November 10, 1998

Hon. Daniel E. Lungren
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Connie Lemus
Initiative Coordinator

Dear Attorney General Lungren:

Pursuant to Elections Code Section 9005, we have reviewed the Constitutional initiative entitled "Fair Tax Initiative" (File No. SA98RF0019). This measure would make major changes in the way in which California's state and local governments raise revenues and finance programs, by replacing most existing revenue sources with a flat-rate tax on transactions and exchanges.

MAJOR PROVISIONS OF THE INITIATIVE

General Provisions Relating to State Government

Elimination of Certain Existing State Taxes. California currently levies a variety of state-level taxes, including the personal income tax, bank and corporation franchise and income taxes, sales and use taxes, gross premiums insurance tax, and various excise taxes.

This measure would eliminate in two phases all current state tax and other state revenue sources (with some exceptions) and replace them with a broad-based flat-rate tax on transactions and exchanges. Under the first phase, on July 1 following the passage of the initiative, all state taxes based on income, including those on individuals, companies, partnerships, or other entities, would be eliminated. This would result in the elimination of the Personal Income Tax and the Bank and Corporation Tax.

In the second phase, implemented one year later, the measure would require that all other state taxes, fees, licenses, assessments, and tolls be eliminated, unless excepted by the measure. This would eliminate the state sales and use tax, motor vehicle fuel license tax, diesel and use fuel taxes, vehicle license fee, and an extensive variety of smaller taxes, fees, and charges. Specific revenue streams tied to the security of bonded debt would be allowed to continue while the debt was outstanding.

Replacement With New Tax. The measure would replace the above eliminated revenue sources with a "fair tax" on the exchange of value, transaction in trade, or exchange of services in California. The base of the fair tax would include transactions involving all property, goods, and services. The tax would be levied on and applied to all transfers of ownership, title, or custody, whether by sale, lease, rental, vending, barter, installment purchase, or any other form of transfer. The fair tax would generally apply to all property—real and personal, tangible and intangible. The fair tax generally would use a statewide uniform tax rate levied on all trade within the state and its subdivisions between and among individuals and businesses. The initiative sets the rate for the fair tax for most transactions at a maximum of 6 percent, to be imposed in two steps coinciding with the tax-elimination phases noted previously. In conjunction with the phase one elimination of income-based taxes, the fair tax rate would be set at 3 percent. With the implementation of the phase two elimination of all other taxes and fees, the rate for the maximum fair tax rate would increase to the full 6 percent.

The specific fair tax rate that would be in effect at any given time would be the lesser of the maximum 6 percent rate, or that lower rate sufficient to generate the total combined revenue received by California's state and local governments from all affected sources in "fiscal 1998" (presumably, fiscal year 1997-98). The fair tax on securities-related transactions, however, would be at a lower rate of ¼ of 1 percent of the amount of the transaction. The rate of the fair tax could be increased by a two-thirds majority vote of the people voting at a regular election.

General Provisions Relating to Local Governments

Elimination of Certain Existing Local Taxes. Local governments in California currently levy a variety of local taxes, including the property tax, local components of the sales and use tax, transactions taxes, business license taxes, utility users taxes, transient occupancy taxes, and many other fees and assessments. On July 1 immediately following the passage of the initiative, any of these taxes relating to the income of the taxpayer would be eliminated. One year later, most other remaining taxes, fees, and assessments levied by local governments would be eliminated. The measure, however, would still allow locals to levy various user fees—such as gas, water, and electric charges. Specific revenue streams used to secure bonded debt would also be allowed to continue while the debt was outstanding.

Replacement of Lost Revenues. Under the measure, each local government would be eligible to be reimbursed by the state government for the same level of revenues it collected in fiscal 1998 from its eliminated revenue sources. In future years, local governments would receive an adjustment to their allocation based on changes in population and cost-of-living adjustments.

Special Local Fair Tax. With a two-thirds vote of the people in any local jurisdiction, a local fair tax could be implemented for up to five years to fund "special needs." The local fair tax would be limited to 1 percent. The Legislature would be responsible for establishing uniform rules to govern these local options. While the initiative limits the rate to 1 percent within a county, city, or special district, it does not specify the procedures if two overlapping jurisdictions both approve local fair taxes totaling more than 1 percent. The local fair tax would cease once its intended purpose had been fully funded.

Administration of the Fair Tax

The measure would require quarterly filings of the fair tax by those parties responsible for paying the tax. It would create the Fair Tax Fund, into which all funds raised by the fair tax would be deposited. This fund would be administered by the State Treasurer through a Department of Revenue, which presumably would be established in implementing the measure.

Allocation of Fair Tax Revenues

Under the measure, all governments will be allocated on a monthly basis 100 percent of their fiscal 1998 budget derived from those taxes, fees, and revenue sources eliminated by it, along with annual adjustments for per capita growth and cost-of-living allowances in future years. For the state government, its agencies would be allocated funding amounts as determined by the Legislature, while allocations to local entities would be determined by the Treasurer, in part based on various information provided and certified by the Legislature.

The measure also creates the Appropriations Fund, into which 5 percent of any revenue amounts exceeding the base allocations to the state and its local governments would be deposited and used to reduce state and local bonded indebtedness. Any additional revenues beyond the base allocations and debt reduction payments would be deposited in the Stabilization Fund, which the measure also establishes. Amounts in this fund would be allowed to reach $4 billion and be used as a supplement for any temporary fair tax revenue shortfall. However, any monies in excess of $4 billion would be used to reduce state bonded indebtedness and, if still available, to reduce the fair tax rate itself.

Bonding Authority. The measure provides that any existing authorization to issue debt would expire on January 1 following the passage of the initiative.

FISCAL EFFECTS OF THE INITIATIVE

There are a number of ambiguities and definitional issues associated with this proposal that would need to be addressed upon its implementation. Because the different alternative ways in which these factors are resolved could affect the measure's fiscal effects, there are inherent uncertainties regarding what its exact fiscal effects would be on both the state and its local governments.

One uncertainty involves what revenue sources would *not* be eliminated. For example, "state accident insurance" is not eliminated, but it is unclear whether this exemption applies only to particular types of insurance versus all insurance trust revenue. If it does not apply to insurance trust revenue (such as from unemployment compensation, employee retirement, and workers' compensation), this would expand the amount of revenue that would need to be raised through the fair tax by tens of billions of dollars. The definition of recreational user or admissions charges also is uncertain. Likewise, the term "Common School Funds" used in the proposal does not reflect any current state fund definition and would need to be clarified.

Another key uncertainty involves exactly what is covered in the fair tax base as transactions and exchanges. For example, securities transactions are taxable, but the legal issues this may raise regarding interstate commerce restrictions would need to be addressed. In addition, since the tax would be levied whenever there is a transfer of any form—including ownership, title or custody—different interpretations of the term "transfer" could lead to wide variations in the amount of revenues raised. For example, the measure may only apply to purchases of securities; however, it could also apply to overnight transfers of stocks or bonds between banks and investment houses, or to inter-bank overnight lending. If the more expansive definition of transfer were used, the tax base could be radically expanded, and vice versa. Based on the wording of the initiative, title changes of property could also be affected, even when these occur without any real change in ownership. Similar types of uncertainties also exist relating to local governments under the measure.

The fair tax would result in substantial behavioral changes by individuals and businesses that could affect the amount of revenues raised through the tax. California export industries could be disadvantaged due to the taxation of intermediate goods and services, while certain other industries could benefit from the new tax structure. The initiative also could have unknown impacts on fixed asset values such real estate, and business factories and equipment. In addition, Californian's federal income tax liabilities would increase (due to reductions in itemized deductions for state taxes) by several billion dollars annually, and this could affect economic activity in the state. These potential impacts have not been incorporated in our fiscal estimates. Important distributional issues would also result from the replacement of the existing tax system with the fair tax.

Fiscal Effects on State Government

Revenues. We estimate that the amount of revenues generated by the fair tax may be sufficient to raise at least the amount of state (and, as noted below, local) revenues raised under the current state and local revenue structure in 1997-98.

Although the fair tax may provide an amount of revenues sufficient to cover current levels, the amount of state revenues under the measure in future years would be determined primarily by adjusting base revenues to account for population changes and cost-of-living adjustments. Future state revenues may be greater or less than under current law, depending on these adjustments and how the revenue base would have changed in the absence of the measure.

The measure's revenue impacts could have two other important implications:

- ***Special Funds.*** Expenditures for certain program areas currently are financed by special fund revenue sources. Although the fair tax may raise an amount of total state revenues at least comparable to current law, revenues received by certain funds from dedicated revenue streams would be eliminated under the fair tax. The activities for which these special funds are responsible would then be subject to the normal budgeting process.

- ***Proposition 98.*** The initiative does not explicitly indicate how the fair tax would interact with Proposition 98. Proposition 98 funding formulas guarantee K-14 education a minimum level of General Fund and property tax revenues. If all the fair tax revenues are deposited in the state's General Fund and distributed from there, this measure could increase the state's funding obligation to K-14 education. In this event, schools would get this increase, even if there was essentially no increase in total state revenues.

State Appropriations Limit. The measure would eliminate several taxes dedicated to purposes that are currently exempt from the existing state appropriations limit, such as portions of the motor vehicle license fee subvened to local governments and the portion of the gasoline tax levied for Proposition 111 purposes. Instead, these revenues would be replaced by fair tax revenues, which would be subject to the state appropriations limit (except to the extent that the Legislature designates them for exempt purposes). While this would not immediately constrain state appropriations, it could bring the state closer to the limit in the future, depending on circumstances.

State Administrative Costs and Savings. This measure would result in both state administrative costs and savings:

- ***Costs.*** Short-run transition costs, possibly into the tens of millions of dollars, would be incurred because current tax agency systems would need to remain in place at the same time that the new tax system was implemented. New costs would be incurred on an ongoing basis since the state would not be able to rely on the federal government's tax system for tax enforcement and auditing purposes. There also could be administrative costs to the extent that more taxpayers file returns under the new system, and there might be other net cost impacts as well depending on whether definitions of taxable transactions require greater or fewer resources to administer and enforce than under the current tax system.

- ***Savings.*** Long-term savings would likely result from the passage of the measure, due to the elimination of existing taxes and fees and the installment of a single tax on transactions. Savings would result from the elimination and/or consolidation of a great number of the tax-related enforcement and compliance activities that are carried out by the state's current tax agencies. The magnitude of these savings is unknown, but could exceed $100 million annually.

Fiscal Effects on Local Governments

Local Government Revenues. While most local government revenue sources would be eliminated by the initiative, each local jurisdiction could expect to receive an equal level of revenues to that which it received in fiscal 1998, along with growth in future years. We estimate that the fair tax may generate sufficient revenues to replace all existing local revenues.

Each local jurisdiction would have the authority to seek voter approval to supplement its existing revenues with a local fair tax in order to fund specific projects. In future years, changes in local government revenue allocations would be based on the annual adjustment factor. This means that individual jurisdictions could experience either a gain or loss in program-related receipts, and thus expenditures, in comparison to what would have been received under current law.

Local Savings. Many local governments would experience significant administrative savings as a result of the initiative. Most revenue-collecting administrative expenses could be eliminated over time, as local governments no longer collected taxes and debt was retired. In the aggregate, local governments would experience savings in the hundreds of millions of dollars annually.

SUMMARY

The fiscal impact of this measure on state and local governments would depend in part on how the measure is implemented, including interpretations regarding revenue sources subject to the measure and how the new tax base is defined. The measure would likely have the following major effects:

- ***State and Local Revenues.*** In the near-term, little or no effect on total governmental revenues. In the longer-term, unknown effects on both total revenues and revenues to individual governmental entities.

- ***State and Local Tax Administration Costs.*** Near-term state costs and local savings in tax administration, with longer-term state and local savings in the hundreds of millions of dollars annually.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Craig L. Brown
Director of Finance