



April 6, 2009

Mr. Gerald Parsky  
Chairman  
Commission on the 21st Century Economy  
915 L Street, 8th Floor  
Sacramento, CA 95814  
Via E-mail

Dear Chairman Parsky:

This is in response to your recent request of Cal-Tax to provide positive input into the Commission's deliberations regarding potential modification of California's tax structure. As you know, Cal-Tax submitted written and oral testimony to the Commission for consideration at its February 12 hearing in Los Angeles. In that testimony, we urged the Commission to refrain from recommending certain actions that would be detrimental to California's business climate, such as imposing a sales tax on services, enacting a split-roll property tax, or attempting to broaden sales tax nexus. Provided below for your consideration are additional suggestions that would enhance California's tax and fiscal structure.

### **Budget Management**

Cal-Tax supports the budget reform proposals included on the May 19 special election ballot. In addition to those proposals, California needs to put in place mechanisms to better manage our state's budget. A two-year budget process would enhance the state's fiscal health by offering legislators more time to review programs and spending, as well as to identify areas where costs can be reduced. In addition, planning two years in advance instead of one would provide a more long-term view of the state's spending plan.

In coordination with a more long-term spending plan, the Legislature should elicit analysis of its final budget package from the Legislative Analyst's Office (LAO) before the plan is enacted. Having the LAO review the final package before it is voted upon could avoid the unintended consequences that frequently accompany budgets.

Finally, the Department of Finance should be held responsible for actually overseeing and managing the implementation of the budget. That oversight does not currently exist.

### **Zero-Based Budgeting**

Zero-based Budgeting is a budgeting and financial management strategy to help policy makers achieve more cost-effective delivery of public services. The concept of zero-based

budgeting has been utilized successfully by private corporations and has been recommended for application to the federal budget for some time. For government use, this planning and budgeting technique endeavors to redirect effort and funds from lower-priority current programs to higher-priority new programs, improve efficiency and effectiveness, and reduce spending.

Traditionally, most government budgets have been constructed by adding to the current expenditure level. In most jurisdictions, expenditures for the coming year will exceed those of the current year. For this reason, most attention is directed to the "increments" that have been added to this year's expenditures to reach the proposed budget total. A major flaw in incremental budgeting is that it assumes the current year's expenditure level is justifiable, and this may not be true. It may be either too high or too low.

Zero-based budgeting, on the other hand, is a detailed and concentrated study of those activities that might be considered costly or ineffective and that continue to be funded primarily because they are never examined.

It may be useful for one or more government programs to be subjected to zero-based budget analysis every year. In such an analysis, it is not assumed that the current year's spending for a particular program is justified. On the contrary, the wisdom of spending any money at all on the program is examined.

These questions are typical for analyses of this type:

- Is there any measurable evidence of the value of the program under review?
- Are the goals and objectives of the program important enough to warrant the expenditure?
- What would happen if the program were not provided at all?
- Are there other less costly and more effective ways of achieving these objectives?
- Where would the program fit in if all programs were displayed in order of importance?
- Would the benefits be greater if a portion of the funds spent on the program under review were used instead for other programs?

An important element of this budgeting procedure is that it forces prioritization of government programs and activities. With the prospect of insufficient revenue to match the demand for spending, it is useful for government to have a ranking of programs and activities based on proven effectiveness, as well as suggested alternatives to expensive or ineffective programs.

There are two basic steps to the process of zero-based budgeting. The first step is to develop what is referred to as "decision packages." The second is to rank the decision packages. The decision package is a document that identifies and explains the specific activity, its goals and objectives, measurement of performance, costs, benefits, and alternative courses of action. Ranking of decision packages is then accomplished at each management level until a comprehensive agency-wide ranking is obtained.

Conceptually, zero-based budgeting is a systematic and logical approach to allocating limited resources where they will do the most good.

## **Modified Zero-Based Budgeting**

Service-level budgeting is a modified zero-based budgeting approach. This concept matches spending levels with services to be performed. Under zero-based budgeting, a great deal of effort can be devoted to documenting personnel and expense requirements that are readily accepted as necessary. Modified zero-based budgeting can avoid this by starting at a base that is higher than zero. An appropriate starting point for a jurisdiction might be 80 percent or 85 percent of the current spending level. High-priority requests above this level could be identified to restore part or all of the current year's service levels. Desirable new programs also could be considered for funding. As a result, a legislative body might be presented the choice of reducing some current operations in favor of adopting a new program. Thus, a new program might be funded out of savings incurred by reduction of an existing program. The phrase "service-level budgeting" is in some cases a better description for this process.

## **Sales and Use Tax Productive Asset Exemption**

Unlike virtually every other state with sales and use taxes, California does not provide an exemption for productive assets (those utilized in manufacturing or research activities here). This is a substantial competitive disadvantage, but more importantly it is a defective tax and economic policy – all academics and tax policy experts agree that business inputs should not be taxable if business outputs are. In other words, to avoid double taxation, the machines making the taxable products (or those producing the ideas that lead to the products) and the products should not both be taxed. The common way to avoid such double taxation is to exempt the inputs, and tax only the outputs.

## **Federal Income Tax Conformity**

A major issue with respect to taxpayer compliance costs is the lack of general conformity with the Internal Revenue Code. California's tax laws have been out of sync with federal law since 2005, when the last comprehensive tax conformity bill was enacted. This lack of conformity has created a huge burden for taxpayers in California, including many small and large businesses, who already are overburdened by excessive regulation and taxation. A lack of conformity merely perpetuates the perception that California is hostile to business. California is in the midst of a budget crisis, and conformity is one tax policy that will not drain the state coffers, but will save significant money for both the State of California and its taxpayers.

Conformity will ease taxpayer compliance burdens. Federal and state tax laws are so complex that when they are out of conformity, taxpayers must spend more time and money unraveling what is required to comply with the law. Conformity with federal law also improves taxpayer compliance. Fewer taxpayer errors resulting from differences in state and federal tax laws will improve taxpayer compliance and increase revenues that are due to the State of California. In addition, conformity will reduce tax agency administrative costs from auditing and correcting taxpayer errors. Fewer dollars spent on accountants and tax penalties inevitably will result in more dollars being invested in jobs and capital in this state. More investment results in more property, income and sales tax revenue to the state due to a healthier economy.

## Use Tax Compliance

Use tax compliance continues to be a major challenge in state tax collection. The fundamental problem resulting in poor use tax compliance is lack of taxpayer education. We applaud the State Board of Equalization's efforts, however, to ensure that businesses pay their fair share of taxes rightfully owed.

The problem of a lack of taxpayer education is apparent. In fact, even some legislators and legislative staff are unaware that the use tax exists and how it works until they come to Sacramento. These are well-informed individuals, so the problem is likely magnified for the general population. Yet, we complain that use tax comprises a substantial part of the state's tax gap – the difference between taxes owed and taxes paid. To ensure voluntary tax compliance and maintain a constructive relationship with the taxpayer, it is imperative that the state allocate more resources to use tax education. A failure to do so would be similar to the state placing a speed limit sign behind a tree and citing a driver for speeding.

The California Taxpayers' Association hopes that the Commission's deliberations take into consideration the importance of a healthy economy, job creation and a strong business climate. Thank you for the opportunity to provide input.

Sincerely,

A handwritten signature in black ink that reads "Teresa Casazza". The signature is written in a cursive, flowing style.

Teresa Casazza  
President

*Teresa Casazza is president of the California Taxpayers' Association, a non-partisan, non-profit research and advocacy organization founded in 1926 to protect taxpayers from unnecessary taxes and to promote government efficiency. Cal-Tax is online at [www.caltax.org](http://www.caltax.org)*