

CHAIR
STEVE PEACE

VICE CHAIR
DENISE MORENO DUCHENY

SENATE

MAURICE K. JOHANNESSEN
PATRICK JOHNSTON
TIM LESLIE
JACK O'CONNELL
RICHARD G. POLANCO
JOHN VASCONCELLOS
CATHIE WRIGHT

ASSEMBLY

ROY ASHBURN
TONY CARDENAS
JIM CUNNEEN
FRED KEELEY
CAROLE MIGDEN
GEORGE RUNNER
RODERICK WRIGHT

March 10, 1999

**Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814**

**Attention: Ms. Connie Lemus
Initiative Coordinator**

Dear Attorney General Lockyer:

Pursuant to Section 9005 of the Elections Code, we have reviewed the proposed initiative entitled the "Keeping the Promise Initiative" (File No. SA 1999 RF 0001).

MAJOR PROVISIONS

Vehicle License Fee

The vehicle license fee (VLF) is an annual fee on the ownership of a registered vehicle in California, levied in place of taxing vehicles as personal property. The fee rate is 2 percent of a vehicle's current estimated value— calculated from the current owner's depreciated purchase price. The revenues are primarily distributed to cities and counties. The 1998 tax relief package passed by the Legislature included a permanent reduction in the VLF of 25 percent, with the potential of greater reductions beginning in 2000-01 if General Fund revenues grow faster than currently projected. As part of this tax reduction agreement, cities and counties will continue to receive the same amount of revenues as under prior law, with the reduced revenues replaced by General Fund spending.

This constitutional measure would further reduce the VLF over a two year period and eliminate it in the third year.

- **First Year of Implementation.** The vehicle owner's purchase price (upon which the VLF is based) would be reduced by \$10,000.
- **Second Year of Implementation.** The vehicle owner's purchase price would be reduced by \$20,000, if General Fund revenues are expected to be greater than in the prior year.
- **Third Year of Implementation.** The VLF would be eliminated, if General Fund revenues are expected to be greater than in the prior year.

In order to provide cities and counties an equivalent amount of revenues that would have been received under current law, this measure would divert state sales tax revenues to a special fund used to reimburse local governments for lost revenues.

Definition of Tax

Current law generally allows the state and local governments broad discretion in establishing fees, charges, or fines. These revenues are collected: (1) for the privilege of engaging in certain activities, (2) in order to regulate a particular activity, or (3) for the purpose of imposing penalties. In some cases— such as many user charges, admission fees, and some regulatory fees— the payment is closely linked to the cost of providing a particular service to an *individual* beneficiary or regulated party. In other cases— for example, certain environmental or regulatory fees— the payment may not be directly related to the costs associated with particular participants, but more loosely related to a discrete *group* of participants or an industry. In some situations, the payment may not relate to direct regulation per se, but rather to broad social costs associated with particular activities— for example, environmental mitigation fees.

Although the state and local governments enjoy wide latitude in establishing fees and charges, under current law some link must exist between these payments and the related cost to governments in order to avoid the voter approval requirements of a "tax." Fees or charges must be based on some established relationship between the amount of the payment, on the one hand, and the costs associated with the regulation of an activity or the provision of a good or service, on the other. Similarly, penalties must be considered reasonable given the specific incident of noncompliance. If a sufficient relationship, or "nexus," is not established between the fee and costs of provision or regulation, the charge is considered a tax.

The initiative establishes a constitutional definition of a tax as any “exaction imposed” by a governmental entity. It then specifically exempts certain types of governmental revenues. While the scope of the definition of tax is ambiguous, it appears to recast as taxes certain state and local governmental revenues (or portions of these revenues) that are currently considered to be fees, charges, civil fines and penalties, regulatory fees, or other payments. To the extent that a governmental revenue is recast as a tax by this measure, the revenue source would become subject to existing Constitutional provisions relating to governing body and voter approval requirements.

In order to avoid having certain revenues reclassified as taxes, the initiative requires governments to establish a much tighter relationship between payments and costs than is required under current law. Under the measure, many payments would be considered taxes unless they did not exceed the cost of conferring a specific privilege on the individual payer. The initiative also would require that regulatory fees relate to the costs of direct regulation of the payer. These stipulations imply that payments must be linked to (1) actual costs of particular services or (2) regulatory costs relating to particular entities. This could raise questions regarding payments levied on the basis of average costs, or those which take into account broad social costs associated with certain activities.

FISCAL EFFECT

Vehicle License Fee

The measure specifies that its reductions to the VLF are to apply concurrently with the reductions contained within the 1998 tax reduction package. We have assumed that the \$10,000 and \$20,000 exemptions would first be applied to the owner’s purchase price. Then the VLF owed would be calculated using the statutory 2 percent tax rate. This amount owed would then be reduced by an additional 25 percent, according to the 1998 tax provisions. For instance, a new \$25,000 vehicle in the first year of implementation would receive a \$10,000 exemption, resulting in a VLF owed of \$300 (\$15,000 x 2 percent). This \$300 owed would then be reduced by 25 percent, resulting in a bill of \$225.

This measure’s fiscal impact, therefore, is the difference between the total revenue loss (from both this measure and the existing tax relief provisions) and the revenue loss from only the existing tax relief. Based on current estimates of General Fund revenues, we have assumed that no additional percentage reductions would occur as a result of the 1998 tax package’s provisions. If these additional percentage reductions did occur, however, the cost of tax relief attributable to this measure could be reduced signifi-

cantly. When fully phased in and the VLF eliminated (2002-03 would be the earliest full fiscal year effect), the ongoing fiscal effect to the state's General Fund for reimbursing local governments under this measure would total about \$4 billion annually. In the interim, the fiscal effect would depend on the timing of the measure's implementation but would total billions of dollars.

The measure does not provide for the replacement of the VLF's share of the Department of Motor Vehicles' (DMV) vehicle registration administration costs. As a result, local governments would experience an increase in VLF revenues (currently more than \$200 million annually) that under current law funds a portion of the department's administrative expenses. These administrative expenses would, in turn, be shifted to two other state accounts— the Motor Vehicle Account and the State Highway Account.

The state would also experience one-time expenses totaling millions of dollars for administrative costs associated with the DMV implementing the intermediate purchase price exemptions. There would be minor savings in the future associated with the department not collecting the VLF.

Definition of Tax

Estimating the fiscal effect of the new Constitutional definition of tax is subject to considerable uncertainty and is dependent upon a number of factors. For instance, there are many legal questions as to the definition given various terms, particularly the terms "exaction imposed" and "cost to the entity of providing the privilege." A narrow definition of the former and a broad definition of the latter would tend to minimize the fiscal impacts, and vice versa. In addition, these impacts would depend on how broadly the courts interpreted the authority of taxpayers to challenge the validity of payments to government imposed *before* the enactment of this measure. In this regard, one reasonable interpretation would require that all revenue sources redefined as taxes be subject to approval by the voters or the governing body in order to be continued.

Furthermore, the fiscal impacts of the measure would depend on future actions by state and local governments. For example, government entities could change the way they "impose" or administer certain payments to ensure that they are exempt from the measure.

Given these factors, estimating the level of current and future government revenues that would be affected by the measure is subject to considerable uncertainty. The measure, however, would likely result in the reclassification of many revenue sources into taxes. These revenues, in turn, would then require approval by governing bodies and

by the electorate in order to be continued. To the extent governments were unable to obtain such approvals, they would experience reductions in overall revenues. The magnitude of this reduction in future revenues could be in the hundreds of millions of dollars— or even in excess of \$1 billion— annually.

Impact on K-14 School Spending

Under current state constitutional provisions, the minimum level of annual state spending on K-14 schools is determined in part by the level of state General Fund tax revenues. This initiative has a provision stating that it will not *reduce* future funding increases for schools. The measure could, however, work to *increase* state funding for schools. To the extent that the initiative resulted in increased state tax revenues (see above), it could also lead to additional school spending.

SUMMARY

The measure would result in the following major fiscal impacts:

- Annual state expenditure increase of about \$4 billion annually, potentially beginning in 2002-03, from eliminating the VLF and reimbursing local governments for their lost revenues.
- Reduction in state and local revenues, potentially in excess of \$1 billion dollars annually, as a result of classifying more governmental revenues as taxes.

Sincerely,

Elizabeth G. Hill
Legislative Analyst