spending advocates resist financial management, including performance and cost-effective measures. The spending lobby refuses to be realistic about financial challenges facing the state. Low-priority, wasteful

government programs cannot be immune from review, regardless of the special-interest lobby protecting them.

Avoid New Taxes and Tax-Like Fees, Keeping in Mind That the Largest Revenue Opportunity Is an Improving Economy

New taxes are high-risk gambles, particularly split-roll property taxes, schemes to tax high-income investors in the California economy, and other punitive taxes that target job creators. New taxes and fees will further destabilize the economy, slow economic investment, and reduce revenue to public agencies over time. Business leaders around the state express concern about the impact of tax increases on the state's competitive position and economic investment here.

California has tried and failed to raise taxes during an economic downturn. It produced damaging results. The effort in the early 1990s to cover a deficit with higher taxes (such as the 10 percent and 11 percent temporary personal income tax brackets on high-income Californians imposed in 1991) produced only a fraction of the revenue expected. The mid-1990s economic recovery did not get traction until the temporary income tax rates triggered off.

New taxes and fees can be the line of least resistance when responding to budget deficits, but must be avoided. Fees and taxes were imposed in response to earlier budget problems, but instead resulted in adverse economic effects or unintended consequences. These are examples from state actions in the early 1990s:

- o A personal income tax increase produced a fraction of the expected revenue. In 1991, when the 10 percent and 11 percent brackets were enacted on a temporary basis in California, they were expected to yield \$1.2 billion in revenue per year. A Franchise Tax Board analysis shows that actual collections were substantially less than that over the next several years.

A study by the National Bureau of Economic Research, analyzing 1993 federal tax increases on upper-income taxpayers, found a similar result. Two new brackets for those with incomes over \$140,000 produced less than half the revenue anticipated in the static analysis.

High state tax rates make it more difficult for small businesses to obtain capital, expand operations, and employ more workers. Moreover, California businesses already are reeling from massive increases in costs of operations, including insurance, unemployment insurance, energy, environmental regulations, a plaintiff-oriented civil tort system and other costs.

- o 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.

- Taxation of snack foods created a consumer backlash until it was rescinded by initiative.
- The maritime bunker fuel tax drove suppliers out of California, and policymakers were forced to rescind the levy.

Solve Budget Shortfalls by Reviewing Ineffective, Low-Priority Spending

California's budget problems are opportunities for elected officials to identify and act on questionable spending that is lowest priority and least cost-effective. Leads to where this questionable spending may be found are in audits and press reports that get little consideration during the budget process. Budget agencies would do a tremendous service for all Californians if ineffective, duplicative, low-priority spending was identified in a systematic way for policymakers as a matter of routine annual budget review.

Some would discourage financial management by framing a budget problem as potentially cutting the life blood out of valued programs like higher education. Such superficial analysis and budget spin is the status-quo argument to discourage sound financial management.

Policymakers at the state level should set examples for cities and counties to follow in eliminating waste, fraud and mismanagement from their budgets. Programs that defraud taxpayers and recklessly spend tax dollars 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.

Fiscal discipline and better management of state finances by the Legislature would be well-received by voters. We know state and local bond measures are routinely approved by voters who are persuaded that these measures meet priority needs, have provisions that promote accountability to taxpayers, and include cost-containment strategies.

Finding the Waste, Fraud and Mismanagement

The waste and fraud line item is rarely found in an official budget document. It is found in numerous press reports in virtually every newspaper in the state. Some taxpayers may think that because the mismanagement of public funds has been identified in a major newspaper, and even in government audits, that corrective action is being taken. This is probably a false assumption. (Visit Cal-Tax Online at www.caltax.org to view our report on waste, fraud and mismanagement amounting to billions of tax dollars. It consists of reporting in major daily newspapers that demonstrates the need for an immediate review and evaluation of these programs. Taxpayers deserve better management of public funds than these press reports describe.)

California Must Manage Its Boom-And-Bust Revenue System

Improved financial management and planning will help protect this state from vast swings in revenue resulting from the normal operation of the tax structure. As predictable as rain in winter, California's progressive income tax structure produces windfall revenue when the economy is sound, and equally predictable drops in revenue growth when the economy turns down. Better financial management and planning of state spending must recognize the volatility of key revenue sources and the need for careful scheduling of spending obligations.

It is vital that policymakers implement strategies that use this state's economic cycle to boost California's financial position. Much the same way we try to protect communities from floods and drought, policymakers need to provide a financial plan for public spending so the state does not over-obligate taxpayers by misspending revenue surges. 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. Buying needed infrastructure with cash from spikes in revenue saves taxpayer 80 percent to 100 percent of the cost of borrowing for 30 years to make this investment.

During the six-year period 1994 to 2001, state General Fund revenues grew 79 percent. This astonishing increase in revenue occurred while the state was enacting taxpayer relief and making the California tax structure and business climate more competitive. Had the Legislature limited spending for operations during this six-year revenue surge, billions would have been available to build schools, highways, and other infrastructure on a cash basis. California also would have avoided deficits in following years that resulted from the run-up in program spending.

Apply Economic Stimulus

Private-sector job growth is California's largest revenue increase opportunity. Each new job created in California generates several thousand dollars of revenue to public agencies. The enormous growth in tax revenue in the 1990s directly relates to growth in jobs and the economy.

State and local policymakers 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 attracts investment. Policymakers must continually review the costs of doing business in California. With regard to tax structure and public infrastructure, these changes should be implemented:

- Exempt investment in new manufacturing plants and equipment from the sales tax. This would make California sales tax law more competitive with other states and would encourage investment in plants, equipment and jobs in the state.

- Encourage investment in research and development in California by making our tax structure and operating costs competitive with other states. California conformity to recent federal research and development tax credit changes is an important action for the California Legislature to take.
- As the federal government reduces taxes to stimulate the economy, California should move in the same direction. Conform California law to changes in federal laws that are designed to improve the economy.
- Foster an attitude of cooperation and assistance in tax administration and regulation. Fairness and predictability in taxation are essential to a positive business climate. Hostile and adversarial attitudes in tax administration create uncertainty and unpredictability and reduce the attractiveness of the state for investment.

Performance Contracting Is a Key Strategy

Performance contracting is a key strategy for state and local policymakers to reduce 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. The report is titled, "Competition and Privatization Strategies to Reduce Government Costs."

Beware of the Spending Lobby

One of the largest, best-financed groups of lobbyists in Sacramento is known to taxpayers as the spending lobby. These are 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 sustain prior-year spending levels as a floor upon which to pressure for increases and ratchet up spending whenever possible. These lobbyists generally resist the most basic management, planning, cost-effective evaluation and performance measures. Although the spending lobby supports increases in spending and higher taxes, the Legislature must say "NO" to its requests when it is obvious that such actions would promote governmental inefficiency, burden taxpayers, and cause an additional drag on the economy.