



## RECOMMENDATIONS ON CALIFORNIA'S STATE BUDGET PROCESS

CALIFORNIA WORKING FAMILIES POLICY SUMMIT  
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### INTRODUCTION

This year's state budget – 85 days late and barraged with bipartisan criticism for its gimmicks – is just one warning of the structural cracks in California's fiscal system. After steady economic growth since the short recession at the turn of the century – and as a potentially deep recession sets in – the state still owes more than \$18 billion that it borrowed to pay operating expenses from past years.

While the state budget should be a bridge to somewhere – better schools and safer neighborhoods – California's budgeting and fiscal systems are a bridge that no one should stand under.

To thrive, California's regional economies need schools and universities that produce a talented workforce and efficient infrastructure that supports the trade of goods, services and information. Communities need healthy and sustainable environments. Families need safe neighborhoods and affordable housing. All Californians need a shot at self-sufficiency.

California's market demands that private enterprise and public services get better every day. But our system for funding essential public services is obsolete, clogged with the unintended consequences of citizen initiatives and confounded by the workarounds intended to fix the glitches.

The budget process is one component of the overall public finance system that desperately needs modernization. The annual arm wrestling is over which programs (constituencies) will be cut and which will be increased, rather than strategically focusing available resources to effectively meet the highest priorities. Indeed, the discussion gets stuck on the overall amount of spending – with chronic borrowing (inexplicably) the only possible compromise.

Compare that reality with this imperative: The budget process must produce balanced plans that ensure adequate long-term investments. It must provide the ability and incentives to hold down the cost of providing services while directing dollars to programs that improve lives.

Now, in this moment of true fiscal crisis, California must improve how it makes critical fiscal decisions. Drawing from the best practices used by other governments, California can create a process that produces:

***Results and accountability.*** Public services address critical public needs and the budget process is an essential tool for making sure those services are efficient and effective.

***Stability and adequacy.*** Fluctuations in the economy and the demands on government are inevitable, but the binging and purging of budgets is not. Better planning and money management can significantly reduce volatility in budgets.

***Transparency and trust.*** Fiscal choices are among the most important decisions elected officials make, so those choices need to be clearly understood and open to public deliberation and scrutiny, which will improve those decisions and stop the erosion of public confidence.

To make the best use of available resources, the budget process must do the following:

1. **Establish a two-year budget cycle and longer-term forecasting.** The annual budget process, which encourages short-term deals, must be replaced with multiyear budgeting that encourages smart investments.
2. **Focus on priorities and results.** Budget decisions should be guided by what programs are trying to achieve and what must change to achieve those goals.
3. **Create a culture of accountability through public, budget-linked legislative review of programs.** Policymakers should spend as much time reviewing what the public is getting for its money as they do deciding how that money will be spent.
4. **Pay our own way.** It is too easy to make promises that someone else must keep. From tax cuts to the full costs of entitlement programs, decisions with fiscal impacts must include associated spending cuts or revenue increases.
5. **Create stability.** Policymakers have made some progress, but fiscal policies must provide stability which is critical to efficient, effective and reliable public services.

The following recommendations detail a new budget process that would give California leaders a more rational way of making fiscal decisions. The new system would prevent fiscally unwise decisions while encouraging sound ones. Each element would improve the process, but the benefits multiply when taken together. For example:

- Multiyear forecasts and budgeting can reduce the time spent creating budgets and free up time for lawmakers to review outcomes and make necessary changes.
- Performance metrics focus decisions on where to allocate dollars – and enable a fact-based oversight process.
- A pay-as-you-go process prevents lawmakers from creating obligations – in terms of new spending or tax cuts – that the state can't afford, and also creates an incentive to transform obsolete programs into better ones.

#### **POLICY OBJECTIVE #1**

#### **Establish a two-year budget cycle and longer-term forecasting.**

##### ***Background***

The one-year lifespan of the state budget puts too much emphasis on matching revenue and spending in a single year, rather than strategically investing public dollars to meet critical needs over the long term. California's annual budget process – just 12 months long – provides little opportunity for effective planning and implementation. Planning for the next budget begins virtually weeks after a budget bill is adopted. The annual cycle infuses unnecessary uncertainty into the budget process and undermines efforts to take the long-term view, focus on implementation, or manage for results.

##### **What we have:**

- Many policy choices have long-term implications: Some increase demands on public budgets, while others have the potential to increase demands. Some create new economic opportunities, which will result in more jobs and increased wealth, including greater tax revenue. The current system

#### ***What the Public Wants***

In structured conversations sponsored by *California Forward* this spring, Californians strongly supported fiscal reforms that would increase accountability and transparency.

“Rebuilding public trust is a fundamental precondition for public support on a wide range of governance and budget reform issues,” concluded researchers with Viewpoint Learning.

The research also revealed strong support across philosophical lines for budget process reforms that would lead to multiyear and result-oriented decision making. To read the full report, go to [www.caforward.org](http://www.caforward.org).

discourages policymakers from incorporating the long-term implications – for better or worse – of the annual spending plan.

- An annual spending plan encourages policymakers to find short-term fixes to long-term problems; some of those fixes actually increase costs in the long-run.
- The public does not have a clear understanding of the long-term implications of fiscal choices, which enables policymakers to rely on gimmicks to achieve balanced budgets and contributes to the lack of public trust in state leaders.

#### **What we need:**

- A two-year budget process would free up time in the Legislature and the Department of Finance to focus on ways to hold down costs while improving access and quality of services.
- Extending the state budget to 24 months would enable public agencies – state, county, city, schools and others – to set goals that avoid the start-stop process of current agency funding.
- A long-term fiscal forecast would allow the Governor, Legislature and the public to better understand the implications of policy and budget decisions and address the underlying issues that are increasing costs or reducing public value.
- The Governor, the Department of Finance, and departments administering programs would need to address increasing costs and explore policy solutions that can reduce the demand for services, such as investing in prevention programs.
- A multiyear budget system would offer:
  - A focus on the longer-range issues that drive public expenditures.
  - More efficient use of government resources.
  - A greater ability to focus on meaningful strategic goals.
  - More time for legislative review and oversight.
  - An ability to measure performance across state and local programs with a longer-term horizon.
  - An obligation for government to realistically project revenues and expenses over a longer period.

#### ***Recommended Actions***

**A. Multiyear budgeting system.** The Governor and Legislature should implement a multiyear budgeting system to focus fiscal choices on the long-term implications of budget decisions while discouraging short-term solutions that push liabilities and difficult decisions into the future. Included in this two-year cycle would be:

- **Priorities and goals.** The Governor's budget would establish priorities and identify goals and measurable objectives for public expenditures, beginning with major initiatives.
- **Two-year spending plan.** The budget proposal would include program-level information for the prior year, the current year, and the next two fiscal years. New initiatives would include a two-year estimate of implementation costs and methods for financing the initiatives.
- **Multiyear forecasts.** The budget proposal would graphically present the long-term costs anticipated for major components of the budget – such as education – as well as rapidly growing elements, such as prisons, or other obligations, such as unfunded pension liabilities.
- **Mid-course corrections to maintain balance.** The second year, the Governor would propose changes and adjustments to the two-year budget to maintain fiscal balance and adapt to changing economic and other circumstances.

## **POLICY OBJECTIVE #2**

### **Focus on priorities and results.**

#### ***Background***

By focusing on spending levels rather than results, the budget process does not encourage policymakers to set priorities and determine how resources can best be used to achieve those goals.

#### **What we have:**

- Without a focus on results, the default is for budgets to grow each year just to accommodate inflation. While some cost increases are inevitable, others can be controlled.
- Without a focus on results, budget decisions are focused on how much money to spend rather than how to spend that money, limiting the ability of policymakers to incorporate proven practices or to steer programs toward priorities.
- When cuts must be made, neither policymakers nor program managers have the capacity to reduce costs without simply eliminating or reducing access to services.

#### **What we need:**

- A results-based framework would enable policymakers to explore policy and other changes that are needed to improve the impact programs have on the lives of Californians.
- Major fiscal choices should be predicated on an agreement regarding the desired results, enabling future leaders to assess whether to increase, continue or alter that course of action.
- Elected leaders should have a better way to consult with the public on the major fiscal choices before them and a way to communicate the value of those efforts.

#### ***Recommended Actions***

**A. Results-based budget decisions.** The executive and legislative branches should develop a results-based process for major budget decisions, and for developing policies, managing programs and reviewing the progress toward public goals.

- **Establishing goals and measuring outcomes.** Under the direction of agency secretaries, departments should establish strategic plans and performance metrics. Systematically, that framework would be matured to benchmark costs, establish budgets, align resources with priorities and publicly review programs to identify potential improvements. The framework should be the basis of the January budget proposal and legislative review of that proposal.
- **Implementing performance measurement.** The Administration should create a unit to work with line departments and the Legislature to build agreement on the substance and the use of performance measurement in the budgeting process.
- **Institutionalizing a legislative role.** The Legislature should review and reach agreement with the Governor on the priorities and the scope of initiatives to pursue those priorities. It should review proposed changes in individual departments and programs to reach agreement on objectives and the allocation of resources to pursue them.

#### ***The Industry Standard***

This approach has been implemented at the federal, state and local levels and requires both executive and legislative leadership. Political leaders in other states have adapted performance or result-based approaches to accelerate progress toward desired goals – such as reducing high school dropouts – to control escalating costs, and to better make difficult budget decisions, both where to spend and where to cut. Other governments also have put in place performance-oriented reforms as part of fiscal reform, because the approach promises greater discipline, focus, and public understanding in fiscal decisions.

## ***Improving and Communicating Results***

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

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

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

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

### **POLICY OBJECTIVE #3**

**Create a culture of accountability through public, budget-linked legislative review of programs.**

#### ***Background***

While the Legislature spends months each year negotiating a spending plan, it does not have the capacity and it has not dedicated the time to reviewing whether programs are achieving their goals and what must change for them to improve results.

#### **What we have:**

- New programs are often launched with some evidence or expectation that they will address an important problem, but those decisions are not systematically revisited to determine if the strategy

was right, whether resources are adequate or need to be redirected, or if other “bureaucratic” problems are limiting success.

- When resources are increasing, the Legislature lacks a systematic way of spending that money to strategically address the highest priorities. When revenue is down, it lacks the capacity to strategically reduce spending while preserving valuable services.

**What we need:**

- Legislative and public discussion of the outcomes we want to achieve – and our progress – will result in better oversight and understanding of the challenges that must be addressed.
- Public understanding of fiscal options – and thus accountability – also would be enhanced.
- Under these proposals, the fiscal dialogue in the Legislature would be more focused and unified. Budget discussions would be held in a single public forum, with the Administration, the Legislative Analyst’s Office, and all other interested parties present.

**Public Trust**

The two-thirds vote requirement to enact a budget often is cited as a critical problem in the current process. Extensive public research shows that a persistent majority of California taxpayers are willing to lower that threshold, but only if other reforms are enacted first to ensure accountability for results.

**Recommended Actions**

- A. Legislative review.** The Legislature should systematically review programs, assess progress toward goals, and explore potential changes in strategies that would reduce costs or improve results. These assessments would inform future policy and fiscal decisions by lawmakers, as well as management decisions and policy changes proposed by the Administration.
- **A public process.** A period of time prior to the adoption of strategic plans and performance measures should allow the Legislature to consider those plans and measures. Within a specified period of time following legislative review unless challenged, the strategic plans and performance measures would become effective.
  - **Outcome-based evaluation.** The Legislature should develop a system of evaluating programs based on progress toward established goals and the barriers – in terms of resources, statutory requirements, organizational issues or management capacity – that are slowing progress.
  - **A joint committee to ensure bipartisan and bicameral consensus.** The Joint Legislative Budget Committee would direct the Legislature’s performance and accountability efforts. The committee should support the review of performance measures and the use of those measures in policy development, fiscal decisions and program reviews.

**POLICY OBJECTIVE #4**

**Pay our own way.**

**Background**

The state’s major spending obligations are growing faster than its revenue. The problem is caused and aggravated when the long-term fiscal impacts of policy decisions are not fully recognized when those commitments are made.

**What we have:**

- Policymakers often find it easier to create new programs rather than improve existing ones, and there is no incentive to eliminate ineffective programs or those that are no longer a priority.

- Policymakers are encouraged to create small programs, with the hope that they will grow over time. In good years, base spending is ramped up, which sets up a conflict among these programs and their advocates when revenue declines.
- Similarly, tax cuts are imposed without offsetting decreases in spending or reliable increases in other sources of revenue. As the structural deficit has grown, state policymakers have shifted liabilities to other governments or into the future.

#### **What we need:**

- A policy that would create funding stability for major programs. Stable funding would allow policymakers and program managers to focus on steadily improving results.
- This would support efforts to set explicit priorities and make difficult decisions sooner.
- Stable funding would help policymakers forge a stronger link between policy and fiscal decisions: They would not be forced to frequently make decisions in a crisis environment and would be able to take a longer view of the fiscal implications of their policy decisions.

#### ***Recommended Actions***

- A. Identify and account for costs.** The Legislature should identify the immediate and long-term costs of new policies or changes in existing policy so those costs can be accounted for in future budgets. The Governor and Legislature should require that any policy change that increases costs identify where the money will come from – either from new revenue or a reduction in other expenses.
- **Understanding costs.** When proposing changes in state programs, whoever is proposing those changes (either the executive or legislative branch) must identify the immediate and long-term costs of the proposed changes.
  - **Consistency matters.** The Legislature should systematically review program costs to assess those that are exceeding projections, and whether the program should be revised, provided additional resources or scaled back. This process should be integrated into the general program of legislative oversight.
  - **The Legislature as partner.** A legislative process should be established to provide an independent analysis on all new or expanded programs that will have a significant out-year cost. The Joint Legislative Budget Committee would be an appropriate vehicle to accomplish this task.
  - **Enforcing the practice.** The Governor and Legislature should require that new program legislation carry an appropriation or identify the revenue that will support the expenditure. A funding source other than the general fund should be identified. The objective is to have a requirement for the state budget process that parallels the constitutional provisions dealing with state/local mandates.

### **POLICY OBJECTIVE #5**

#### **Create stability.**

##### ***Background***

California's dependence on a highly progressive personal income tax results in General Fund revenues that are more volatile than in most states. Since 1990, revenues have fluctuated from a decrease of 5 percent to an increase of 23 percent. That volatility in revenue makes it difficult for state leaders to effectively manage the state's resources.

#### **What we have:**

- When revenues are growing faster than the base budget, policymakers strive to lock in those new dollars to new initiatives, or to expand existing programs.
- Program advocates then strive to fend off cuts when revenue returns to normal or declines.

- Program performance ultimately suffers from false starts, budget uncertainty and unanticipated cuts.

**What we need:**

- Policies that distinguish between reliable revenue growth and one-time revenue.
- A reserve where the state saves one-time revenues for one-time needs.
- Improved use of a reserve to avoid the tendency to rely on revenue that may not be available from one year to the next.

**Recommended Actions**

- A. Identify and strategically use nonrecurring revenues.** The Governor and Legislature should implement a process to identify nonrecurring revenue. This revenue should be reserved for economic downturns or one-time uses such as tax rebates. That process should have the following elements:
- **An executive-legislative process for identifying nonrecurring revenues.** As part of the May budget revision, the Joint Legislative Budget Committee and the Department of Finance would estimate nonrecurring revenue for the current year and budget cycle. In addition, the committee and department would certify the amount of revenue available for appropriation in the budget year, exclusive of nonrecurring revenue. The estimate of nonrecurring income would exclude any estimated amount required pursuant to Proposition 98.
  - **Nonrecurring revenue would be held in reserve.** Nonrecurring revenues for the current fiscal year would be transferred into a subaccount within the Budget Stabilization Reserve.
  - **Appropriate uses for nonrecurring revenue.** Upon certification by the Joint Legislative Budget Committee and the Department of Finance that revenues for the budget year fall below the long-term revenue trend, the Legislature could pass legislation to appropriate from the reserve to make up the gap. That legislation would be separate from the budget act and would require a two-thirds vote and approval by the Governor.
- B. Criteria for modernizing the revenue system.** Any effort by the Governor or Legislature to modernize California’s revenue system must reduce the volatility inherent in the current sales tax and personal income tax system.

***How we got here***

In early 2008, *California Forward* distilled problems with the state’s budget process and identified broad principles to frame a public discussion on potential solutions. Comments on those principles were received during more than 50 meetings involving more than 5,000 Californians, as well as emails and numerous other conversations. The recommendations in this document are based on those comments.

***What’s next***

*California Forward* is working with legislative leaders and state administrators to develop and refine these budget reforms into formal legislative proposals. The draft language will be available on our web site at [www.caforward.org](http://www.caforward.org). *California Forward* is soliciting comments on these reforms in hopes of building a coalition of Californians committed to fixing the budget process.

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

***For more information***

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