CENTER FOR CONTINUING STUDY OF THE CALIFORNIA ECONOMY

132 HAMILTON AVENUE • PALO ALTO • CALIFORNIA • 94301

TELEPHONE: (650) 321-8550
FAX: (650) 321-5451
www.ccsce.com

California's Future Economy and Population:
Implications for a Fiscal Policy Agenda

Stephen Levy

Director, Center for Continuing Study of the California Economy (CCSCE)

Prepared for *California Forward*

February 2009

Introduction

California Forward asked CCSCE to identify key economic and demographic trends that will determine the future of the California economy and to identify the implications for a fiscal policy agenda to address the state's future economy.

Getting From Today to Tomorrow: A Role for Fiscal Reform

As deep as today's budget challenges seem, it is important to remember that the state budget also helps shape California's future. While residents and leaders struggle to **solve today's crisis**, we must find time to **look to the future** and plan for tomorrow**.** The state budget has a critical role in supporting a strong economy with hope and broad opportunity for current and future Californians.

Most of the decisions underlying California's economic growth prospects will be private sector decisions. Most of the projected job growth will be in private sector jobs. Firms and workers will make the decisions about investing, working and living in California.

Yet these private decisions are made in a context of public policies. Will California provide the **public foundations** that attract **private investment?** Will entrepreneurs and families continue to be attracted to California's economic opportunities? Will our schools be good enough to educate and train California residents to fill the jobs we need? Will California's infrastructure measure up to that in other locations? Will our communities be great places to live and work?

Fiscal reform is critical for long-term budget balance but fiscal reform will also play a role in developing budget strategies to support prosperity and broadly shared opportunity in California's future economy.

About CCSCE

CCSCE was founded in 1969 to provide an independent assessment of long-term economic and demographic trends in California. CCSCE works with public agencies and private companies that require an explanation of the state's long-term economic growth prospects as well as detailed quantitative projections.

In recent years Stephen Levy has worked extensively on the links between California's future economy and public policy. With support from the James Irvine Foundation Steve published a series of memos on the state's economy and budget and wrote two reports *Smart Public Investments and the California Economy* and *Shared Prosperity and the California Economy* that focused on infrastructure and workforce investment issues. Steve led the Next Ten team that developed the California Budget Challenge. He is a member of the NOVA Workforce Board, has been active in the California EDGE Campaign and has written extensively on workforce and immigration issues in California.

Three Trends That Will Shape California's Economic Future

CCSCE has identified three major trends that can inform the state's budget strategies to support economic prosperity. These trends include:

- California's economic growth opportunities will be increasingly concentrated in the application of creativity to developing new goods and services and in our connections to the rest of the world through foreign trade, immigration and access to capital.

- California's population growth will be concentrated in the 55+ age groups, in young adults, in Latino and Asian population groups and in the children and grandchildren of recent immigrants.

- A tidal wave of baby boomer retirements will create millions of replacement job openings in the years ahead. Replacement job openings will outnumber new jobs, will occur in high, medium and low wage sectors and are critical for making California communities great places to live and work. They are both a critical need and an enormous area of opportunity.

California's Economic Base—Where the Opportunities Are

Economists assess job growth prospects for states and regions by examining the growth prospects for what economists call *basic industries*. Basic industries sell primarily to markets outside the state—markets in other states and other countries. These firms have a choice of where to locate and their decisions are critical determinants of how fast California will grow in terms of jobs and income.

The composition of California's economic base has been changing and will continue to change in the years ahead. Job growth will continue to be concentrated in sectors that emphasize creativity, innovation and technology as well as California's growing foreign connections with trade, tourism, and talent.

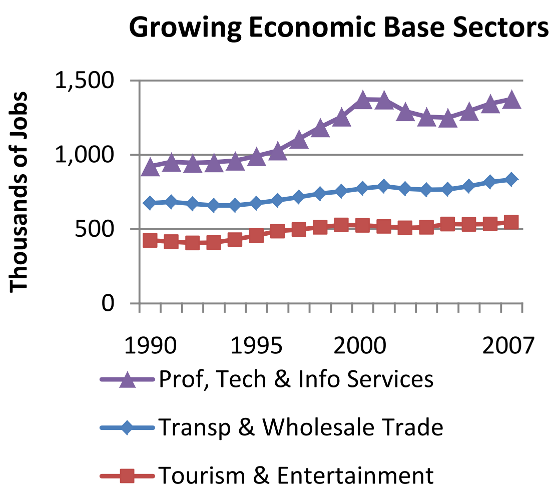
One critical change is that the application of creativity and innovation has broadened dramatically from a focus on manufacturing to newer fields related to Internet activities, to the application of design to goods and services, to new entertainment products and to a rapidly growing array of professional, technical and scientific services that help customers around the country and world.

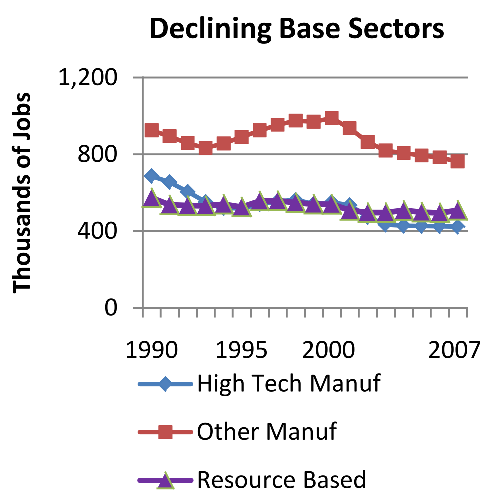
From technology developed for defense in the 1950s and 60s by companies like Lockheed and Fairchild Semiconductor to civilian technology giants like Hewlett Packard, Apple, Cisco, Intel, Qualcomm and many others, California's creative edge has broadened. Newer names like Google, Yahoo, eBay and Facebook and biotech giants like Genentech and Amgen have taken California's "creative technology" job growth in new directions.

California is home to world leading design and engineering companies including Jacobs, AECOM and Parsons. Our state is home to creativity in entertainment including firms such as DreamWorks, Pixar and Electronic Arts. California is famous for creative design in clothes, toys, furniture and other products. We produce few cars but are home to the U.S. design center for most worldwide automobile companies.

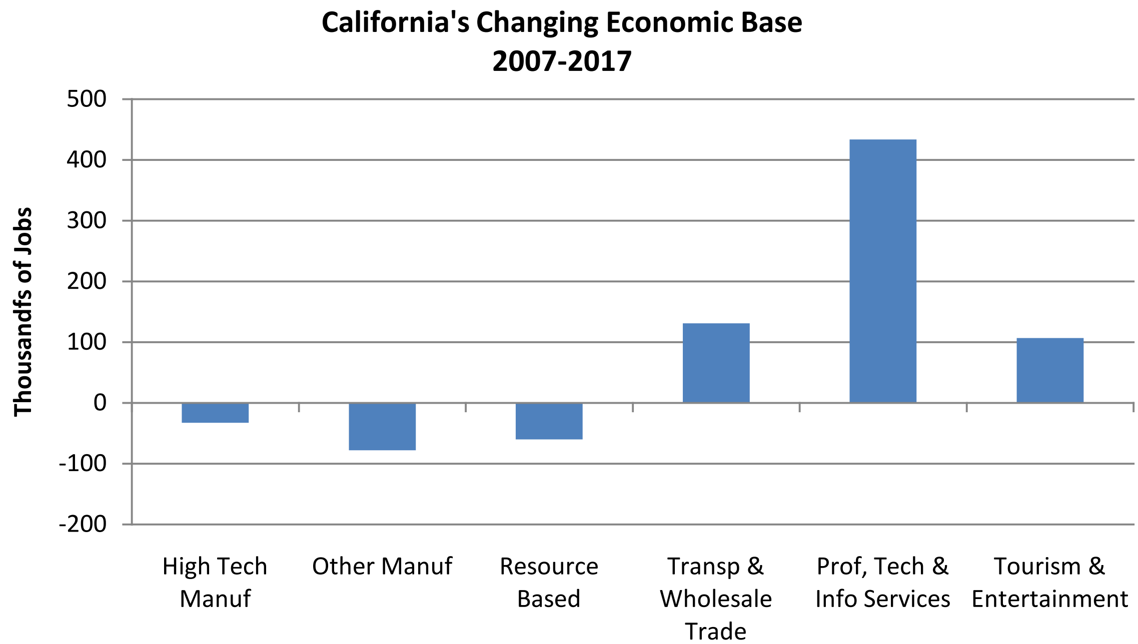
The application of creativity is shifting also from goods to services. The creative focus with products like computers and mobile phones has broadened to the development of applications and to high-margin services. California's competitive advantage in the growing green technology sectors will be strongest in design and engineering. The explosive power of the Internet is in the development of applications and services that lower costs and increase market size.

CCSCE combined California's basic industries into six major sectors to give a broad picture of past job trends and where growth opportunities are concentrated. The sectors include high tech manufacturing (computers, electronics, aerospace and pharmaceuticals); other manufacturing; wholesale trade and transportation; professional, technical and information services; tourism and entertainment and resource industries (primarily agriculture, mining and food products).



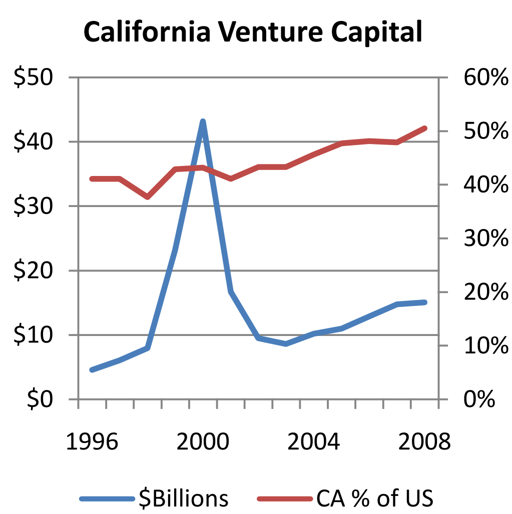


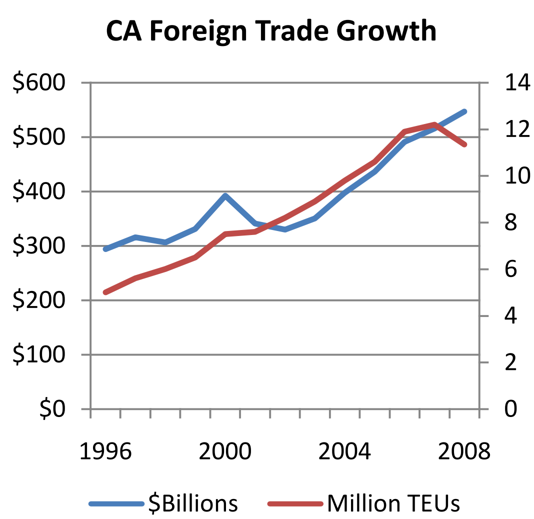
Job growth since 1990 has been concentrated in professional, technical and information services, tourism and entertainment and wholesale trade and transportation tied to the state's rapid growth as a world foreign trade center. Future economic base job growth opportunities are tied to the application of creativity and to California's connections to world markets for trade, tourism and finance. By far the largest opportunities for job growth will be in the high wage professional, technical and information services sectors.



The older economic base sectors of manufacturing and agriculture remain important and will continue to be sources of innovation but residents should expect continuing overall job declines as productivity gains outpace production increases. The manufacturing job declines are worldwide and since 2000 both California and the nation have lost 24% of their manufacturing job base—approximately 475,000 jobs in California and 4.5 million jobs in the nation.

California faces growing opportunities **and** growing international competition in two critical areas—venture capital funding and as the nation's major port complex for handling Pacific Rim trade. In both areas the state has demonstrated strength but future growth faces substantial challenges.





Venture capital funding has been a major source of support for California's creative entrepreneurs and workforce. Funding has increased steadily, but slowly, after falling from $43 billion to $9 billion in the dot.com crash. Here, too, change is in the air. New funding is concentrated in biotech, green tech, software and other services. The Obama agenda should create opportunities for California to target. And in recent years our share of new funding in U.S. companies has risen to near 50%.

Foreign trade has been another strong growth sector—one whose continued success is important for the California economy and for supporting a wide range of middle class jobs. The Los Angeles/Long Beach port complex is the nation's largest and 5th largest in the world serving nearly half of the nation's trade volume with Asia. Even though the state has seen substantial gains in the dollar and physical volume of foreign trade as shown above, increasing competition means that California must solve port and inland goods handling infrastructure challenges while meeting regional air quality and health goals.

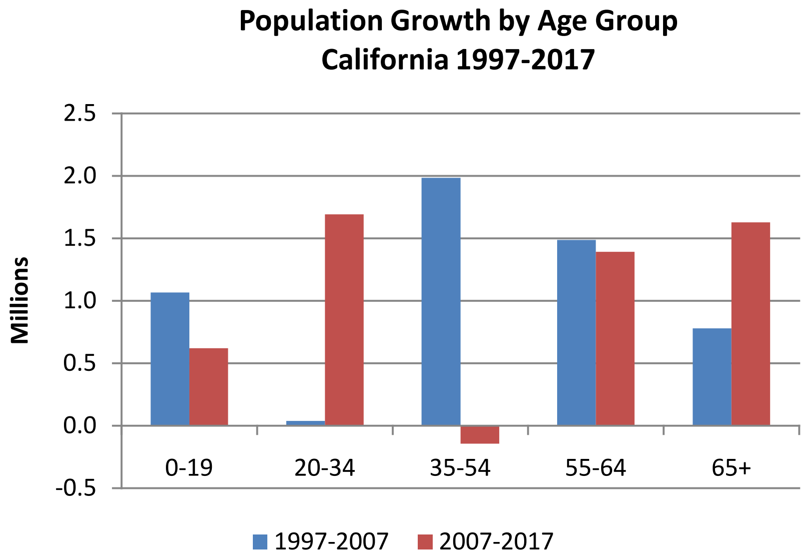
California's Population Growth
Immigrants and Boomers--The Generational Shift Begins

The next ten years will bring substantial changes in the age profile of population growth in California as baby boomers age. At the same time the majority of population gains will come from Latino and Asian residents. These trends make the next ten years a story of generational change featuring immigrants and boomers, the title of a recent book by Dowell Myers from USC (www.russellsage.org/publications).

The data below come from analyses by CCSCE and the California Department of Finance with thanks to Myers for framing the issue of generational change.

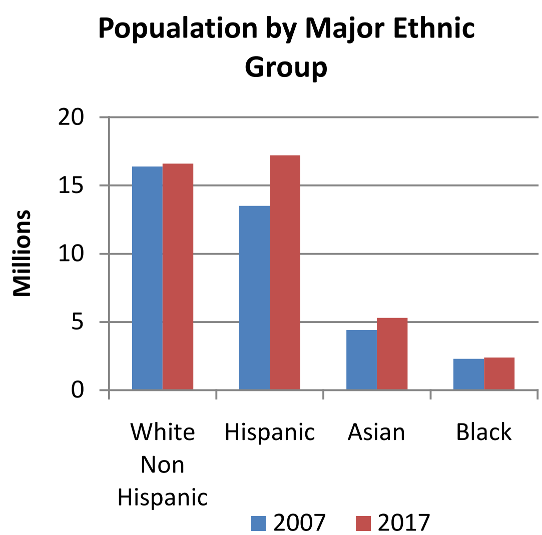
During the past ten years, California added 2 million residents in the 35-54 age groups. This surge defined the state's housing and labor markets as baby boomers moved into these prime family forming and higher-earning age groups. **During the next ten years the number of residents in the 35-54 age groups will remain constant—no growth at all.** This change will profoundly affect housing and labor markets throughout California's major economic regions.

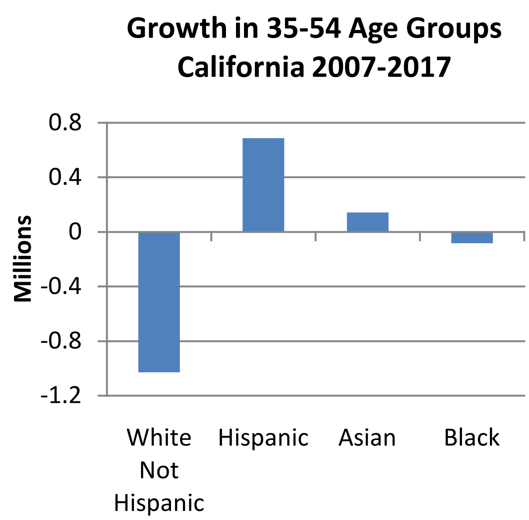
The new surge in California's population will occur among young adults and older residents. Between 2007 and 2017 California will add 3 million residents aged 55 and above and 1.7 million residents between the ages of 20 and 34 after a decade when this age group showed virtually no growth.



The ethnic population trends in California are well known by now. Most of the state's population growth will be from growth in the number of Hispanic and Asian residents and most of this growth will be from the children and grandchildren of recent immigrants and from new immigrants.

Many, if not most, of the retiring baby boomers will be replaced in California's workforce by the children and grandchildren of recent immigrants, by immigrants who have now been here for more than ten years. The number of immigrants who have resided in California for less than ten years will become a smaller and smaller proportion of California's immigrant and Latino and Asian populations according to Myers' research.





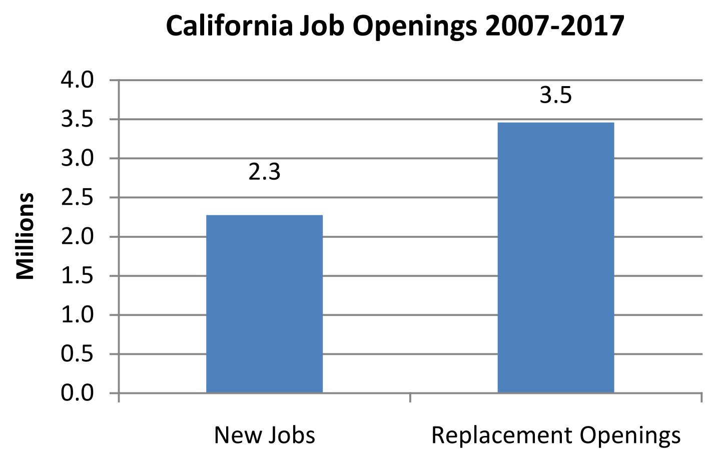
The graph above on the right shows how this generational shift will play out over the next ten years with younger Hispanic and Asian residents replacing White Non Hispanic (Anglo) residents in the 35 to 54 age groups.

Replacement Job Opportunities—Linking Needs and Hopes

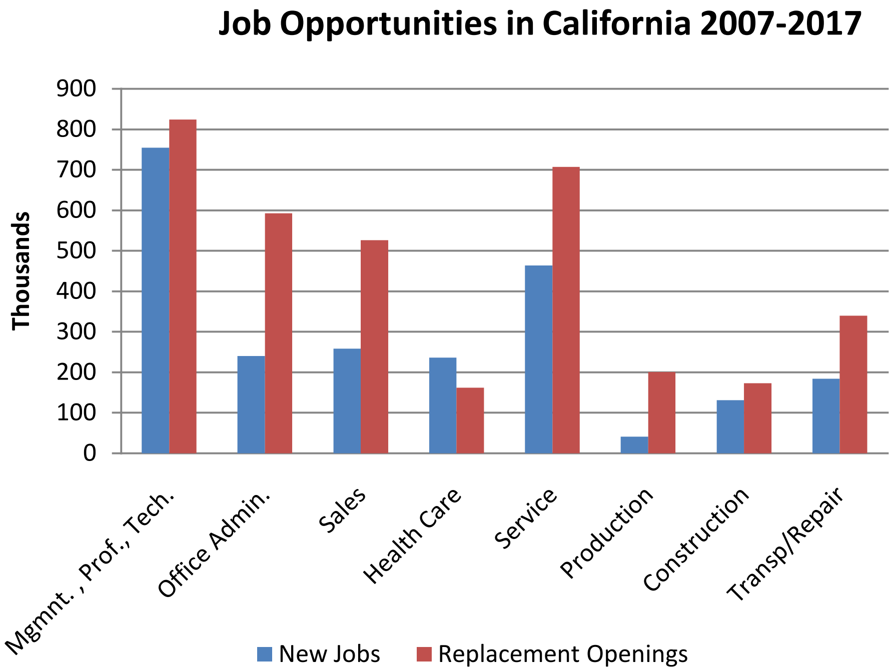
Most workforce analyses focus on new jobs and, often, on exciting new high-tech job opportunities. They ask which sectors are growing the fastest, where will the most jobs be created and where will new high-paying jobs be found. These questions often fuel a conversation about math and science and finding pathways for more people to complete a four-year college education or more.

But California's workforce conversation is expanding now that people recognize how many job openings will come from replacing workers who retire or permanently switch occupations. And while there may be many middle level jobs that pay well in fields like solar or other alternative energy technologies or Internet services, there are more middle level jobs in fields outside of technology.

The tidal wave of baby boomer retirements means that for every 100 new jobs created in the next ten years, more than 150 job openings will be available (and required) to replace existing workers. California's 2.3 million new jobs over the next ten years will be outnumbered by the expected 3.5 million replacement job openings. The following charts combine analyses from CCSCE and the California Employment Development Department.



Replacement job openings outnumber new jobs in most occupational categories and job openings exist in occupations where no growth is expected. In some broad areas of the economy replacement job openings outnumber new jobs by two or three times as much.



CCSCE, the NOVA Workforce Board and the California EDGE Campaign hosted a conference about replacement job needs and challenges. As background we prepared a video http://www.youtube.com/user/NOVASiliconValley filled with stories from local organizations-stories that have been repeated across the state.

The stories tell of cities where more than half of the key managers may retire within the next five years, cities facing the loss of police and firefighters to retirements; the local water district where 80% of the senior technicians are due to retire; non-profit organizations facing the loss of nurses and other staff; and local construction leaders worried about where the next round of trained electricians and carpenters will come from.

After the video was completed we continued to see stories about retirements and replacement needs. The *Los Angeles Times* had a story that 1,000 machinists were needed even though the total number of machinists was not growing—it was all replacement demand. Then the national media carried a story about the impending retirement of many of the air controllers hired 30 years ago. The Santa Clara Valley Transportation Authority has openings for transit operators and mechanics due to internal transfers, retirements and general attrition.

Replacement jobs represent both a challenge and an opportunity. They are a challenge because these jobs are critical foundations for attracting private investment in cutting-edge areas. Why would anyone locate in California if there were not an adequate number of highly trained nurses, firefighters, teachers, plumbers, mechanics and construction workers? But at the same time filling these replacement jobs gives hope to the millions of Californians who simply hope for a better job and a career path that leads upward.

More on California's Future Economic and Demographic Trends

Both CCSCE and PPIC have ongoing publications about California's future economic and demographic trends.

CCSCE's work can be found at www.ccsce.com under topic areas including *Opportunities and Challenges for the California Economy, Numbers in the News, CCSCE on the Issues* and sections on workforce and immigration.

PPIC has a large volume of research on relevant topics including an ongoing *California 2025* research and policy effort http://www.ppic.org/main/ca2025.asp.

California's Future Economy and Population: Implications for Budget Policy and Reform

California's future will be determined in part by state budget choices. Californians must address the budget challenges of **today** but must also establish reforms that make the budget a **strategic guide to a prosperous tomorrow.**

There are many voices looking toward defining budget reform agendas for California. *California Forward's* ongoing efforts are joined by efforts from the Commission on the 21st Century Economy, ongoing work from PPIC including their recent infrastructure funding recommendations, ongoing work from the California Budget Project and many, many others.

California Forward asked CCSCE to identify the implications of the economic and demographic trends described above for a state fiscal policy agenda. What reforms will make the budget a strategic foundation for a prosperous tomorrow?

What Makes the California Economy Competitive?

Developing a budget reform strategy to support economic prosperity requires conversations and some level of agreement about what makes the California economy competitive. For the past decade CCSCE has written that the key to competing successfully for the economic opportunities facing California is a state strategy that focuses on making California **a great place to work and live**.

A great place to work and live embodies **two key ideas for a competitiveness strategy**. First, California's strategy must recognize that we compete not only for entrepreneurs and capital but also that we compete to attract talented people and their families to want to live in California. As a result a state budget strategy to support the state’s economy must include policies that make California an attractive place to live.

Second, the state’s economic competitiveness strategy should reflect the kind of industries that will lead in the 21^{st} century. Given the dependence of our future prosperity on creativity and innovation, California must be the kind of place that creative and innovative people want to work and live. Both the kinds of industries that will dominate California’s economic base are changing as the state has moved from the mid 20^{th} century to the end of the century and into the 21^{st} century.

To summarize one finding from the first section “Future economic base job growth opportunities are tied to the application of creativity and to California’s connections to world markets for trade, tourism and finance. By far the largest opportunities for job growth will be in the high wage professional, technical and information services sectors.” California’s future economy is centered in the application of creativity and innovation and in our connections to the rest of the world. This is the principal audience for a competitiveness strategy for California.

Competing for these opportunities means creating great places to live and work, which in turn means that California must offer world-class infrastructure, a world-class workforce and world-class communities. **Achieving these goals will require an investment agenda for the future—investment in our people, our infrastructure and our communities.** States, like private companies, must maintain investments, even in tough times, to lay the foundation for future prosperity.

The silver lining in these goals is that achieving them simultaneously improves our economic competitiveness while improving the quality of life for all residents including newcomers and families in their sixth generation in the state.

For a long time in California there has been a spirited debate about the role of public policy in creating the foundations for broadly shared prosperity. The two competing views can be broadly summarized as 1) emphasizing tax, cost and regulatory considerations as compared to 2) an emphasis on the state’s workforce, infrastructure and attractiveness as a place to work. While both sets of considerations are important, CCSCE’s analysis of California’s future trends and opportunities points toward an emphasis on the second set of considerations—creating great places to live and work—and pursuing a smart investment agenda to make this happen.

Implications for Converting Economic Opportunities into Broad Prosperity

What are the implications of the economic and demographic trends identified in the first section for public policy and for California’s state budget?

California's budget and future economy are linked in three important ways all three pieces should be part of the same conversations—with elected leaders, business leaders, community leaders and residents. One link is between the future economy and what level and type of public services best supports a competitive and prosperous economy. That conversation leads directly to the second link--consideration of the taxation structure that best supports the level of public services desired by California residents.

And both conversations are improved by careful consideration of the third link--reforms in the way services are delivered and revenues are collected. Reforms in service delivery and the alignment of revenues and responsibilities hold the potential for funding investments in our workforce, infrastructure and communities with the minimum of new revenues needs.

Success in increasing efficiencies, where possible, through careful reforms, will be especially important for California, as **strong pressures exist to increase investments in education, training and infrastructure.** California faces infrastructure investment funding goals of $500 billion over the next 20 years and while some of this funding is already in place, substantial additional funding is needed. And all studies of the state's educational challenges point toward additional efforts for at-risk students, for achieving the goal of higher college participation and for creating a 21st century adult workforce training system. Moreover, these increased investments receive high approval ratings in most recent public polling.

And these investment pressures do not include other budget pressures such as the continuing high rate of heath care inflation or the court recommendations to increase funding for prison capacity and health care.

The following sections examine the implications of California's economic and demographic trends for infrastructure, education and supporting communities that are great place to live and work. *California Forward* asked CCSCE to identify implications for budget reform with an emphasis on those areas related to CCSCE's experience and/or ideas that have not been given adequate attention in the many, many reform proposals already in the public debate.

World-Class Infrastructure

California faces continuing infrastructure and infrastructure funding challenges.

A state that competes to attract world leaders in innovation and creativity needs a transportation system that can move people and goods quickly and efficiently. This is important for businesses that we hope to attract but also for the families who we want to choose California as a place to live and work. The world's center for Pacific Rim trade and tourism needs ports and airports with adequate capacity and the ground infrastructure that can move goods from ports to warehouses efficiently and without harming residents or the environment.

A state that competes to attract world leaders in innovation and creativity (and their families) needs to be able to deliver water in adequate amounts, safely and with attention to flood control and environmental protections.

A state facing challenges in educating a growing number of students) for the 21st century economy needs facilities that are adequate in number, technologically cutting edge with that quality available in all communities within California. This is true for K-12 education but also for facilities that will provide college education and training to high school graduates and adult workers.

A state that competes for skilled workers and their families must have communities that offer world-class local public facilities and an environment as free as possible from pollution and congestion.

And the state faces questions about the adequacy of state prison facilities.

For three decades California accumulated a large backlog of deferred maintenance on our existing infrastructure (roads, schools, water systems and public buildings) as well as falling behind in keeping pace with the addition of 15 million residents in the past 30 years. Residents have recently recognized the impact of these infrastructure challenges and begun to pass a large number of new state and local bonds since 2006.

Yet, a large backlog of infrastructure investment remains. The Governor's recent statements and Strategic Growth Plan (http://gov.ca.gov/issue/strategic-growth) speak of $500 billion needed over the next 20 years with nearly half required by 2016. Some of these investments will be covered by existing sources of funding and some will be funded by recently passed bonds. **But there is a large portion of future infrastructure investment that will require new funding and new funding sources.**

California's infrastructure investments will be funded by several partners—the state government, local governments, federal funding and private sector partners. Future infrastructure investments and funding raise many policy questions for Californians:

- How much emphasis should be placed on state General Obligation bonds that require debt service payments from the General Fund budget?

- What is the appropriate role of private financing and the user fees and tolls that would attract private investors?

- Should voting rules be changed to encourage more local funding?
- What is the role of conservation and efficiency versus new facilities?
- What is the appropriate way to tax vehicle use in an era of increasing fuel efficiency and declining gasoline usage?

There are many analyses of these issues including a recent PPIC study referenced below.

A Budget Reform Agenda for World Class Infrastructure

A fiscal reform agenda should have three main objectives—1) to raise the required funding, 2) to broaden the base for infrastructure funding and 3) to develop funding policies that support efficiency in infrastructure investment.

- **PAYGO Funding for State General Obligation (G.O.) Bonds**

One challenge facing the state budget is that debt service funding for state G.O. bonds directly competes with other funding priorities in the General Fund. The potential collision between long-term growth in General Obligation bonds and funding for other budget priorities was identified in the 2007 Treasurer's Debt Affordability Report (http://www.treasurer.ca.gov/publications/2007dar.pdf).

Unlike local bonds and sales taxes for transportation, state G.O. bonds do not include a revenue source. Recent ballot arguments were filled with announcements that passing a particular state bond would not increase taxes.

One fiscal policy reform would be to make state G.O. bonds **self-funding** similar to the way local bonds are structured. Such a reform would address three important reform principles—1) PAYGO for new spending, 2) transparency and 3) addressing California's structural budget shortfall.

While the current system may make it easier to pass state bonds, it is harder to argue that it represents good governance principles. Moreover, as shown below, voters are approving $billions in new investment funding at the local level all of which include passage of taxes to fund the investments.

- **Adopt a 55% Voter Approval Threshold for More Local Funding**

Another reform would allow all local government bonds and sales taxes for transportation to be adopted with a 55% majority vote similar to the passage requirements for local school bonds. Eighty-five of 92 local school bonds passed in the November 2008 election. Of these bonds 42 or half would not have passed if a 2/3 majority were required.

Lowering the voter threshold for local governments bond and sales tax passage would allow local governments to be more active partners in planning and funding future infrastructure investments. Such a reform would not only broaden the base for infrastructure funding; it would also be part of an agenda to make California communities great places to work and live through local choice. The impact of a 55% voter approval threshold is explored more in the last section.

Lowering the vote threshold would allow local voters to finance a larger share of the state's future infrastructure investments and help reduce the potential conflict between state funding and other state budget priorities.

This proposal as well as proposals below about private-sector fee-based infrastructure funding is explored in a recent PPIC report—*Paying for Infrastructure: California's Choices* at http://www.ppic.org/main/publication.asp?i=863.

- **Develop Guidelines for Private Sector Infrastructure Investments**

State and local governments in California and across the nation are actively pursuing private sector funding for infrastructure investments. The major advantages are 1) the private sector would incur the up-front funding costs and 2) users would see the direct costs of infrastructure in the fees they would pay, which would increase the transparency of infrastructure funding choices. User fees are another example of "paygo" funding for infrastructure by having users pay for new investments.

Californians already pay fees for water and energy and the use of congestion fees on freeways and variable fees for energy use by time of day are expanding. There are strong economic arguments for making users aware of the direct costs of infrastructure as a way to provide incentives for more efficient use of existing and future infrastructure.

Increased use of user fees is not universally accepted because there are equity concerns about requiring residents (particularly low-income families) to pay for activities that were previously free. And extending the scope of user fees does not require private sector as opposed to public sector investment and management of the infrastructure. However, the potential benefits of having the private sector as an infrastructure funding partner suggest that California's fiscal agenda for infrastructure should develop clear guidelines for private investments.

The proposed high-speed rail project is one example where private sector participation is anticipated if the project is to be implemented successfully. Another example, which has been discussed for many years, is to have private sector financing for dedicated truck capacity from the Los Angeles ports to the Inland Empire distribution centers—capacity that is needed to facilitate the growth in port volume without adding congestions to already crowded Southern California freeways.

The Reason Foundation (www.reason.org) is an advocate of fee-based infrastructure funding with active private sector participation and their website contains many studies related to fee-based transportation infrastructure funding. The Keston Institute for Infrastructure at USC (http://www.usc.edu/schools/sppd/keston/) is another source for analyses of California's infrastructure funding choices and public-private partnerships.

- **Improve Transportation Funding From Vehicle Use**

California funds many transportation investments from taxes on fuel use. The state has an 18 cents per gallon tax on gasoline and diesel fuel and also collects sales tax on fuel use. Gasoline usage has declined in recent months and the long-term trend will show little growth or a decline in fuel usage as federal and AB32 standards and consumers support large improvements in fuel efficiency.

The LAO (http://www.lao.ca.gov/analysis_2009/transportation/trans_anl09.pdf) has written recently about the slow growth of vehicle-related tax revenues for transportation and currently favors an increase in the gasoline tax and careful consideration of vehicle fees related to usage. The reasons for these recommendations include 1) developing a funding stream that takes account of vehicle usage, not gasoline usage, and gives incentives for fuel efficiency while 2) providing a funding stream that keeps pace with the growth in the economy and transportation funding needs.

The current system is on track to continually grow more slowly than the economy as the per-gallon tax is not indexed to inflation and any fuel usage tax will grow slowly as fuel efficiency increases. The LAO report is the latest in a series of recommendations on the need to reform California's system of vehicle-related transportation revenues.

A World-Class Workforce

California faces three separate workforce challenges. First, the economic opportunities described above will require an increasing number of highly skilled workers. Recent analyses by Public Policy Institute of California, the Campaign for College Opportunity and others point to the need for more college graduates in California. And, as Deborah Reed of PPIC pointed out in her recent report *California's Future Workforce* (http://www.ppic.org/main/publication.asp?i=809), it is unlikely that the state's future demand for college graduates can be met from immigration or domestic migration. Over time an increasing share of California's college graduate workforce will come from efforts to improve college participation by residents born here.

While this goal is essential and work can begin immediately, California's economy cannot wait or depend solely on the next round of college graduates. That means that California must remain an attractive and welcoming state—for workers and their families from other states **and** countries.

Second, most jobs in California will be filled by people born and educated here. There is broad agreement including the recommendations of the Governor's Committee on Education Excellence (www.everychildprepared.org) that all of the state's children, but especially those at risk, need a good education through high school and that will require attention to both resources and reform.

Third, filling the replacement jobs will require an upgrade in the skills and training of **existing workers.** Giving all students a better education is a critical goal but 80% of the workforce in ten years is already in the workforce today. That means California needs an education/training strategy that can reach existing workers who are mostly adults with families and work schedules.

Given the large role that immigration contributes to California's recent and near-term workforce growth, the replacement worker challenge will require attention to expansion of ESL opportunities for adults combined with programs that allow people who are working to upgrade their skills toward targeted job opportunities.

A Budget Reform Agenda for Creating a World-Class Workforce

The state budget plays a role in developing strategies and funding to meet these workforce challenges.

California already has many fine analyses and recommendations for funding and service delivery reform to move toward a 100% success rate for high school graduation. And California also has many fine analyses of issues surrounding access and planning for higher education. These two areas account for more than 50% of General Fund spending so education financing and reform and state budget funding and reform are closely connected.

In addition to the work of the Governor's Commission on Education Excellence cited above and the Campaign for College Opportunity which focus on issues of both resources and reform, the Legislative Analyst recently released proposals for reforming the delivery of existing state programs for at-risk students (http://www.lao.ca.gov/2009/edu/academic_success/academic_success_0109.pdf).

Here are two ideas to add to today's rich education and training conversation.

- **The Role of Community Colleges**

California’s 108 community colleges serve more than 2 million students, many of whom are already in the workforce. Community colleges have a history of developing local workforce partnerships and offering courses at times and places convenient to the community. They are the primary source for existing workers to acquire additional skills. In short community colleges working with local industries and community based organizations are a critical partner in addressing California’s replacement job needs.

However many training programs have higher classroom and laboratory costs compared to teaching English, math or history. This is certainly true for community college efforts to broaden access to nursing training. Should industry be expected to pay for the additional costs? Should or will students pay more for such training? Or is there a way to get additional funding for community colleges to aggressively pursue a role in training workers for replacement jobs?

The California EDGE Campaign (www.californiaedgecampaign.org) has an ongoing effort directed to addressing California’s challenge of workforce preparation and training. The California EDGE Campaign is developing analyses and proposals for reform of the state’s workforce training system to meet the economic and demographic changes set forth above.

- **Other Components of an Education/Training System for Adults**

One of the EDGE Campaign’s proposals is “The Governor and Legislature must lead a strategic effort to forge the state's impressive **education and training infrastructure** into an integrated system of talent development that addresses the needs of all California workers and employers.” While this effort may not lead to a large increase in spending, it will require a degree of broad thinking and coordination among institutions that is not currently in place.

Helping adult workers improve their skills will require efforts including 1) strengthening gaps in basic education, 2) ESL classes that are available at convenient times and places, 3) a renewed focus in the adult education system toward coordinating with other adult workforce efforts and 4) the implementation of career technical education efforts focused on adult workers who must combine education and training with supporting their families.

Communities that are Great Places to Live and Work

California wants to attract private investment to continue our great tradition of innovation and creativity. This investment requires that the people who fill these new jobs are attracted to live and work in California. California competes not only with the education and infrastructure investments discussed above but also with communities that attract and retain workers and their families. The same education and infrastructure investments that attract companies also provide good schools and transportation options for families deciding whether to move to or stay in California.

A healthy local government finance structure and a carefully developed strategy of state-local finance are critical components of the ability of local governments to support communities that are great places to live and work.

There are some **worrisome trends** about the future major government revenue sources for California's local communities.

Property tax and sales tax revenues are the two large general revenue sources that serve local governments. The current recession has highlighted both current and **future vulnerabilities** in these revenue sources and, as a result, in California's system of local government finance.

Property tax revenue, driven by rising home prices and resale volumes and high levels of new construction rose by 133% between 1998 and 2008 outpacing the level of economic growth in California and providing local governments a fast growing revenue source. The recent plunge in home prices and construction has introduced volatility and uncertainty into future property tax revenues. A report prepared for *California Forward* by Beacon Economics (http://www.caforward.org/resources/Fiscal_Reform_Econ_Backdrop_Beacon_11-08.pdf) forecasts a drop in property tax revenues for the next three years. While property tax revenue may begin to grow again after that, it is unlikely that property tax revenue growth will soon return to the levels of 1998-2008.

Home prices have fallen substantially, which means that there will be further rounds of downward reassessments and future home sales will not provide the growth in assessed value that home sales in recent years have provided. Moreover, it will take many years for new private construction levels to return to the levels seen between 2005 and 2007. The implication is that property taxes over the next decade may become a below-average, not an above-average, local government revenue source.

Sales tax revenues have grown more slowly than the overall economy for most of the past 30 years. This downward trend in the amount of income spent on taxable items was mitigated somewhat by the surge in taxable sales related to home construction and modernization and by the temporary rapid rise in gasoline prices and related sales tax revenues. But recent data show that sales tax revenue fell throughout the state in 2008 and the Beacon report and DOF analyses expect continuing declines in 2009, which could now easily extend into 2010 given the rapid decline in employment and income.

Moreover, the long-term trend of relatively slow growth in sales tax revenues is very likely to return in the decade ahead. First it will take quite a while for taxable sales to return to 2007 levels so these years will have no overall growth. Beyond that, three trends are worrisome for sales tax revenues—1) the trend for spending growth to be faster in areas not subject to sales tax, 2) the likelihood that revenues from fuel sales will grow slowly as fuel efficiency increases and 3) the likelihood that home construction will not fully rebound for several years.

A Budget Reform Agenda for Creating Great Places to Live and Work

- **Realignment of Revenues and Responsibilities**

The allocation of responsibilities and revenues between the state and local government has been the subject of continuing discussion and reform for more than three decades following the passage of Proposition 13 in 1978. A major restructuring occurred in 1991 and the Legislative Analyst's Office has proposed many reforms with the latest proposal covering recommendations for criminal justice system funding and responsibilities (http://www.lao.ca.gov/2009/crim/Realignment_012709/Realignment_012709.pdf).

The hope of realignment and reform is that local services can be delivered in a more responsive and effective manner, which will help to build communities that are great places to live and work.

Fortunately the *California Forward* staff has extensive experience in state-local finance and reform issues with Jim Mayer, former Executive Director of the Little Hoover Commission and Fred Silva with decades of experience as a legislative fiscal consultant and as lead staff for the California Constitutional Revision Commission.

- **Creating A Strong Local Government Finance Structure for the Future**

The long-term prospects for property tax and sales tax revenue growth are worrisome as noted above. Currently the Commission on the 21st Century economy is studying **state** tax reform ideas. CCSCE's analysis suggests that it will be helpful if reforms of state and local revenue structures are considered together. A first step would be to carefully examine long-term local government revenue trends under the current state and local tax structure.

If it is determined that the current local revenue structure needs to be strengthened, the ideas being discussed in the context of state tax system reform can do "double duty" by improving the stability and growth of local revenues.

Broadening the sales and property tax bases would simultaneously affect local and state revenue trends. Broadening the sales tax base to include some additional service sectors would add a fast-growing element to the state sales tax base and, at the same time add these fast-growing sectors to city, county and local transportation agency tax bases.

Two often proposed property tax reforms would have the similar impact of helping both state and local budgets without changing the Proposition 13 property tax rates. One reform would be to have more frequent reassessment of non-residential property and another reform would be to change the 2% limit on assessed value increase for existing properties to a somewhat higher annual limit. These changes would increase the rate of growth of local property taxes while lowering the required K-12 funding assistance from the state budget.

Lowering the voter approval required for local bonds and taxes to 55%, discussed above as part of the infrastructure agenda, would allow more flexibility for local residents to deal with a possible long-term decline in sales and property tax revenue growth. This, in turn, would allow local governments to be a stronger partner in California's very interconnected system of state-local finance.

The results in the review of local voting trends at the end of this paper say both that local voters are ready to make investment decisions about their future and that the voting majority (2/3 or 55% or 50%) can make a difference.

- **The Importance of Regions**

Regions are critical components of planning for California's future. The way in which regions fit into a discussion of state and local budget reform is not clear. But many aspects of planning for California's future occur at the regional level so it is important to bring regional considerations into California policy discussions.

California doesn't have one economy. The state has a set of regional economies, which have very different economic bases and some unique as well as some similar policy challenges. Regional economies mean that workforce policy should be considered in a regional context. The state has regional transportation planning, regional air quality planning and regional water planning issues.

Regional planning agencies have the responsibility for long-term land use and transportation planning. And now under SB 375 and AB 32, regional land use and transportation plans must be coordinated with considerations of the impacts of these regional plans on greenhouse gas emissions.

There are complicated issues of how local governments can work together within a region to achieve regional and state goals. There are also complicated issues of how to make sure that regional planning can be flexible enough to respond to unique regional considerations but also, in the end, be consistent with statewide planning for the future.

Can Talking About Our Connections and the Future Inform the Budget Reform Discussion: What Are Local Voters Telling Us?

Local voters are raising taxes to invest in the future. The November 2008 election, occurring in a deepening recession, was no exception. Data from the California City Finance website (http://www.californiacityfinance.com/) show that 76% of bonds and tax increases were approved. More than 90% of school bond measures were approved resulting in $22 billion in new school bond authority.

Twenty three local jurisdictions adopted sales tax rate increases ranging from 1/8 percent to 1 percent. Communities ranging from El Cajon to Pico Rivera, La Habra, Capitola, Galt and Arvin raised sales taxes to support local government services. Seventeen of twenty one school parcel taxes were approved even though a 2/3 vote majority was required.

One explanation is that voters are more likely to approve funding locally where they trust that results are forthcoming and see the benefits more clearly.

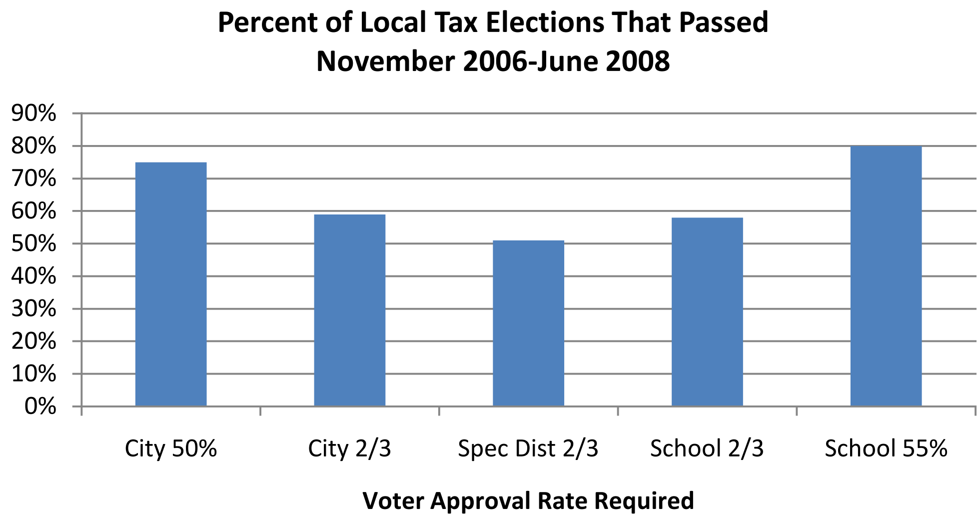
However, these votes also suggest that people see **connections** between their future and the future of their broader community members. Voters in the City of Los Angeles approved $7 billion in school bonds (and the associated property taxes) even though many voters have no children or grandchildren in the schools and many voters were building a future for children who lived in far different parts of the city and were the children and grandchildren of recent immigrants. What **connections about a shared future** did they see?

Voters in Los Angeles County and Santa Clara County approved sales tax increases to fund transportation projects even though many voters would see no project funding at all near where they lived. What **connections about a shared future** did they see that prompted taxing themselves for $billions in transportation infrastructure investments?

The November 2008 results would have been even stronger if a 55% or 50% majority vote approval rate were in effect for all local bond and tax elections. According to data from California City Finance (http://www.californiacityfinance.com/Votes0811final.pdf) there were 13 local general purpose sales tax votes that required a 2/3 approval. Of these 7 passed and 5 others received more than a 55% majority. There were 26 local government parcel taxes also requiring a 2/3 majority. Of these 9 passed, 9 more received a 55% majority and 3 received between 50% and 5% of the vote.

Local school bonds now require just a 55% majority to pass. In the November 2008 election, 44 received more than 2/3 of the vote and 43 more received between 2/3 and 55% of the vote while 4 of the remaining 8 bonds received more than 50% of the vote.

The November 2008 voting pattern continues a strong pattern of local approvals.



These data offer hope and a challenge for conversations about budget reform.

Future Trends Call Californians to Recognize Our Connections

How can budget strategy and reform conversations tap into these connections that people feel when they vote in local elections?

This look at California's future economy and population suggests that **our future is connected across age and ethnic groups and geography** in California. We are connected across generations. The retiring baby boomers will turn the state's economy over to a younger generation who must fill the replacement jobs and build our future prosperity. The older generation cannot have a secure retirement unless the generations that follow have the skills to succeed.

Local elections say that voters see these connections as they vote for school bonds and infrastructure investments for our future.

Californians are connected across ethnic groups. There is no "majority" ethnic group in California and our diversity grows each year. The passage between generations is also a passage of largely Anglo baby boomers being succeeded by generations of Latino and Asian immigrants and their children and children. Local voters are investing in this generational and ethnic shift with their votes to support education for the newly largely Latino and Asian generation of students.

Californians are connected across geography. Local voters in affluent communities within regions are funding investments that will mainly benefit different communities within the same region. Residents are funding transportation investments within regions that may not benefit themselves but will improve mobility within the region. And we are connected north and south and east and west on issues of water, energy and transportation investments.

California has many regional economies yet many issues affect all regions and must be decided at the state level.

Can we learn from the connections that people see locally across age, ethnicity and geography in investment decisions about our future? Can these connections inform California's upcoming budget reform conversations?