State of California

LITTLE HOOVER COMMISSION

July 12, 2004

The Honorable Arnold Schwarzenegger
Governor of California

The Honorable John L. Burton
President pro Tempore of the Senate
and members of the Senate

The Honorable Dick Ackerman
Senate Minority Leader

The Honorable Fabian Núñez
Speaker of the Assembly
and members of the Assembly

The Honorable Kevin McCarthy
Assembly Minority Leader

Dear Governor and Members of the Legislature:

California's vital signs are showing improvement, and icy political stalemates are beginning to thaw. But California government faces significant problems that existed even before the tech-bubble burst, and must be addressed if the performance of government and the public's confidence in government are going to improve.

To provide high quality services at an affordable cost and to make California an attractive place to live and do business, state leaders need to confront and resolve a range of issues that hobble how policy decisions are made, resources are allocated, programs are administered and services are delivered. Experts across the political spectrum believe the state's revenue system needs to be realigned to the changing economy. The State and local governments need to be synchronized partners, not political adversaries. Budget gimmicks, special interest initiatives, partisan redistricting, campaign contributions, and term limits are to the political landscape, what wildfires, flashfloods and earthquakes are to California's natural landscape.

In good times and in bad, well intended reformers set out to solve these and other "structural" problems that are considered responsible for budgets that aren't balanced, and policy failures that attract national attention.

The Commission examined these reform efforts and gleaned the lessons to be learned – from the successful and the unsuccessful – and charted a critical path, a process for reform. Each step on the path is based on actual experiences from people who have been involved, and frustrated, by the attempts-to-date to find a better way of funding government, setting policies and priorities, allocating resources among programs and measuring performance.

It is tempting for anyone who ponders these problems to declare the solutions that others should embrace. Alternatively, some have concluded that the traditional political institutions are broken beyond repair and advocate that critical decisions be delegated to an appointed panel and their recommendations placed directly before voters to approve or reject.

But the Commission concluded that the most legitimate and substantive reforms will require a combination of detailed analysis and creative negotiation among the parties most directly involved. The general public and community leaders from throughout California need to be consulted in meaningful ways. And political leaders will need to be resolute and united on the problem to be solved, the range of acceptable solutions, and the importance of stakeholders acting in good faith. Solutions cannot be divined; they must be developed, vetted, refined and embraced.

This path is challenging. But these essential steps will substantially raise the potential that reforms will be enacted and that those reforms will make a significant difference in the performance and the perception of government in California.

With each wave in the business cycle fewer jobs are tied to physical geography, yet millions of individuals will choose to be Californians in the coming decade. And science and technology have not rendered poverty, crime, illness and addiction obsolete.

Clearly government will have to find ways to surely and swiftly progress toward public goals, such as an educated citizenry, safe communities and adequate health care. And in making these improvements, public leaders have an opportunity to restore the public's faith and confidence.

In previous reports, the Commission has offered recommendations for improving the performance of specific state programs. In this project the Commission began from the premise that quality programs and services must be supported by a solid foundation, including a reliable revenue stream and strong partnerships among the hundreds of government agencies within the state.

This report makes the case for thoughtfully and systematically addressing the political and policy issues that threaten the state's economic, social and civic well-being. It describes in detail the lessons that can be learned from past attempts at reform, and how California leaders could use a critical path to develop technically sound and politically supported improvements. And it details how that path could be applied to solve two of the biggest problems, the state's revenue system and the state-local relationship.

The Commission respectfully submits these recommendations and is prepared to help you take on these challenges.

Sincerely,

Michael E. Alpert
Chairman

Governing the Golden State

A Critical Path to Improve Performance and Restore Trust

July 2004

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Executive Summary

For more than a decade, there has been growing concern that California is "ungovernable." Academics, pundits, and increasingly, elected leaders have voiced concern that the state is so large and diverse, that the political landscape is so treacherous, that meaningful solutions to fundamental problems are beyond reach.

The conclusion infers that California is on a steady, unstoppable slide toward economic, social and civic decline, and that individual Californians will survive or prosper despite the efforts of government, not with the assistance of government.

That assertion is untenable.

The public and opinion makers have acknowledged that individual leadership is essential to resolving public problems, while at the same time recognizing that the challenges are so momentous that California's leaders must match its mountains.

The fiscal crisis, now in its fourth year, has elevated both concerns – intransigent problems and the leadership imperative – to a fateful point in time. And while a recovering economy will in part ease the budget woes, it will not by itself improve the performance of public policies and programs that are essential to the quality of life or the ability to economically compete and prosper.

California's traffic congestion and air quality are among the worst in the nation – which is not news, but must be resolved.

California fourth-graders are ranked 46th in the percentage of students with basic math and 47th in basic reading skills. Eighth-graders rank 46th in basic math and 49th in basic reading skill levels. California ranks 42nd in its high school completion rate. Clearly, large numbers of immigrants increase the challenge for educators, but California simply cannot thrive in a global economy with bad educational outcomes.

While crime has declined across the nation, California still has more than its share of violence. The State ranks 24th in the nation for overall crime and 41st for violent crime.[1] California has among the highest rates of illegal drug use in the nation. And the State's parole system has one of the lowest success rates in the nation, with two out of three parolees returning to prison. In 1980, it was only one out of four.[2]

These problems can and should be solved, and to do so will require examining how public policies are designed, how resources are allocated and how programs are administered. Some veterans of the policy-making and budget process blame system failures, the consequence of term limits, redistricting, campaign finance rules and other factors that influence how the Legislature functions. Other veterans blame structural defects, such as the dysfunctional state-local relationship, for breeding distrust and undermining the performance of programs that directly affect the lives of Californians.

Over the years there have been multiple efforts to address the structural issues, often with blue-ribbon commissions. But for discernable reasons – if not frustrating ones – those recommendations have largely not been implemented.

In this project, the Commission examined those efforts to assess how California leaders could more successfully resolve these issues. With the benefit of hindsight, much of it offered by those who were involved in these efforts, one can discern how to approach complex and contentious issues that should be solved through public and democratic means. In this report, the Commission uses those hard-learned lessons to define a critical path, a process that if followed would enable the leadership of California government to achieve a permanently balanced budget while delivering the highest quality public services at an affordable cost.

Why Previous Efforts Fell Short

The challenges of the legislative process and the apparent futility of blue ribbon task forces are a frequent topic in and around the Capitol. A close look at how reform efforts have been approached reveals some fairly obvious weaknesses. Among them:

- A lack of state-level leadership to drive reform efforts.
- A lack of meaningful public involvement that informs residents about public problems and consults with them about the universe of acceptable solutions.
- Inadequate agreement on the problem to be solved and the range of acceptable solutions.
- A lack of analytical resources to define the problem in detail, to assess alternatives and to support detailed negotiations.
- An unwillingness on the part of stakeholders and other participants to engage in a public process that vets alternatives, forges compromises, and holds people accountable to support those compromises as they solidify into policy.

For a reform effort to succeed, specific solutions must be fashioned that are technically sound and have broad public support. It is not a failure of the legislative process if lawmakers do not embrace conceptual and controversial solutions. At the same time, if policy-makers want to receive a fully mature solution, they must ensure that the necessary elements are in place when they initiate reform efforts.

The Necessary Elements

Developing sound solutions that can be widely supported requires a combination of analytical capacity and political skill. Reformers must have the political sponsorship to get the right stakeholders to the table and clear direction to solve specific problems. The process itself must be framed with integrity – via meaningful involvement of the public and civic leaders, good faith negotiation to resolve differences, and the courage to stand by agreements.

The Commission identified eight essential steps that a reform process should follow to do this:

1. ***Recognize and define the problem and set the reform goal.*** The Governor, Legislature and other elected leaders must formally agree on the problem that needs to be solved and the goals for reform.

2. ***Create a structure for success.*** The reform process could be managed by the executive branch, or a collaboration of executive and legislative resources or regional and local leaders. A State Executive Council could be established to define statewide issues, help to define specific goals for reform and acceptable solutions, and facilitate agreements at the local and regional level.

3. ***Establish the parameters of an acceptable solution.*** The Governor and the Legislative leaders should validate or amend the problem and validate the scope and schedule for work by formally establishing the parameters of an acceptable solution.

Essential Values

At every step of the critical path, everyone involved in the reform process must be guided by essential values.

Leadership. Commit to a reform, prioritize the goal with the public and enact the reform.

Trust. Build trust among participants and the public by honestly working toward common goals and keeping promises.

Transparency. Clearly and openly evaluate all issues, identify goals, acknowledge agreements and establish ground rules.

Public Involvement. Educate and engage the public in identifying problems and solutions.

Inclusiveness. Identify and include all stakeholders throughout the process.

Commitment. Commit to reform and prioritize the goal. Participants in the process must obtain agreement and a commitment from constituents.

Timeliness. Accomplish reforms while there is consensus on the need for reform. Establish a timeline for the reform process and the implementation.

4. ***Identify and agree on solutions.*** Through a series of public meetings, informed by the best available analysis, key stakeholders should explore alternatives and develop the best solutions with broad public support.

5. ***Validate and vet solutions.*** The Executive Council needs to make sure that the proposed solutions are technically sound and politically viable. The product at the end of this stage should be a technically sound solution that has a critical mass of solid support.

6. ***Enact the proposal.*** The Legislature needs to assess the proposal based on the established parameters and the support stated by interest groups throughout the process, and, if consistent with the parameters, enact it.

7. ***Implement and monitor reform.*** The Governor and the Legislature should support the implementing agencies by providing clear direction, adequate resources, and an effective means for communicating progress and making refinements to the plan.

8. ***Refine the reform as necessary.*** The Governor and the Legislature should periodically assess the need for refinements or the next generation of large-scale reform, and be willing to repeat all or part of the critical path to ensure progress toward desired goals.

This critical path is detailed on pages 27 to 29, and is graphically presented on pages 30 and 31.

Applying the Critical Path

The principles embedded in these steps can be applied to resolve many of the problems plaguing state government. Each problem presents unique factors, and the process needs to be tailored to account for them. The Commission explored two of those problems: the State's revenue system, and the allocation of those resources among state and local agencies. A well-performing revenue system is essential to fairly and efficiently taxing Californians and reliably providing state and local government with the resources to fund essential services. Those resources also must be distributed in a fair and efficient manner among the levels of governments responsible for providing those services. The level of taxation – whether taxes should be increased or lowered – is a distinct issue for policy-makers to consider, separate from the structure of the tax system and was not considered by the Commission. In this report, the Commission describes how the critical path could be adapted to take on those two problems, which have been the subjects of so many previous reform efforts.

Particularly when it comes to the state-local relationship, one reform effort will not be enough. Beyond the basic allocation of revenues, the State has many different program relationships with many different local agencies; health and human service programs, education, and public safety programs are three large examples. Each of these relationships is unique, each is defined by complex legal and other issues, and each needs to be improved if California government is to keep pace with the economic and technical changes that are redefining markets, communities and lifestyles.

The ultimate lesson embedded in this critical path is that fundamental reform is possible, provided that we commit ourselves and our resources to a process that values trust and transparency. The critical path could demonstrate that California is governable, as well as restore the faith and confidence of Californians in their government.

The Case for Reform

The Golden State long has been a beacon for opportunity and innovation. People flock to California for its majestic beauty, its culture, its climate, and its educational and economic opportunities. Over the past decade, California's golden reputation has been tarnished – by the energy crisis, the boom and bust in the technology industry and the State's overwhelming budget deficit. Last year, voters took the historic measure of recalling a Governor who had recently been re-elected. New leadership brings new opportunities to forge the trust necessary to address some of California's most divisive challenges. However, new leadership alone will not solve all of California's maladies. Many of the State's troubles go back several decades and cannot and will not be solved without consensus among state and local lawmakers and the citizens they represent.

The Little Hoover Commission began this study because the State faces severe challenges on multiple fronts. The potentially catastrophic budget deficit has been the largest threat. But in its work on foster care, public health and parole, the Commission has documented that despite enormous expenditures Californians were not consistently receiving quality services. Meanwhile, lawmakers mired in political gridlock were making little progress toward alleviating these serious problems. Newspapers were likening California to a Banana Republic.[3]

The Commission Study Process

In conducting this study, the Commission delved into the decade of work from various committees and commissions. Many appropriate and well-designed reforms had been proposed, but no major efforts were implemented. A summary of some of these major efforts and applicable reforms is located in Appendix D. The Commission's focus was not to define superior reforms, but to craft a process that could be used to more successfully develop and implement reforms.

To explore these issues, the Commission conducted three public hearings. It received testimony from state, regional and local leaders and members of the business and labor communities. The Commission also heard from veterans of previous reform commissions, public opinion experts, financial market advisors, and the Legislative Analyst and the director of the Department of Finance. Assemblymembers Joseph Canciamilla and Keith Richman testified on their efforts to implement reforms through a bipartisan legislative committee. A national expert who has assisted other states through reform processes provided guidance and models that California could employ to address its unique problems. The witnesses are listed in Appendix A.

The Commission convened an advisory committee comprised of a diverse group of stakeholders, participants from prior reform commissions, economists and business leaders. The advisory committee met three times. Participants in the advisory committee are listed in Appendix B.

The Commission convened three focus group meetings to further examine some of the most complicated and overarching issues. The first two meetings focused on the State's revenue system and state and local government relationships. The third meeting was convened to identify the barriers that have impeded prior reform efforts and determine strategies to overcome these barriers. Participants in the focus group meetings are listed in Appendix C.

Policy-makers did not lack information or alternative solutions. Numerous proposals by highly respected commissions, think tanks and committees are quietly lining their bookshelves. The Commission sought to understand why these proposals had failed to become policy and what type of process would be necessary to successfully implement reform.

Where Does California Stand?

Many California communities and regions publish performance indicators to guide policy and provide accountability. Joint Venture Silicon Valley has been a leader in a collaborative effort to gather information and plan for the future based on regional indicators. The California Center for Regional Leadership is working with 14 regional collaborative efforts to establish guidelines and potentially develop statewide benchmarks. These efforts are critical to the long-term effort to restore the luster to the Golden State. In previous reports, the Commission has advocated the establishment of statewide indicators to drive policy decisions.

Given the difficulty of reform, the need for reform must be compelling and the goals must be clear. The Commission reviewed numerous benchmarks and gathered a variety of data points to try to illustrate California's standing today, with the hope of inspiring citizens and policy-makers to set priorities and goals and be able to evaluate whether or not government policies are achieving these goals.

Regional Quality of Life Indicators

California's regional collaboratives have been tracking and publishing quality of life indicators for a decade. The California Center for Regional Leadership (CCRL) recently documented the indicator projects of 14 self-designated regions and analyzed the data sets. The regional collaboratives use more than 200 indicators to track and prioritize strengths and challenges in their communities and provide accountability.

Evaluating these regional indicator projects is the first stage of CCRL's effort to identify best practices, build capacity of current and new projects, identify issues with statewide implications and consider the potential for a region-based statewide indicator effort.

Source: California Center for Regional Leadership, www.calregions.org.

California's sheer size and diversity complicate benchmarking efforts. The lack of consistent, accurate and timely data and disagreement on which core indicators to track also pose challenges.[4] Despite these obstacles, it is important not only to compare California to other states, but also to track how California is performing over time.

The Commission reviewed various performance measures and statistical analyses. In certain areas, California is performing well and the available data proved some perceptions about the State to be false. For example, eight of California's nine economic regions out-performed the national average for job creation and seven of the top 20 job-creating metropolitan areas are in California.[5]

In other areas, the State is on par with the rest of the nation, such as in job losses. California ranks fairly close to the national average for jobs lost during the recent recession.[6]

In many critical areas, however, the state's policies and programs are performing poorly. California still has one of the highest rates of unemployment, its cities have the worst air quality and it has the third lowest home ownership rate in the nation.[7] These and numerous other key areas of failure persuaded the Commission that reform is necessary. The evidence that convinced the Commission that the State is in need of serious reform is presented on the next several pages.

California's Economy

The linchpin of a healthy state government is a robust economy that continually generates high-paying jobs in growing business sectors. Prosperity provides a stable revenue source to fund programs that citizens deem necessary, such as education, infrastructure and social services, which in turn fosters innovation, entrepreneurial ventures, and growth. The ingredients of a robust economy include a competitive business climate, an efficient transportation system to move goods and people, an adequate housing supply, a healthy environment and an educated workforce. The Commission found that California must improve on multiple fronts.

California businesses struggle with high costs. California receives mixed reviews on its business climate, depending on the source. But extraordinary burdens – such as skyrocketing health care fees, energy costs and reliability, various state-imposed regulations and still worrisome workers' compensation costs – make running a business in California more costly than running a similar business in neighboring states.[8] A report by the California Business Roundtable, based on a survey of California businesses, estimated the cost of doing business in California is 30 percent higher than the average of other Western states, with 6 percentage points attributed directly to state regulations.[9] The Roundtable concluded that changes to various state regulations could improve California's business climate without affecting wages. Business representatives participating in the Commission's advisory committee process echoed this sentiment.[10]

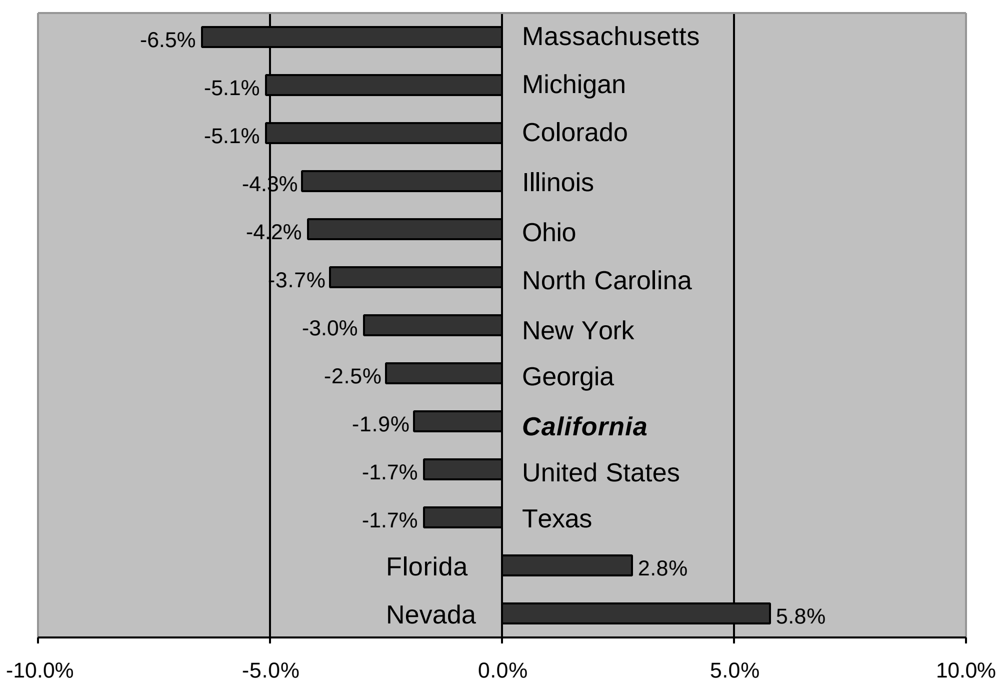
Additionally, businesses that participated in the Roundtable survey indicated they planned to limit further expansion and move some jobs to other states and other countries.[11] However, the state is not alone in the job export trend; California and the United States as a whole experienced similar job losses. Data for the period between February 2001 and February 2004 show that California lost 1.9 percent of the February 2001 non-farm wage and salary base compared to a loss of

1.7 percent nationwide. The bulk of the job losses were in technology and manufacturing in the Bay Area. Many other states with high-tech and manufacturing sectors suffered more job losses as depicted in the chart below.[12]

Yet California's economy continues to grow. Despite the struggles reported by businesses, between March 2001 and March 2004, eight of California's nine economic regions out-performed the national average in job growth. Job levels in six regions were higher than before the 2001 recession began.[13] Additionally, data published by California's Employment Development Department and the Small Business Administration reflect a steady increase in new business incorporations since the 1990s, with an all-time high in 2003.[14] In the Milken Institute's annual publication on the best performing cities for job creation, seven out of the top 20 metropolitan areas were in California. While that was a decline from the prior year in which California garnered nine of the top 20 spots, the performance was still noteworthy.[15]

Job Loss and Growth

Percent Change in Non-farm Wage and Salary Jobs (2001-2004)



Source: Stephen Levy, Institute of Regional and Urban Studies, An Update on the California Economy, April 14, 2004.
http://www.ccsce.com/pdf/bseries8-economic_update.pdf

California has one of the highest unemployment rates in the nation. Like the rest of the nation, California's economic recovery has not created robust job growth. In 2003, California ranked 43rd in unemployment.[16]

However, regional unemployment rates in California vary widely, with the San Joaquin Valley having the highest unemployment rate at 12.3 percent.[17] Additionally, many Californians are under-employed with one in seven involuntarily working part-time.[18] Approximately 20 percent of working parents are poor despite holding a job.[19]

California's National Tax Burden Ranking
(1 is highest, 50 is lowest)

Year	Ranking
1970	8
1980	24
1985	25
1990	25
1995	24
1998	16
1999	11
2000	11
2001	10
2002	25
2003	24
2004	26

Sources: Tax Foundation. "Comparing the 50 States Combined State/Local Tax Burdens in 2004," April 2004. www.taxfoundation.org.

California's tax burden is near the national average. There is a perception that California is a high-tax state. California's top personal income tax rate is one of the highest in the nation and as a result, in the late 1990s when California's high-income individuals earned huge capital gains, the state and local tax burden in California was higher than in most other states. But after the tech bubble burst, the state returned to the middle of the pack. The overall tax burden combines all personal taxes, including income tax, sales tax and property tax. As depicted in the table, California has ranked fairly close to the national average for tax burden in most years since the passage of Proposition 13. Despite the fact that California has a relatively high personal income tax rate, the overall tax burden is near average when other taxes, such as the property tax, are factored into the equation. In 2004 California's state and local tax burden, at 9.8 percent of personal income, is just below the 10 percent national average.[20] Detailed analysis, however, suggests more attention needs to be paid to how these taxes are structured, particularly in relation to small businesses and struggling families.

Californians are stuck in traffic. Los Angeles ranks first, followed by the San Francisco/Oakland area for the amount of time that drivers spend in congested traffic.[21] In a 2002 poll on land use, 81 percent of Californians surveyed ranked traffic congestion as somewhat of a problem or a big problem.[22] Despite this concern, the State has diverted billions of dollars originally earmarked for transportation projects to help balance the budget. The decline in funding severely restricts the State's ability to fund new projects and delays existing projects that could benefit the economy. Traffic congestion costs California drivers an estimated $4.7 billion per year in wasted time and fuel.[23] Traffic congestion, in turn, contributes to another issue of concern, poor air quality.

California cities have the worst air quality in the nation. The greater Los Angeles metropolitan area is the most ozone-polluted urban area in the nation. Six other California cities rank among the top 10 most ozone-polluted cities. The American Lung Association gives 26 of California's 58 counties a grade of F for the number of high ozone days. Despite this dour prognosis, California has led the nation in reducing ozone levels, particularly in industrial pollution. The primary contributor to air pollution today in California is highway vehicles. Rapid growth and heavy reliance on cars will continue to pose challenges to the state's progress in improving its air quality.[24]

Thousands of Californians have nowhere to live. Californians increasingly find themselves priced out of the housing market. As a result, people move farther and farther away from core job areas, exacerbating traffic congestion and poor air quality. Approximately 43 percent of Californians are renters and 58 percent of these find rent unaffordable. Californians must earn $21.18 per hour to afford the fair market rent for a two-bedroom unit, a 47 percent increase from 1998 when $14.37 per hour was required. In 2003, California ranked second to last in the nation for rent affordability.[25] Approximately 360,000 people are homeless in California on any given day.[26]

Student performance is inadequate. California fourth-graders are ranked 46th in the percentage of students with basic math and 47th in basic reading skills. Eighth-graders rank 46th in basic math and 49th in basic reading skill levels. California ranks 42nd in its high school completion rate.[27] These figures mask some of the success stories in California, where many schools have multilingual, multicultural student populations. Many students experience poverty as well, with nearly half of all California students qualifying for free or reduced price lunches.[28] While California spends 38 percent of its General Fund budget on education, it still ranks 24th for spending on K-12 education.[29] And while California schools may have more challenges than in other states, California's prosperity depends on the outcome of the educational system, regardless of these challenges.

Costs for higher education in California colleges are climbing. One of the ways the State has attempted to balance its budget has been by raising fees at California's community colleges and public universities. Additionally, the Governor has proposed reducing enrollment in the UC and CSU systems and expanding enrollment in community colleges. However, in the 2003-04 school year, California's college fees were low by comparison to public universities in other states. Undergraduate fees in the UC system were 20 percent less and CSU fees were more than 50 percent less than comparable public universities in other states. Community college fees in California were the lowest in the nation.[30]

Enrollment has been soaring at California's higher learning institutions, a partial cause of the cost increases. In comparison to other states, California ranks above the national average in college participation of 18- to 24-year-olds and has the highest participation in the nation for students 25 and older.[31]

California lacks an overall economic strategy. The Commission's evaluation of the various policies, as well as the state's response to the fiscal crisis, reveals that California lacks a coherent strategy for economic development and workforce development. An overall economic strategy would include:

- Policies that encourage an increased supply of housing, including affordable housing.
- Investments in transportation and infrastructure.
- Streamlined regulations to reduce the cost of doing business without diminishing worker safety, environmental quality or other goals.
- Access to a quality education for all Californians and training for jobs that match current and future workforce needs of employers.

Government Performance Issues

California's customers are often dissatisfied with the cost and quality of government services. Too frequently, the State lacks the information technology to allow lawmakers to make informed choices on policy and programs. Californians do not trust government to do what is right and the majority believe that the State wastes a lot of their tax dollars. Wall Street's faith in California also has faltered in recent years.

California customers are not getting what they pay for. The Commission's work over the past few years has uncovered numerous shortcomings in various program areas. California spends over $2 billion on children who have been removed from their homes and placed in the foster care system. Yet one-fourth of the children in foster care do not receive timely medical care and half do not receive appropriate mental health services.[32] California ranks 49th in the nation for the percentage of children in foster care.[33] California has nearly the highest rate of illicit drug use in the nation.[34] Responding to the social and criminal justice problems resulting from drug and alcohol abuse costs California $11 billion per year.[35] California spends billions on prevention, treatment and enforcement, yet these efforts are not strategically coordinated.[36] California spends $1.5 billion annually on parole, yet ranks second to last for parolee success rates.[37]

California lacks data to make informed decisions. In numerous studies of many departments, agencies and programs, the Commission has found repeatedly that the State has neglected to invest in the information technology that would allow it to evaluate programs, track outcomes and make modifications to improve effectiveness and efficiency. In the Center for Digital Government's Annual Digital Survey of computer proficiency in state government, California ranked 34th in 2002, having dropped from a rank of 23rd in 2001.[38]

Californians do not trust their government. In a survey of Californians, the Public Policy Institute of California found in January 2004 that just 27 percent of those surveyed believed that California government can be trusted to do what is right almost always or most of the time. In the same survey, 56 percent of those surveyed thought that the State wastes a lot of taxpayer dollars.[39]

California's bond rating has dipped. As a result of the ongoing structural deficit and the State's overall weak economy, financial market investors in 2003 reduced California's general obligation credit rating to BBB. In May 2004, Moody's Investors Services upgraded California's general obligation bond credit rating for the first time in four years, citing improved economic conditions. Despite the upgrade, California has the lowest credit rating of any state. And as of mid-June 2004, the other two major credit rating organizations, Fitch Ratings and Standard & Poors, had not upgraded California's credit rating and indicated that future upgrades would depend upon continued improvement in the economy and lawmakers closing the State's budget gap.[40] The chart depicts California's credit history based on Fitch Ratings. In testimony before the Commission, a financial market expert asserted that while California would likely never go bankrupt, the low bond rating would result in California paying higher interest rates at the very time it is setting a record for borrowing.[41]

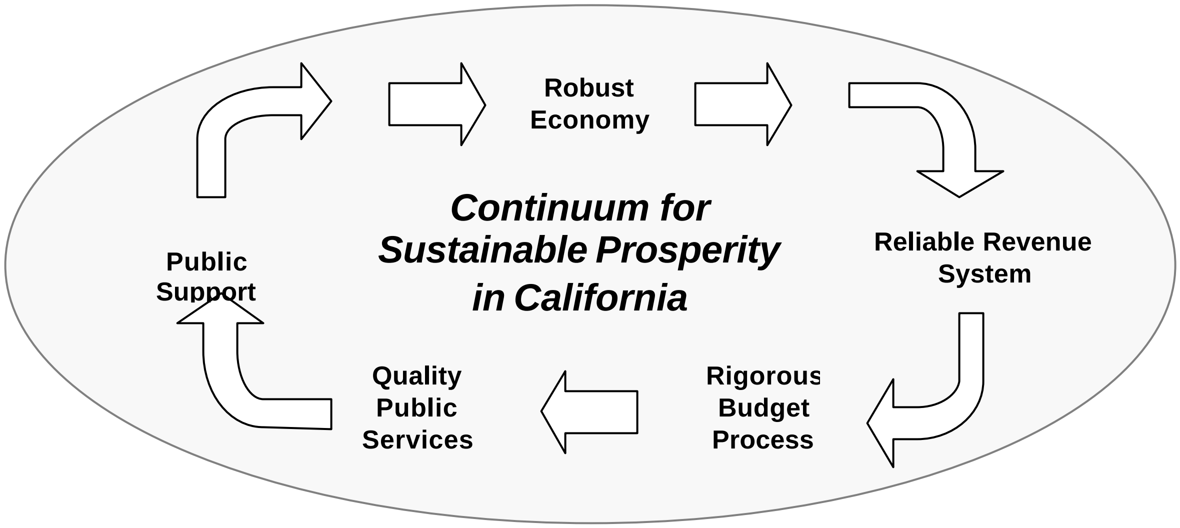
General Obligation Bond Rating Over Time

Date	Rating
12/03	BBB
12/02	A
2/00	AA
10/97	AA-
2/96	A+
7/94	A
9/92	AA
2/92	AA+
7/86	AAA
10/82	AA

Source: California State Treasurer.
http://www.treasurer.ca.gov/ratings/history.htm
Accessed June 8, 2004.

A Continuum of Challenges

While pockets of improvement are bringing hope that California can once again attain its golden status, many structural challenges must be conquered first. Several key elements form a continuum for sustainable prosperity: a healthy economy that adapts and succeeds in a global marketplace; a fair and efficient tax system that provides reliable and adequate revenue to state and local government; a sound budget and policy-making process that encourages wise choices in designing and funding programs and in making capital investments; and good management of public programs built on accountability for outcomes and continuous improvement.



These interdependent challenges must be addressed to achieve sustainable prosperity, starting with a robust economy. The chart on the next page highlights organizations and reform efforts that have identified the need for reform in each of these issue areas. The listing reveals the general agreement that structural changes are needed for California to prosper and reach its public goals.

A robust economy. A healthy business climate contributes to a robust economy that generates jobs, promotes self-sufficiency and improves the lives of Californians. A prosperous economy, in turn, provides revenues to fund state services. As the State climbs out of the most recent recession, state and local lawmakers and business leaders must work together to identify and prepare for the economy of the future and formulate policies that will continue to promote high-end job growth.

A fair, efficient & reliable revenue system. Tax policies in California have remained fairly stagnant for more than 30 years. The system relies heavily on personal income taxes on high-wage earners and sales taxes, both of which decline at times when the state's needs are the greatest. Current sales taxes focus on goods, while most economic growth is in services. Additionally, the methodology for allocating revenue from the State to local governments was devised in the late 1970s and has not been adjusted to address current local needs. The State on more than one occasion has raided local government coffers to backfill state budget shortfalls. The repeal of the vehicle license fee increases in November 2003 created a hole in the budgets of local governments, which relied on these fees to provide services.

Agreement on Reforms Needed

Subject of Reform	Organization Advocating the Need for Reform
A Robust Economy	
Business Climate	Joint Venture: Silicon Valley Network Performance Institute
Infrastructure Investment	California Commission on Tax Policy in the New Economy California Tax Reform Association Joint Venture: Silicon Valley Network League of California Cities
A Fair, Efficient & Reliable Revenue System	
Revenue Reform	California Budget Project California Commission on Tax Policy in the New Economy California Constitution Revision Commission California State Association of Counties California Tax Reform Association Joint Venture: Silicon Valley Network League of California Cities Public Policy Institute of California Speaker's Commission on State-Local Government Finance
A Rigorous Budget & Allocation Process	
Budget Process Reform	California Commission on Tax Policy in the New Economy California Constitution Revision Commission Joint Venture: Silicon Valley Network Performance Institute Speaker's Commission on State-Local Government Finance
Spending Growth Limits	Howard Jarvis Taxpayers Association Joint Venture: Silicon Valley Network Public Policy Institute of California
Budget Reserves	California Constitution Revision Commission California State Association of Counties Joint Venture: Silicon Valley Network League of California Cities
Quality Public Service	
State-Local Relationship	California Constitution Revision Commission California State Association of Counties League of California Cities Speaker's Commission on State-Local Government Finance
Government Effectiveness	California Budget Project California Constitution Revision Commission California Performance Review Howard Jarvis Taxpayers Association Joint Venture: Silicon Valley Network Performance Institute Public Policy Institute of California Speaker's Commission on State-Local Government Finance
Cost of Government	California Budget Project California Performance Review Howard Jarvis Taxpayers Association Joint Venture: Silicon Valley Network Performance Institute Public Policy Institute of California

Sources for this chart and links to Web sites for the organizations listed are provided in the Appendix Notes on page 93.

A rigorous budget process and allocation process. California's budget process is based on marginal changes to the status quo – looking at what was spent last year and then adding to or subtracting from that number. Customers of the State – both taxpayers and program participants – are not asked which services they want funded, nor are they told whether the current programs are achieving the desired goals. Budget procedures have made it difficult to create and manage a workable state budget. Among the elements that analysts have said thwart timely and prudent budget decisions are the two-thirds requirement to pass a budget and constitutional amendments that limit flexibility such as Propositions 98 and 13, and the one-year budget cycle.

Quality public services. Over the past 30 years, there has been a gradual concentration of revenue in Sacramento and devolution of responsibility for public services to local governments. The roles and responsibilities of state and local agencies are often muddled or conflicted. Both state and local governments lack accountability for policies and services provided. The connection between taxes paid and services rendered has become increasingly convoluted. The State lacks data to determine whether or not programs and policies are achieving public goals. The complexity of the state government organization adds to the lack of accountability and often results in duplicative efforts and wasted resources.

Informed public support of government. A majority of Californians distrust their state government. Only 36 percent of Californians surveyed by the Public Policy Institute in January 2004 approved of the job the California Legislature was doing at that time. However, 59 percent of those surveyed approved of the way that Governor Schwarzenegger was handling his job as governor.[42]

The lack of trust or confidence can at least partly be attributed to the poor performance of both policy-makers and public programs. Some of this dissatisfaction is based on perception alone, because most state-sponsored programs do not have explicit goals or adequate means for measuring performance.

In part, this explains conflicting goals expressed by Californians in public opinion polls – voters generally do not support tax increases, nor do they support cuts to services. But a majority of Californians were willing to pay more taxes for specific programs, such as education. The table on the following page depicts results from a January survey of Californians on taxes, government spending and services and reflects some of the conflicting goals.

Conflicted Californians: Survey Results On Taxes and Spending

How would you prefer to deal with the state's structural deficit?				
		Party Registration		
	All Adults	Dem	Rep	Ind
Mixture of spending cuts and tax increases	50%	63%	40%	65%
Mostly through spending cuts	28%	16%	47%	20%
Mostly through tax increases	7%	8%	4%	6%
Okay for the state to borrow money and run a budget deficit	8%	6%	6%	3%
Don't know/Other answer	7%	7%	3%	6%

Do you think state government could spend less and still provide the same level of services?				
	All Adults	Dem	Rep	Ind
Yes, could spend less	67%	59%	78%	75%
No, could not spend less	27%	33%	18%	23%
Don't know	6%	8%	4%	2%

Would you be willing to pay higher taxes to maintain current funding for:					
		All Adults	Dem	Rep	Ind
K-12 Public Education	Yes	67%	77%	50%	70%
	No	30%	20%	47%	27%
	Don't Know	3%	3%	3%	3%
Local Government Services	Yes	56%	62%	46%	59%
	No	40%	35%	50%	36%
	Don't Know	4%	3%	4%	5%
Health & Human Services	Yes	54%	66%	31%	51%
	No	41%	27%	65%	42%
	Don't Know	5%	7%	4%	7%

Source: Mark Baldassare, Director of Research, Public Policy Institute of California, "Californians' Support for Structural Reforms and Public Priorities," Written testimony to the Little Hoover Commission, January 22, 2004. www.ppic.org

The challenges are interdependent. Particularly in the long-term, state policies influence the nature of the economy. The revenue system links the marketplace and the government. And the management of government programs determines the effectiveness of education and economic development, health and welfare, and public safety programs – and ultimately the willingness of the public to support them.

What Needs to Change

California must conquer multiple challenges in the structure of the revenue system and in the delivery of services to regain sustainable prosperity. It must prioritize the most critical issues and make changes so the state and Californians thrive. Areas for consideration include:

Use Information and Evidence to Analyze Problems and Devise Solutions. The State needs to improve its data collection to determine whether its programs are achieving desired outcomes. The State needs to know what does and does not work to accurately target resources. Lawmakers and government workers need to establish priorities and goals, monitor and evaluate the State's performance and implement reforms when necessary. The public needs to be fully educated in all aspects of government performance to choose what programs are desired and how much taxpayers are willing to invest in these programs. The State must be required to consider available information to drive decision-making.

Develop Strong Partnerships. Lawmakers must be willing to put partisan differences aside to achieve the public good. Term limits have produced legislators who are less experienced and more susceptible to the influences of special interests. The redistricting process has led to less competition in general elections and more extreme political viewpoints among the elected. Lawmakers must prove to the public that they can forge effective policy despite these challenges. And trust must be rebuilt, between government and its customers and among government entities.

Streamline Government. The large number of elected state officials and departments in general dilute executive authority, mask accountability and frustrate the ability of state agencies to coordinate complex policies and operate effective programs. There must be competent, trained people serving in an organizational structure that allows them to perform evaluations, make changes and improve services.

The Critical Path

California faces big challenges. Its customers are unhappy. It has lost the trust of its clients, taxpayers and the financial market. Many reforms have been researched and vetted, but never implemented. As described in the following pages, both the ordinary policy-making process as well as numerous committees and task forces have not produced the needed improvements. To help transform California from a national laggard to a national leader, the Commission has developed and defined a critical path that can be adapted to many problems and policy areas that are in need of reform.

Why the Standard Process Has Failed

California's public problems are often blamed on the failure of its political institutions and elected leaders. The events of recent years – from the electrical blackouts to fiscal meltdowns – have been attributed to actions, and more often inaction, through ordinary policy-making processes. Among the factors cited:

Inadequate leadership. Increasingly in recent years, stakeholders and others involved in the process have blamed the State's problems on the unwillingness or the inability of elected officials to drive change.

The leadership of the California State Association of Counties listed "lack of committed leadership" as one of six consistent reasons why numerous attempts at meaningful change have failed. CSAC leadership observed that: "Reform efforts are long-term, intense and difficult processes. A leader who is fully committed to reform and willing to devote the necessary time and energy to the reform process is essential to success."[43]

More specific factors help to explain why so much "leadership' is both essential and difficult to muster. Many of the issues are extraordinarily complex and developing reasonable and agreeable solutions requires extraordinary analysis, creativity and political skills. Some stakeholders asserted that term limits prevent elected officials from developing expertise, interest or ability to engage in sophisticated multi-year reform efforts.

But long before term limits, California had a history of letting small problems fester into large ones, and often it is only then that voters intervene. For years, policy-makers failed to deal with the excesses of the property tax system before voters approved Proposition 13. Similarly, Proposition 98 grew out of frustration in many communities that in post-Proposition 13 California, schools were not given priority for funding in Sacramento and local school boards did not know until late each summer what the

Other States' Leaders Take on the Tough Issues

Other states' leaders have successfully tackled complex and divisive issues. Among those leaders, two stand out.

Washington. Responding to a $2.7 billion shortfall in the 2002-2004 biennial budget and an electorate reluctant to raise taxes, Governor Gary Locke of Washington refocused the debate. Instead of deciding what programs to cut, he began with what services Washingtonians wanted from government and how the State could best provide them. The result was a new approach to budgeting that began with the revenues available and focused on achieving results in priority areas. An initially skeptical legislature has since enacted this budget process into statute.

Wisconsin. Governor Tommy Thompson served four terms spanning 14 years before accepting President Bush's appointment as Secretary of the U.S. Department of Health and Human Services. Among his many accomplishments was his "Wisconsin Works" welfare reform initiative that became the model for federal welfare reform. He cut Wisconsin's monthly welfare caseload by more than 90 percent and improved the economic status of participants. Prior to Wisconsin Works, the average welfare family had been 30 percent below the federal poverty line. The average of families leaving the governor's program was 30 percent above the poverty line.

Sources: David Osborne and Peter Hutchinson, "The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis," 2004. U.S. Department of Health and Human Services. Biography of Tommy G. Thompson, Secretary of Health and Human Services.

budget would be for the new school year beginning in September.

Ballot box legislation and budgeting. Regardless of their inspiration, many initiatives have reduced legislative discretion. Nearly half of the General Fund each year, for example, is reserved for education by Proposition 98 (1988). Proposition 172 (1992) imposed a half cent sales tax and dedicated the resulting revenue to local public safety programs. Proposition 99 (1988) imposed a surtax on cigarettes to pay for health programs. Proposition 10 (1998) imposed a surtax on cigarettes to pay for early child development programs. Such measures limit the discretion of the Legislature in solving fiscal problems.

When the Legislature fails to respond to local concerns, local officials as well as special interests, look to voters for relief and assistance. To some, direct democracy is an important California tradition that provides an alternative when state leaders fail to solve problems.[44] To others, the process results in major policies that inflict unintended consequences that are difficult to fix.

Lack of bipartisan cooperation. A politically divided public elects a politically divided Legislature. But these philosophical disagreements among voters are compounded by "safe" redistricting, which has made it difficult for moderate candidates of either party to get elected in the primary. Once elected, legislators are discouraged from attempting or are unable to forge bipartisan compromises. Term limits prevent legislators from developing long-term relationships with members in the opposite party, discouraging cooperation, limiting understanding and reinforcing ideology as the primary factor of legislative relationships.[45]

The fate of the 2003 Assembly Bipartisan Budget Proposal is a good example of how ideology can undermine efforts to reach compromises. The proposal would have balanced the budget with a mix of budget cuts and tax increases. But to one side of the aisle the cuts to poverty-related programs were too deep and to the other side no tax increase was acceptable.[46] The seriousness of the State's fiscal condition called for compromise, but the stalemate of ideologies precluded it. And the institution did not resolve the deadlock.

Premature legislative proposals. The Legislature often receives proposed legislation that is not well developed or thoroughly analyzed and is not supported by a broad political consensus. Proposals that affect large portions of the State need to be tested with sophisticated computer modeling to identify unintended outcomes and verify the effects on interest groups that are involved. And the strongest answers are those that have popular support and bring meaningful change.

While it is possible to develop sound proposals through the legislative process, the deadlines, crowded agendas, and highly political and partisan atmosphere make it an inhospitable place to negotiate such solutions.

One recent effort to reduce the fiscal incentive for local governments to favor new retail over housing and industrial uses, a problem called the fiscalization of land use, suffered from these defects.[47] Without the ability to do the necessary analysis, the ability of the proposal to meet its policy goals was in question, and the unknown consequences translated into opposition by the leery. On the opposite side of that coin, analysis could have facilitated negotiations and refinements that would have strengthened the technical solution and the political support.[48]

Legislative overload. Facing so many issues, the Legislature finds it difficult to devote the time and effort required to resolve issues that are even more complex in California because of its size and economic and social diversity. The 58 counties range from Alpine County with 1,210 residents to Los Angeles County with 9,889,300.[49] More than 250 distinct languages are spoken in California and some 40 percent of Californians speak a language other than English at home.[50] The $100 billion state budget finances thousands of departments and programs.[51] The Legislature itself considers some 5,000 bills each session dealing with the range of public issues: How to provide health care to millions of working but uninsured Californians. How to provide reliable, clean and low-cost electricity. How to use modern science, technologies and knowledge to counter age-old scourges of violence, poverty and disease. The competition for attention, expertise and political capital is intense.

Declining legislative expertise. While the challenges seem to increase, the conventional wisdom is that the institutional capacity to solve problems is decreasing. Term limits have reduced the knowledge and experience required to navigate the difficult issues the Legislature confronts.[52]

Proposition 140 (1990) not only limited the tenure of lawmakers, but limited the Legislature's budget and resulted in a smaller and less experienced staff. Specialists on high profile issues gave way to generalists less acquainted with a greater variety of issues. The Senate Office of Research and Legislative Analyst's office shrank. The Assembly Office of Research and the Auditor General were eliminated.[53] (The Bureau of State Audits was subsequently created, but placed outside the legislative branch.)

The decline of expertise becomes even more evident when considering leadership turnover. Assemblymember Willie Brown served 31 years in the Assembly, 15 of them as speaker before losing the Speakership and being termed out in 1995. Since then, eight different speakers have led the Assembly, in some cases with little opportunity to gain the preferred experience. The same trend applies to committee chairs and other leadership positions within the house. In 2004, some of the most senior lawmakers will term out. Reform takes time and requires continuity of leadership. Term limits pose challenges in both these regards.

Special interest influence. The vacuum is filled in part by special interest groups, who link their deep understanding of issues with their own political agenda and the need for elected officials to maintain political support for their next campaign.

In 1991, for example, the alcohol industry was able to thwart legislative efforts to raise taxes on alcoholic beverages and defeat the "Nickel-a-Drink" initiative (Proposition 134). This initiative proposed to raise excise taxes on alcoholic beverages served at public bars and restaurants in order to update a tax that had not been raised in three decades. The following year, policy-makers raised alcohol taxes by approximately a penny per drink, the amount originally advocated by the alcohol industry as an alternative to Proposition 134.[54]

Similarly, the California Correctional Peace Officers' Association, because of the millions of dollars the 31,000 member union has to invest in electoral contests, is considered one of the most influential organizations in the capitol. The most visible evidence is the lucrative pay increases the union negotiated at a time when other public employee unions were foregoing raises and employees were being laid off.

But the "tort" wars between trial lawyers and business interests and health-related battles between doctors, hospitals and consumer groups also display the influence of special interests.

When the Policy-Making Process Fails

When the standard policy-making process does not produce timely and effective solutions, policy-makers often turn to extraordinary processes – creating temporary commissions and other venues to search for answers or otherwise advance causes that stalled in the traditional decision-making venues. California's leaders have made many such attempts to solve the fiscal and governance issues that sometimes are considered chronic problems and sometimes viewed as acute crises. The track record of these extraordinary measures, however, is not that much better than that of the standard policy-making process.

Why Extraordinary Reform Efforts Failed

When a high-profile problem collides with political stalemate, officials often turn to the blue ribbon panels. Task forces and committees can serve both important and dubious functions, from providing thoughtful and independent analysis and conclusions to deflecting criticism and delaying action.

While many of these temporary, single-purpose panels have successfully completed their missions, others have had little impact on the problem they were charged to resolve. California has turned frequently to such panels to deal with issues that could not be given the necessary attention and deliberation in the traditional statutory or budget processes. But for the most part, these panels have not been much more successful at delivering a proposal that solves the problem and has the necessary political support to be enacted in legislation. Hindsight offers some lessons.

Poor definition of the problem. The problem to be resolved is often not properly or precisely identified. Sometimes it was too broadly defined, posing an insurmountable task in the time available. The California Commission on Tax Policy in the New Economy, for example, was created by the Legislature in September 2000 to review the State's tax and revenue programs in light of the new economy and rapidly changing technology.[55] In February 2003, Governor Davis asked the commission to expand its mission to explore a variety of options for changing California's tax system and offer ideas on budget structural reform.[56] With a final report deadline of December 2003, the commission had insufficient time to thoroughly review all the relevant issues and create the consensus required to support changes of the magnitude that was desired. The final report included scant analysis and no implementation plan. On a more positive note, the commission provided a public forum up and down the state for discussion of tax issues.

Poor definition of the mission. In many cases, groups are empanelled with the vague job of “advising” policy-makers. In many instances, policy-makers are already being offered advice on the issue, and are looking for something other than another voice. What is the real task? To validate the problem or to explore options? To find new solutions? To consult and educate the public? To negotiate solutions among the parties or to develop legislative-ready proposals?

Sometimes groups attempt to do several of these tasks. But if it is not clear what policy-makers want, and the group does not have the resources and the work plan to produce the desired result, success is unlikely. If the goal is detailed analysis, the task force needs to have the capacity to do analysis. If the goal is a solution ready to be implemented, agreement among a dozen of California's civic leaders will not likely be enough to represent agreement among stakeholders. If the goal is legislation, conceptual recommendations are inadequate.

Waning leadership. At times, policy-makers establish a reform process, but lose interest before proposals are fully developed or considered by the Legislature. For example, the California Constitution Revision Commission was created in 1993 out of concern that state government was not capable of responding to the fiscal crisis of the early 1990s. By the time the commission completed its work in 1996, the political calculus and even the leadership had changed. The recession was over and the crisis had abated. Governor Wilson was running for president. And new leadership was in place in the Legislature.[57]

Lack of policy-maker participation. Policy-makers at times have recognized the need to shepherd reform efforts, but seldom has a process been completed with more legislative support than when it began. In 1999, the Legislature (by a 77-0 vote in the Assembly and 32-0 vote in the Senate) commissioned an analysis of the property tax allocation system with the goal of enacting reforms that would increase taxpayer knowledge, provide greater local control, and correct the skewed land use incentives faced by local governments.[58] The analysis was completed, and no legislation was ever introduced.

A lack of information and analysis. In some cases, policy-makers lack the data that could help them to better understand a problem. In other cases, analysts lack the technical capacity to project how certain reforms will affect those who are interested. This type of analysis is critical in revenue-related negotiations, where minor reforms may have substantial fiscal consequences in later years.

Good information is needed to produce good analysis, to thoroughly explore solutions and to support alternatives that arise through negotiations. Oftentimes legislative compromises are neither informed nor supported by analysis, raising the financial and other risks of unintended consequences.

The last decade in particular has seen a number of attempts to deal with allocation of sales and property taxes to increase the reliability of funding and mute the fiscalization of land use. Most of the analysis quantified immediate impacts on the parties. Some analysis projected future impacts. Little of the analysis examined how changes in revenue policy would change the incentives to policy-makers. For example, some analyses of AB 1221 (Steinberg, 2003) and the tax swap plan by former

Assembly Speaker Robert Hertzberg suggest the proposals would actually increase the incentive for local governments to seek commercial development rather than affordable housing in some areas.[59]

This deficiency plagues many policy areas. While crime rates have declined, researchers have not been able to document the specific contributions that prison policies, prevention efforts and economic and social trends have made toward that trend, frustrating efforts to make additional progress.

Overly ambitious reform agendas. Many task forces are given assignments that are too complex or too extensive. The Legislature and the public are loath to accept complex proposals without detailed analysis. They do not accept what they do not understand.

Sometimes, reformers take on too much. Representative David Swinford, chairman of the Texas House Committee on Government Reform, took two years to craft a major restructuring of state government agencies. His bill was so comprehensive that it contained something for everyone to dislike. His advice: Target reform like a rifle, not a shotgun.

Insufficient resources. Given the complexities of the problem, the resources allocated to the reform effort are often insufficient. Most reform efforts have modest staff and few resources. The most needed reform efforts are often launched during recessions. Task forces are sometimes created because the preferred solution is considered to be too expensive. And it is difficult to win appropriations for "more studies."

For example, the California Commission on Tax Policy in the New Economy was tasked with analyzing and recommending changes to the complex state-local tax structure. But it was provided with no staff and the commission chairman had to arrange a loan of personnel from the California Research Bureau.[60]

Key players did not participate. In part because expectations are not clear, they often do not involve all of the people necessary to instigate reform. Among those who must be involved at some point in the reform process:

- ✓ ***The public.*** Broad political consensus is important to making meaningful and legitimate reforms.
- ✓ ***Policy-makers***. Elected officials need to invest political capital at the beginning, during and at the end for enactment and implementation.
- ✓ ***Planners and experts***. Technical experts need to guide the reform process and provide the detailed analysis required to test proposals and reduce the fear of the unknown that can thwart agreement among stakeholders.

- ✓ ***Stakeholders.*** Major interests need to ensure the relevance of the proposal to their groups and negotiate tradeoffs with other involved parties.
- ✓ ***Implementers.*** Public administrators and others need to be involved in fashioning reforms so they can be successfully implemented.

Lack of trust. Most political stalemates are laced with distrust, and few reform efforts take affirmative steps to build trust. As a result, public input is not candid, negotiations are stifled, and stakeholders are biased against investing much in either the process or the product. When it comes time to implement recommendations, stakeholders support only the ones they advocated for, and express their opposition to other proposals.

Missed reform opportunity. Most task forces are created to respond to a crisis or opportunity. During boom years, policy-makers see a chance to use additional funds to make changes in the state-local relationship. During lean years, policy-makers hope the pain of both budget cuts and tax increases will forge compromises on both. But task forces by their nature take time – and a lack of resources, vague direction, overly broad scope and other predictable factors can further delay the process. As described earlier, the Constitution Revision Commission's efforts were frustrated by several important developments from the time of its creation to the time of its completion.

Reform process participants did not gain their constituents' support. Some task forces are designed to include necessary stakeholders, but the process does not ensure that an agreement among members of the panel reflects agreement from the interest groups. In other instances, interest groups agree to a package of reforms during the process, but that consensus does not hold through the ensuing legislative process.

For example, the support expressed by interests involved in developing the State's Master Plan for Education did not remain united behind those recommendations as they moved through the legislative process.

Lack of public consensus. While many task forces conduct public hearings, few take the trouble to consult or inform the array of community leaders and concerned residents. In some ways, this weakness is understandable. Meaningful public involvement is expensive and time consuming, and as previously stated most groups are given too little to accomplish too much in too short a time.

But without a mandate to build the awareness necessary for recommendations to survive the political process, task forces often generate their own ideas for reform and disband. Public sessions seldom include the significant participation by interest and civic groups and the general public that is required to develop broad political support for action.

Unanticipated resistance. In part because of limited public involvement, proposals are often not adequately vetted with interested parties and revised. In addition, reformers sometimes failed to anticipate and deal with resistance. Almost any reform proposal will affect vested interests and generate resistance based on misunderstanding or desire to maintain the status quo. Reformers need to anticipate these concerns, and be prepared to deal with them.

Cause and Effect

"*Most of the ills in the current system that we now seek to cure are the result of usually unforeseen effects of some previous reform.*"

Source: Michael Coleman, Principal, CaliforniaCityFinance.com, Testimony to the Little Hoover Commission, March 25, 2004.

No planning for implementation. Many advisory groups interpret their jobs to be complete when the advice has been offered. Many originating statutes dictate that fact. There is often no planning or resources for refining conceptual ideas into legislative proposals, let alone plans for monitoring and evaluating reforms after they are enacted.

Flawed proposals. Many proposals have died justifiably because they were not sound public policy. More detailed analysis and vetting can help ensure that the reform measure will achieve the policy goal.[61]

Rebuilding Public Trust

Regardless of where reforms have been attempted, the public has not been adequately involved. As a result, the public does not necessarily support reform or trust government leaders.

A majority of Californians and their locally elected leaders do not trust state government.[62] Decades of poor performance and raids on local government coffers have deeply severed faith in good government. Experience suggests that for meaningful reforms to occur, lawmakers will need to rebuild trust by engaging Californians and their local elected and community leaders in any reform process. Participants in a reform process must continue an open and ongoing dialogue, providing opportunities for the public to identify, understand and evaluate problems and to comment on alternative solutions. Without public involvement and support, eventually even well-intended reformers fail and give up.

Experts who assisted Washington State overcome major budget shortfalls advocate a reform process that puts the focus on the public, not agencies, interest groups or lobbyists. By focusing on the results that the public expects from government, the Governor of Washington was able to develop a budget that was generally accepted by the state legislature and the public, even though it included painful program cuts.[63] The consultants said engaging the public helps to break stalemates among elected leaders and makes it possible to reach compromises.[64] There are many ways to engage the public and local leaders in the reform process, including:

- ✓ ***The Internet.*** A Web site with email links allows for public review and comment on the need for reform, reform proposals and implementation ideas. It is the quickest way to reach large numbers of people. Because of the "digital divide," however, many economically disadvantaged people do not use the Internet.
- ✓ ***Focus groups.*** Policy-makers and advocates for reform often rely on small, representative groups to help validate or suggest revisions to proposals.
- ✓ ***Surveys.*** Surveys can be used on a more extensive scale than focus groups to test ideas and obtain input. Internet surveys with on-line input mechanisms combine two outreach media.

The SACOG Conferencing Model: A Regional Forum

The Sacramento Council of Governments uses a technology-based conferencing model to gain instant feedback from attendees at meetings. A thousand attendees at a conference on transportation, air quality and land use, for example, listened to presentations by experts. Questions with multiple-choice answers were then flashed on a large screen and attendees were given 20 seconds to respond using wireless devices. Computers tallied the responses and within 10 seconds provided graphs illustrating this snapshot of opinion. The snapshots were recorded in a database for future reference.

Source: Tom Stallard, Chairman of the Board of Directors, Valley Vision. Testimony to the Little Hoover Commission. November 20, 2003.

✓ ***Public Meetings.*** Open meetings engage and educate the public and usually provide opportunities for comments and input. For large-scale reforms, public meetings may be logistically impractical. However, business leaders, locally elected officials and civic leaders can be invited to participate in regional forums. Neighborhood meetings can be used to engage the public and gain perspectives from regions throughout the state.

✓ ***Broadcast media.*** Broadcast media tend to be less interactive than the other means of involving the public. Broadcasts can be combined with other media to improve the feedback capability. Radio and television can air public service announcements, for example, telling where citizens can find Internet sites, focus groups or public meetings or how to participate in surveys.

✓ ***Print media.*** Editorials and news stories can provide opinions and details on reform proposals beyond what broadcast media provide. Printed media tend to reach the more educated audience but provide limited feedback capabilities unless combined with other media, like the Internet, focus groups, public meetings or surveys.

✓ ***Direct mail.*** Legislators often use direct mail to inform constituents of problems and proposed reforms. Feedback is limited because recipients must pick up the phone, make a visit or write a letter to respond. Using direct mail to alert constituents to other ways to get involved increases the feedback capabilities of mailings.

Regional Budget Education Forums

Civic leaders have had limited involvement in state budget issues and priorities. The California Center for Regional Leadership and the California Policy Reform Network, a collaboration of 14 regional and statewide civic organizations, have developed the Next Ten project. The goal of the Next Ten project is to educate regional civic leaders and a broader group of Californians on state budget basics, through 16 regional forums.

Other goals of the Next Ten project include:

- Creating a long-term vision for California looking out 10 years.
- Clarifying the budget trade-offs and priorities the public is willing to make to achieve that vision.
- Prioritizing the five to 10 reforms that have broad support among participants in the process.
- Moving policy choices forward by sharing the perspectives of participants with lawmakers through the media, reports to the Legislature and administration and events.

The Next Ten project is in the process of creating user-friendly briefing materials on budget basics and plans to utilize the Internet to open the dialogue to a much broader group of Californians. The public will have access to information and will be able to share views online through the project Web site and budget simulation tool.

Source: Leticia Miranda, California Center for Regional Leadership, Written communication, May 24, 2004 and Web site: www.calregions.org. California Policy Reform Web site: www.calpolicyreform.net.

A Critical Path Defined

Few reform efforts begin with a firm game plan for what will be needed to actually achieve a specific goal. Developing sound solutions that can be widely supported requires a combination of analytical capacity and political skill. Reformers must have the political sponsorship to get the right stakeholders to the table and clear direction to solve specific problems. The process itself must be framed with integrity by providing for meaningful involvement of the public and civic leaders, requiring good faith negotiation to resolve differences, and fostering the expectation that stakeholders will have the courage to stand by agreements.

In addition, most of the reform efforts were not imbued with some important intangible characteristics that are necessary to craft legitimate agreements that can survive even a streamlined political process. Those characteristics are described in the box below as "essential values."

Essential Values

At every step of the critical path, and in every venue where the cause of reform is strengthened or weakened, leaders and participants of reform must be committed to the following operational values:

Leadership that is willing and able to stick with the reform process is crucial. Terms of office, therefore, may influence leadership selection and also the timing of the reform effort.

Trust in the process, in other participants and in the final product. The current distrust between state and local governments, as an example, is derived from a history of mutual antagonism that will be difficult to work through. Trust building begins with successful joint efforts that identify and satisfy the interdependence of interests.

Transparency in the analysis of issues, statement of goals, positions that are taken, and agreements that are reached. Ground rules must be clear to all participants so they can decide whether to invest their time and efforts.

Public involvement must be part of defining the problems and the parameters of solutions. The public must be educated to the challenges and need for change, and their support gained for solutions. Public involvement is the key to unlocking the broad political support needed for reform.

Inclusiveness requires identifying major stakeholders and appropriately involving them so their concerns are known, and to the extent possible resolved. Leaving out a key stakeholder can sabotage implementation.

Commitment means a deal is a deal. Participants agreeing to a solution must ensure that the constituents they represent also support the agreement and will not sabotage implementation. Leaders must be committed to reform and prioritize the goal with the public. There must also be a commitment to be accountable, from all constituents. Accountability requires monitoring the implemented reform and adjusting it as necessary to improve effectiveness and efficiency.

Timeliness in completing the process. Reform must be accomplished while there is consensus on the need for reform. The process must allow sufficient time to gather input and negotiate compromises and tradeoffs, but it must not drag on to the point where the public loses interest.

The Critical Path

Effective reform processes have common elements:

1. ***Recognize and define the problem and set the reform goal.*** The Governor, Legislature and other elected leaders must formally agree on the problem that needs to be solved and the goals for reform. This will require:

- ❑ Initial technical analysis of the problem and the desired goal.
- ❑ Consultation with community leaders and the general public to identify the problems, solidify support for change and agree on general goals.
- ❑ Agreement among elected leaders to make change a priority, to work in good faith, abide by the process and be biased toward action.
- ❑ A legislative commitment to expeditious consideration of the finished proposal.

2. ***Create a structure for success.*** The reform process could be managed by the executive branch, or a collaboration of executive and legislative resources or regional and local leaders.

- ❑ Select committed, long-term leadership.
  - ✓ Create a venue and a staff to support the reform effort.
  - ✓ Identify essential stakeholders and other contributors.
  - ✓ From stakeholders, delegate an executive committee and chairperson.
- ❑ Structure the executive committee's activities.
  - ✓ Establish ground rules and a time line.
  - ✓ Determine which issues to include and exclude from the process.
  - ✓ Establish objective criteria to evaluate proposals.
  - ✓ Report back for agreement with leadership sponsors.
  - ✓ Phase the project to coincide with the legislative calendar.

3. ***Establish the parameters of an acceptable solution.*** The Governor and the Legislative leaders should validate or amend the problem and validate the scope and schedule for work by formally establishing the parameters of an acceptable solution.

For example, an acceptable revenue reform proposal will be:

- Reliable – relatively stable across swings in the business cycle.
- Accountable – linking the tax levied and the service rendered.
- Transparent – simple to understand and operate.
- Neutral – minimizing impacts on economic decisions.
- Equitable – balanced in relation to the taxpayer's ability to pay.
- Implemented over an extended period to allow time to adjust.

4. ***Identify and agree on solutions.*** Through a series of public meetings, informed by the best available analysis, key stakeholders should explore alternatives and develop the best solutions with broad public support.

- ❑ Develop the best available network of analytical talent to explore alternatives and quickly analyze concepts developed by stakeholders.

- Engage contributing interests, civic leaders, and the general public in an ongoing discussion of the potential solutions and their costs and benefits.
- Employ conflict resolution processes to identify and expand areas of agreement, areas of mutual gain and acceptable compromises and tradeoffs.
- Ensure the commitment of representatives reflects the support of their group.
- Involve public administrators who would be responsible for implementing changes to begin planning and identify potential pitfalls and resource needs.

5. ***Validate and vet solutions.*** The executive committee needs to make sure that the proposed solutions are technically sound and politically viable. The product at the end of this stage should be a technically sound solution that has a critical mass of solid support.

- Use computer modeling or other sophisticated analyses to test the reform proposal against the established criteria and parameters. The UCLA Economic Forecasting Model, for example, could be used for revenue-related proposals.
- Involve state and local leaders to ensure there are no hidden roadblocks.
- Ensure commitment of interest groups.
- Consult with the general public.

6. ***Enact the proposal.*** The Legislature needs to assess the proposal based on the established parameters and the support stated by interest groups throughout the process. If consistent with the parameters, enact it.

- Lawmakers should respond to opposition about potential unknown consequences by establishing rigorous means of monitoring outcomes.
- Lawmakers should respond to "flaws" in the reform by establishing a rigorous means of identifying follow-up solutions.
- Lawmakers should establish in the reforms clear expectations for implementation, a means of measuring progress, and a process for reviewing and refining the reforms.

7. ***Implement and monitor reform.*** The Governor and the Legislature should support the implementing agencies by providing clear direction, adequate resources, and an effective means for communicating progress and making refinements to the plan.

- Analysis should periodically assess reforms to determine how well they are meeting established criteria and to detect unintended consequences.
- Civic leaders and the public should be informed on how the reforms are working.
- Core stakeholders should be briefed on the performance of reforms and consulted on when, whether and how refinements should be made.

8. ***Refine the reform as necessary.*** The Governor and the Legislature should periodically assess the need for refinements or the next generation of large-scale reform, and be willing to repeat all or part of the critical path to ensure progress toward desired goals.

The diagram on the following page illustrates the Critical Path to Reform. The graphic displays the participants and their roles at each step and how the essential values bring credibility to the process and its products.

Reform Participants

The key participants in a reform process are involved throughout the entire effort, but play different roles and have different levels of engagement throughout the process as depicted across this chart. The key participants in a reform process include:

- The general public.
- The Governor & the Legislature.
- Local elected & civic leaders.
- Stakeholders representing major interests.
- Planners/Experts who can provide analysis.
- Implementers working in organizations that will carry out reforms.

A Critical

Consult with **civic leaders** and the **public**.

The **Governor, the Legislature and other elected leaders** need to agree on the problem definition and goal.

They must make change a priority.

Identify **planners, stakeholders and experts**.

Legislative leaders validate or amend the problem definition and validate the parameters of an acceptable solution.

Develop the best available network of analytical **experts** to analyze the reform proposal.

Engage **stakeholders, civic leaders, the public and** administrators who will lead the **implementation** in an ongoing discussion of potential solutions.

1. Recognize and define the problem & set reform goal.

Formal agreement on the problem that needs to be solved and the goals for reform.

2. Create a structure for success.

Create a venue and staff. Include key stakeholders. Establish ground rules and timelines.

3. Establish the parameters of an acceptable solution.

Formally validate the scope and schedule for work.

4. Identify and agree on solutions.

In public meetings and with informed analyses, explore options and develop the best solutions.

Leaders must make a **commitment** to reform and prioritize the goal with the public. The **public** and civic leaders must be **involved** in defining the problem.

Inclusiveness of all stakeholders and **transparency** in the process to evaluate proposals, establish ground rules and a **time line** are critical. **Trust** is imperative.

Honest **commitment** from leaders regarding the acceptable parameters for reform is crucial in this step.

Public involvement and **transparency** in the process are fundamental to gaining support.

Essential Values

The behavior of everyone involved must be guided by essential values throughout the process. The essential values in the reform process include:

- Leadership
- Trust
- Transparency
- Public Involvement
- Inclusiveness
- Commitment
- Timeliness

Path to Reform

Involve **implementers** to ensure the reform can work in the real world.

Involve **state and local elected leaders** to gain support.

Ensure the **stakeholders** are committed. Consult with the **general public**.

The Legislature and the **Governor** enact the reform.

The **Governor** and the **Legislature** must provide adequate resources to the reform implementers.

Civic leaders, the public and stakeholders should be informed on how the reforms are working.

Core **stakeholders** should be consulted regarding refinements to the reform.

The **Governor** and **the Legislature**, with input from the reform **implementers,** should periodically assess the need for refinements or the next generation of large-scale reform.

5. Validate and vet solutions.

Test and refine the proposal to ensure it is technically sound and politically viable.

6. Enact the proposal.

Enact the proposal, but establish rigorous means to monitor and refine unintended consequences.

7. Implement and monitor reform.

Provide the implementing agencies clear direction, resources and the means to refine the plan.

8. Refine the reform as necessary.

Periodically assess the need for refinements and be willing to repeat all or part of the critical path.

Include all reform participants in validating the reform. Ensure **commitment** of the interest groups. **Involve** the **public** in the validation process.

The Governor and the Legislature must provide the **leadership** to enact the reform.

The reform implementation should be **timely**. The process to monitor and evaluate the reform should be **transparent**.

Inclusiveness and **trust** among all participants is critical to determining whether or not to repeat all or part of the critical path.

If the reform effort hits a roadblock, part of the process may need to be repeated.

Reform is a continuous process. Refining the reform may require repeating all or some of the critical path.

The Critical Path

To a Stronger Revenue System

Taxes are always controversial, and particularly in tight fiscal times. But there is broad agreement that California's revenue system has structural flaws. Some of those flaws disproportionately reduce revenues during recessions. Others gradually reduce the government's capacity to meet anticipated public needs.

Some of the more persistent issues stem from how revenue – particularly property and sales tax revenue – is allocated among local governments. Distributing sales tax based on where those taxes were collected encourages local governments to compete for retail business rather than manufacturing or other enterprises that result in greater wealth. The current allocation of property taxes among local governments reflects the preferences of taxpayers and public officials from when *Happy Days* was the number one television show. The issue of distribution is intertwined with a forest of complex issues that confound the "state-local relationship," including poorly defined roles and responsibilities, the ability to establish priorities and the authority to change the level of taxation to support those priorities.

Over all and over time, a surprising array of interest groups has concluded that fundamental reforms are needed, from the Performance Institute to the California Budget Project.

The Legislature has declared that the tax structure was developed for an agricultural and manufacturing economy and needs to be transformed to reflect an information and services economy.[65] The chart on the following page shows how the evolution of the economy has altered the composition of revenues over the last 30 years. Similarly the Legislature has declared the property tax allocation system to be "seriously flawed" and has established goals for reform.[66]

In January 2003, then Governor Davis declared in his proposed budget that the revenue system and budget process were "obsolete and irrational." Specifically, the Governor cited piecemeal attempts to limit taxing or spending

Virginia Reforms Tax Code

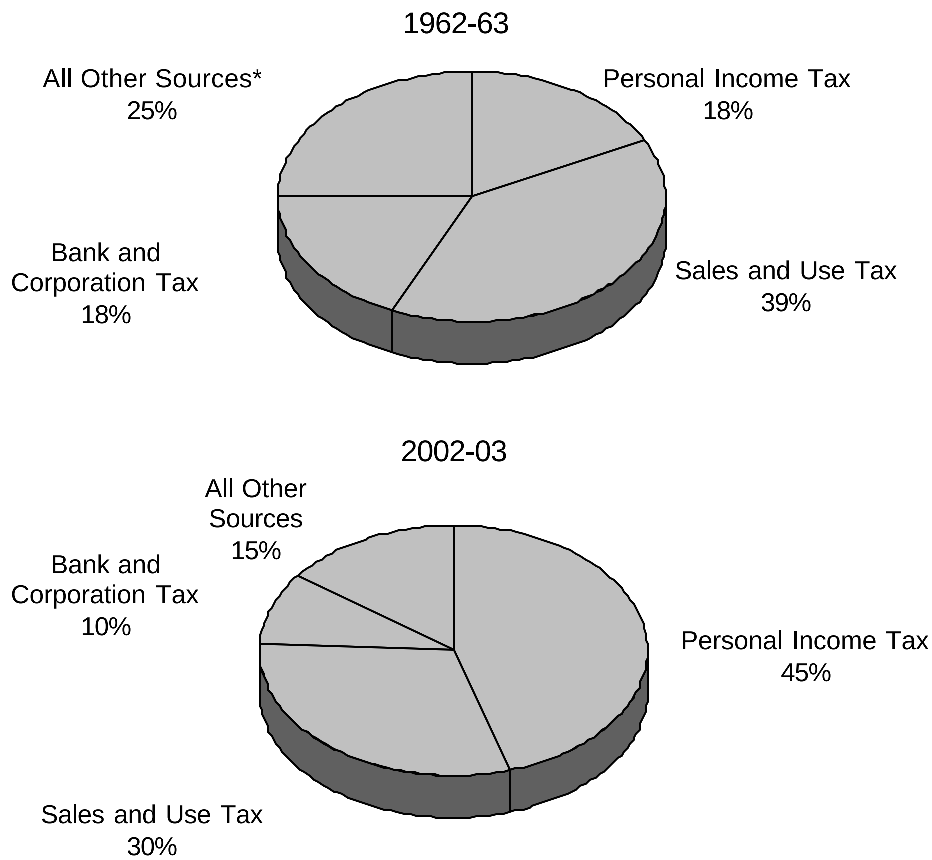
The Republican-dominated Virginia Legislature recently approved the outlines of Democratic Governor Mark Warner's plan to overhaul the state's revenue system. The plan would close corporate tax loopholes, make the personal income tax more progressive and modify the state sales tax.

The impetus for reform was primarily a $1 billion deficit. But the inability of the tax code to keep up with changes in an increasingly mobile and service-centered economy also motivated policy-makers. The increasing demand for services and the prospect of further declines in revenue prompted lawmakers to modernize the tax structure.

Like other governors seeking tax reform, Governor Warner restrained spending through government reorganization to improve performance. These efforts reduced resistance from anti-tax groups.

Source: "State Taxes: Quick Fixes Won't Work Anymore." Business Week, April 26, 2004, p. 53.

The Composition of General Fund Revenue Has Changed Over Time



*Other sources of revenue include taxes on insurance premiums, alcoholic beverages, tobacco, inheritance/estate and gift taxes, horse racing revenue and interest on pooled money investments. Data Source: Elizabeth Hill, Legislative Analyst, "Reforming California's Tax System," Written testimony to the Little Hoover Commission, January 22, 2004.

that have resulted in a volatile system for funding state government. The Governor urged lawmakers to use the budget crisis to develop "a new fiscal blueprint for California." Among the proposals: rebalance state revenue streams to create a more stable source of funds and more fairly allocate the tax burden.[67]

While there also is agreement that California does not need another study on fiscal reform, stakeholders are frustrated that the existing stack of reports has not resulted in the desired change.

Closer examination of those efforts reveals why years of analysis, task force reports, and even legislative negotiations have been unable to develop sophisticated solutions that have the political support necessary for enactment. The critical path described earlier, developed by assembling the lessons learned from these previous efforts, could be used to develop both the solutions and the support necessary for change. In turn, the fiscal crisis could provide enough motivation for stakeholders to engage in such a process. The common ground, however, and the Commission's consideration of this issue, concerns the structure of the system and not whether taxes should be increased.

The Problem and the Crisis

While there was agreement before the recession that the State's revenue system warranted reform, the fiscal crisis elevated those concerns, as well as the interest in change.

When the exceptional boom times of the late 1990s ended, state governments came under severe fiscal pressure. Virtually all states faced the same challenge, triggered by a rapid decline in revenue. Many states responded in ways similar to California – with internal loans, external borrowing, higher fees and program cuts.

But California's actions did not balance its budget and the gap between revenues and spending is disproportionately larger than in other states. Moreover, despite a widely held belief that California must approve a balanced budget, the State rolled over deficits two years running.

How California Responded to the Crisis

Between 1998 and 2002, General Fund expenditures increased by about one-third, or $19 billion, to about $77 billion. Funding was increased for education, social services and prisons. Infrastructure investments actually fell during the period. As revenue fell, however, California was slow to react.

FISCAL YEAR/ACTION

2000-01	$700 million deficit. Covered with reserves.
2001-02	$13 billion deficit. Covered $7 billion with reserves. Reduced spending by $ 4.6 billion. Pushed $1.4 billion deficit to next fiscal year.
2002-03	
June	$23.6 billion deficit. Reduced spending .2 percent. Temporarily suspended some tax credits. Securitized tobacco settlement. Projected federal help that did not materialize.
January	To meet $38.4 billion projected deficit, Governor Davis proposed: $8.3 billion in tax increases. $26.9 billion in reduced spending. $2.6 billion in shifts to local governments. $3.3 billion in loans and borrowing. $2.1 billion in transfers and new revenues.
2003-04	
September	Legislature enacted budget without tax increases by relying on a $10.7 billion deficit-financing bond. State shifted local government sales tax revenue to repay the bond.
November	Governor Schwarzenegger repealed VLF increase, added $4 billion to deficit.
March	Voters approved Propositions 57 and 58.

Sources: E. Kersten and J. Decker. California Senate Office of Research, Memo to Senator Gil Cedillo, "Expenditures-Background on the Structural Deficit, July 8, 2003, pp. 2-3. Kenneth Finegold, et. al. Social Program Spending and State Fiscal Crises. The Urban Institute. Occasional Paper 70. 2003, pp. 14-23.

The growing debt is one indicator, and consequence, of a deadlock among policy-makers. Even as the economy – and state revenues – begin to recover, the State's fiscal crisis has not been resolved. The ongoing imbalance between revenues and expenditures has produced a structural deficit that will continue to add to California's debt burden until fiscal balance is restored.

In March 2004 voters passed two measures. Proposition 57 authorized the State to borrow nearly $15 billion to refinance the State's operating deficit. Proposition 58 amended the Constitution to require that the Legislature enact a balanced budget. It also allows the Governor to propose mid-year adjustments to correct imbalances between revenues

How Other States Responded to the Crisis

Virtually every state faced a rapid decline in revenue in 2001. Most states initially relied on relatively painless short-term solutions – transferring special funds into general funds, shifting expenditures or revenues across fiscal years, refinancing debt and securitizing tobacco settlements. Many states had built up hefty reserves from the boom in the late 1990s and these reserves also kept states from having to make painful choices in the first year of the revenue shortfall.

Spending Cuts

Most states also controlled spending to help close the budget gaps. General Fund spending nationwide between 2001-02 and 2002-03 grew by only 0.6 percent. And in 2003-04, expenditures increased by 0.2 percent, the smallest nominal increase since 1979. In fiscal 2002-03, 32 states enacted across-the-board cuts, 16 states laid off employees, 13 states used early retirement, 13 states reorganized programs and 29 states used a variety of other methods to reduce expenditures.

Revenue Increases

Legislators in most states were more reluctant to raise taxes in the first two years of the fiscal downturn than in prior recessions. In response to the 1990 recession, states increased taxes by 3.4 percent of total revenue in 1990-91 and by 4.6 percent 1991-92. In contrast, states increased taxes 0.3 percent in 2001-02 and 1.6 percent in 2002-03. In states such as Colorado and Washington voters have enacted laws making it difficult to raise taxes. Washington officials increased tax enforcement to enhance revenues.

After two years of tapping reserves, shifting funds and cutting programs, 36 states increased taxes or fees in 2003-04. Nationally, these increases total $9.6 billion in projected revenue. Thirteen states increased sales taxes, several of them on a temporary basis. Some states broadened the services that are taxed and others eliminated certain exemptions.

Nine states increased personal income taxes, with New York and Connecticut reaping the largest revenue benefits. Oregon enacted a temporary tax increase, placing a surcharge on personal income tax liability, however, the measure was repealed by voters in February 2004. Eight states increased corporate income taxes, primarily by closing loopholes.

Fifteen states increased tobacco taxes and four raised taxes on alcoholic beverages. Two states, Illinois and Ohio, increased taxes on motor fuel. Fourteen states made changes in other taxes and 25 states increased fees.

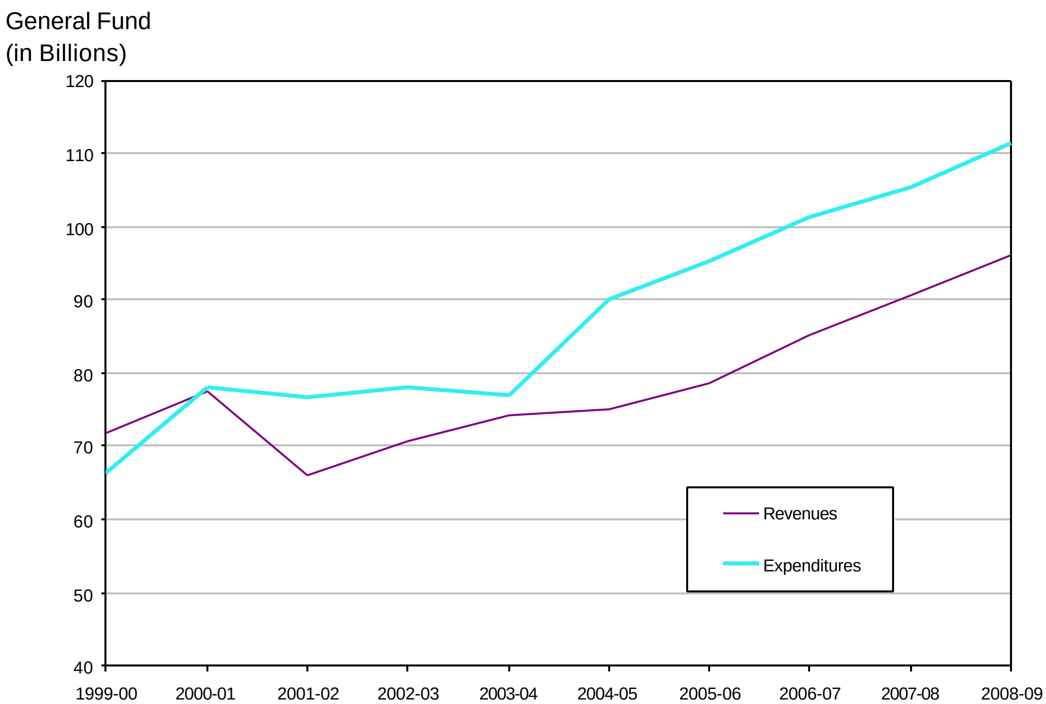
Sources: Kenneth Finegold, et al., "Social Program Spending and State Fiscal Crises," Urban Institute, Occasional Paper Number 70, November 2003. National Governors Association and the National Association of State Budget Officers, "The Fiscal Survey of States," December 2003.

and expenditures. If the Legislature fails to act on the proposal within 45 days, it cannot act on other bills or adjourn. The measure creates a reserve account funded by annual transfers from the General Fund. And it restricts the use of long-term borrowing to cover deficits.[68]

Neither measure resolved the imbalance between revenues and expenditures. As a result, the State cannot meet its current statutory commitments. Certainly, it cannot expand programs, assume new spending obligations or enact new tax cuts.[69]

The economic recovery is not expected to improve this situation much between now and the end of the decade.[70] Budget analysts forecast revenues to increase an average of 4.19 percent annually between 2002 and 2008, with most of the increase coming after 2005.[71] Expenditures are expected to grow an average of 5.5 percent a year over that period.[72]

General Fund Revenues and Expenditures



Source: Legislative Analyst's Office, "California's Fiscal Outlook," November 2003.

Underlying Problems

While part of the structural deficit is driven by expenditures, the gap also is the result of a tax system that does not provide a stable source of revenue that has been aligned to reflect changes in California's economy. The state's revenue system was crafted in an industrial-age economy and so does not capture the transactions of an information and service-based economy. And some revenues are allocated according to the preferences of previous generations. There are four fundamental weaknesses in the California revenue system:

1. Over-reliance on the volatile personal income tax.

California's General Fund increased from $58.9 billion in 1998-99 to $77.6 billion in 2000-01. The following year it declined by more than $13 billion. This dramatic rise and fall in revenue was due primarily to California's heavy reliance on the personal income tax as its major revenue source.

The Role of Capital Gains

Over the past 30 years capital gains revenue was five times more volatile than that from ordinary income or sales taxes.

Economists predict that the states that rely most heavily on personal income tax, and particularly capital gains tax, will struggle the most. Of all the states, California ranks highest on the importance of capital gains as a source of revenue.

Source: Donald Boyd, Director, Fiscal Studies Program, The Nelson A. Rockefeller Institute of Government. "The Current State Fiscal Crisis and its Aftermath," prepared for The Kaiser Commission on Medicaid and the Uninsured. September 2003.

Like most large industrial states, California's personal income tax is highly progressive. Even in relatively average revenue years, a small percentage of taxpayers pay the majority of the personal income taxes. One consequence of this tax policy is in boom times, particularly when the stock market is rising rapidly, there is a spike in revenues, primarily resulting from capital gains from those high-earning taxpayers. In 2000 those with an adjusted gross income of more than $100,000 paid more than 80 percent of all state personal income taxes.

When the market declines as it did in 2001, the state's personal income tax collections plummet. In 2000, taxpayers with incomes greater than $1 million contributed 38 percent of personal taxes in the state, a total of $15.2 billion. In 2001, the wealthiest Californians paid only 26 percent of personal taxes, only $8 billion.[73] It's estimated that in 2001 capital gains and income from non-qualified stock options declined 62 percent in California, from $200 billion to $77 billion.[74]

2. Declining contribution from sales tax revenue.

In the 1950s, the sales tax was the largest source of revenue, providing 60 percent of all General Fund revenue, while the personal income tax generated slightly more than 10 percent of revenue. In 2003-04, it is estimated that the sales tax will generate slightly more than 30 percent and the personal income tax will represent 48 percent of the State's General Fund revenue.[75]

Economists cite the growing use of mail order catalogs and Internet sales as two reasons for the decline in the contribution of sales tax to California's budget. But the sales tax also is limited to a selected group of goods, while most economic growth has been in services, such as legal, accounting, lodging and entertainment. Compared to other states, California taxes few services. In a 1996 survey, the Federation of Tax Administrators found that California taxed only 13 of the 164 potentially taxable services identified in the survey, with only four states taxing fewer services. Other large states taxed many more services with Texas taxing 78, New York taxing 74 and Florida taxing 64 services.[76]

Declines in sales tax revenue impact both state and local government services. In addition to being the second largest tax source for the State, sales tax revenue supplies about one third of the general purpose tax revenues of cities and 6 percent of all county revenues.[77]

3. Unintended effects of previous property tax reform.

Among property tax reforms, Proposition 13 stands out because of its popularity with property owners and its unanticipated consequences, among them:

- ✓ ***Fiscalization of land use.*** Limits on property taxes increased the value of sales tax to cities, increasing the incentive for local governments to favor retail development over affordable housing, which often imposes more costs on local services than is generated in property taxes.
- ✓ ***Inequities among similar taxpayers.*** The assessed valuation of property can only increase by 2 percent a year, but can be reassessed at market value when sold. This results in neighbors with like properties paying significantly different taxes depending on when the properties were purchased.
- ✓ ***State control over local revenues***. When state revenues have declined during economic recessions, the State has shifted property tax revenues from local governments to buttress the General Fund. These shifts have caused fiscal problems and political umbrage among local governments.
- ✓ ***Property tax allocation locked in***. In response to Proposition 13, the Legislature passed AB 8, which distributes property tax revenues based on levels of taxation in the late 1970s. Communities that were willing to tax themselves more at that time receive a greater allocation of property tax revenue under AB 8. Moreover, the allocation also is

> ***Proposed Revenue Reforms***
>
> Various commissions and task forces have recommended revenue reforms. Among the most prominent and reiterated reforms:
>
> - Broadening the sales tax to include services and reducing the sales tax rate.
> - Increasing property tax allocations and reducing sales tax allocations to local governments.
> - Implementing a flat tax rate.
> - Re-assessing non-residential properties to fair market value or increasing the rate of taxation on these properties.
> - Increasing excise taxes on specific items such as alcohol or tobacco.
> - Increasing the personal income tax rates on high-income Californians.
>
> These options were assessed using accepted principles and are detailed in Appendix E.

locked in among cities, counties, and special districts. Times and priorities have changed, but the allocation scheme is locked in.[78]

4. Declining contribution of corporate income tax.

Corporate income taxes have declined as a share of total General Fund revenues and as a share of corporate profits.[79] In 1962-63, the Bank and Corporation Tax represented 18 percent of General Fund revenues. By 2002-03, it had declined to 10 percent of General Fund revenues.[80] This decline followed a national trend for such state taxes. Future growth in the corporate tax may also be affected by a reservoir of net operating losses yet to be deducted.[81]

Efforts to Solve the Underlying Problems

While the tax system itself needs to be reformed, the ability of elected leaders at the state or local government to change the system has been more difficult because of supermajority votes required to raise taxes and pass the budget.

Numerous blue ribbon commissions and state task forces have proposed solutions for many of the problems inherent in the state revenue system. Few of their recommendations have been implemented. Appendix D outlines six such efforts, their charters, membership, processes and recommendations.

Why Reform Measures Have Not Succeeded

Changing the structure of California's revenue system has proven difficult, if not impossible. Few revenue reforms have been implemented. Among the reasons:

- ***Inadequate political will.*** In addition to the daunting complexity of revenue system reform, policy-makers are reluctant to embrace reform because of divisions in the body politic. Efforts to heal these divisions have been inadequate.

- ***Tax reforms are politically dangerous.*** During the recession in the early 1990s, legislators and governors in many states increased taxes and other revenue reforms to address budget shortfalls. Similarly, California temporarily increased the top personal income tax rates from 10 to 11 percent. Voters reacted across the nation by using the referendum and initiative processes to impose statutory or constitutional provisions making it difficult to raise taxes. Tax increases in the early 1990s played a major role in unseating several governors. Policy analysts looking at how states dealt with the current crisis concluded that policy-makers were less likely to raise taxes as part of the solution or to make even revenue-neutral changes to tax policies.

- ***Powerful interests resist change.*** Special interests that could be negatively impacted by reforms in tax policy lobby heavily against change. Many of the proposed reforms create fiscal winners and losers, and the perceived losers often successfully negotiate compromises that dilute real reform efforts. They also successfully flex political muscle against the new and sometimes uninformed lawmakers who churn through the Legislature as a result of term limits. Lawmakers have little interest in carrying reform proposals with stiff opposition from powerful special interest groups. Several fiscal policy experts reported that many viable options for reform had never even made it to legislative committees.

- ***Inadequate information to support negotiations.*** Data that could be used to analyze the potential results of various reform measures is often lacking in reform proposals. In the current climate of distrust between local entities and the State, not knowing the full impact of the proposed change makes it much easier for stakeholders to oppose proposals than to support them. The local revenue system is complicated and varied throughout the state. In most proposals, the fiscal effects of the reform have not been analyzed. A municipal fiscal policy expert who has reviewed various revenue swap and reallocation proposals testified that most proponents and opponents of these proposals examine the budgetary impacts on local agencies and the State. He said they don't really evaluate the overall fiscal impact or more importantly, whether the proposed reform will actually achieve the intended policy outcome.[82]

- ***Citizens are divided.*** Lawmakers are polarized on revenue issues with Republicans resisting any tax increases and Democrats refusing program cuts. California citizens themselves are strongly divided along party lines when it comes to tax policy. Significant majorities of independents and Democrats think that a mix of spending cuts and tax increases is the best way to deal with the structural deficit while Republicans favor spending cuts over a mix of cuts and tax increases.[83]

The critical path suggested by the Commission provides a process of reform and a roadmap for reformers. It could improve the success rate of reformers by addressing problems encountered by previous reform efforts, especially the building of political consensus to support reform.

Applying the Critical Path to Reform the Revenue System

The following analysis walks the reader through the eight-step critical path process highlighting critical points that caused previous revenue-related reform efforts to falter. The critical path offers a generic checklist of important considerations that apply to any reform effort. This analysis suggests how the generic process could be applied to the specific problem of reforming the state-local revenue system.

1. ***Recognize and define the problem and set the reform goal.*** The Governor, Legislature and other elected leaders must formally agree on the problem that needs to be solved and the goals for reform. This will require:

Base the effort on a common goal. Whether to raise taxes or lower taxes is a policy decision that is distinct from the structural issues of what should be taxed, how it should be taxed and how policy-makers could systematically think about changes to the tax structure in the future. Reformers should be focused on the "performance" of the tax structure, leaving policy-makers with the task of adjusting the level of taxation based on the resources necessary to accomplish evolving public goals.

Establish goals focused on outcomes. A diverse group of interests seem to accept that a strong revenue system would have the following characteristics:

- ✓ ***Reliable*** – The tax system is relatively stable across swings in the business cycle.
- ✓ ***Accountable*** – The system provides a clear nexus between the tax and service rendered.
- ✓ ***Transparent*** – The process is simple to understand and operate.
- ✓ ***Neutral –*** The tax reform minimizes impacts on economic decisions.
- ✓ ***Equitable*** –The system is balanced in relation to the taxpayer's ability to pay.
- ✓ ***Phased –*** The reform is implemented over an extended period to allow time to adjust.

Define the limits of acceptable reform. Those charged with developing reforms must know what is on the table and what is off the table. Proposition 13, for example, is a flammable issue, particularly as it benefits residents. But there may be more willingness to change how commercial property is reassessed. Political leaders need to set realistic parameters, and empower reformers to think creatively within them.

Values	***Participants***
The Governor and other backers must publicly commit to the effort and make it clear to stakeholders that this venue will be the best and only path to improving the status quo.	The most robust effort would have the bipartisan backing of the Governor, legislative leaders, perhaps some Constitutional officers, as well as local government leaders.

2. ***Create a structure for success.*** The reform process could be managed by the executive branch, or a collaboration of executive and legislative resources or regional and local leaders.

Identify a committed revenue system reform champion, venue for action and supporting staff and other resources. The reform group, possibly a special commission, an executive branch workgroup, or a regional or local entity would have to identify issues, stakeholders and other participants, design and schedule activities to involve them and establish objective criteria to evaluate finished reform proposals. This step has often been excluded in past reform efforts at the state level.

***Plan the involvement of*:**

- ✓ State and local government leaders.
- ✓ Policy implementers, including professional organizations and their contractors that provide government services.
- ✓ Taxpayers, voters and government service recipients.
- ✓ Advocacy groups such as the California Budget Project and the California Taxpayers Association.
- ✓ Professional organizations, such as California State Association of Counties, California League of Cities, California Chamber of Commerce, etc.
- ✓ Policy experts, government planners, accountants, researchers and analysts.

***Establish the process for reaching agreement*.** A conflict resolution process like the one used by the Legislative Consensus Project, described at the end of this section, could be used. The same conflict resolution process used to reach agreement on the problem definition and desired goal could be used to secure executive and legislative commitment to make change a priority and expeditiously consider the finished proposal.

Values	***Participants***
Because of disputes over the level of taxation, efforts to develop revenue neutral reforms will have to be bipartisan, transparent and based on trust among the reformers and with the public. These values can be supported by competent staff capable of quality analysis and good communication with stakeholder groups, opinion makers and the general public.	The executive committee will have to involve state and local government leaders, small and large business leaders, and representative of individual taxpayers. The committee must develop a process for assessing ideas and secure the consent of participants and the state leadership that the process will be fair and rigorous.

3. *Establish the parameters of an acceptable solution.* The Governor and Legislative leaders should validate or amend the problem and validate the scope and schedule for work by formally establishing the parameters of an acceptable solution.

Validate commitment of sponsors and stakeholders. Too often reform efforts have quickly lost sponsorship of top leaders, and the first place of division is often over specific focus and the process that reform efforts will use. With those details in place, the sponsors must affirm their commitment and ensure the commitment of essential stakeholders. This is a '"go/no go moment."

Refine parameters. As the reform effort gets underway, the first wave of objections will surface. Before in-depth analysis and specific negotiations begin, sponsors must refine changes in the scope, timeframe, parameters and other foundational issues.

Because this step is often neglected, reformers are surprised by the lack of interest or outright resistance from policy-makers to finished proposals.

Values	*Participants*
A sincere commitment by elected officials will be necessary to get stakeholders to take the process seriously and to create the trust among participants that will enable reform.	Without the direct and meaningful involvement of top elected leaders from both parties, the effort will lose political momentum.

4. *Identify and agree on solutions.* Through a series of public meetings, informed by the best available analysis, key stakeholders should explore alternatives and develop the best solutions with broad public support.

Create a network of analytical talent. The reform group will need to recruit analytical talent from universities, think tanks, and state agencies to analyze concepts and explore alternatives. The University of California and the California State University System have individual experts and organizations that specialize in fiscal policy issue analysis.

Employ a collaborative conflict resolution process to:

- ✓ Engage the participants, county and municipal leaders and the general public in a discussion of potential solutions and their costs and benefits.
- ✓ Identify and expand areas of agreement, areas of mutual gain, and acceptable compromises and trade-offs.

- ✓ Ensure the commitment of representatives reflects the commitment of the interest groups they represent.
- ✓ Involve public administrators who would be responsible for implementing changes to begin planning and identify potential pitfalls and resource needs. This requirement would involve the Franchise Tax Board, the Board of Equalization, the State Treasurer and others involved in the collection of revenue. The process used by the Center for Collaborative Policy is a good model. The Center's website is at http:/www.csus.edu/ccp/collaborative/.

Values	***Participants***
Public involvement, process transparency, trust among participants and inclusiveness are all key to this step. Time is crucial; while there must be time to craft compromises and tradeoffs, participants must not risk losing public interest.	In addition to executive committee leadership, analytical experts, stakeholders, civic leaders and public administrators who will implement the reforms must become and remain involved.

5. *Validate and vet solutions.* The executive committee needs to make sure that the proposed solutions are technically sound and politically viable. The product at the end of this stage should be a technically sound solution that has a critical mass of solid support.

Validating revenue reform solutions. This activity requires the reform group to employ sophisticated computer modeling techniques that will:

- ✓ Identify winners and losers under various scenarios.
- ✓ Determine whether the proposed reform will accomplish its intended result.
- ✓ Establish that the reform proposal satisfies the criteria and parameters developed in steps two and three.

Vetting the reform proposal. The reform group can use the structure developed in Step 2 to verify acceptance of the proposed reform with stakeholders and participants.

Values	***Participants***
Economic and revenue analyses must be widely distributed and presented in ways that are easy to understand. Stakeholder commitment to positions agreed to by their representatives is crucial: a deal is a deal.	This step offers the opportunity to involve the general public and those who will implement reforms. The Internet, public meetings, and focus groups could be used to gather feedback, which can then be shared publicly to build awareness, make refinements and build support.

6. *Enact the proposal.* The Legislature needs to assess the proposal based on the established parameters and the support stated by interest groups throughout the process. If consistent with the parameters, enact it.

When enacting the proposal, the Governor and Legislature need to assess the performance of the proposal based on the parameters established in Step 3. For example:

- ✓ ***Reliability across swings in the business cycle*** - can be verified over time using revenue collection figures provided by the Department of Finance.
- ✓ ***Accountability*** - could be established by Franchise Tax Board and Board of Equalization Web sites that collect and report taxpayer comments on the acceptability of a specific tax for the level of service rendered.
- ✓ ***Transparency*** - could be established by reports from tax collecting agencies that show the number of erroneous tax returns and the numbers and skill levels of staff required to administer the tax.
- ✓ ***Neutrality*** - could be measured by the number and seriousness of distortions of reform intent. For example, does the tax skew land use decisions by encouraging local governments to seek commercial development rather than housing in order to boost tax receipts, or does the tax encourage consumers to spend to the exclusion of investing and saving? Most importantly, is the reform conducive to a vibrant economy with high-paying jobs?
- ✓ ***Equitability -*** could be determined by the progressiveness of the tax and its impact on consumer spending, investing and saving.

Values	*Participants*
State-level leadership must honor commitments made and accept solutions that fall within parameters agreed to previously. The executive committee can help maintain transparency and trust by ensuring public access to deliberations, analyses and documents.	The Governor and legislative leaders must secure acceptance by the Legislature. Local leaders, stakeholders and the public can communicate their support. Lawmakers should designate an agency to monitor and report on reforms and consider including sunset provisions in implementing legislation.

7. *Implement and monitor reform.* The Governor and the Legislature should support the implementing agencies by providing clear direction, adequate resources, and an effective means for communicating progress and making refinements to the plan.

Effective reform implementation requires the support of state leaders to provide clear direction, adequate resources and an effective way to communicate progress and make refinements to the reform plan. The reform group will have to:

- ✓ ***Conduct periodic analysis.*** The analysis will be based on the data identified in the data collection plan to assess how well the reform implementation is meeting the desired goal established in Step 1.
- ✓ ***Keep interested parties informed.*** The reform group will need to keep state and local leaders, reform process participants and the public informed on how well reforms are working and possible changes.
- ✓ ***Identify new participants.*** Analysis during this step may divulge the need for participation by groups or agencies that were not part of the original reform effort.

Values	***Participants***
Implementation must be timely. The monitoring process must provide for public scrutiny of the effects of revenue reforms so that all participants will remain committed to monitoring the implemented reform and revising it as necessary to improve effectiveness and efficiency.	The Governor and the Legislature must provide adequate funding, personnel and other resources and support to state and local officials who will implement the reform and make a state official accountable for monitoring and publicly reporting on the effectiveness of the implemented reform.

8. *Refine the reform as necessary.* The Governor and the Legislature should periodically assess the need for refinements or the next generation of large-scale reform, and be willing to repeat all or part of the critical path to ensure progress toward desired goals.

Repeat the critical path as required. Based on reform group recommendations in Step 7, the Governor and Legislature may opt to repeat all or part of the critical path to refine the reform or create the next generation of large-scale reform.

Include new participants in the critical path. Including any groups or agencies that have a contribution to make to the reform planning process but did not participate in the original reform effort is essential to a smooth implementation of any reform revisions.

Values	Participants
Commitment to accountability is the centerpiece of this step. The Governor and Legislature must review implementation reports to decide whether to revise or scrap the reforms. Publicizing these reports will provide transparency and retain public interest. New opposition may reveal key participants not included in the original process.	The state official appointed to monitor the reform must inform the public, civic leaders and stakeholders how the reforms are working, consult periodically with implementers and core stakeholders regarding possible refinements to the reform and recommend changes to the Governor and the Legislature.

The Legislative Consensus Process

The Legislative Consensus Project is the brainchild of the Center for Collaborative Democracy in New York City. It grew out of the MIT-Harvard Public Disputes Program, which has turned intense political conflicts into productive solutions at both the state and national levels.

Just as interest group representatives are often motivated to work out their differences, a task force that organizes a legislature into cohesive groups can resolve tough issues when traditional methods fail. Consider Oregon's experience. In 1994, the Oregon Department of Transportation asked the state Legislature to lower environmental hurdles for improving rural roads. The Department of Land Conservation protested. The Legislature told the two agencies to work it out. Unable to do so on their own, the agencies met with representatives from relevant groups, including the state's planning directors, the Oregon Farm Bureau, environmentalists and advocates for economic growth. In five sessions, these representatives reached consensus on a rule that the agencies accepted. The Oregon Legislature then passed a bill mandating similar councils to address other land use issues.

In 1983, the Texas Legislature established a council representing relevant groups to help site and regulate waste disposal facilities. The council has resolved many heated issues over the years and is now developing procedures for deciding when localities, rather than the state, should have jurisdiction.

A consensus building task force can help any legislature craft optimal measures. It usually takes the following steps:

1. Leaders decide an issue warrants a special task force.
2. Leaders ask candidates for the task force to submit position statements.
3. These statements are circulated in the legislature.
4. Any blocs that find none of the candidates right for them have to recruit candidates.
5. Position statements of those candidates are circulated.
6. Leaders decide the size of the task force, or decide to limit it to candidates who get a minimum number of supporters.
7. All lawmakers pick a representative from among the candidates.
8. The candidate with the fewest supporters is out of the running. His or her supporters make a second choice. This step is repeated until the task force reaches the size decided.
9. A chairperson is selected.
10. The staff is appointed.
11. A preliminary meeting schedule is set. The schedule should include time slots when there are no other legislative activities, so that all lawmakers can caucus with their task force representatives. As the negotiations progress, these caucuses will help the task force build support for its work, and serve as a reality check.

Source: The Center for Collaborative Democracy. Accessed 5/25/04 at http://www.democracy2000.org/index.htm

The Critical Path

To Improving the State-Local Relationship

Reforms of the early 1900s put in place in California the Separation of Sources Doctrine, which divided state and local government responsibilities. That doctrine provided local governments the authority to levy taxes to discharge their responsibilities. It was officially repealed by the Riley-Stewart Act of 1933, but continued as a guiding principle of state tax policy until the passage of Proposition 13 in 1978. Proposition 13 also shifted to the State the authority to distribute property tax revenues, which in turn gave state lawmakers greater discretion in how that revenue would be spent. These developments accelerated a trend that emerged in the early 1970s of trying to develop solutions to local problems at the state level.

The concentration of revenue in Sacramento and diminishment of authority by local governments over many aspects of local programs has pitted the State against their local partners, particularly in the annual budget battle. The muddling of responsibilities also has reduced accountability, confused efforts to measure performance and even to set priorities. There is no overarching goal or principle guiding the distribution of responsibilities between state and local entities.[84]

Problems in the State-Local Relationship

Over the last decade, as the unintended consequences of Proposition 13 and other changes have become clear, academics, elected leaders and others have attempted to realign the relationship between the State and local governments. Among the problems that often are cited:

Organizational complexity. More than 6,000 units of local government in California are overseen by more than 15,000 elected officials. Many entities overlap, and sometimes have conflicting duties and responsibilities. This complexity makes it difficult for residents to access or influence government. It frustrates efforts to coordinate related activities and to hold government accountable for malfeasance or poor performance.

Inappropriate assignment of responsibilities. While parole is a state responsibility, the costs and consequences of an unsuccessful parole system are borne by communities. From a community perspective, a struggling parolee should be returned to state prison, adding to state costs – but only until they return home again, still unprepared for their release. Most of the activities associated with successful parole are community functions, and should be operated by communities.

Incomplete authority. The system does not adequately link the authority over control and funding responsibility so decision-makers can be held accountable for program outcomes. It is difficult for residents, therefore, to know where to take complaints.

Counterproductive fiscal incentives. The revenue structure that funds local government encourages local officials to make decisions that are not in the long-term interest of their community or the State. For example, commercial development is favored over housing because the former increases local revenue, while the latter imposes local costs.

Erosion of local control. Proposition 13 and its aftermath empowered the State to divert local resources to pay for the increasing costs of state programs. The Constitution and court decisions such as Serrano have defined education as a state program. And State laws have severely circumscribed the ability of local governments to raise, allocate and manage revenues. For example:

- ✓ Local governments have no control over the allocation of property taxes collected in their communities.
- ✓ State policy-makers have restricted funds through categorical programs, either because they do not trust local officials to meet particular needs, they do not trust local officials to manage resources well, or they believe their priorities are more important than locally determined priorities.

Pervasive distrust. Local officials distrust state policy-makers who divert local revenues to pay the increasing costs of state programs during economic downturns. State policy-makers decry the lack of local accountability for outcomes from state-funded programs.

Ineffective administrative oversight. State monitoring and reporting requirements focus on compliance rather than outcomes. They serve little purpose and divert scarce resources from more productive uses. Oversight of the Medi-Cal program, for example, is focused primarily on tracking expenditures rather than improving the health of clients.

Long-standing Problems that are Growing Worse

Reports going back a decade have blamed many of the state's governance problems on this basic division of public responsibilities. The Constitution Revision Commission, for example, called for a

"...fundamental reorganization of state and local government responsibilities."[85] A local government official recently characterized the State's actions as "...stealing of local revenues and mandating costs."[86] Still, state and local leaders have failed to reach agreement on how to redefine their relationship. The complexity of local government organization in California may encourage caution. In addition to being numerous, local government agencies are highly diverse, including counties, cities, special districts and school districts.

This dense forest of public agencies makes it difficult for policy-makers and residents alike to know who to turn to for help or what to do when government as a whole fails to perform. There is not a standard template for services or authority and so the government infrastructure varies from community to community. Water service is sometimes provided by the city or county government, sometimes by an independent special district, and sometimes by a privately owned but publicly regulated utility. Libraries are sometimes city operations, sometimes county operations, and sometimes assigned to special districts. Jails are local operations; prisons are operated by the state. Air quality is (usually) regulated by independent regional districts, as well as a state board. Water quality is regulated by state-operated regional boards. While each arrangement has some logic to it, the complexity makes it difficult to understand, access, influence and trust. The arrangement also leads to competition among the agencies over development, authority and revenue. In some cases, alliances are based on a mutual distrust of another government agency.

Local Government Agencies

California has a mosaic of more than 6,300 local government entities:

- 478 cities providing municipal services
- 58 counties providing municipal services to unincorporated areas, countywide services and selected services acting as an agent of the State.
- 4,741 special districts providing specific services within a county or several counties. Such districts include water, fire, library, park and recreation, etc.
- 1,041 school districts and county offices of education providing K-12 and adult education services.
- 72 community college districts providing academic and vocational programs.

Source: Chris McKenzie, Executive Director, League of California Cities, Testimony to the Little Hoover Commission, March 25, 2004, California State Controller's Office, "Special Districts Annual Report, FY 1999-00," April 2003 and "School Districts Report, FY 1999-00," July 2003, California Community Colleges Chancellor's Office, www.cccco.edu.

In general, cities provide municipal services. Counties partner with the State to administer most health and human service programs, in addition to their local responsibilities, including municipal services for unincorporated areas. While school districts are more uniformly defined, they range in size from one-room schoolhouses to the Los Angeles Unified School District, with more pupils than four states have residents. Special districts often have lower public profiles; but some, such as the Metropolitan Water District of Southern California, have tremendous assets and directly impact the health and prosperity of California's economy and ecosystem far beyond its service boundaries.

The relationship between state and local governments, like the California landscape, is constantly evolving. Occasionally seismic-like lurches make dramatic – and often unintended – changes. And in the event of initiatives, those changes for better or worse are usually locked into the constitution. For example, when Proposition 13 shifted control over the allocation of property taxes to the state, the Legislature locked in those allocations in AB 8, essentially freezing in place revenue decisions made in the mid-1970s.[87] In response to state policy-makers giving local governments more assignments than revenue, voters in 1979 enacted a constitutional amendment requiring the state reimbursement for mandated programs.[88]

The California Constitution Revision Commission

The 1994-1996 California Constitution Revision Commission (CCRC) recommended that the Governor and the Legislature adopt a state/local realignment plan governed by a set of constitutional principles. The process would be continuous and include local governments, private and public organizations that provide services, and users of these services. Ideally, this plan would be renewed every four years as input to the long-term budget planning process. Finding the right mix of program responsibility and revenue for shared programs, in particular, is essential to repairing the state-local relationship.

The State-Local Realignment Plan would assign policy authority, administration and finance for each program administered by the State or local government. For ease of administration, programs would be classified into four categories delineating responsibility:

- ***State Responsibility:*** Programs for which the State role is policy-making, standards-setting, administrative and financial. Examples include higher education, K-14 education, vehicle registration and environmental regulation.
- ***Shared Responsibility:*** Programs for which state and local agencies share policy-making, administration and finance, or standards-setting for a specified level of local financial effort. Examples include mental health and transportation.
- ***State Responsibility - Locally Administered:*** Programs for which a local agency, usually a county, is acting as the agent of the State. Examples include indigent health care, general assistance and the judicial system.
- ***Local Responsibility:*** Programs for which a local agency has the responsibility, authority and financial control of a program. Examples include law enforcement, libraries, recreation and cultural activities and other traditional municipal services like utilities.

Objectives of the CCRC Realignment Plan

- Ensure that roles and responsibilities for providing services and exercising regulatory authority are clear.
- Ensure that the entity responsible for a service or regulation has the resources to finance it.
- Ensure that the entity assigned to conduct an activity has the ability to organize and administer the activity.
- Ensure that program responsibilities that are shared between state and local agencies are identified and that local administrative flexibility is given priority over state administration.

Source: Final Report of the California Constitutional Revision Commission, 1994-1996. www.library.ca.gov/CCRC/.

But other analysts have pointed out that the state-local issues are not confined to fiscal issues, and are not unique to California. Peter Hutchinson, co-author of the book, "The Price of Government," said that the current budget crisis has only revealed underlying state-local tensions. These tensions include how governments use power, how governments interact with each other, and how communities envision themselves and the future. These issues must be addressed for state and local governments to work in partnership.[89] Corrective action will require amending the Constitution, revising statutes and reaching agreement with the federal government on issues that distort government organization in California.

Past Reform Efforts

Numerous efforts have been made to redefine the state-local relationship. Some of those efforts have focused on the responsibilities of different levels of government and some have focused on fiscal issues. Still others

The LAO's Making Government Make Sense

In 1993 the LAO recommended reorganizing the state-local relationship using four basic principles:

- Maximize separation of state and local government duties through appropriate alignments of control and funding responsibilities. Duties assigned to the State would be those that represent truly statewide functions that require state control to ensure adequate service levels. Examples include public health and long-term custody.
- Match redistributive programs with redistributive revenue sources at the highest level of government. The portion of local property taxes now allocated to schools, for example, would be reallocated to local governments and replaced with higher state assistance. This approach would require modifying the Proposition 98 funding guarantee to K-14 schools. The LAO asserted that earmarking specific portions of state-level resources is fundamentally inconsistent with the recommended changes.
- Recognize program linkages by restructuring to promote coordination of service delivery mechanisms, removing barriers to innovation. Individuals in need of assistance often need a combination of services to achieve independence. An adult criminal offender, for example, may need a mix of services such as substance abuse, mental health, education, parole supervision, low-cost housing, and job training to successfully reenter the community after release from incarceration.
- Rely on financial incentives to promote prevention and coordination by establishing:
  - ✓ Failure cost incentives – these incentives would impose a cost on programs that did not meet outcomes.
  - ✓ Success awards – these incentives would financially reward programs that successfully reduced the demand for state support.
  - ✓ Planning and performance sanctions – these sanctions would change the local planning process into a community strategic planning process like those used by major corporations. The goal would be to motivate better coordination between levels of government to promote better achievement of outcomes.

Source: Legislative Analyst. "Making Government Make Sense." February 1993.

have recognized the interplay of both issues. Appendix D summarizes several of these efforts. The California Constitution Revision Commission and the Legislative Analyst's Office, "Making Government Make Sense," which are detailed on the previous pages, are two often cited efforts. The first is the product of a "blue ribbon" group created by the Governor and the Legislature to propose reforms; the second reflects a legislative-branch effort to advance reform.

Why Reform Measures Have Not Succeeded

While there have been many recommendations, there has been little implementation. The problems remain and are becoming increasingly intractable. Factors contributing to lack of reform include:

- ***Investment in the status quo.*** Those who benefit from the current lack of accountability for state and local government performance have little incentive to support reforms. Currently, neither state nor local officials have adequate authority to manage programs. Responsibility is so diffused that it is difficult to determine who is responsible for the effectiveness and efficiency of government services.

- ***Influence of special interests.*** A focus on outcomes with appropriate rewards for good performance and sanctions for poor performance, an approach recommended by policy analysts for years, would cause a shakeout among current service providers. Service providers and their professional organizations often unite to oppose the introduction of performance standards on the basis that the effects of their efforts are not easily measured.

- ***Distrust.*** A large reservoir of distrust has accumulated in recent years because of State preemption of local revenues to solve budget problems. Having been rebuffed by state officials, local leaders are seeking other methods of initiating changes in the structure of the state-local relationship. There is little desire to work together to solve problems.

- ***Lack of a structured reform process.*** Most efforts did not accomplish everything necessary to implement reforms or did not provide for

California Home Rule Amendment

Proponents of an initiative to provide local governments with a reliable and growing source of revenue are gathering signatures to place the "California Home Rule Amendment" on the November 2004 ballot.

The measure would shift about $7 billion in city and county vehicle license fee and sales tax revenues to K-14 schools. An equal amount of property taxes would be shifted to cities and counties.

Additionally, the measure would prohibit the State from enacting measures that reduce city and county revenues from local taxes.

The measure would expand the circumstances under which the State is required to reimburse local governments for mandated programs. And it would allow local governments to suspend state-mandated programs when the State does not provide timely reimbursements.

Source: William J. Rosendahl, Chairman, California Commission on Tax Policy in the New Economy, Written testimony to the Little Hoover Commission, March 25, 2004, Legislative Analyst's Office, Letter to the Honorable Bill Lockyer, Pursuant to Elections Code 9005, review of the "California Home Rule Amendment." March 4, 2004, and http://www.calhomerule.com/.

someone else to complete the process. Without a structured process to manage reform, important steps often are left out, particularly the time-consuming consensus building ones, making legislative approval unlikely.

Overcoming these hurdles and redefining the roles of government agencies is essential to improving the efficiency and effectiveness of services. California taxpayers deserve a smooth, coherent and productive relationship between the state and local governments that deliver the services they fund.[90]

Other States' Reform Efforts

A variety of states have used blue-ribbon commissions, advocacy groups, academics and think tanks to devise a way to restore a sense of partnership to state and local relationships. Their record of success is mixed.

Wisconsin – Governor appointed the Blue Ribbon Commission on State-Local Relationships for the 21st Century. The Commission rendered a comprehensive report in January 2001 with 139 recommendations, including proposals on restructuring revenue sharing programs, redefining targeted aid programs for counties, and comprehensive regulatory reform.

Florida, Georgia, North Dakota and New Mexico – Created similar commissions and task forces to improve efficiency and cooperation of state and local governments. Georgia implemented a resulting recommendation for incentive grants to promote certain types of activities that encourage fast-growing counties to preserve a minimum of 20 percent of their land for green space. Few of the other efforts have been tested.

The Minnesota Grant Board – In 1993, Minnesota established an independent board composed of the state auditor, commissioners of finance and administration, two administrative law judges and six legislators, to approve grants to local governments seeking to innovate service delivery. The board also granted three-year test waivers of state rules that could be made permanent if they improved effectiveness or efficiency without unintended consequences.

Beyond the success of many of its experiments, the board provided an intangible benefit. Its existence changed the mindset of state administrators and made them more receptive to new ideas because failure to adopt good change proposals could result in waiver requests to the board and accompanying publicity.

Oregon – The landmark "Oregon Options" project created a set of agreed upon outcomes between the state and federal governments and agreed to eliminate bureaucratic hindrances to achieving these outcomes. Oregon Options is considered a successful experiment in results-driven governance.

Iowa – The Iowa Legislature gave local governments incentives to consolidate into "Freedom Communities" for more efficient operation.

To create Freedom Communities, Iowa completed a five-step process:

1. Make having a successful state-local partnership someone's job.
2. Complete a top to bottom review of state and local government activities to establish responsibility, authority and accountability.
3. Tie financial resources to responsibility and accountability.
4. Focus on a common agenda and listen to people who matter most – Iowans.
5. Make performance and accountability visible to citizens.

Sources: David Osborne and Peter Hutchinson, "The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis," Basic Books, pp. 242-244, May 2004. Peter Hutchinson. Freedom Communities. Unpublished, 2004, pp.1-2. Peter Hutchinson. Iowa State-Local Framework. Unpublished, 2004, p. 1.

Applying the Critical Path

Many aspects of the state-local relationship warrant reform. To be successful, reformers will have to systematically work through the issues, prioritizing efforts and concentrating on one major policy issue at a time. The two major policy issues most often mentioned are the allocation of revenues and the distribution of responsibilities.

Reform will not be possible until the level of trust between state and local leaders improves. Because this distrust is based primarily on revenue issues, some solution must be found that distributes tax revenues to enable each level of government to perform its assigned functions. Resolving that fundamental issue would allow stakeholders to discuss subject-specific realignments, such as education, public safety, health and social services. The following discussion describes how the critical path could be employed to develop and implement changes to the foundational issue of realigning the distribution of tax revenues.

1. ***Recognize and define the problem and set the reform goal.*** The Governor, Legislature and other elected leaders must formally agree on the problem that needs to be solved and the goals for reform.

While local governments are creatures of the State, substantive reform will require full commitments by both state and local officials. The Governor and the Legislature alone cannot successfully redefine the state-local relationship, and state leaders in the past have been reluctant to divest themselves of the control and discretion they have acquired.

Any effort to re-engineer this intergovernmental relationship must be based on a commitment to clarifying roles and responsibility and a willingness to vest the authority and discretion with that responsibility.

The Governor, legislative and key local government leaders should agree on a set of principles that outlines these issues and can serve as the foundation for restructuring government.

Values	***Participants***
State and local government and civic leaders must agree on the mission and functions of each level of government and the degree of autonomy the State will permit local	From Day 1, a bipartisan partnership of key state and local elected officials must champion the reform process and rally the support of their peers.

2. *Create a structure for success.* The reform process could be managed by the executive branch, or a collaboration of executive and legislative resources or regional and local leaders.

Because of the size and diversity of the state, and the complexity of government organization in California, the State should consider a structure that provides statewide guidance and assistance, while allowing for local or regional solutions to emerge.

Iowa's Freedom Communities

The Iowa Legislature empowered local governments to structure services and payments and to enhance public accountability for results. In exchange for this freedom, the Legislature required local governments to achieve significant spending efficiencies by merging, consolidating and sharing at least 50 percent of services delivered. Local governments that did were rewarded with "Freedom Community" status and required to report progress on outcomes to their constituents every six months. They also benefited from unique rules that provided more flexibility in administering state programs. This approach provided local government with incentives and authority to consolidate for efficiency and increased accountability.

Sources: Peter Hutchinson. Freedom Communities. Unpublished, 2004, pp.1-2. Peter Hutchinson. Iowa State-Local Framework. Unpublished, 2004, p. 1.

- ✓ ***Create a State Executive Council.*** The council's task would be to define statewide issues, help to define specific goals for reform and acceptable solutions, and facilitate agreement at the local and regional level. For example, the council could identify acceptable ways to modify Proposition 98 to create possibilities and put boundaries on reforms. Reallocating local sales tax might be best done locally, provided the reallocation met statewide goals.

- ✓ ***Provide state assistance to local reform efforts.*** Some regional forums have made progress toward redistributing sales and other tax revenue. The State could encourage regional and community-based efforts by providing technical, financial and other assistance. It also can serve as a network for process and policy issues, and assist with financial and other analysis so good ideas generated in one community can feed into forums elsewhere.

- ✓ ***Develop objective criteria to evaluate proposals.*** These criteria will be used to evaluate and monitor reforms in the state-local relationship.

- ✓ ***Develop ground rules for discussing issues and building agreements.*** While specific reforms will vary, standard procedures can be developed to encourage agreement and prevent procedural missteps.

Values	***Participants***
The reform structure must include meaningful regional and local participation. Trust will be built by initial successes that resolve local issues of autonomy and state concerns about performance and accountability.	Stakeholders must include not-for-profit organizations that contract with local governments to provide services, recipients of public services, and professional and advocacy organizations.

Values	Participants
The reform structure must include meaningful regional and local participation. Trust will be built by initial successes that resolve local issues of autonomy and state concerns about performance and accountability.	Stakeholders must include not-for-profit organizations that contract with local governments to provide services, recipients of public services, and professional and advocacy organizations.

3. ***Establish the parameters of an acceptable solution.*** The Governor and the legislative leaders should validate or amend the problem and validate the scope and schedule for work by formally establishing the parameters of an acceptable solution.

- ✓ The Governor, Legislature, the League of California Cities and the California State Association of Counties should formally validate the specific goals established by the State Executive Council.
- ✓ State policy-makers also should create incentives devised by the council and provide financial and political support to the state effort.
- ✓ State leaders should make sure that budget and other policy decisions that are made during this time do not preclude reforms that are under consideration by the state or local venues.
- ✓ The parameters should include an appropriate alignment of responsibilities. For example:
  - Statewide functions, for example, may include ensuring service levels and providing technical assistance.
  - Community-based services are best assigned to local governments.
  - Duplication should be avoided and economies of scale realized.
- ✓ Oversight should be outcome-based, not compliance oriented.

Values	Participants
To encourage commitment on the part of all participants, state and local leaders must invest political capital. The new partnership will have to be based on shared commitment to reaching public goals. Policies and programs will have to be guided by outcomes, and the state-local relationship built on trust.	Elected officials at the state and local level, in the executive and legislative branches, must be engaged to ensure other stakeholders take the process seriously. A common factor in previous unsuccessful efforts was that initial support for reform efforts quickly faded.

4. ***Identify and agree on solutions.*** Through a series of public meetings, informed by the best available analysis, key stakeholders should explore alternatives and develop the best solutions with broad public support.

The State Executive Council assembling will need to assemble the best analytical talent from universities, think tanks, and state and local government organizations to assess proposals and project their effects.

Also at the state and local level, extraordinary efforts must be made to involve the large numbers of both official and informal community leaders – to build understanding of the problem, momentum for change, and agreement on the best available solutions.

State and local reform leaders must ensure that stakeholders are fully engaged, faithfully representing the position and support of their organizations, and identifying areas of disagreement.

Values	***Participants***
Forging agreement requires that the public is meaningfully consulted and that interest groups are actively involved. Transparency in the process is essential to building trust among the participants and restoring trust with the public.	The executive committee must be vigilant to make sure that negotiations are well informed and making progress. Clients and their families, service providers, faith-based and other community organizations need to be involved to ensure solutions are meaningful.

5. ***Validate and vet solutions.*** The executive committee needs to make sure that the proposed solutions are technically sound and politically viable. The product at the end of this stage should be a technically sound solution that has a critical mass of solid support.

All the participants and factors that facilitate or hinder success in Step 4 also apply to Step 5. Experts, state and local officials, stakeholders and the public are key to identifying, validating and vetting the solution. This step, however, usually takes longer than expected in order to deal with unanticipated concerns from interest groups whose representatives committed to the proposal without the support of their constituents. The staff needs to ensure that:

- ✓ ***Sophisticated analysis techniques are used.*** This analysis will ensure that proposals are technically sound and politically viable by demonstrating who the winners and losers will be.
- ✓ ***State and local leaders remain involved***. Their involvement will help preclude roadblocks from arising.

- ✓ ***Interest groups have the support of their constituencies for proposals*** This will prevent roadblocks from developing in later steps.
- ✓ ***The general public is consulted***. The use of standard public forums, including city council, school board and board of supervisors' meetings is important to respectfully build community support.

Values	***Participants***
If the commitment from top leaders waivers, the momentum for reform can easily dissipate. Trust that has been built so far in the process must be used to ensure participants that proposals will be refined and unanticipated problems will be resolved as they emerge.	Expert analysts must demonstrate that the proposed reforms will accomplish their intended purpose. Stakeholders must affirm the support of their organizations. And policy-makers must affirm their support for change and encourage participants to work out lingering concerns.

6. *Enact the proposal.* The Legislature needs to assess the proposal based on the established parameters and the support stated by interest groups throughout the process. If consistent with the parameters, enact it.

The Legislature should be biased toward implementing statewide reforms that meet the goals and fall with the parameters it validated at the start of the process. Policy-makers should be similarly biased toward approving regional solutions that enjoy regional support, even if those proposals are opposed by state organizations or groups from other regions. Policy-makers must stand by agreements made earlier and must hold stakeholders accountable for their agreements. To respond to uncertainty, the Legislature could:

- ✓ ***Develop ways of measuring reform impacts.*** The criteria for success and the parameters of a successful solution developed earlier in the reform effort can be used to assess proposals and deflect last-minute opposition.
- ✓ ***Provide for periodic review and revision***. By establishing standing committees or specific procedures, the Legislature could deal with uncertainty – and the opposition it generates – by carefully monitoring implementation for unintended consequences of reforms.
- ✓ ***Consider enacting sunset provisions***. Few reforms maintain their effectiveness forever in a constantly changing environment. A sunset review offers the opportunity to discontinue policies that are no longer working.

Values	*Participants*
All participants must deliver on their commitments to support enactment. The executive committee and reform leaders will need to keep participants engaged and supportive. The Governor and Legislature must have broad support to act decisively and in a timely manner. To ensure accountability, rigorous monitoring provisions must be included in enacting legislation.	Although the Governor and Legislature must enact the reforms into law, all participants must remain active during this phase. Supporters of reform will have to defend their proposals against those who would benefit from a continuation of the status quo. The Governor must appoint someone, possibly the executive committee, to oversee the implementation.

7. ***Implement and monitor reform.*** The Governor and the Legislature should support the implementing agencies by providing clear direction, adequate resources, and an effective means for communicating progress and making refinements to the plan.

The Governor and Legislature need to protect and support the new state and local relationship by living up to commitments to shift responsibility and staying focused on the outcomes of public policies. They also must ensure that the state bureaucracy, budget and other procedures are adapted to reflect the new reality.

State and local leaders can work together to:

- ✓ ***Encourage thoughtful analysis.*** Universities and think tanks should be enlisted to examine aspects of the reforms and critique whether goals are being met and how reforms could be refined.
- ✓ ***Report progress to stakeholders and the public.*** These reports will demonstrate the value of government services and create support for reforms and subsequent revisions.
- ✓ ***Periodically assess reforms.*** This assessment will guide the implementation process.

Values	*Participants*
The executive branch must change its structure and operations to reflect the new state-local relationship. The Governor's appointed reform overseer must report on the effectiveness and efficiency of reforms to officials, stakeholders and the public.	The Governor and Legislature must provide sufficient resources, clear direction on expectations, formal ways to provide feedback to all participants and the public on how the reforms are working and the means to refine reforms to improve effectiveness and efficiency. Reform leaders and participants must remain vigilant to ensure that the new state-local relationship accomplishes established goals.

8. *Refine the reform as necessary.* The Governor and the Legislature should periodically assess the need for refinements or the next generation of large-scale reform, and be willing to repeat all or part of the critical path to ensure progress toward desired goals.

State leaders should assess periodically all reforms to ensure that they are working as intended. If reforms are not working as intended, state leaders may need to:

- ✓ ***Repeat the critical path or portions of it.*** The process may need to be repeated to refine the new state-local relationship to accomplish intended outcomes.
- ✓ ***Invoke sunset provisions of the enacting legislation***. Sometimes the best course of action is to start anew.

Values	***Participants***
The commitment that accomplished reform must be transformed into a commitment to accountability. The transparency that encouraged reform must be transformed into transparency of how well programs are working to serve the public.	The appointed overseer should work with public agencies and stakeholders to recommend needed refinements to the new system. Substantial problems may need to be resolved by repeating some of steps in the critical path.

The Commission on Local Governance for the 21st Century: A Blue Ribbon Panel That Resulted in Reform

The Commission on Local Governance, created by AB 1484 (Hertzberg), was convened in August 1998. The commission enjoys the rare distinction of having most of its recommendations adopted in statute. Its success was due in part to having a well-planned step-by-step process. Among the steps:

Recognize and define the problem and set the reform goal. AB 1484 directed the commission to review laws that govern city, county and special district boundaries and recommend appropriate changes. Commissioners considered their task to include governance issues that needed to be addressed by the Governor and Legislature. The problem definition (boundaries and governance issues) focused the group's efforts.

Create a structure for success. AB 1484 provided the commission with a staff and requisite resources. At its first meeting, commission members elected Susan Golding, mayor of San Diego, as chair. She and other commissioners provided continuity for the commission throughout 18 months of effort. The commission leadership structured activities to coincide with legislative and other calendars.

Identify and agree on solutions. Over a 16-month period, the commission held 25 days of public hearings and received and analyzed over 100 recommendations.

Validate and vet solutions. The commission established a public Web site to share analyses and deliberations. Ninety thousand people visited the Web site. The final report included an implementation plan with proposed legislative changes to specific statutes.

Enact the proposal. Because the final report included an implementation plan that listed recommendations and proposed wording changes to specific statutes, the Legislature was able to quickly evaluate the commission's product. Most of the proposed changes were enacted into statute.

Persistent leadership. The author of the bill carried the legislation to implement the reforms. The measure, AB 2838, was adopted by a 45 to 29 vote in the Assembly and a 25 to 12 vote in the Senate.

While the commission's work was criticized by some for not comprehensively addressing all of the local governance issues that should be addressed, its focused and deliberate efforts delivered practical reforms for the issues identified by the Legislature. Senate amendments softened some of the bill's provisions that attempted to address California's growth issues more on a regional basis as a first step toward a statewide approach to managing growth. Opponents viewed provisions relating to growth patterns, in-fill development and LAFCO discretion over cities' spheres of influence to be unwarranted intrusions into local control of land use.

Sources: Growth Within Bounds: Report of the Commission on Local Governance for the 21st Century. January 2000. E-mail from Susan Golding, commission chair, May 10, 2004. Commission on Local Governance for the 21st Century. Recommended Revisions to the Cortese-Knox Local Government Reorganization Act of 1985 – Tab 6: Table of Changes. January 20, 2000. AB 2838 Analysis, accessed June 1, 2004 at http://www.leginfo.ca.gov/cgi-bin/postquery.

Conclusion

Significant change in a democratic society is difficult to achieve. Political power is intentionally diffused to prevent tyranny. The day-to-day competition over resources and among ideologies spews distrust. Large-scale reform requires the support of a critical mass of stakeholders, yet often any one of those organizations has enough clout to kill a proposal it opposes. Complicated problems require sophisticated solutions, but analysis is often ignored in pursuit of compromise and simplicity is often a prerequisite of public support. Finally the informal political justice system punishes public administrators who take risks, often before the results of their efforts are even known.

To overcome these and other barriers requires a convergence of fortitude, political capital, creativity, good will – and a game plan.

Over the last 20 years government in California has suffered from several “structural” problems that have progressed from chronic maladies to acute illnesses. Two stand out: A revenue system that is unreliable and anachronistic; and, a division of responsibility among state and local governments that thwarts performance and accountability.

The Cost of Government

“The American people are immensely frustrated. They pay the price of government, and they want a government that is worth what they pay.”

Source: David Osborne and Peter Hutchinson. "The Price of Government." Basic Books, 2004, p. xii. The quote was taken from a draft provided by Mr. Hutchinson at the Commission’s March 25, 2004 public hearing.

Reform is most possible during times of economic transitions and social dislocations. The Progressive Movement in the early part of the 20th Century was prompted by the transition from a rural and agricultural economy to an urban and manufacturing economy. California’s leaders responded to the public’s concern over the concentration and abuse of political and economic power by creating the civil service system and the Public Utilities Commission, as well as the initiative, referendum and the recall processes.

Today, knowledge-based and other technologies are again radically altering California’s economy, creating new problems and new possibilities – for entrepreneurs and policy-makers, workers and educators. In the private sector, improvements in productivity create wealth. In the public sector, improvements are required just to keep pace with new demands for quality education, life-saving health and human services, efficient environmental safeguards and transportation systems, and smart public safety programs.

Today's progressive governments are redefining responsibilities to focus on these essentials – realigning functions to enhance accountability, reduce duplications and fill gaps in necessary services.

These reforms are steps in the right direction, rather than ends in themselves. These reforms are the result of a process rather than an event. As detailed in this report, this process would overcome the weaknesses of democracies by tapping their strengths – by using a transparent course that involves all major stakeholders focused on advancing shared goals that represent the public interest.

Through a process such as this, California could move beyond the debate of whether to raise or lower taxes, to first developing a revenue system that is reliable and equitable. California also could systematically work through the issues of state and local governance that undermine efficiency and effectiveness and just defy common sense.

The threshold for instigating change of this magnitude is usually a "crisis." While there is some debate about the direness of California's straits, there is broad agreement that structural change is warranted and necessary.

The threshold for enacting a particular reform is often placed even higher – all winners no losers, no downsides or uncertainties. That is unrealistic and in the long run irresponsible. California's leaders need to aggregate political capital and good will, analytical capacity and creative thinking. They need to enact the smartest available solutions that have the requisite public support, and then be equally dedicated to responding to unforeseen and unacceptable consequences.

Appendices & Notes

- ✓ ***Public Hearing Witnesses***
- ✓ ***Advisory Committee***
- ✓ ***Focus Group Meetings***
- ✓ ***Summary of Prior Reform Efforts***
- ✓ ***Revenue Reform Options for a Superior Tax Policy***
- ✓ ***Notes***

Appendix A

Little Hoover Commission Public Hearing Witnesses

Witnesses Appearing at Little Hoover Commission Roadmap for Reform Hearing on November 20, 2003

Carl Demaio, Executive Director
The Performance Institute

B. Timothy Gage, Former Director
State of California
Department of Finance

Perry Kenny, Past President
California State Employees Assocations

Lucy Killea, Ph.D.
Former Legislator, California State Senate

J.J. McClatchy, Chief Executive Officer
McClatchy Management

Joe Peters, Secretary/Treasurer
California Farm Bureau Federation

Tom Stallard, Executive Director
Valley Vision

The Honorable John Upton,
Council Member, City of South Lake Tahoe
and Former President, California State
Association of Counties

Witnesses Appearing at Little Hoover Commission Roadmap for Reform Hearing on January 22, 2004

Donna Arduin, Director
State of California
Department of Finance

Mark Baldassare, Ph.D.
Director of Research
Public Policy Institute of California

John Bohn
Chairman and Chief Executive Officer
GlobalNet Venture Partners, LLC

The Honorable Joseph Canciamilla
Member of the California State Assembly

Bill Hauck, Director
California Business Roundtable

Elizabeth Hill
Legislative Analyst

The Honorable Scott Peters
Council Member, City of San Diego

The Honorable Keith S. Richman , M.D., M.P.H.
Member of the California State Assembly

Steven C. Szalay
Executive Director
California State Association of Counties

John Upton, Member, South Lake Tahoe
City Council and Former President,
California State Association of Counties

Witnesses Appearing at Little Hoover Commission Roadmap for Reform Hearing on March 25, 2004

Michael Coleman
Principal
CaliforniaCityFinance.com

Russell Hancock
President & Chief Executive Officer
Joint Venture: Silicon Valley Network

Peter Hutchinson
President
Public Strategies Group, Inc.

Chris McKenzie
Executive Director
League of California Cities

William J. Rosendahl
Chairman
California Commission on Tax Policy in the New Economy

Steven C. Szalay
Executive Director
California State Association of Counties

Appendix B

Little Hoover Commission Roadmap for Reform Advisory Committee

The following people served on the Roadmap for Reform Advisory Committee. Under the Little Hoover Commission's process, advisory committee members provide expertise and information but do not vote or comment on the final product. The list below reflects the titles and positions of committee members at the time of the advisory committee meetings in 2003 and 2004.

Paul Arevelo, City Manager
City of West Hollywood

Kent Briggs , Executive Director
Council of State Governments - West

Matthew A. Cahn, Ph.D., Professor
Calfiornia State University at Northridge

Ralph Carmona , Director, Public Relations
Sacramento Metropolitan Utility District

John Decker, Staff Director
Senate Office of Research

John Ellwood, Ph.D.
Professor of Public Policy
University of California at Berkeley

Timothy Hodson, Ph.D.
Director, Center for California Studies
California State University - Sacramento

Lucy Killea, Ph.D.
Former Legislator, California State Senate

Kenneth Larson, Director of Public Policy
California Association of Nonprofits

Steve Levy , Director
Center for Continuing Study of California Economy

J.J. McClatchy, Chief Executive Officer
McClatchy Management

Chris McKenzie, Executive Director
League of California Cities

Peter Mehas, Ed.D, Superintendent
Fresno County Office of Education

Roger Noll, Ph.D., Director
Center for Research on Economic Development & Policy Reform
Stanford Univeristy

George M. Passantino
Public Affairs Director, Reason Foundation

Joe Peters, Secretary/Treasurer
California Farm Bureau Federation

Jean Ross, Executive Director
California Budget Project

Fred Silva
Senior Advisor on Governmental Relations
Public Policy Institute of California

Dwight Stenbakken
Director of Legislation, Policy Development, Grassroots
League of California Cities

Steven C. Szalay, Executive Director
California State Association of Counties

John Upton, Member, South Lake Tahoe City Council and Former President,
California State Association of Counties

Roger Valine, President
Vision Service Plan

Appendix C

Little Hoover Commission Roadmap for Reform Focus Groups

The following people participated in one of the Commission's three focus group meetings convened during the Roadmap for Reform Study. The meetings focused on revenue reform proposals, the relationship between state and local government and a process for implementing reform proposals.

Focus Group – Revenue Proposal

Michael Coleman, Principal
CaliforniaCityFinance.com

Lenny Goldberg, Member
California Commission on Tax Policy in the New Economy and Executive Director, California Tax Reform Association

Jean Ross, Executive Director
California Budget Project

Steven Szalay, Executive Director
California State Association of Counties

Focus Group – State & Local Government Relationship

Steve Keil, Legislative Coordinator
California State Association of Counties

Chris McKenzie, Executive Director
League of California Cities

Marianne O'Malley
Principal Fiscal & Policy Analyst
Legislative Analyst's Office

Peter Schaafsma, Staff Director
Assembly Republican Fiscal Committee

Jennifer Swenson, Consultant
Senate Committee on Local Government

Caprice Young, Chief Executive Officer
Charters Schools Association

Focus Group – Implementation Plan

Nick Bollman, President & Chief Executive Officer, Center for Regional Leadership

Bruce E. Cain, Ph.D., Director
Center for Governmental Studies
University of California at Berkeley

Marney Cox, Chief Economist
San Diego Association of Governments

Bill Hauck, President
California Business Roundtable

Bud Wendell, Principal
Management Communications and Strategic Communications Consultant, Joint Venture: Silicon Valley Network

Appendix D

Summary of Prior Reform Efforts and Recommendations

Numerous commissions and task forces have worked to achieve structural reforms of the California revenue system. Each organization had a slightly different mission, and as a result, recommendations from each group differ as they were tailored to address unique problems. Often work overlapped, and several recommendations were reiterated numerous times. While these efforts created many valuable and viable solutions, the Legislature has not enacted any of the major recommendations. The following pages summarize the recommendations relating to structural and revenue reform from several of the most prominent bipartisan efforts.

California Constitution Revision Commission

Origin:	Created by legislation enacted in 1993.
Membership:	23 members. Ten selected by the Governor, five by the Speaker of the Assembly and five by the Senate Rules Committee. The Chief Justice of the Supreme Court, the Legislative Analyst and the Director of the Department of Finance also were members.
Process:	Held 30 public meetings including four public hearings and held 39 community forums and video conferences. Report published in 1996.
Web site:	http://www.library.ca.gov/Ccrc/reports/

***Recommendations**:*

- ✓ Require the Governor to submit, and the Legislature to adopt, long-term goals for the state and performance measures for the budgetary process.
- ✓ Require a four-year capital outlay plan.
- ✓ Adopt a two-year budget cycle.
- ✓ Provide a budget re-balancing mechanism.
- ✓ Require the State's budget to be balanced.
- ✓ Require a 3 percent general fund reserve.
- ✓ Prohibit borrowing to finance a deficit.
- ✓ Require a majority vote to enact the budget and budget-related legislation.
- ✓ Allow for multiple subject budget implementation legislation.
- ✓ Link budget passage to salaries.
- ✓ Revise Proposition 98 so that additional funding over the guarantee would be for one-time purposes (unless the Legislature specifies otherwise) and would not be built into the base.
- ✓ Develop and adopt a state-local realignment plan to distinguish responsibilities.
- ✓ Evaluate local governance structures and have local governments develop a charter.
- ✓ Lower vote requirements for local taxes and general bond obligations to a majority unless a community charter provided for a higher threshold. (This would not apply to the Proposition 13 property tax limit.) The non-school share of the property tax and the locally levied 1 percent sales tax could be allocated by the charter.
- ✓ Strengthen the home rule provisions of the Constitution.[91]

The recommended constitutional amendment legislation was co-authored by commission members Lucy Killea and Phil Isenberg. The 1995-96 Legislature failed to enact the legislation.[92]

California Citizens Budget Commission

Origin: Formed in 1993 as a nonprofit, bipartisan, private organization funded by the Center for Governmental Studies.

Membership: 25 members. Volunteer commission members included business, labor, judicial, civic and public service representatives.

Process: Examined the budget practices of California and other states, interviewed elected officials, government staff, budget experts and canvassed literature on budget practices. Final report 1998.

Web site: http://www.cgs.org/

Recommendations:

- ✓ Require a balanced budget.
- ✓ Prohibit external borrowing except to meet legitimate cash flow needs.
- ✓ Limit long-term debt to capital items.
- ✓ Constitutionally prohibit off-budget expenditures and borrowing.
- ✓ Require budget re-balancing either through legislative recommendations by the Joint Legislative Budget Committee or in the absence of corrective action by the Legislature, provide the Governor authority to reduce expenditures.
- ✓ Require a majority vote to pass the budget.
- ✓ Adopt a two-year budget cycle.
- ✓ Require a long-term spending plan in the budget.
- ✓ Require the Department of Finance or Legislative Analyst's Office to summarize the final budget in simple language and mail this document to all taxpayers.
- ✓ Build accountability into the budget by including performance objectives for all agencies and programs.[93]

Commission on Local Governance for the 21st Century

Origin: Created in 1997 by the Legislature to evaluate municipal boundary changes, policies to increase community participation in municipal government, and conformity to the federal Voting Rights Act.

Membership: 15 members. Nine appointed by the Governor, three appointed by the Assembly Rules Committee and three appointed by the Senate Rules Committee. Members were to have a proven academic or professional ability in the fields of demography, urban economics, land use planning, public finance or the legal aspects of municipal organization.

Process: Held 25 days of public hearings throughout the state with 160 individuals and groups testifying. Report published in 2000.

Web site: Web site no longer accessible. However, the final report can be downloaded at http://www.opr.ca.gov/publications/PDFs/79515.pdf.

Recommendations:

- ✓ Comprehensively re-align state and local fiscal resources.
- ✓ Require the State to fully fund all mandates.
- ✓ Revise tax bills so taxpayers can easily understand which agency receives funds and which agency is responsible for levying the tax.
- ✓ Revise allocation of the sales tax from the current point-of-sale basis.[94]
- ✓ Increase property tax allocations to general-purpose local governments.

Speaker's Commission on State/Local Finance

Origin: Created by former Speaker of the Assembly Antonio Villaraigosa to identify appropriate and viable fiscal reform measures, with particular focus on the flawed fiscal relationship between the State and local governments.

Membership: 34 members. Included representatives from local government, business, education and non-profit foundations.

Process: Met and held public meetings across the state for more than a year. Final report 2000.

Web site: http://speaker.metroforum.org/report.html

Recommendations:

- ✓ Devise a sales/property tax swap for local governments.
- ✓ Return $1 billion in property taxes to local governments from ERAF (Education Revenue Augmentation Fund).
- ✓ Create a constitutional obligation for the State to maintain the VLF (vehicle license fee) subvention.
- ✓ Place the 0.5 percent countywide sales tax authority in the Constitution.
- ✓ Require performance measures for programs based on outcomes.
- ✓ Develop a state/local compact that defines roles and responsibilities.
- ✓ Revise the county budget process to distinguish the county role in providing services.
- ✓ Require an audit of property tax revenues.
- ✓ Require an equity impact assessment of proposals for finance reform.
- ✓ Stabilize the revenue stream from the gas tax.[95]

Legislative Analyst's Office

Origin: Created by the Legislature in 1941 to provide nonpartisan fiscal and policy advice.

Membership: Currently 49 staff members provide analyses for the Legislature.

Process: The Legislative Analyst's Office has reviewed structural reform of the revenue system at the request of the Legislature and as part of its ongoing fiscal analysis. In various reports, including, "Making Government Make Sense" and "Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes", the LAO offered alternative reform options the Legislature could pursue.

Web site: www.lao.ca.gov

Recommendations:

- ✓ Revise the assignment of primary program control.
- ✓ Change state and local revenue sources to support program assignment changes.
- ✓ Offset cost impacts of programs by shifting property tax allocations from schools to cities and counties.
- ✓ Implement a sales/property tax swap.
- ✓ Increase state funding for schools to offset property tax shift.
- ✓ Equalize allocation of property taxes across communities.

- ✓ Establish new incentives and sanctions to promote the achievement of public goals.[96]
- ✓ Assign specific shares of property tax revenue to specific local government services.
- ✓ Shift ERAF property taxes to general-purpose local governments by reducing the overall property tax rate by 0.1 percent. Allow local governments the discretion to raise the property tax rate back up 0.1 percent.
- ✓ Link property taxes to municipal services and school finance with each receiving 50 percent. Shift sales tax and VLF revenue to the counties.
- ✓ Re-balance the tax burden through various alternatives, including:
  - Reduce the sales tax by 1.25 percent.
  - Increase city and county property tax revenues (local governments would forego VLF backfill; property tax revenue shift would come from schools).
  - Increase local control over property tax rate (each local entity would be authorized to raise or lower its own property tax rate, no more than 2 percent maximum annual increase).
  - Assess non-residential property at market value.[97]

California Commission on Tax Policy in the New Economy

Origin: This commission was created by the Legislature (SB 1933 Vasconcellos) in September 2000 to review the State's tax and revenue programs in light of the new economy and rapidly changing technology. In February 2003, Governor Davis asked the commission to expand its mission to explore a variety of options for changing California's tax system and offer ideas on budget structural reform.

Membership: 9 members. Three members represent businesses, three represent local government and three represent various segments of the public. Appointed by the Governor, the Senate Rules Committee and the Speaker of the Assembly. There also are nine ex-officio members from various state agencies and legislative committees.

Process: Held 17 hearings throughout the state. Final report December 2003.

Web site: http://www.library.ca.gov/CaTax/index.cfm

Recommendations for Tax Policy Reforms:

- ✓ Improve collection of the use tax on remote sales.
- ✓ Broaden the sales tax to include selected services and reduce the overall rate.
- ✓ Decrease sales tax revenue for local governments and replace it with property tax revenue.
- ✓ Provide a constitutional minimum allocation of property taxes to local government.
- ✓ Reduce the voter threshold for local tax measures from two-thirds to 55 percent.
- ✓ Establish a state tax court.

Recommendations for Budget Process Reforms:

- ✓ Revise the State's spending limit to tie it to population and economic growth.
- ✓ Require a reserve fund.
- ✓ Re-balance an unbalanced budget.
- ✓ Require multi-year budget planning.
- ✓ Foster a culture of accountability in the budget process.[98]

All Web sites for these organizations and their reports were accessed in May and June 2004.

Appendix E

Revenue Reform Options for a Superior Tax Policy

Various revenue reform options were recommended by previous reform commissions or discussed during the Little Hoover Commission's Roadmap for Reform Advisory Committee meetings.

Each option has been evaluated using the following criteria or guiding principles agreed upon at the Commission's advisory committee meetings:

- ✓ Reliability – The tax system is relatively stable across swings in the business cycle.
- ✓ Accountability – The system provides a clear nexus between the tax levied and the service rendered.
- ✓ Transparency– The process is simple to understand and operate.
- ✓ Neutrality – The tax reform minimizes impacts on economic decisions, especially job creation and consumption decisions.
- ✓ Equitability – The system is balanced in relation to the taxpayer's ability to pay.

Additionally, some of the value judgments and policy tensions within each alternative are identified.

The major reform options outlined include:

- Broadening the sales tax to include selected services and reducing the overall sales tax rate.
- Increasing property tax allocations and reducing sales tax allocations to local governments. This reform often is coupled with a constitutionally mandated minimum allocation of property taxes and a reconfiguration of the allocation formula set in place in the late 1970s following the passage of Proposition 13.
- Eliminating all taxes and implementing a flat tax rate on personal income and a value-added tax on businesses.
- Re-assessing non-residential properties to fair market value for tax purposes or increasing the tax rate on non-residential properties.
- Increasing specified excise taxes, such as taxes on alcohol or tobacco.
- Increasing personal income tax rates on high-income Californians.

A brief analysis of each of these options follows.

Proposal – Broaden the sales tax to include selected services and reduce the overall tax rate.

In the 1950s, the sales tax was the largest source of revenue, providing nearly 60 percent of the General Fund revenue.[99] In 2002-03, California's sales and use taxes made up just under 30 percent of the General Fund revenue.[100] Since the early 1980s, the sales tax has ranked second as a revenue source, with the personal income tax providing the most revenue to the General Fund.[101]

Currently, the focus of the California sales tax is on goods, while most economic growth is in services, such as legal, accounting, lodging and entertainment. Compared to other states, California taxes few services. In a 1996 survey of state tax policies, the Federation of Tax Administrators found that California taxed only 13 of the 164 services identified in the survey. Other large states taxed many more services including Texas with 78, New York with 74 and Florida with 64 services taxed.[102]

Broaden and Reduce the Sales Tax Rate	
Guiding Principle/Criteria	
Reliability	While the sales tax has provided a small but steady increase in revenues in all but a few of the past 50 years, it has declined as a percentage of total General Fund revenues and has not kept pace with population growth or inflation. The sales tax is vulnerable to shifts in the economy. Broadening the sales tax to cover services could increase its reliability.
Accountability	Currently it is unclear to most taxpayers what services are supported by the sales tax. Broadening the sales tax without aligning the tax with specific services will not improve accountability.
Transparency	Consumers typically understand what goods are taxed and the rate. However, small businesses providing services affected by new taxes may not have the accounting and bookkeeping skills to collect and track taxes.
Neutrality	An overall reduction in the sales tax rate could stimulate purchases. Depending upon which services were taxed, small businesses providing the services would incur new costs collecting and tracking taxes. Services taxed in California, but not in other states could lose business to competitors in neighboring states. New taxes on selected services may cause consumers to choose untaxed services.
Equitability	An overall reduction in the regressive sales tax rate would improve equitability. Depending upon which services are taxed, users of those services would pay more taxes.

Value Judgements and Policy Tensions

The California Commission on Tax Policy in the New Economy recommended broadening the sales tax to include selected services while lowering the rate to retain revenue neutrality. The Commission emphasized the importance of revenue neutrality and clarified that its recommendation was not a two-part process to increase the sales tax rate at a later date. Revenue neutrality seems key to bipartisan support. Opposition to a broadening of the sales tax would likely come from industries targeted by a new levy and those opposed to any new taxes.

Proposal – Property/Sales Tax Swap

During the past two decades, local governments have increased their reliance on sales tax revenue to fund local services. Proposition 13 severely restricted the growth of property taxes to fund local services and the complex allocation methodology was based on taxation levels from the late 1970s. In the early 1990s, the Governor and the Legislature diverted a significant percentage of property tax revenue from cities and counties to fund education.

As a result, local governments and cities in particular have increasingly relied on sales tax revenue to fund local services, resulting in what is called the fiscalization of land use. Cities compete with neighboring communities to zone big box retail and auto dealerships to bring in sales tax revenues and are discouraged from approving housing and manufacturing developments, which do not positively impact local revenue.

Several entities have recommended various forms of property/sales tax swaps to improve land use planning and stabilize revenue for local government services, including the Speaker's Commission on State/Local Finance, the Legislative Analyst's Office, and the California Commission on Tax Policy in the New Economy. This concept has been proposed in legislation, including AB 1221 (Steinberg & Campbell) and SB 1212 (Ducheny) which is based on a San Diego Association of Governments (SANDAG) proposal.

Property/Sales Tax Swap	
Guiding Principle/Criteria	
Reliability	Property tax revenue has grown more quickly and has been more stable than sales tax revenue.[103] A shift could improve the reliability of funding for local governments.
Accountability	If property taxes were aligned and dedicated 100 percent to local services, such as police, fire fighting and local transportation, accountability would be improved.
Transparency	Without realignment of local services, a property tax/sales tax swap would further complicate the understanding of funding currently not clear to many voters.
Neutrality	A tax swap is expected to decrease the fiscalization of land use. Cities would be less likely to compete for retail and potentially would zone more housing and manufacturing, which would enhance the business climate.
Equitability	A tax swap would not impact equitability, unless the allocation formula was changed.

Value Judgements and Policy Tensions

A property/sales tax swap creates winners and losers among local governments. Local governments who have planned and zoned for retail based on the existing sales tax structure would oppose a shift. The Ducheny bill attempts to alleviate this concern by leaving current funding amounts unchanged and shift only future revenue growth. Local governments who currently receive limited property tax revenues due to the methodology designed in the 1970s would probably not support a swap without revisions to the allocation formula. Local governments with favorable property tax allocations would not support revisions that negatively impacted their communities.

Proposal – Flat Taxes and Value-Added Taxes

At a Little Hoover Commission advisory committee meeting, it was suggested that the State replace existing taxes and create a flat tax rate – a personal income tax for people and a value-added tax for businesses. California's tax system was designed piecemeal over time and for the most part mirrors the federal tax system. California currently has a relatively high sales tax rate, yet this tax is not deductible from federal returns. Switching to federally deductible flat and value-added taxes would decrease the amount of revenue that Californians pay to the federal government that is not returned to the State. In general, flat taxes broaden the tax base and reduce the tax rate. Additionally, a flat tax also would simplify the tax system for California taxpayers.

The California Commission on Tax Policy in the New Economy conducted a hearing on this concept, most of which focused on a flat tax proposal championed by Arthur B. Laffer, Ph.D. Laffer's proposal would establish a 6 percent flat rate personal income tax and a 6 percent business value-added tax. Seven of the nine commissioners recommended further study on this issue and two did not support further study asserting that tax rates should be based on ability to pay.[104]

Flat Taxes and Value Added Tax	
Guiding Principle/Criteria	
Reliability	It is hard to predict the reliability of an untried concept; however, presumably a flat tax would be as stable as the existing personal income tax and sales and use tax.
Accountability	A flat tax would eliminate current links between taxpayers and local governments and would decrease accountability for local services.
Transparency	A flat tax structure would simplify the tax system by eliminating deductions. A simplified tax could increase compliance. Implementing the value-added tax could be complicated.
Neutrality	Businesses would need to develop systems for tracking and paying taxes. Michigan is the only other state with a value-added tax and currently is phasing it out, so there would be significant tax collection challenges for company's doing business outside of California. Value-added taxes are generally passed on to consumers.
Equitability	Depending on how it is structured, a flat tax could be regressive or progressive. Equitability would be improved if the tax were structured with several rate levels.

Value Judgements and Policy Tensions

The most vocal argument against a flat tax is that is places a greater tax burden on low-income taxpayers. It rewards property owners by eliminating property taxes. While a flat tax would seemingly simplify California's tax system, converting income for federal taxes could become more complicated. Additionally, such a major overhaul would incur costs for the State in developing a new system for administering the tax.

Proposal – Re-assess Non-Residential Property Taxes or Increase the Tax Rate

Proposition 13 revalued all property for tax purposes in California at the 1975 value plus an inflation factor of no more than 2 percent, unless ownership changes. Efforts have been made periodically to re-assess non-residential property to fair market value for tax purposes or to tax non-residential property at a higher rate than residential property. Proponents argue that there are too many loopholes in the non-residential change of ownership and corporations are not paying their fair share of property taxes. The tax burden of single family residential properties has risen steadily as a percentage of the total tax roll during the past 20 years in California's major cities while the tax burden for commercial and industrial properties as a percentage has declined.[105]

Proposition 167 in 1992 attempted to change tax rates on non-residential property, but was soundly defeated by the electorate. The California Commission on Tax Policy in the New Economy considered this tax policy option with six members voting to further study the option and three voting against the option. Two measures currently before the Legislature target this issue. SB 17 (Escutia) would tighten the loopholes for changes in ownership on non-residential property. ACA 16 (Hancock) would re-assess commercial property annually beginning in fiscal year 2005-06 at fair market value.

Re-Assess Non-Residential Property Taxes or Increase the Tax Rate	
Guiding Principle/Criteria	
Reliability	Non-residential property taxes have been a slow-growing but stable source of revenue. It's estimated that a reassessment to market value would provide approximately $3 billion in additional revenues annually. Annual reassessments would cause revenues to rise and fall with property values.[106]
Accountability	Tying an increase in non-residential property taxes to specified programs, such as education or infrastructure, potentially would provide increased accountability for those programs. Simply creating a split roll would not improve accountability unless the new revenues were tied to specific expenditures.
Transparency	The current change in ownership laws for non-residential property are complex and full of loopholes. Eliminating loopholes could improve transparency.
Neutrality	Raising taxes on non-residential property could cause businesses to reduce facilities in California and would discourage facility expansion.
Equitability	All non-residential property taxes would be assessed at fair market value eliminating current inequities where competitors in the same business pay widely different property taxes on similar facilities.

Value Judgements and Policy Tensions

Critics of a split tax roll do not agree that homeowners are paying an increasingly greater percentage of property taxes and that re-assessing or raising the tax rate for non-residential property will hurt California's business climate by driving expansion out of state. Proponents argue that the current structure favors existing businesses and thwarts competition and that a fair market re-assessment would attract new businesses to the State.

Proposal – Increase Excise Taxes on Specified Items

Governor Schwarzenegger did not propose raising taxes in his 2004-05 budget released in January, although this option was proposed last year by Governor Davis. The Davis proposal included an excise tax increase on cigarettes. Numerous bills in the Legislature last year would have raised the so called "sin" taxes, those excise taxes placed on alcohol and tobacco products. None of the legislation passed, even though tobacco and alcohol use create a tremendous burden on state budgets.

In its 2003 study of alcohol and drug programs, the Commission learned that drug and alcohol use results in $11 billion in related costs. Alcohol use and abuse contributes to a large percentage of this cost. In 2001, alcohol taxes created $288 million in revenue for the state. California ranks in the mean of all states for tax rates on beer and distilled spirits and is third lowest in the nation in taxes on wine.

Increase Excise Taxes on Specified Items	
Guiding Principle/Criteria	
Reliability	Cigarette tax revenues have declined in recent years due to the effectiveness of anti-smoking campaigns and a declining population of smokers. Alcohol taxes were last increased in the early 1990s and have provided a relatively steady source of revenue.
Accountability	New taxes on alcohol or cigarettes would only increase accountability if the revenues were tied to specific programs with performance objectives, for example, tying new alcohol taxes to alcohol and drug treatment programs.
Transparency	Excise taxes are easily understood by taxpayers.
Neutrality	Increases in cigarette and alcohol taxes would decrease consumption of both products. An increase in the tax on wine could particularly impact the State's wine industry.
Equitability	The burden of additional taxes is born by those who consume the specified products that are taxed.

Value Judgements and Policy Tensions

The beer, wine and liquor industries have successfully lobbied against alcohol tax increases in every attempt to increase alcohol taxes in the past decade. The only alcohol tax increase in California in recent history was a bill that mirrored an initiative proposed by the industry itself in an effort to defeat the "Nickel a Drink" initiative. Because the wine industry plays a key role in the California economy, there is rarely support for any tax increases that would negatively impact the wine business.

The public overwhelmingly supports increases in alcohol taxes when the resulting revenues are dedicated to addressing the costs of alcohol problems.[107] The Public Policy Institute of California in a recent survey found that 75 percent of likely voters indicated they would favor increasing taxes on the purchase of cigarettes and alcoholic beverages.[108]

Proposal – Increase Personal Income Tax Rates on High-Income Californians

Raising taxes was not part of Governor Schwarzenegger's January 2004 budget proposal, although Governor Davis in 2003 proposed re-instating the top tax rates of 10 and 11 percent. The income tax increase on high-income Californians was used by former Governor Wilson to combat a budget shortfall during the recession in the early 1990s. The 2003 proposal to re-instate the 10 and 11 percent tax rates was defeated by one vote in the Senate.

California's personal income tax is already very progressive. In 2001, the top 13 percent of taxpayers paid nearly 75 percent of all income taxes. Less than 1 percent, those making over $1 million paid more than 25 percent of all income taxes.[109]

Increase Personal Income Tax Rates on High-Income Californians	
Guiding Principle/Criteria	
Reliability	The increase would increase the State's reliance on a fairly volatile revenue source.
Accountability	Increasing the personal income tax rate would not improve accountability.
Transparency	Adding additional tax rates would provide little change to a tax system that is hard to comprehend.
Neutrality	Some experts suggest increased taxes would hurt the business climate and cause high-income earners to leave the State. Other economists suggest a tax increase would have less of a negative impact than spending reductions.
Equitability	The burden of additional tax rates would be borne by the wealthiest Californians.

Value Judgements and Policy Tensions

Anti-tax advocates argue that re-instating the top tax rates would drive wealthy Californian's to relocate to neighboring states with no or low personal income taxes. Supporters of a tax increase argue that only 2.4 percent of Californians would be affected by this type of tax increase. Taxpayers with incomes in the top 1 percent of California households, who average $1.5 million in income, would pay more than 98 percent of the increase. After accounting for deductions from federal taxes, the average tax increase for this group would be $9,695. The average increase for taxpayers in the next 4 percent, with average incomes of $250,000 would be $53 after adjusting for deductions. Supporters of the increased tax argue that these high-income earners benefited the most from the recent federal tax cuts and the savings in federal taxes will far exceed the costs of an increase in state taxes.[110]

It is doubtful that there would be enough political will to pass this type of tax increase in the Legislature. However, the Public Policy Institute of California in a recent survey found that 69 percent of likely voters indicated they would favor raising the top tier of the state income tax rate.[111]

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