August 2003

A Roadmap to Reform

A Commission and Seven Principles for Fundamentally Reforming California State Government

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About This Project

On April 30, 2003, Reason Foundation and the Performance Institute—two think tanks specializing in government reform—jointly released a *Citizens' Budget Plan* for balancing California's $38.2 billion budget deficit. The plan presented a myriad of short-term and long-term reforms to state government.

To solicit ideas on how to translate the ideas in the *Citizens' Budget Plan* into action, a bipartisan working group of former state officials was created. As the budget debate dragged on, the officials worked within and across the two major political parties to advance ideas for fundamental reform. While some of the ideas contained in the *Citizens' Budget* were debated and accepted, the final budget agreement failed to produce the level of fundamental reform necessary to bring the state's budget back into permanent balance.

This white paper presents the analysis and recommendations for achieving fundamental reform in light of the recently adopted state budget plan. The bipartisan working group authoring this white paper stands ready to assist state lawmakers in any way appropriate to advance the effort to restore the fiscal soundness of California.

Reason

As a division of the Los Angeles-based Reason Foundation, Reason Public Policy Institute is a public-policy think tank promoting choice, competition, and a dynamic market economy as the foundation for human dignity and progress. Reason produces rigorous, peer-reviewed research and directly engages the policy process, seeking strategies that emphasize cooperation, flexibility, local knowledge, and results. Through practical and innovative approaches to complex problems, Reason changes the way people think about issues and promotes policies that allow and encourage individuals and voluntary institutions to flourish.

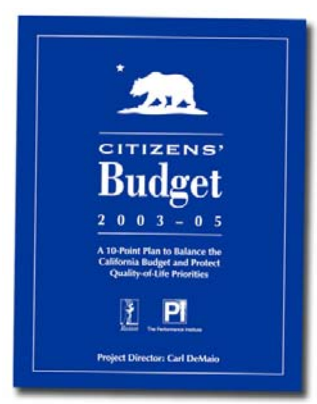
The Performance Institute

The Performance Institute is a private think tank that serves as the nation's leading authority and repository on performance-based management practices for government organizations. Its mission is to identify, study, and disseminate the leading management innovations pioneered by "best-in-class" government programs. Through its national conferences on pressing issues, interactive executive training programs, and best practice research projects, the Institute provides cutting-edge expertise in the design, implementation, and evaluation of strategies to solve operational challenges and enhance government performance.

Access the Full Citizens' Budget Plan

The *Citizens' Budget* is non-partisan — it rejects the assertions made by leaders of both political parties in Sacramento. The *Citizens' Budget* is an objective, line-by-line analysis of the governor's proposed budget. The methodologies and strategies used by The Performance Institute and Reason Foundation were applied to demonstrate that governments in this kind of situation have more than two choices. It is not merely an issue of raising taxes or slashing budgets across the board.

www.rppi.org/cacitizensbudget.html



Dear Fellow Californians:

Our beloved state finds itself at a crossroads. Whereas once California was the envy of the nation in terms of economic opportunity and quality of life, those traits have been undermined by a hostile regulatory climate and state mismanagement. Businesses are leaving the state in droves. California schools continue to perform at the bottom of the pack in terms of competitiveness with other states. California infrastructure is crumbling. Everywhere one looks, California's quality of life seems to be eroding.

Sadly, while the recent budget crisis presented a very real opportunity for reform, the problems have only been made worse by a state budget that pushed all of the difficult questions into the future through accounting gimmicks, deferrals, and unnecessary debt.

Saddest of all, the opportunity for lasting and fundamental reform was totally disregarded and our future looks darker than it did at the onset of the current budget crisis.

We have come together as a bipartisan group, concerned about the path the state is on, hoping to suggest a vehicle for fundamental reform in state government. Drawing on the groundbreaking work conducted by Reason Foundation and The Performance Institute earlier this year when they released their comprehensive *Citizens' Budget Plan*, we have highlighted a series of reforms that the state must adopt in order to emerge from the current crisis stronger, healthier, and more competitive. We are also suggesting a mechanism by which reform can be made: a bipartisan Commission.

To be sure, creating a reform commission and enacting these reforms will require tremendous political leadership and will to overcome the status quo and embedded special interests. But the costs of inaction are simply too high at this point to not pursue them. And that cost increases every day.

We are confident that California's brightest days lie ahead if we commit to the path of fundamental reform.

That choice is ours.

Signed,

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A Roadmap to Reform

Seven Principles for Fundamentally Reforming California State Government

From November 2002 to August 2, 2003 (nearly eight months), California lawmakers debated what to do about the state's mind-numbing $38.2 billion deficit. There were calls for revenue increases, program cuts, tax changes, and constitutional reforms. After papering-over the deficit for the previous two years, lawmakers vowed to solve the budget crisis once and for all.

In the end, after a long and contentious debate, and a marathon 29-hour session in the California State Assembly, lawmakers punted, adopting what can be described at best as a "get-out-of-town" budget. At worst, it could be a "recipe for disaster."

Why the Current Budget Plan Is a Recipe for Disaster

After all the rhetoric of reform, state lawmakers were unable to break the log-jammed political process and instead settled on a budget that relied on excessive borrowing, accounting gimmicks, and other maneuvers that did nothing to confront the state's fiscal crisis. To be sure, instead of reducing state spending, the budget actually *increased* general and special-fund spending by $1 billion on paper—and over $8 billion when one takes out the various accounting gimmicks. In fact, the plan includes roughly $18 billion in accounting gimmicks, internal fund transfers, deferrals of spending, and heavy use of short-term debt (more than $10.7 billion). On top of that, the plan includes numerous fee increases—tripling the Car Tax by roughly $160 per car-owner and raising tuition fees on college and university students.

And everybody sees it for what it is.

State leaders openly acknowledge that this year's budget will result in a beginning deficit of at least $8 billion next year—and that is making big assumptions that the tenuous cost savings and revenue projections made in the budget plan will actually materialize. Indeed, like an airplane held together with duct tape, when the budget actually comes in for a landing next year, a number of elements might very well have already fallen apart:

- **Questionable Bond Financing**: Lawsuits are challenging the state's use of $2 billion in bonds to pay its general pension obligations, as well as floating $10.7 billion of the inherited deficit through a five-year bond. Ignoring the $500 million in payments due to the state teacher's retirement fund is also the subject of a lawsuit. Finally, $2 billion in tobacco bond revenue could be lost if the bonds are not properly secured. Moreover, it is an open question whether Wall Street will even purchase the $10.7 deficit bond—which, because of constitutional limits on borrowing, would arguably be structured as a "gentleman's agreement" without a right or access to a security.
- **Questionable Tax and Fee Increases:** Four billion dollars in Car Tax revenue could be lost if the courts or a new governor reject the increase of this unpopular tax. Moreover, nearly $700 million in Indian gaming revenue might not materialize.

- **Phantom Spending Reductions**: The budget assumes a number of spending reductions that are not likely to be achieved. First, many state programs have shown a complete inability to manage within their budgets. From the time the governor's January budget was released to the May Revise, state agencies overspent their budgets by an astonishing $2.5 billion. Moreover, the budget assumes over $1.1 billion in personnel cost reductions. Powerful unions and weak managerial controls within the agencies will make this a hard target to achieve.
- **Economic Downturn:** The budget uses rosier economic forecasts than originally used by the governor in his January proposal. This is risky given the fragility of California's economy. What's worse, the state's economy might slide into another downturn with all the bad press over the budget, skyrocketing worker's compensation costs, and increased fees.

In short, what looks like an $8 billion deficit today could mushroom into a $10 billion to $20 billion shortfall next year… and that's not accounting for the $10.7 billion deficit bond being carried forward each year. This puts the state in worse shape than it was in last year…tens of billions in debt but with a lousy credit rating.

There is another sad and lingering legacy of the current budget deal and one that is often overlooked. While lawmakers might have passed a budget, the effects of their inaction and gimmickry will continue to haunt the state not only throughout the year but also for years to come. California's credit and borrowing capacity has been seriously undermined. For example, Standard and Poor's rating agency recently downgraded the state's general obligation debt by a massive three levels, from "A" to "BBB." In the history of this country, only the state of Massachusetts has ever suffered the ignominy of such a low rating. Moody's quickly followed suit with its own downgrade of California's credit rating.

What does California's lost credit rating mean? The downgrade will result in hundreds of millions of dollars in increased interest costs for the outstanding bonds California will have to issue. It will also significantly affect the pool of investors who choose to hold California securities in their portfolios. When totaled up, the higher interest costs that the state will pay will impact budgets far into the future.

As we saw firsthand from the 1995 Orange County bankruptcy, this reduced credit worthiness will not only affect the state's own ability to borrow, it will also create a chilling effect on local municipal bond issues and threaten the ability of local governments to deliver services like libraries, parks and recreation, and police. Orange County's bankruptcy and junk bond status severely undercut the ability of other municipal governments to borrow. That was just one wealthy county. This time around we are talking about the state government, the largest economic entity in one of the largest economies in the world. The rapid credit decline may well suffocate municipal borrowing.

It is, therefore, no surprise that the governor, the Democrat and Republican caucuses in the legislature, the media, and interest groups all repudiated the budget plan as soon as it was passed.

Everyone recognizes that California deserves a better budget plan—one that addresses the underlying problems that created the budget crisis in the first place and will put the state back on a firm path to financial solvency.

An Opportunity for Real Change: The 60 Days Leading Up to October 7th

For the next few weeks, policymakers, the media and the general public will all be preoccupied with the October 7 recall election. Unfortunately with so much attention focused on the recall's political machinations, California is missing the real, and deeper, crisis outlined above that cannot wait until the dust of the recall has settled.

Instead of being an election about the affirmation or recalling of one leader, this election must be about the solution to the budget crisis. Whether one supports or opposes the recall (and as authors of this report our views cross the spectrum of opinion), it is clear that California must take the next 60 days to raise questions about fundamental reform.

It is time for Californians to awaken to the immediacy of the economic threat that undermines the future of our great state, risks the success of our businesses, and reduces the quality of life for all our citizens. It is time for taxpayers, as shareholders in the state of California, to demand the fiduciary responsibility that is required of any corporate director. Just as the shareholder has forced corporate America to a new standard of transparency and accountability, so should the California taxpayer require that those standards replace backroom negotiations and accounting gimmicks in the state budget process.

Over the coming weeks, all gubernatorial candidates should be measured by their response to specific proposals to restructure the state government's fiscal operations. Many previous proposals have urged these common-sense reforms. This year, Reason Foundation and The Performance Institute took the unprecedented step of preparing a *Citizens' Budget Plan* that highlighted significant opportunities for restructuring state government. Sadly, the *Citizens' Budget*, like other reform proposals before it, has largely been ignored in this year's budget debate. Both incumbent Governor Davis and the would-be replacements must take a clear and firm position on these reforms and offer a detailed plan for really solving the state's budget crisis.

Getting Reform Started: A Commission on Budget Reform and Government Restructuring

California lawmakers must recognize the political limitations of the current system. As demonstrated by the delay in reaching a budget agreement this year, the governor and legislature have a very difficult time making politically painful decisions. To cope with this, lawmakers should take a cue from the federal government, which had the same challenge when confronting military base closures.

Immediately after the recall election is completed, the newly elected/reaffirmed governor and legislature should create a Commission on Budget Reform and Government Restructuring to propose ways of balancing the budget through fundamental reforms in each state program, as well as to provide an ongoing oversight mechanism during the implementation phase of reform to ensure progress toward reform goals and enacting mid-year budget changes as needed. This commission would function similarly to the federal base realignment and Base Realignment and Closure Commission (BRAC), which made politically unpopular decisions regarding the closure of military bases. Such a commission could become the independent watchdog, akin to a bankruptcy judge in a corporate restructuring.

Composed of respected business, academic, and former political leaders, the commission should be action-oriented and limited to ten individuals. Members of the independent, bipartisan commission would be chosen by the Senate and Assembly Republican and Democratic leaders (two appointments each) and the governor (two appointments). The chair should be elected by the members of the commission.

Bipartisan membership is absolutely imperative for the success of the commission. Any commission that does not include this feature runs the risk of alienating the very leaders that will ultimately be needed to approve its recommendations, making the commission yet another wasted "blue ribbon panel" that accomplishes little.

In order to begin the work of reform immediately, the legislature should request that the Legislative Analyst's Office and the Director of the Department of Finance spend the days leading up to the recall election analyzing state programs and preparing recommendations for the commission consistent with the seven reform principles laid out in this proposal. The commission should begin its work within 15 days of the completion of the recall election. The commission should immediately review the recently passed budget as well as the reports from the LAO and Director of Finance stipulated above. Within 60 days the commission should submit to the legislature and governor a biennial budget plan, complete with a 180-day action plan, reflecting the necessary changes to the fiscal practices of state government.

The commission's biennial budget plan and its associated proposals, like those of the federal base closure commission, could be voted either up or down, but not amended by the legislature or governor. The value of a BRAC-like commission is that it would depoliticize the decisions that the legislature has shown an inability to make independently.

Overall Objective of Reform: Getting More, Paying Less

In conducting its analysis of state government and in formulating its recommendations for reform, the commission should see its primary goal as preserving and improving the delivery of vital services to the citizens, while doing so at a lower cost. Unfortunately, this philosophy for balancing the budget has, thus far, been largely ignored. Instead, policymakers have offered the false choice of either destroying our quality of life through draconian cuts in services or undermining our economic well-being through increased taxes and fees. This set of false choices is largely why we are in the situation we are in with chronic delayed budgets, accounting gimmicks, and heavy reliance on borrowing.

In the *Citizen's Budget* and other program-specific evaluations of state programs, comparisons of cost and performance benchmarks have demonstrated time and time again that California taxpayers pay more for less than citizens in other states. Until this challenge is addressed, California will find itself in crisis.

Ingredients of a Reform Package: Key Principles

Once the legislature and governor have appointed this commission, their task would be very clear—draw a new map for reform. Presented below are the most fundamental concerns that such a commission must address to not only remedy the current crisis but also to prevent it from ever happening again.

Though simple in nature, the set of principles that California must pursue is a significant departure from status quo operations and will be a great challenge of political will and leadership. To end the ongoing financial crisis, California government must implement the following five principle reforms:

Reform Principle # 1:
Adopt a Biennial Budget with a Bankruptcy-Like Restructuring Plan

Twenty-three other states currently use a biennial, or two-year, budget process. California would be wise to implement such a system as well—particularly since many of the program reforms and cost savings will require two years to implement. Like a bankruptcy reorganization plan, a biennial budget will provide time and space for California to restructure its operations.

Moreover, the restructuring plan would contain clear and measurable "targets" for revenue collections and spending reductions. If revenue collections or spending reductions in year two of the budget are off from projections, proportional budget adjustments should occur automatically, eliminating the need for the legislature and governor to confront politically difficult decisions. The governor and legislature should be encouraged to propose their own, priority-based package of reductions but gridlock would be prevented by an automatic mechanism such as this.

On a more permanent basis, a biennial budget would make accounting gimmicks and deferrals more transparent and would also dramatically expand the legislature's ability to serve in an oversight capacity. Currently, budget subcommittees begin meeting in the spring of each year, only a few months before the budget deadline. The remainder of the year is focused mostly on other legislative priorities. In fact, only nine days before the constitutional deadline for the state budget (June 15), the legislature is focused on meeting the joint legislative rule that all bills must be voted out of their house of origin. Hence, rather than being *exclusively* focused on passing an effective, on-time budget, legislators are focused on moving *their* bills along in the process.

Legislative oversight should be an ongoing activity and a biennial budget makes this possible. In the first year of the session, the legislators would conduct extensive legislative oversight of state programs and spending and work on the timely passage of the state budget. In the second year, legislators could focus on other legislative priorities, as well as ongoing legislative oversight. Emergency legislation could still be considered during the first year by a special session called by the governor. Such a system would create a greater legislative role in controlling spending and monitoring the way that state agencies *invest* taxpayer resources.

Reform Principle # 2: Adopt a Constitutional Spending /Revenue Limit

Contrary to assertions that California's budget crisis is the result of a collapse in revenues, the real culprit has been uncontrolled spending. Since 1998, the state has grown by 21 percent while revenues grew by 28 percent. State spending, however, increased by 36.5 percent. Clearly this spending resulted from numerous factors, including faulty assumptions about revenue growth. Most importantly, however, there exists no effective constitutional limit to spending and revenue collection.

This must change. California state government must be constrained in its ability to collect and spend revenues through the adoption of a watertight spending and revenue limit.

Fortunately, there is a healthy debate surrounding various approaches to constitutionally protecting California from a boom-and-bust cycle of state spending. This paper takes no position on which model is best, however, the following characteristics must be considered most important:

- **Revenue Limit**: California desperately needs a revenue limit to serve as a de facto discipline on spending, as well as on the collection of taxes. A revenue limit would stabilize tax revenues to the state and provide for taxpayer protections against excessive taxation.
- **Reserve Requirement**: Any revenue limit implemented by the state should include an ample reserve requirement. This "rainy day fund" could be used to offset the effects of the business cycle and provide for a more consistent expenditure path. Importantly, education should be identified as the very first program to receive augmentations from this fund.
- **Restored Gann Limit**: California should restore its Gann Spending Limit, which was effectively neutralized in 1990 with the passage of Proposition 111.

Reform Principle #3: Overhaul the California Tax System

California's system of taxes is much like the foster care system—it is attacked from all sides as being utterly dysfunctional. Some critics argue that the system centralizes too much authority in Sacramento and discourages economic investment. Others argue that the system creates a "feast or famine" cycle. Some argue that the state's revenues rely too heavily on a small number of wealthy taxpayers (many from the high-tech sector), making the state vulnerable to dramatic swings resulting from changes in the business cycle. Still others argue that the relationship between local governments and the state is such that cities must compete "dog-eat-dog" for commercial activity to generate sales tax revenues.

For example, in some localities, the Car Tax represents three-quarters of their revenue streams. In other localities, an overreliance on sales tax revenues has created incentives for an explosion in retail development - which in turn generates more sales taxes and makes it more attractive to local policymakers than residential housing development. Regardless of whom you believe, the California tax system has a pervasive impact on virtually every aspect of our society.

The common theme is that NOBODY is satisfied with the current system. Some claim that all that is necessary is a revocation of the historic Proposition 13 limitation on property taxes. Unfortunately, history shows that before Proposition 13, the California tax system was far more volatile than it is today due to the unregulated and unlimited increases in property tax rates linked to a ballooning real estate market.

Instead of presenting the solution to tax reform as merely the revocation of Proposition 13, California must begin a fundamental reexamination of the state/county relationship of sales, personal income, car and property taxes to produce a less volatile system that is more reliable and does not discourage economic investment. While many proposals of this sort are on the table in the legislature, such as swapping a portion of sales taxes for property taxes, such piecemeal efforts will not solve the problem. California must reexamine the way it raises its revenue and restructure its entire system of taxation.

Reform Principle #4:
Create the Most Jobs-Friendly State in the Nation

The state must stabilize its revenues in order to balance the budget. The most sustainable way to stabilize and grow revenues long term is to create economic opportunity that spurs job and wage growth. Unfortunately, right now a sign hangs on the door of California saying "Closed for Business." Any effort to restructure the state's finances would be incomplete and doomed to utter failure absent a concerted effort to restore the confidence of businesses in California as a place to invest. Without this confidence, California will face a steadily shrinking revenue "pie," as opposed to an expanding one.

When compared to other states, once-invincible California now suffers from a "competitiveness crisis" that is draining our economic vitality and threatening the state's long-term fiscal health. The largest title insurer in the country, Fidelity National Financial, announced it is moving its headquarters from Southern California to Florida. Buck Knives, a longtime Southern California business, recently announced it is moving to Idaho.

Earlier this summer Forbes ranked the "Best Cities for Business" and California took a major hit. In 2002, California dominated the list - the two best cities in the United States for business were both in California (San Diego and Santa Rosa) and six of the top ten cities were from this state. Now, just one year later, California's highest-ranking city, Santa Rosa, is 23rd. Los Angeles is not even in the top 125 - falling from number 100 in 2002 to 126 this year, and Ventura plummeted from 4th to 67th.

Why did the state tumble down the ratings? And why are so many businesses fleeing California with its highly trained labor pool, access to international trade, and abundant natural resources?

A new study out by the Tax Foundation ranked California 49th - only Mississippi is worse in terms of its business tax climate. But it isn't just taxes. California is plummeting across the board: California companies pay three times as much for workers' compensation as neighboring Arizona; the state boasts some of highest retail energy rates in the nation and yet has less reliability (remember those blackouts?); and gridlocked Los Angeles has fewer miles of freeways per capita than most major metropolitan areas.

Three specific reforms could be enacted to improve the state's climate for jobs creation:

- **Resist Tax and Fee Increases:** California's economy currently is in such a delicate state that increases in taxes and fees may very well prove to be counterproductive. Instead of turning to tax and fee increases to raise revenues, lawmakers should strive to stabilize tax and fee rates to provide assurance to businesses and individuals that California has a welcoming economic environment. Unfortunately, throughout September, individuals and businesses will receive their first notices of a dramatic tripling of the state's Car Tax. Because of the regressive and sudden imposition of this tax, this action alone could cause a severe jolt to the economy. To the extent possible, lawmakers should reevaluate the imposition of the Car Tax, to be offset by spending reductions and/or other revenues, such as divestiture of unused state assets.
- **Workers' Compensation Reform:** Finally, workers' compensation insurance needs a dramatic and fundamental overhaul. California businesses already pay three times what Arizona businesses pay for workers' compensation insurance. Survey after survey demonstrates that this is one of the greatest concerns to retaining existing businesses and attracting new businesses. Unfortunately, rather than improving the system, legislation signed last year will increase workers' compensation insurance costs by $3 billion per year. This law should be repealed and more serious worker's compensation reforms undertaken. Immediately after the recall, the governor should call an immediate emergency session, as have governors in Florida, West Virginia, and Washington, to overhaul the system. Some potential reforms include:

- **Reduce litigation costs.** According to *The Wall Street Journal*, employers and insurers must hire a lawyer to deal with 29 percent of the claims. California should consider alternative dispute mechanisms to keep workers' compensation cases out of court.
- **Reduce medical over-utilization.** According to Insurance Commissioner John Garamendi, while the price of medical service in California is around the national average, California workers' compensation claims result in greater numbers of visits per claim and a higher number of services rendered per claim. *The Wall Street Journal* points out that the national average number of chiropractor visits on a workers' compensation claim is 14. In California the average is 34.
- **Utilize recovery auditing to reduce fraud.** The state could use a "share-in savings" contract that hires an outside firm on commission and only pays ita percentage of the fraud and errors that it identifies and corrects.
- **Implement a managed-care style system**, similar to other states like Connecticut, which seeks to rein in excessive medical spending.
- **More broadly utilize generic drugs** when they are appropriate replacements for brand name drugs. This is proven cost saving method in health care and should be fully utilized in workers' compensation claims.
- **Reform Penalty Structure**s. According to Insurance Commissioner John Garamendi, rather than basing penalties on the amount of payment money delayed or refused altogether, penalties can currently be based on the entire amount of the claim, both past and future. The Garamendi Worker's Compensation Plan points out "in a case where $200,000 in medical benefits was paid, a late $10 payment on reimbursement for a prescription to an injured worker can result in a 10 percent penalty or $20,000. The current structure provides very strong incentives for allegations of penalties to gain larger settlements and unnecessary litigation."

- **Regulatory Innovation:** Businesses regularly comment on the hostile regulatory climate that discourages investment in the state's economy. Hence, a similar reform of the regulatory structure must occur in California. Currently, regulatory structures follow a "gatekeeper" or "troll under the bridge" paradigm. Regulators must be appeased before a business can commence (or continue) activities.

  As a result, regulatory goals (cleaner environment, fewer workplace injuries, etc.) are often lost in the focus on process (permit compliance, fine collection, etc.). This paradigm must be transformed into one that perceives the regulatory structure as a facilitator—an agent that seeks to help businesses achieve their goals while achieving the goal of the regulation. Such a paradigmatic shift requires a degree of flexibility and outside-the-box thinking.

  Many other states have demonstrated the success of systematically reviewing regulations for outdated, obsolete, and unfocused regulations. California must follow that lead and establish a Regulatory Innovation Commission. Much like the "Red Team" concept utilized during the Wilson administration, the goal of such a commission would be to streamline and expedite regulatory compliance.

  Equally important, the commission would *welcome* proposals from business to meet the *performance goals* of regulation at lower cost. If a business can demonstrate the effectiveness of an alternative regulatory approach, the commission should possess the flexibility and authority to approve such pilots on a case-by-case basis, holding the applicant company to strict performance measures (specific reductions in worker injuries, specific achievements in reducing pollution emissions, etc.) Businesses that fail to achieve these agreed-upon goals would lose their flexibility, return to the existing regulatory structure, and be held responsible for all previous requirements, targets, fees, etc.

Reform Principle #5:
Enact Performance-Based Reforms in State Programs

California currently utilizes what is commonly referred to as baseline budgeting. Budget requests are made as changes from the previous year's budget level. In essence, this results in a system that focuses only on new spending proposals and assumes that the previous year's expenditure levels are acceptable. Often, justifications for budget increases under the baseline budgeting system are very weak. Moreover, a system of budgeting that assumes previous year spending is acceptable tends to promote a "we do it this way because we have always done it this way" attitude. Hence, innovation is stifled and "mission creep" is more pronounced.

California must fundamentally restructure its budgeting process. As noted in the *Citizens' Budget*, produced earlier this year by Reason Foundation and The Performance Institute, "Performance budgeting changes the state budgeting process to focus less on the *intentions* of programs and more on the *results* of programs. Instead of automatically granting programs adjustments to the base budget, performance budgeting would examine a program using the three criteria...relevance, performance, and management."

Unlike traditional budgeting approaches, performance-based budgeting rests on a firm understanding of the actual costs of different activities and then correlates those costs with service delivery and actual, measurable results. Since performance-based budgeting focuses not only on costs but also on improved outcomes explicitly, savings are possible along with service delivery innovations.

Importantly, California is well past the point of a "pilot project" for performance-based budgeting as was proposed this year in the budget deal. Governments across the nation have successfully utilized performance-based budgeting—most notably the federal government with its Government Performance and Results Act. While recent movement toward adopting a performance-based budgeting pilot program as a part of the budget deal is positive, a flawed implementation of this pilot, as has occurred in the past, would render the effort meaningless. California must adopt a formal performance-based budgeting law that uses results-oriented performance measures and is aligned to high quality financial information drawn on activity-based costing (ABC).

Besides eliminating or reducing programs that do not work, performance-based budgeting allows the state to consolidate duplicative and overlapping programs that waste money and lead to poor coordination. California has a convoluted state organizational chart with a myriad of departments, agencies, boards and commissions. The state can achieve savings and improve citizen service by consolidating similar programs into single agencies, and providing services through "one-stop" centers. In addition, functions such as information technology, facility maintenance, purchasing, personnel management, financial management, and administrative support can all be provided at a lower cost and in a more consistent manner by consolidating these overhead services into centralized offices serving all state programs.

Reform Principle #6:
Control Personnel Costs and Empower State Employees to Improve Performance

The state desperately needs to improve management of its personnel if it is to address the structural nature of the budget problem—short term (labor costs) and long term (retirements). It is estimated that California will spend approximately $17.4 billion in salaries and wages ($22 billion when including benefits) in fiscal year 2002-03 for the state's 327,000-plus workforce. While state employees should not bear the brunt of the entire solution to budget challenges, some state contracts with unions have offered excessive raises and benefits over the years. Moreover, employee management is the key to improving the performance of state programs—and identifying cost savings. Finally, like any organization, state government must view its employees as a key asset—to be cultivated and well managed.

Through attrition, eliminating vacant positions, renegotiating egregious raises, and reassigning state personnel the state can reduce personnel costs by the 10 percent target called for the in the current budget plan. One of the key objectives of the Commission on Budget Reform and Government Restructuring will be to ensure that commitments such as these are met and the savings achieved.

Reform Principle #7: Evaluate and Improve Efficiencies through Competition and Procurement Reforms

California is also dreadfully behind the curve when it comes to asking the fundamental question of "make or buy" public services. Democratic and Republican governors, mayors, and even presidents have openly advocated innovative new approaches to tapping into the private sector to deliver vital public services at reduced cost and higher quality. Yet very little of this sort of competition occurs in California state government. Hence, taxpayers must bear the cost of a system with few competitive pressures to achieve improved quality and reduced cost.

California must create a competitive government structure with the requirement of open bidding for state services, including both public and private sectors.

Every time that we go to the grocery store, pick up the phone, or visit the car dealer, we see the real benefits of competition—benefits that can be realized through the competitive delivery of public services as well. Of course, some special interest groups will frown upon such a competitive government reform effort. But California simply cannot let their opposition derail meaningful reforms that permit California taxpayers to receive "more for less." Hence, the challenge requires political will and a concerted effort to unify diverse groups around the shared goal of improving public services.

To be truly effective, any competitive bidding process must contain real incentives for public employees and their programs so that they reap the rewards of competition, not just bear the costs. Experience at the federal and state level demonstrates that public agencies will win these competitively bid contracts more often than not. They understand the workflow, the peaks, valleys, and unique circumstances that a private-sector or non-profit bidder might not.

A very compelling illustration of this potential comes from *Government Executive* magazine, which describes how in 2002, the federal Office of Management and Budgeting sought private bids to compete with the Government Printing Office's deal for printing the 2004 federal budget. GPO responded to these bids by reducing its price 23 percent and *saving more than $100,000 on the printing of the budget alone!*

Regardless of the outcome of these competitions, the state should reform its procurement system to use performance-based contracts that contain clear goals and measures of cost and quality. By moving away from "fee for service" contracts, which give vendors incentives to just spend money, the state can change incentives through new "pay for performance" contracts that compensate vendors for results.

Reflecting Reform on a System Level

Using the crosscutting reforms outlined above, the state should reform three key "systems" of services in education, health care, and social welfare. Taken together, programs falling within these three systems account for more than 80 percent of the state's budget. As mentioned above, these key systems of services that citizens most depend on are being provided at higher cost and lower quality than similar services in other states. Instead of cutting services, the state should reform *how* the services are provided through system-wide restructuring.

As such, the budget should propose fundamental reforms to these key systems using benchmarks from other states, encouraging competition and choice in each service area, expanding local control and delivery of service, and ensuring voter-approved bonds in the special fund are not raided to cover general fund expenses.

Conclusion: California at a Crossroads

California is indeed at a crossroads—arguably unlike any the state has ever faced before. We confront two paths. First, California can come to grips with the persistent structural deficiencies that have plagued the state and resulted in the current financial crisis. Or, California can continue down the same path it has pursued in recent years and we can witness our quality of life deteriorate even more.

If California misses this opportunity to ask the right questions of its leaders and candidates and allows a continuation of the same pattern of deferral and denial, the problem will only worsen and next year's budget crisis will make this one look like a picnic. At that point it will matter little who sits in the governor's office.

The proposed Commission on Budget Reform and Government Restructuring creates a politically viable mechanism for tackling these difficult challenges. Here in California, there are many of them.

Embroiled in the politics of the recall, meaningful reform will be difficult, but it simply cannot wait.

California must begin down the road of reform today so that regardless of the outcome on October 7, this state can recover its luster and again become the Golden State of Opportunity.

Our best days need not be behind us.

Like the Phoenix from the fire, California can emerge stronger, more competitive, and with a better quality of life. And, ultimately, that should be the yardstick against which our elected leadership should be measured.

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