January 29, 2002

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

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the constitutional and statutory initiative entitled "Fair Tax Act" (File No. SA2001RF0051, Amendment No. 1-S). This measure would make major changes in the way in which California's state and local governments raise revenues and finance programs. This would be accomplished by (1) replacing the existing sales and use tax (SUT) with a value added sales tax on certain tangible personal property, (2) replacing various excise taxes, (3) eliminating certain local taxes and fees, (4) eliminating taxing authority of certain local governments, and (5) making certain other changes in the law governing taxation.

Provisions of the Initiative

General Provisions Relating to State Government

Elimination of Certain Existing State Taxes. California currently levies a SUT on the final sale of tangible personal property (with exemptions for certain products such as food and medicine). The state also levies certain excise taxes (product-specific levies) and a vehicle license fee (VLF), which is in lieu of taxing vehicles as property. This measure eliminates the current state SUT, as well as current excise taxes on gasoline, diesel fuel, and alcoholic beverages. The measure also eliminates the VLF.

Replacement With New Taxes. The SUT would be replaced with a value-added tax (VAT), based on value added to certain tangible personal property at each point of sale. The measure forbids the levying of the VAT on food, beverages, medicine or drugs, fuel of any type, and electricity. The measure sets forth certain constitutionally established rates that are imposed at the state level for the purpose of funding the current Local Public Safety Fund (LPSF). In addition, the measure provides through statutory provisions optional tax rates that may be imposed in addition to the constitutionally established rates. The measure also allows for the levying of an ad valorem tax on the sale of gasoline and diesel fuel up to a certain rate.

General Provisions Relating to Local Governments

Elimination of Certain Existing Local Taxes. Local governments—including cities, counties, and special districts—currently levy uniform and optional SUTs on top of the state rate. Local governments may also levy utility users' taxes as well as certain fees and charges. This measure eliminates local SUTs and would, under certain conditions, eliminate other local government revenue sources.

Replacement With New Taxes. The measure establishes that a VAT and an ad valorem tax on fuel may be levied locally but only by cities and counties. The various restrictions regarding the VAT base are identical to those governing the state. If a locality opted for a tax on fuel, it could not levy a utility users' tax (UUT).

Tax Rates

The VAT. The measure constitutionally establishes a mandatory state VAT at the rate of 0.5 percent to provide revenues for the LPSF, and allows optional local rates of up to an additional 0.5 percent for the same purposes. In addition, statutory provisions would allow an additional state rate of up to 3.5 percent (except in calendar year 2003, when a mandatory 2.5 percent additional rate would be levied) and additional local rates of up to 5.5 percent. The VAT rate may be adjusted by the Legislature or a county or city governing board up to the maximum amount established by statute. The maximum amount of the VAT may be increased by a vote of at least two-thirds of the electorate.

Fuel Tax. The measure constitutionally establishes that a state ad valorem tax on fuel may be levied at a rate of up to 8 percent and allows local rates of up to an additional 12 percent.

Other Provisions

The measure also makes certain other changes regarding existing taxes. It prohibits the levying of any tax on sales of items through the Internet that are shipped from outside of the state and prohibits the levying of a use tax. The measure also establishes an amnesty program during calendar years 2003 and 2004 for tax and fee liabilities. The measure defines "taxes" in a manner which potentially could expand the number of revenue sources that would be considered taxes. The Board of Equalization is directed to administer both the VAT and the ad valorem fuel tax for both the state and local governments.

The measure designates that proceeds of the constitutionally established VAT rates for the LPSF are to be allocated by the Legislature and used for local public safety and the California Highway Patrol. In addition, certain fines and forfeitures from municipal and superior courts would be deposited in the LPSF to be used for particular purposes. Proceeds of the ad valorem tax on fuel collected by the state or local governments are designated to be used for public and mass transit, street and highway construction and maintenance, and earthquake and storm damage.

Fiscal Effects of the Initiative

This initiative entails a major restructuring of state and local finance. Its fiscal impact would depend on the decisions state and local officials make in response to the measure, such as:

- The VAT and gas tax rates chosen.
- Whether to adjust taxes not directly affected by the measure.
- Budgetary decisions regarding spending on existing programs.

In addition, there exist a number of uncertainties and definitional issues associated with this proposal that would need to be addressed upon its implementation. For example:

- There are issues regarding the definition of "fees." The proposal includes fees within the definition of taxes, but only to the extent that they constitute fees for governmental purposes. The latter are not defined.
- The VAT would most likely result in behavioral changes by individuals and businesses that could affect the amount of revenues raised by the tax.

With these factors in mind, we estimate that the amount of revenues generated by the VAT and the ad valorem tax on fuel may be sufficient to raise at least the total amount of state and local revenues that would be raised in 2002-03 under the current tax structure. However, the elimination of certain taxes and imposition of new ones would likely result in overall *declines* in state revenues and *increases* in local revenues, as described below.

Fiscal Effects on State Government

State Revenues. The actual amount of revenue raised by each tax under the measure would depend on the Legislature's actions regarding the exact rates that are set for the VAT and the ad valorem fuel tax.

- ***General Fund Revenues.*** It is likely that the amount of revenues generated by the VAT at the maximum state rate would be less than the amount of revenue that is otherwise estimated to be raised in 2002-03. We estimate that the annual revenue reduction would likely be in the low billions of dollars.

- ***Special Fund Revenues.*** It is likely that the amount of revenues generated by the ad valorem tax on fuel and the VAT designated for the LPSF would together be less than current revenues in 2002-03—potentially by more than $1 billion.

State Spending. The measure's revenue changes would have resulting major impacts on state spending. For example:

- ***Special Funds.*** Expenditures for certain programs are currently funded through dedicated SUT revenues or certain charges, such as sales taxes for local realignment and fuel excise taxes. Funds from dedicated revenue streams are eliminated by the initiative and, thus, the programs they currently support would require alternative funding.
- ***Proposition 98.*** The state constitutional provisions known as Proposition 98 require the state to provide a minimum amount of funding for K-14 educational programs. This annual guarantee changes each year on the basis of changes in K-12 enrollment and specified economic and revenue factors. By reducing annual rates of growth in state revenues, this measure could significantly reduce the minimum funding requirement for 2002-03 and 2003-04. The actual impact on K-14 school funding would depend on whether the Legislature appropriated funds in those years at the minimum guarantee or at some level in excess of the guarantee.
- ***State Savings.*** The state would realize savings of approximately $4 billion annually from reduced VLF subventions to local governments.

The initiative would also have significant impacts—especially in the near term—on tax administration costs:

- ***Costs.*** Establishing a new tax system involving a VAT would likely result in substantial short-run administrative costs—in the high tens of millions of dollars. The new tax system would require the registration of new sellers as well as the establishment of new auditing and collection systems. In addition, the state would be required to continue to administer the SUT while conversion to a VAT took place. (The ongoing administration's costs of a VAT would be similar to the SUT.) The ad valorem tax on fuel would also result in short-term costs—likely to be in the low tens of millions of dollars.
- ***Savings.*** Minor savings would result from the elimination of administrative expenses of certain fees and excise taxes.

State Appropriations Limit. This measure could affect the level of spending subject to the state appropriations limit. The impact is unknown, however, as it would depend on future revenue and spending decisions by the Legislature.

Fiscal Effects on Local Governments

Local Government Revenues. The measure would result in the elimination of some sources of revenue for local governments, totaling in the range of $20 billion annually. The uniform SUT would be eliminated, as would any optional SUT rates for particular purposes. The VLF would be eliminated and the UUT would be eliminated under certain conditions. Since only cities and counties would be allowed to levy a VAT, some special districts would no longer have a dedicated source of funds from the SUT. We estimate that the VAT and the ad valorem fuel tax at maximum rates would raise more than the revenue currently raised by local SUT, UUTs, and various governmental fees—potentially by the low billions of dollars annually.

Local Government Spending. As with the state, the restructured revenue system could have major effects on spending—both in the aggregate and among programs. These impacts are unknown, as they would depend on subsequent decisions by local officials. In addition, some local governments could experience administrative savings as a result of the initiative. Some revenue collecting administrative expenses could be eliminated over time, as local governments might no longer collect the UUT or governmental fees and charges. In the aggregate, these savings could reach millions of dollars annually.

Local Appropriations Limit. Certain taxes that could be raised through this measure could result in some local governments meeting or exceeding their appropriations limits. In this case, these local governments would be required to take further action, such as raising appropriation limitations through a vote, using excess revenues for capital outlay purposes, or refunding excess revenues to taxpayers.

Summary

The measure would have the following major fiscal effects:

- Major restructuring of state and local finances.
- ***State and Local Revenues.*** Major annual decrease in total state government revenue in the low billions of dollars and potential annual increases in local government revenues of a similar magnitude.
- ***State and Local Spending.*** Unknown but potentially major changes in spending both by level of government and among program areas.

Sincerely,

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Legislative Analyst

B. Timothy Gage
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