Chapter 1

Improving Fiscal Management

In the 166 years since it began, the California Legislature has made just two comprehensive changes to the state's tax structure: first in 1911, and again in 1935. These structural overhauls likely were responses both to the state's maturing economy and to changing preferences about how wealth should be taxed.

The tax structure that worked for the state during the Gold Rush emphasized the value of land and its potential for extractive wealth. In those years, the state relied on the property tax as its main revenue source. Later, the system that relied heavily on taxation of private utilities reflected a sympathy for Progressive-Era values.

The present system—perhaps unrecognizable to a 49er or Governor Hiram Johnson—depends on taxing current income, irrespective of the source of income or a person's underlying wealth. (See Appendix II on page 55, which traces the changing nature of the state's tax structure and policy considerations that motivated alterations.)

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In the 81 years since the last large-scale tax reform, California's economy has grown substantially and changed dramatically. Weighing the cumulative effect, the state should again overhaul its tax system. An analysis of the tax structure should consider whether it supports sound fiscal management, and how it could be modified to encourage future economic growth.

Does the Present System Support Sound Fiscal Management?

A primary function of any tax system is to finance the state's current and ongoing budgets. Does California's tax structure generate adequate revenue to finance the state's budget under a variety of conditions? For example, revenues are adequate for the 2015-16 budget, but the tax structure must keep pace with rising state costs, particularly for health care and post-retirement employee benefits.

The tax structure must generate enough revenue to finance both operations and investments. Capital projects require multi-year commitments that compete with the operating budget. While capital costs can sometimes be deferred, they cannot be eliminated.

A related concern is whether the current tax structure generates enough revenue over an entire business cycle. One might expect the structure to under-perform in the down part of the cycle and to over-perform relative to expenses in the good times. However, it appears the tax structure amplifies changes in the economy, resulting in even greater revenue gains and losses than would be expected from a tax structure that simply tracked economic cycles. In recent years, even a modest economic downturn (much less a recession or a Great Recession) could cause a precipitous decline in state revenues and create multiyear operating deficits.[1]

Further, a review must examine whether the tax structure generates revenue predictable enough to construct a responsible, balanced budget and to support future spending and investments. If estimators are unable to precisely predict revenue, then the budget likely will gyrate between balance and imbalance.

Can the Present System Be Modified to Encourage Future Economic Growth?

Encouraging economic growth is essential to sound fiscal management. California's tax structure should serve the development of a robust and diverse private-sector economy including start-ups, small businesses, and established firms. Many desire a tax structure that can easily adapt as the economy changes.

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Business interests express concern about the rising cost of regulations, such as labor expenses and environmental standards. They contend these costs, which have the same impact as taxes on the ability to sustain and grow a business, must be incorporated into the tax reform conversation. The effects of taxes and regulatory burdens vary across companies, industries, and geographic areas. Can mom-and-pop businesses be sustained as globally competitive industries continue to grow and thrive?

In an effort to build skills and knowledge for quality employment, many families encounter financial obstacles beyond taxes through steep tuitions and related expenses. How can the state invest in the productive potential of Californians through education, child care, and job training to broaden prosperity, translating into steadier revenues?

Local governments, just like the state, need to be able to anticipate revenues. Cities, counties, and special districts are primarily responsible for providing the services that businesses need. Should local governments be accorded more flexibility to raise taxes to cope with the state's revenue volatility, especially in higher-cost areas and communities that aspire to higher service levels?

Many businesses are concerned about the high cost of housing. Can taxes and other financial incentives encourage development of housing? How can the relationship between the state and local governments be strengthened to encourage job creation and private investment?

On a broader scale, many business interests recognize the state is pushing the "greening" of the economy and business climate, as evidenced by the enactment of numerous laws that create infrastructure financing entities, promote the development of sustainable communities, and accelerate greenhouse gas emissions limits. Are these policies sufficient to significantly stimulate growth of California's green economy?