No time to cut spending

By Stephen Levy - Special To The Bee
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The Legislature and Gov. Arnold Schwarzenegger this week will begin deciding how to erase a projected $10 billion to $14 billion gap in the state budget. As they go about the task of planning next year's budget, policymakers should consider four undeniable facts about our economic future.

First, California has a great set of industries, workers and entrepreneurs. We have established leadership positions in fast-growing sectors including Internet services, biotech and green tech, Pacific Rim trade and finance, and tourism and entertainment. In economist talk, we have a strong economic base.

Second, we face a tidal wave of upcoming retirements. Over the next decade 3 million Californians will retire and another 3 million will retire in the following decade. This tidal wave of baby boomer retirements will create both needs and opportunities for the state's work force.

Third, California's new work force will increasingly come from immigrants and their children and grandchildren. Latino and Asian residents will be a larger and larger share of the state's labor force over the next 10 to 20 years. This will be true for high-, middle- and lower-wage jobs, and there will be plenty of openings at all skill levels.

Fourth, California must rebuild its physical infrastructure – in transportation, water, schools and public buildings. Our economy and our quality of life demand these investments. We have made a new start, but there is a long way to go.

As director of the Center for Continuing Study of the California Economy, my job is to think about the state economy. To compete in the world economy, we need to be investing. Businesses know it is an "invest or die" world. It is the same for states.

California competes by being a great place to live and work. This means investing in our people, in our infrastructure and in our communities.

How does the state budget relate to preparing California to compete for economic prosperity? We know the choices for closing the budget gap – reduce the rate of growth in spending or increase the rate of growth in revenue. Which choice is best? Take education as an example.

Reducing next year's state spending by $10 billion would mean taking $5 billion from education. Maybe that could be done without ruining our schools, but why should we
even try? Educating our children is absolutely critical to maintaining a competitive work force.

California already ranks near the bottom in librarians, counselors, nurses and even teachers in relation to the number of students. Expanding access to higher education is necessary to replace the retiring and highly educated baby boomers. And we need a revolution in the way we think about career technical education – both for students and for many in the current work force.

Reforms in education will be helpful in improving performance and efficiency but the bottom line is that California can only compete successfully by investing more in education.

And we know we have to spend more on infrastructure.

I value the spending that invests in our people and our infrastructure, but I also like to pay for what I want (put my money where my mouth is, so to speak). So here is a proposal.

Let's set a target of raising revenues by about $7 billion, which amounts to one penny out of every $2 earned each year by Californians. Our parents and grandparents made painful decisions during the Great Depression so they could keep their homes and educate us. Compared to their sacrifice for us, switching one penny of every $2 from other spending to support the state budget hardly seems draconian.

If your household income is $50,000, one penny out of every $2 would increase your state taxes by $250 per year, or about $4.80 a week.

But let's be smart and make the revenue increases part of starting to modernize the state's tax structure. Let's broaden the sales tax base to include some spending on professional and repair services.

California's current sales tax base will be approximately $600 billion in 2008 and is mainly concentrated in sectors that figure to grow more slowly than the overall economy. Broadening the sales tax base to include $120 billion in services would accomplish four important goals.

One, the change would raise $6.5 billion per year for the general fund and another $3.5 billion for cities, counties and local transportation districts. Look at it as replacing the $6 billion from the vehicle license fees that were supposed to help the state in fiscal emergencies and pay back some to local governments, which have been raided by the state in past budget crises.

Two, the tax base would be expanded to include some fast-growing areas of the economy. This would help sales tax revenues keep pace with economic growth in the future.

Three, the increase would be broadly shared but also be slightly progressive because many of the services that would be taxed are purchased by upper-income residents.
Four, the change would begin to reduce dependence on the income tax for state funding — a goal that has political and policy appeal. And, if the idea of taxing services catches on, additional broadening of that tax base could be combined with a reduction in the sales tax rate.

What services should be taxed? My sense is to start with professional and repair services such as lawyers, accountants, architects, consultants and computer services and also look at repair services such as auto and home repair. The board of Equalization staff can produce a menu of options for extending the sales tax base by $120 billion.

What can be done with infrastructure finance? Here are a few ideas to fund the billions of dollars more we will need without increasing the burden on the general fund. The Treasurer's Debt Affordability Report has additional proposals that can work.

Let others help. Lower the voting majority for approving local infrastructure bonds and transportation district taxes to 55 percent like we did for schools or even to 50 percent as we have for state general obligation bonds. Make it easier for local jurisdictions to finance part of our infrastructure investments.

Consider letting user fees like tolls or container fees at the ports help pay for infrastructure. Consider private financing for infrastructure to be repaid by tolls or congestion fees.

Start to make bonds self-financing. For example if we added 10 cents per thousand dollars of assessed value to everyone's property tax bill, that would raise more than $4 billion per year, which would finance $50 billion to $60 billion of state infrastructure bonds. By doing so we could slowly lower the debt service payments in the general fund, freeing up more money for services.

My mother made girls' clothing. After every successful season, she would say, "Remember that we are only as good as our next line."

So it is with states. California needs to continue to invest and innovate in our "next line" of people, places and infrastructure. We need to make California a great place to live and work. A penny from every $2 is not too high a price to pay.