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To Members of the California Legislature:

As the economy struggles out of the recent recession, the latest data on output and employment growth do not bode well for a strong, quick recovery of our national economy. This news is discouraging to California and virtually all other states facing extraordinary budget gaps, but it does not change the fundamental task they face. Because of the size of its budget gap and the lack of flexibility to run deficits, California must face up to the need for immediate and substantial budget cuts and tax increases and act now. Delay in taking these actions will make the eventual policies even more severe and, by jeopardizing the state's creditworthiness, could exacerbate their impact on the state's economy.

At the federal level, the President has argued the need for a stimulus package. Unfortunately, much of what the President has proposed would provide little immediate economic stimulus, and the fiscal retrenchment required by California threatens to push the economy very much in the opposite direction. To provide an effective stimulus, fiscal actions must take effect immediately and encourage spending, public or private. Temporary federal aid to the states would help. It is an effective stimulus tool that would also provide needed support for beleaguered state budgets, but there is precious little in this regard contained in the President's package.

In this environment, the measures California takes in addressing its budget crisis are particularly important for the economic health of the state and of the nation. In the short run, California must adopt policies that address its current fiscal imbalance with the least damage to the state's economy and its social fabric. But fiscal policy actions should not be limited to short-run measures. Like that of the rest of the nation, California's current crisis is due, in part, to unanticipated declines in revenues caused by the recession and the end of the stock market boom, to which California's income tax revenues have been especially sensitive. Steady growth in mandated expenditure programs, particularly for health care, is implicated as well. But systemic problems also beset California's fiscal system and budget process. While addressing these problems will have little immediate political or economic payoff, farsighted reform measures can obviate the future need for the type of painful adjustments we must now undertake.

For the short term, the policy prescription is fairly clear, if dismal:

- Identify cuts in spending and increases in taxes that distribute the burden of fiscal adjustment equitably and with the smallest possible damage to the economy. These changes must be put in place quickly. Delay will exacerbate the state's fiscal problems and thereby send a negative signal to financial markets.

- To the extent that tax increases are needed – and it is totally unrealistic to pretend that spending cuts alone can solve the problem – they should be broad-based and should reflect the need to protect the incentives to engage in economic activity.
- Progressivity is also an important objective, although the distributional effects of taxes and spending cuts should be considered together. The Governor's proposal to raise the state sales tax by 1 percentage point and to reintroduce personal income tax brackets of 10% and 11% are reasonable short-term measures in light of these objectives: they avoid narrow tax increases, spread the burden fairly, and eschew tax increases on business activity. Further, they require little fundamental change in the state's tax structure, and so can be implemented quickly.

For the longer term, many structural tax issues need to be considered and the Governor's call for reform is helpful:

- These reforms include broadening the sales tax base to include services and internet sales and, yes, perhaps even reform of the commercial and residential property tax distortions that have accumulated since the passage of Proposition 13. The objective in undertaking these reforms should be not to *increase* taxes, but rather to permit less distortionary taxation through base broadening and tax rate *reduction*.
- On the spending side, thought should be given to whether or not it is wise to earmark revenue increases for specific categories of spending. No matter how worthy the spending may be, mandates and earmarks reduce the state's budget flexibility and contribute to the harshness of fiscal adjustment.
- Finally, the budget process itself needs reform, given its contribution to delay in dealing with our current problems, delays that have made the measures that we must take this year much more painful.

The state's fiscal condition presents us with both a crisis we must solve and an opportunity to address the systemic problems that have contributed to our current situation. We urge action without delay both to restore stability to the state's fiscal structure and to ensure the state's continued creditworthiness.

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