PAYING FORWARD
Responsible Revenue Reform

Commission on the 21st Century Economy

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Presented By

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Good afternoon Chairman Parksy and members of the Commission. Thank you inviting *California Forward* to comment on some of the fiscal issues that are facing California.

California Forward is a bipartisan, public interest government reform effort seeking long-term changes to California's political and fiscal systems. We don't claim to have all the answers, but we are committed to engaging Californians in a bipartisan way to find practical solutions to the governance problems facing the state.

When we launched our efforts last spring we started on budget reform as the first of several projects envisioned to restructure California's governance and finance system. With respect to the finance system there are three elements:

- Developing a smarter state budget process.
- Initiating a new dialogue about our revenue structure.
- Revisiting the state and local fiscal relationship.

California has the potential to enjoy another century of prosperity as the state's regional economies flourish through trade, technology and tourism. But capturing this prosperity will require innovation and investment that yields efficiencies, creates new products – and most importantly – generates new jobs. This innovation and investment will be required of government as well as business.

What are we going to tax?
How do we make those choices?
Where will the money go?
Who decides how to spend it?

The revenue system, as a pillar of governance, is essential to our success – public and private, individual and community. Taxes help us meet basic community needs, including public safety and care for the elderly and the poor, and allow us to enjoy a high quality of life. Taxes also allow us to invest in our children through education. That investment, if linked with modern infrastructure and efficient regulations, can attract the private capital needed to spark a "virtuous cycle" of economic growth. This cycle can:

1. Create more high quality jobs, self-sufficient families and a growing middle class;
2. Generate more tax revenue from a growing economy, which will enable additional investment in education and infrastructure; and,
3. Lower the public costs of dealing with poverty, crime and blight.

Taxes are about more than money.

A significant factor in the state's money problems is the rollercoaster of the personal income tax, and to a lesser degree the sales tax. This volatile revenue system has resulted in painful binge and purge budgeting practices. The stalemate over the state's chronic budget shortfall has been overshadowed by the global economic decline and sinking tax revenue. Both the state and local governments will need to make significant budget cuts, and increase taxes to maintain basic levels of essential services. But the response to the immediate crisis may or may not move the state toward a better revenue structure.

The desirable mechanics of a robust tax system are understood: As summarized by the California Commission on Tax Policy in the New Economy, taxes should be fair, simple and efficient.

In addition, previous blue ribbon commissions have recommended that California's tax system be restructured in the following ways: 1) Where possible, there should be a clear relationship between the revenue source and a level of government, or even a particular service or program; 2) The level of government that is responsible for delivering services should have adequate authority over the revenue and budget decisions; and 3) Voting thresholds – for raising and lowering taxes – need to give Californians a meaningful chance to invest in public programs, balancing the need for government to be responsive while protecting the long-term interests of future Californians.

In short, California needs to rethink and resolve these issues: What are we going to tax, how do we make those choices, where will the money go, who decides how to spend it, and how will we know what we are getting for our tax money?

These structural issues are particularly important since Proposition 13 severed the control of local governments over the level of property tax and its distribution. Without taking issue with the tax limitations that are the cornerstone of Proposition 13 (particularly residential property taxes), many blue ribbon commissions have called for restoring the fiscal independence of local governments.

Which tax system, which future?

The governance issue is not limited to restoring local control. The fundamental dynamics and authorities of the tax system are critical to the level of public investment, the responsibility for those investment decisions and accountability for the results.

These governance decisions should be guided by the reality – not fully recognized by government structures or policies – that wealth is generated by distinct regional economies that largely ignore political boundaries and governmental jurisdictions.

There is not one 21st century economy in California, but nine or 10 or 12. The comparative advantage of these regional economies will be influenced by the ability of state and local governments to coordinate efforts to support the future they want. Aligning the revenue system to that new governance paradigm can increase the efficiency and effectiveness of those efforts.

In other words, California's tax system is not just volatile but outdated, and the choices go beyond familiar recommendations such as expanding the sales tax to include services.

Trust is a remedy to long-term and immediate ills.

No one likes to pay taxes. And while California is often thought of as the Lexington of the Tax Revolt, time and again Californians have supported (even with super majorities) proposals to raise their taxes when they are persuaded the money will be well spent on a high priority.

In this way, improvements to the tax system must be simultaneous with improvements in budgeting and expenditures. Taxes, if managed appropriately, are investments with transparent results. As with all investments, trust and confidence is essential.

For nearly a decade California has suffered from a structural fiscal deficit because of an unwillingness to match revenue and expenditures. While partisans define the issue as either a spending or a revenue problem, there are valid examples of both: Tax cuts were made without corresponding spending cuts or efficiencies, and expenditure decisions have been made that nearly ensure that costs will grow faster than revenue. This chronic condition has been inflamed by the acute decline in revenue as a result of the global economic recession.

In the short-run, additional revenues will be needed to maintain essential public programs in education, public safety, health and human services. That revenue must be balanced with spending cuts to restore fiscal balance.

Neither requirement is desirable, but at the macro level the impact of both cuts and taxes are not automatic or guaranteed. How savings are achieved and how additional dollars are spent will determine the ultimate impact – on families, communities and regional economies.

Budget reform matters.

California Forward is now working with members of the Legislature as well as regional and community leaders to develop understanding and agreement on the following key budget reforms:

1. **Look to the future.** A multiyear budgeting system would focus fiscal choices on long-term implications and discourage short-term solutions that push liabilities and difficult decisions into the future.

2. **Focus on priorities and outcomes.** A results-based process for making budget decisions would enable leaders to assess whether to increase, continue, or alter policies and programs, rather than letting budgets grow on auto-pilot, regardless of whether services are, in fact, having a positive impact on the lives of Californians.

3. **Create a culture of accountability.** The Legislature does not dedicate adequate time to reviewing whether programs are achieving their goals and what must change for them to improve. Budget decisions should be guided by what programs are trying to achieve and what must change to achieve those goals. A system of evaluating programs based on progress would strategically reduce spending while preserving programs that provide the greatest value.

4. **Pay our own way.** Create a process so that any policy change that increases costs must also contain a provision that identifies where the money will come from, whether from new revenue or expenditure reductions elsewhere. Changing the state's spending obligations so that they do not grow faster than revenue would safeguard long-term fiscal planning so programs can be fully implemented and their costs accounted for in future budgets.

5. **Create stability.** A new budget process would identify nonrecurring revenue and hold it for times when economic downturns reduce tax revenue. Since 1990, revenues have fluctuated wildly – from a decrease of 5 percent to an increase of 23 percent, which makes it difficult for state leaders to effectively manage resources.

Balance and value.

A natural tension exists between the imperative of meeting community needs, including education and infrastructure programs that attract the private capital for job creation, and the potential for taxes to siphon capital away from private investment.

That tension can be mitigated in part by ensuring continuous improvement in the value of essential public expenditures. Similarly, not all taxes limit economic growth and not all tax deductions and credits provide the intended benefits. On both sides of the ledger, taxpayers are entitled to rigorous review by policymakers.

The beginning is a good place to start.

In a sound-bite world, the simple can mask the truth. Public discussions about tax policy can quickly get stalemated on whether California is a high tax state or a low tax state. We begin with the belief that many Californians are ready for a thoughtful discussion about how California can create an adequate and reliable revenue system that reflects the regional nature of our economies, and the role for state and local governments in supporting those economies.

We are committed to providing understandable and accurate information about California's tax system and how we got here, and to providing a balanced and fact-based discussion about the options – those in the near term, as well as more fundamental changes to the revenue system.

Our first goal is to raise public understanding, so citizens can engage with each other and their elected representatives. We also will solicit and report on public concerns and preferences as expressed through in-person and online discussions. By sharing that information with the Governor, the Legislature and with their representatives on the Commission for the 21st Century California, we hope to help policymakers reach the best possible decisions.

While the changes will likely be on the margin, they can be strategic and position California to better manage tax dollars to efficiently support families, communities and regional economies. Toward that end, *California Forward* will assess progress following the public discussions held this winter and spring and consider how to best support this evolution of California's revenue system.