



# Curing Deficits and Creating Value

## *Principles for Improving State Fiscal Decisions*

Essential public programs provide a foundation for California’s long-term health, safety and prosperity, and the state’s fiscal system is the reinforcing steel in that foundation. Adequate and reliable funding, strategically allocated and professionally managed, is critical to the success of public programs and the communities they serve.

In recent decades, California’s fiscal system has evolved in ways that have made it difficult for state and local agencies to consistently provide high quality services and proficiently respond to complex problems. These changes have limited the ability of regional economies to compete in the global marketplace and be wise stewards of environmental resources, and they have frustrated efforts of neighborhoods to remedy difficult social challenges.

The fiscal system does not suffer from a single ailment, and many of its infirmities are the unintended consequences of previous efforts to “fix” the system or respond to the imperative of the moment. Changes made to the tax structure have made revenues more volatile; at the same time, the sales and use tax structure has not been adapted to a service-based economy. A slew of initiatives approved by voters has created a complex web of restrictions, and have distorted in profound and largely unforeseen ways how fiscal decisions are made. In many critical areas, such as education and economic development, the authorities over fiscal, policy and management decisions are so intertwined among state and local agencies that the ability to provide cost-effective services is compromised and accountability is lost.

For California to achieve its economic, social and environmental goals, government agencies must manage revenues to continuously improve the quality and efficiency of education, transportation, public safety and other programs. This will require comprehensive changes to the fiscal system and how key decisions are made.

The significant gap between revenues and spending is a symptom of this dysfunction. Given the size and complexity of the issues, strategic and incremental changes are more likely to succeed. A logical first step is to improve the state’s annual state budget process – the central venue for fiscal choices that then ripple through the thousands of public agencies statewide.

### ***About These Principles***

One way to assess the concern over California’s fiscal system is the number of efforts to fix it. More than a dozen commissions and organizations, public and private, have issued recommendations during the last boom and bust cycle.

*California Forward* has distilled those ideas related to the state budget process to direct a public discussion on the “principles” of sound budget reform. The principles distilled in this document were first published in June 2008 and have prompted many valuable comments and discussion. Rather than refining the principles, *California Forward* is crafting specific budget reform proposals based on those comments.

While these principles include some elements of the revenue system, additional changes in tax policy are warranted. Changes also are needed to strengthen the state-local fiscal relationship and local finance; *California Forward* expects to address those issues in future projects.

## ***Beginning with the state budget-making system***

The state's annual spending plan is just one component of California's fiscal system, yet it is one of the most important tools for policy-making. The Budget Act drives what will be done in the coming year, which agency will perform those duties, and – often with great precision – how tasks will be pursued. While the spending plan lasts but a single year, it inherits the successes and failures of the plan before it, and generates benefits and consequences into the future.

The current budget process is largely a relic of the mid-20<sup>th</sup> Century, with the focus on how much to increase spending (or how much to cut), rather than the value that public services bring to Californians over time. These annual budget decisions often either push California's fiscal systems toward long-term solvency or away from it. The ongoing and chronic imbalance between revenues and expenditures is one indicator of system failure. Changing how budget process decisions are made could enable public leaders to deal with the more intractable and complex problems involving the revenue system and the state-local relationship.

**Key problems:** The costs of operating state programs are growing faster than the revenue base that supports them. The revenue system is highly sensitive to changes in the economy, producing significant volatility. The single-year budgeting horizon encourages short-term fixes, rather than long-term solutions. The budget does not take a strategic approach to ensure a return on public investments and there is a lack of public and legislative review of how money is spent.

**The bottom line:** The common good would best be served by controlling costs, managing volatile revenue and taking a long-term investment approach. Through a strategic budget process, policy-makers can set priorities, redirect funds to better solutions to difficult problems, and make steady improvement toward public goals. A reformed budget process would enable the Legislature to do better oversight and has the potential to increase public trust.

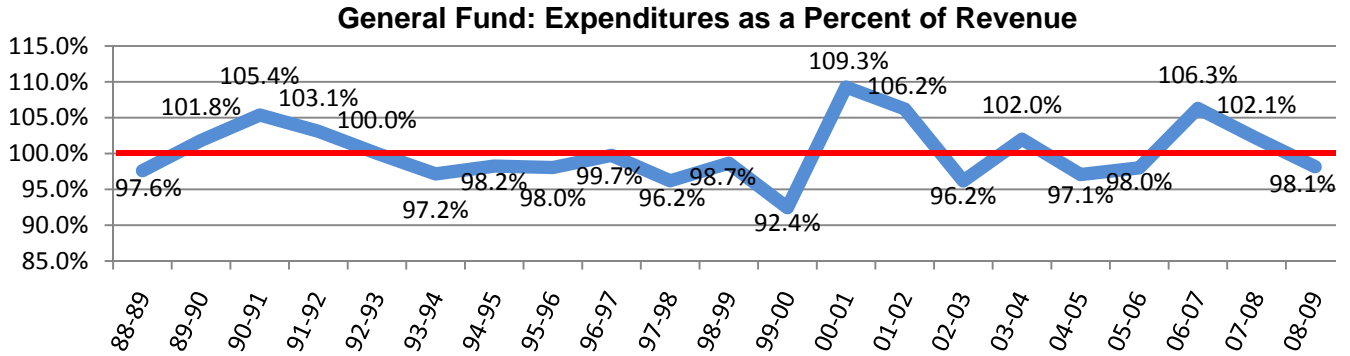
## ***Problems and Principles to Guide Solutions***

### **“Structural” Deficit**

#### **Problem 1: The state's spending obligations grow faster on average than revenue.**

Two primary factors drive costs. First, the state has had a habit of spending nearly all of the revenue it receives in a given year. When revenues decline or even flatten, lawmakers must either cut programs or rely on internal borrowing and other mechanisms that critics consider to be gimmicks. The consequences of this dynamic are compounded by the state's relatively volatile tax structure and the reliance of local agencies on state-controlled funds.

The second underlying cause of spending growth is a series of fiscal demands on the system – including rising caseloads, university enrollments, payroll increases, prison admissions, and cost of living allowances. While all of these demands can ultimately be controlled by lawmakers, the budget process assumes those costs will be covered, which requires the base budget to grow each year whether or not revenue increases.

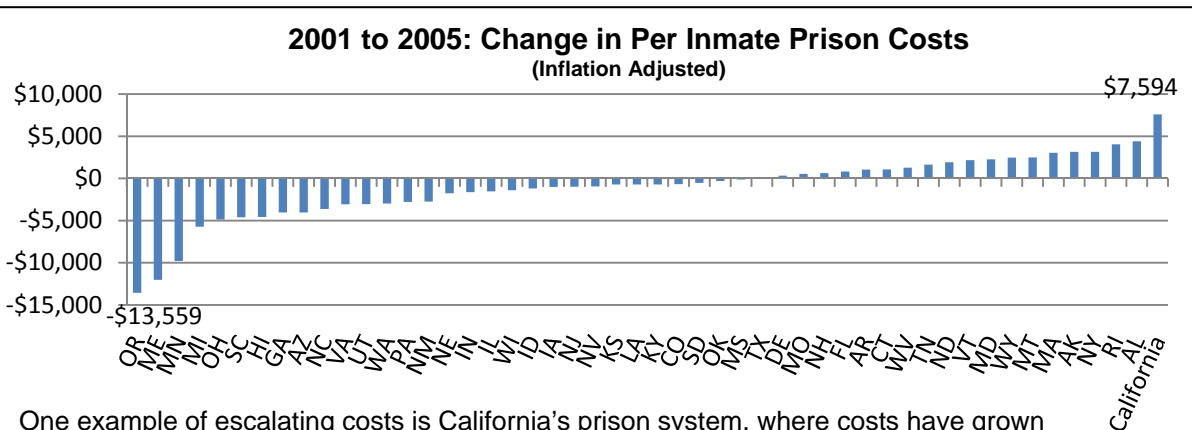


State spending has increased in all but four of the past 20 years. During this period, lawmakers overspent the state's General Fund roughly half the time. The greatest single year increase was in fiscal year 2000-01 when spending grew by 17 percent or \$12 billion over the prior year. That year, lawmakers overspent the General Fund by \$6.6 billion dollars, making up the difference by borrowing or other cost shifts.

### PRINCIPLE 1.1: CONTROL ESCALATING COSTS

**The state needs to systematically scrutinize fast growing expenditures to control costs or get the job done in a different way.<sup>1</sup>**

- The state's revenue and expenditure forecasting processes should be thorough, accurate and accessible to the public, and provide a multi-year perspective.
- Program costs should be systematically reviewed to assess those that are exceeding projections, and assess whether the program should be revised, curtailed or eliminated. The soaring costs of publicly funded health care, for example, must be controlled if budgets are to be balanced.
- Efforts to control costs and improve the delivery of services need to be integrated into the budgeting process.



One example of escalating costs is California's prison system, where costs have grown faster than in all other states. In 2001, California spent \$26,556 per inmate, ranking California 23rd in the nation. By 2005 per inmate costs increased to \$34,150, and 6<sup>th</sup> in nation. In contrast, 31 states reduced costs. During the same years, Texas reduced its costs by \$14 per inmate.

Source: Pew Charitable Trusts. Public Safety Performance Project.

## **PRINCIPLE 1.2: PAY AS WE GO**

**New programs and major expansions of existing programs should have an identified funding source as a condition of approval.<sup>2</sup>**

- New program proposals, whether by legislation or through the initiative process, should include sources of new revenue, offsetting spending reductions, or redirection of existing program allocations to fund the proposal on an ongoing basis.
- Consideration should be given to program improvements that may increase costs in the short term but reduce costs or demands on public services in future years.
- Current infrastructure planning requirements should be strengthened by being integrated into a multi-year fiscal planning process and providing “pay as we grow” financing models that ensure a reliable investment through good years and hard times.

### **PAYGO**

PAYGO requires policy change that increases costs to identify a source of funding – either new revenue or reductions elsewhere. Some form of PAYGO has operated in Congress since 1990.

California does not have a PAYGO requirement. Occasionally, revenue is linked with new programs, but not always. Consider two examples:

The Mental Health Services Act was passed by voters to expand community-based mental health services and imposed an additional 1 percent tax on incomes of more than \$1 million to cover the additional costs.

In contrast, in 2000 legislation was passed that guaranteed financial aid to college students who are admitted to state colleges and universities and meet educational and income requirements. Prior to the legislation, grants were awarded on a priority basis based on the amount of funding allocated each year. The 2000 entitlement was passed without specifying a source of funding.

## **PRINCIPLE 1.3: ANALYZE THE IMPACT OF TAX BREAKS ON THE BUDGET**

**Preferences and incentives within the tax system should be periodically analyzed to determine if they are effective.<sup>3</sup>**

- The legislative and executive branches should formally and systematically review tax credits, deductions and other “tax expenditures” to determine if they are still necessary and a cost-effective way of accomplishing their stated goal.
- The legislative and executive branches should consider an institutional mechanism – such as a commission on tax policy – to encourage consistent oversight of the tax structure and identify the best ways for tax and other policies to support those goals.

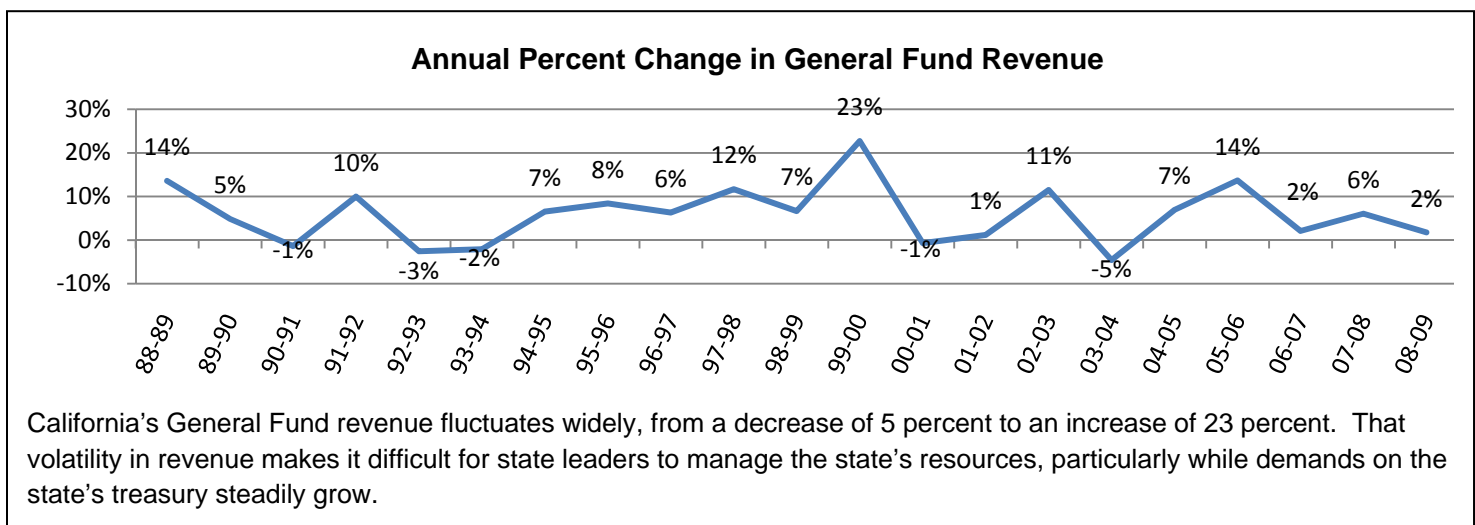
## Volatile Revenue

### **Problem 2: California’s volatile revenue system requires better fiscal management to ensure reliable public services through good times and bad times.**

California’s dependence on a highly progressive income tax results in General Fund revenues that are more volatile than in most states. California also has made strategic errors by building short-lived “spikes” in revenue into the spending base or using the spikes to justify permanent tax cuts.

This problem ultimately needs to be addressed by modernizing California’s tax structure. In fashioning those reforms, stability should be one consideration, along with opportunities to align revenue streams to California’s comparative economic advantages and restoring local control over revenue for local services. But the state also can manage the negative consequences of this volatility by disciplining spending and appropriately managing one-time revenue.

Similarly, the state needs to find ways to respond quickly when revenues decline below what was anticipated in the current year. Timely response to declining revenue can minimize the impact of those declines on the following year.



### **PRINCIPLE 2.1: MANAGE ONE-TIME REVENUE**

#### **Major “spikes” in revenue should be used to maintain a significant reserve and one-time purposes, such as infrastructure investment or tax rebates.<sup>4</sup>**

- A collaborative effort between the Governor, appropriate constitutional officers and legislators should be used to determine when revenues are growing unsustainably fast. Above-normal revenues should be used to maintain a significant reserve for future years, and other appropriate one-time uses that do not increase long-term spending requirements or permanently reduce revenue.

- The state should not be overly dependent on windfall revenues, debt or accounting changes to finance current expenditures.

### **PRINCIPLE 2.2: MANAGE MID-YEAR SHORTFALLS**

**The state needs a joint executive and legislative response to declining revenue during the budget year.<sup>5</sup>**

- The state’s revenue and expenditure structure should include strategies that will accommodate fluctuating economic climates. These strategies could include pre-authorized reductions in Budget Act appropriations and triggered revenue increases.
- The state should enhance the current “fiscal emergency” provisions in the constitution to increase the consultative process between the Legislature and the Governor. The current process lacks incentives to reach agreement. Improvements might include designated reductions if agreement can not be reached.

### **PRINCIPLE 2.3: MODIFY THE TAX SYSTEM**

**One ingredient to long-term fiscal balance is to adjust the tax system to reflect the contemporary economy.**

- The state’s transaction taxes should be reviewed in a revenue neutral manner so that the tax base is broadened and the tax rate reduced as one way to increase stability and to align the revenue system with a service-based economy.

## **Short-term Perspective**

**Problem 3: The one-year lifespan of the state budget puts too much emphasis on matching revenue and spending in a single year rather than strategically investing public dollars to meet critical needs over the long-term.**

In nearly every year, the Legislature struggles to match expenditures with revenue, as required by the constitution. Part of that struggle is the difficulty of reaching the two-thirds majority vote requirement in a polarized and partisan Legislature.

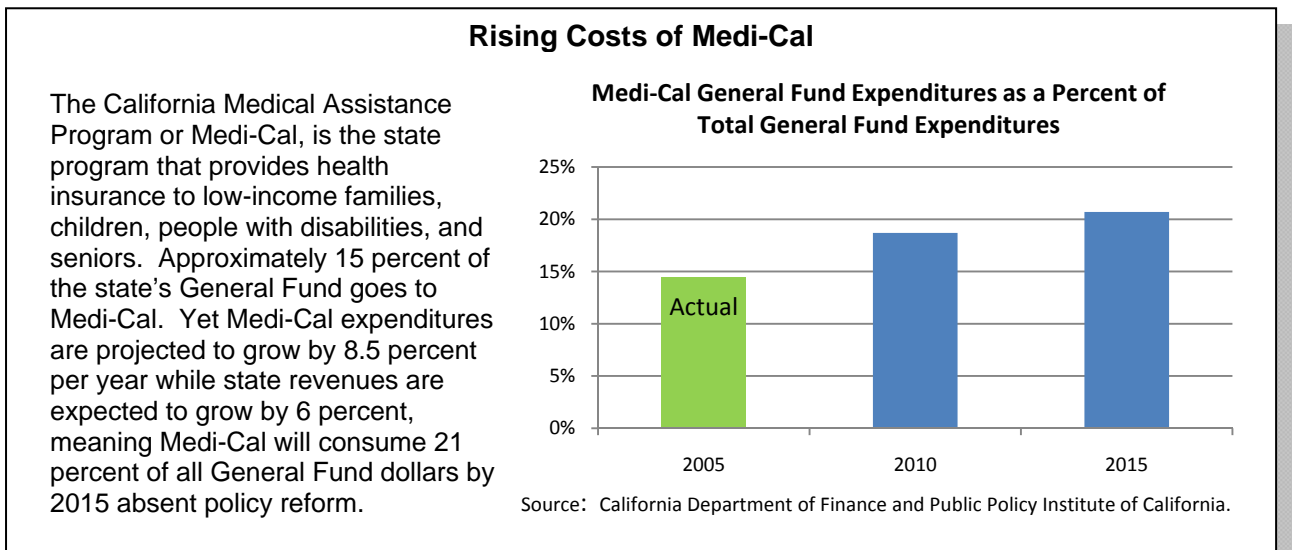
But the more significant consequence is the focus on single-year solutions, which encourage lawmakers to shift special funds to cover General Fund obligations – or to shift costs from one level of government to another, one year to another, and even one generation to another.

One challenge to creating a multi-year budget is that both revenues and public demands cannot be predicted with adequate certainty. Still, fiscal decisions should be guided at least as much by the long-term implications as by a one-year accounting exercise. By not focusing on the out-years, policy-makers undervalue choices that have long-term benefits and they often avoid the full costs associated with politically popular decisions. Both failures ultimately contribute to growing demands on the budget that are passed on to their successors and the general public.

### PRINCIPLE 3.1: CONSIDER LONG-TERM IMPACTS

**When making fiscal decisions, policy-makers and the public should understand the long-term fiscal impacts of choices to better control costs and improve the return on investment over time.<sup>6</sup>**

- The Governor’s published budget proposal should include a multi-year fiscal plan that displays the anticipated growth in spending, potential public benefits and potential savings associated with elements of the proposal.
- Where appropriate, multi-year funding commitments should be implemented when tied to program improvements.



### PRINCIPLE 3.2: EVALUATE LONG-TERM IMPACTS OF BUDGET DECISIONS

**Increase public awareness of long term commitments.**

- The Department of Finance and Legislative Analyst should jointly publish an assessment of the three- and five-year implications – to revenues and expenditures – of the Budget Act.

## **No Strategic Vision**

**Problem 4: While the budget appropriates more than \$140 billion a year, it does not set clear priorities or ensure that dollars are allocated in the best way to achieve results.**

There is a time-honored tradition in state spending: *Programs get what they got in the prior year — plus growth.* New programs typically receive limited funding in the first year, and then seek more as they get a foothold. The next budget is built on top of the budget that came before it. The focus of discussions among the Governor and Legislature is on marginal changes in spending to programs from one year to the next, rather than how to best use available resources to achieve state goals.

This process tends to lock spending within programs and artificially limits the discretion that policy-makers have to direct dollars within policy areas to the most effective strategies, agencies or programs.

This process also fails to focus initial fiscal decisions on budget-wide priorities, contributing to the difficulty of reaching agreement among lawmakers, who are pressured by all interest groups to make their concerns the highest priority. In turn, it is difficult for the public at large to understand the choices that lawmakers are considering, and for lawmakers to be confident that they are acting on behalf of their broader constituencies.

### **PRINCIPLE 4.1: FOCUS ON RESULTS**

**The Governor's proposed budget and the Budget Act should be developed and discussed with a focus on improving results.<sup>7</sup>**

- The Governor's budget proposal should establish strategic goals and objectives and performance targets.
- The Legislature should incorporate cost and performance information in its deliberations on the best ways to achieve objectives.
- The public debate on the budget should focus on what the state wants to achieve, how quickly the objectives need to be achieved, and the changes in revenue and expenditures that are needed to achieve the goals.
- In the pursuit of cost-effective improvements, the state needs to consider delegating authority and responsibilities to local governments and regional entities. Some of these opportunities will emerge through a result-oriented approach to the budget.
- Local agencies implementing state programs should develop a results approach to budgeting and management that reflects the state effort. State agencies, in turn, can similarly learn from results-oriented local governments leaders.

## Improving and Communicating Results

### Virginia Performs: Vision, Focus, Results *Agency Performance Measures Report: Department of Health*

<b>CHILDHOOD IMMUNIZATIONS</b>	Year	Measure	<b>TOBACCO USE</b>	Year	Measure
<b>Objective:</b> We will increase immunization rates of children at two years of age.  <b>Governor's Key Summary:</b> We will increase the percentage of two-year old children in Virginia who are appropriately immunized to 90 percent by June 30, 2009.	2000	71.3	<b>Objective:</b> We will reduce the prevalence of smoking among Virginians.  <b>Governor's Key Summary:</b> We will reduce the number of adults who smoke to 19% by June 30, 2009.	2000	21.4
	2001	79.1		2001	22.5
	2002	67.0		2002	24.6
	2003	80.9		2003	21.9
	2004	81.0		2004	20.8
	2005	85.8		2005	20.6
	2006	80.7		2006	19.3

California's budget process is commonly evaluated on whether it produces a state budget that is balanced and on time. But other states have put in place tools that allow policymakers to establish and report broad public goals, assess progress toward those goals and support deliberation on improving progress.

In Virginia, which consistently receives high marks from the Government Performance Project of the Pew Center on the States, the Governor has established clear goals for state programs. Progress toward those goals is readily available, enabling residents to track progress over time. Consider the above two examples of healthcare goals.

Similarly, Virginia's Department of Transportation has an online dashboard allowing residents to track progress on several performance measures, including vehicle accident fatalities, roadway congestion and fiscal management within the agency. The Virginia Department of Transportation's dashboard can be found at: <http://dashboard.virginiadot.org/Default.aspx>.

### PRINCIPLE 4.2: PUBLISH RESULTS

**Californians and their elected leaders should have information on the quality of public services and the impact of those services on individuals and communities.<sup>8</sup>**

- Agency-level strategic plans should define management objectives and budget priorities, assess how to better use available resources, and report their results to the public and Legislature.
- The result of the strategic planning process should be incorporated into the budget making process.
- Citizens should have access to performance information to better understand the quality and outcomes of public services. California's performance should be benchmarked against other states.
- Fiscal allocations that are made through the initiative process should have the same status as legislation and be subject to the same review as programs and services enacted by the Legislature.

## **Inadequate Public Debate and Oversight**

**Problem 5: Elected officials spend more time debating incremental changes in state spending than whether money is well spent – and how it can be better spent in the future.**

The legislative budget process focuses on the administration's request for additional funding for specific programs. The focus is on inputs rather than outputs, results, or how dollars could be spent differently to improve results. Program oversight by the Legislature is largely ad hoc, often driven by headlines and scandals. There is no institutionalized process or consistent information base for legislators to methodically or consistently review program spending or results. Combined with the short-term institutional memory associated with term limits and the consequence is minimal and largely ineffective legislative oversight.

In turn, the Legislature's process for developing the annual budget also has become less understandable to the public. Both houses act through small budget subcommittees and the houses never act on their version of the budget. The work of the subcommittees is simply transmitted to a two-house conference committee. Any attempt at consensus between the party caucuses and the houses is often left to the last phase of the budgeting schedule, when there is less time and inclination for open debate and public comment.

### **PRINCIPLE 5.1: SEEK AGREEMENT ON GOALS**

**The Legislature should organize its fiscal activities to achieve broader agreement on the state's goals and the fiscal choices that will best advance those goals.<sup>9</sup>**

- Through joint house resolutions or related mechanisms, broader budget policies should be adopted to guide the Legislature as it crafts the budget document.
- Forums for early agreement may include the expanded use of the Joint Legislative Budget Committee.
- The Legislature should revisit the vote requirements for the passage of the state budget. A discussion of vote requirements should be undertaken on a bipartisan basis and should be pursued along with other reforms designed to improve performance, accountability and public trust.
- To increase transparency, legislation enacting the budget and related legislation should be available to the public for at least three days prior to final action by the legislature and signature by the Governor.

## **PRINCIPLE 5.2: CONDUCT BETTER OVERSIGHT**

**The Legislature should systematically review the performance of programs and their contribution to the state's goals and objectives, and encourage expert and public comment on how public funds could be better used to achieve objectives.**<sup>10</sup>

- The Legislature through the budget committees – acting together or via the Joint Legislative Budget Committee – should conduct systematic reviews of program performance using metrics developed by the Legislature and the administration.
- Performance reviews should be scheduled ahead of the budget review process so those reviews inform the budget deliberations and the results of those reviews should be integrated into the executive and legislative budget development process.
- For new programs, unproven strategies or struggling programs, policy-makers need to consider a sunset review system to create an incentive for improvement and to prompt changes if results are elusive.

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- <sup>1</sup> Similar recommendations have been made by the California Citizens Budget Commission, the Legislative Analyst's Office, and Governor Davis' 2003-04 Budget.
- <sup>2</sup> This proposal has previously been recommended by California Policy Choices, the California Citizens Budget Commission, and Governor Davis' 2003-04 Budget.
- <sup>3</sup> Similar recommendations have been suggested by the California Governance Consensus Project, the California Budget Project, and Governor Davis' 2003-04 Budget.
- <sup>4</sup> A number of groups and individuals have proposed creating a "rainy day fund" or budget reserve account, including the California Citizens Budget Commission, the California Constitution Revision Commission, the California Business Roundtable, the League of Women Voters of California, Governor Davis' 2003-04 Budget, and Governor Schwarzenegger's 2008-09 Budget.
- <sup>5</sup> Similar recommendations have been made by the California Citizens Budget Commission, the California Constitution Revision Commission, the California Business Roundtable, Governor Davis' 2003-04 Budget, and Governor Schwarzenegger's 2004-05 Budget May Revision.
- <sup>6</sup> The following organizations and individuals have advocated reforms of this kind: the Government Accounting Office, the California Business-Higher Education Forum, the California Citizens Budget Commission, the Little Hoover Commission, John W. Ellwood and Mary Sprague in "Options for Reforming the California State Budget Process," the California Constitution Revision Commission, the California Business Roundtable, the League of Women Voters of California, the Legislative Analyst's Office, the Reason Institute and the Performance Institute in *The Citizen's Budget 2003-05*," the Commission to Study the Management of State Government, the Governance Performance Project, the National Advisory Council on State and Local Budgeting, the Government Finance Officers Association, the National Association of State Budget Officers, Standard & Poor's Credit Ratings Criteria for State and Local Public Finance, the California Performance Review, and Governor Schwarzenegger's 2004-05 Budget May Revision.
- <sup>7</sup> Similar recommendations have been made by the Senate Cost Control Commission, the California Constitution Revision Commission, the Bay Area Economic Forum, the California Citizens Budget Commission, the California Governance Consensus Project, The Finance Project, Cal-Tax, the California Business Roundtable, the California Business-Higher Education Forum, and the California Performance Review.
- <sup>8</sup> The following organizations and individuals have advocated reforms of this kind: The Senate Cost Control Commission, the California Citizens Budget Commission, the Government Accounting Office, John W. Ellwood and Mary Sprague in "Options for Reforming the California State Budget Process," the California Budget Project, the California Business-Higher Education Forum, and Governor Schwarzenegger's 2004-05 Budget May Revision.
- <sup>9</sup> The following organizations have previously recommended similar reforms: the Senate Cost Control Commission, the California Governance Consensus Project, the Little Hoover Commission, the California Constitution Revision Commission, the California Business Roundtable, the Bay Area Economic Forum, The Finance Project, and the California Performance Review.
- <sup>10</sup> This proposal has been recommended by The Finance Project, the California Constitution Revision Commission, Cal-Tax, the California Business Roundtable, the Bay Area Economic Forum, the California Business-Higher Education Forum, the Little Hoover Commission, the California Performance Review, Washington Office of Financial Management, and Governor Schwarzenegger's 2004-05 Budget May Revision.