July 28, 2003

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 initiative relating to the vehicle license fee, the definition of taxes, and certain other related matters (File No. SA2003RF0026).

Vehicle License Fee (VLF) Provisions

Background Information

VLF Rate. The VLF is an annual fee levied in-lieu of the local property tax, and based on the depreciated value of the vehicle as set forth in statute. The VLF is collected by the state and allocated to local governments—cities and counties—based on population. In 1998, the Legislature began a series of reductions in the effective VLF rate, resulting in a decrease in the fee from 2 percent of the depreciated value to 0.65 percent, representing an overall decline of 67.5 percent. Based on 2001-02 data, the average VLF for an automobile owner is approximately $70. (The average VLF would be approximately $210 based on the 2 percent rate.) For individual taxpayers who itemize deductions and business taxpayers, the VLF is deductible from income—resulting in lower tax liabilities than would otherwise occur.

VLF Revenues and Backfill. As a component of the VLF reduction, the state agreed to compensate—or "backfill"—local governments for their revenue losses from the General Fund. The General Fund backfill, plus the amount still collected under the VLF from vehicle owners, are together equal to the amount that would have been collected under the 2 percent VLF rate. For 2002-03, the VLF backfill amount was approximately $4 billion and the VLF collected from vehicle owners was approximately $1.9 billion, for a total of $5.9 billion going to local governments

Increase in VLF and Elimination of VLF Backfill. Under current law, the VLF rate is to be increased (with a corresponding decrease in the VLF backfill) any time the state has "insufficient moneys" to make such backfills. The administration—through the Department of Finance—and the State Controller's Office made a determination in June 2003 that the state would have insufficient moneys for 2003-04. As a consequence of this determination, the General Fund backfill payments ended, and beginning October 1, 2003, the VLF is scheduled to return to the full 2 percent rate.

The Sales and Use Tax and the Retail Sales Tax Fund. California's state and local governments levy a sales and use tax (SUT) on tangible goods used or consumed within the state. The SUT rates are: 5 percent state General Fund, 0.5 percent Local Public Safety Fund, 0.5 percent Local Revenue Fund, and 1.25 percent Bradley-Burns (local). The minimum statewide rate is 7.25 percent, with some counties levying additional optional SUT rates. The Retail Sales Tax Fund (RSTF) is the initial fund for the receipt of all retail sales taxes and related fees, penalties, and interest collections, which are then allocated to the state General Fund, local governments, and special districts.

Provisions of the Initiative

Elimination of the VLF. The initiative eliminates the VLF and prohibits the levying of any other fee or ad valorem property tax on any vehicle registered in the state. Although the measure is silent regarding the General Fund VLF backfill, we assume the provisions under current law related to the backfill would not be in effect in the event this measure is approved.

Redirection of Existing Revenues to Local Governments. Section 2 of Article XXIII of the State Constitution (established under this measure) would annually redirect a portion of moneys deposited into the RSTF for local government fiscal relief. The moneys would be transferred from the RSTF to the Local Government Independence Fund (LGIF)—established under this initiative—and would be based upon what local governments would have received had the VLF and/or the General Fund backfill been in place at the 2 percent level. These amounts would be adjusted annually for changes in population and inflation.

Tax and Fee-Related Provisions

Background Information

The Constitution requires a two-thirds vote of each house of the Legislature for measures that result in increased revenues through the levying of new—or changes to existing—*taxes*. In contrast, approval of new or additional *fees* requires only a majority vote of each house of the Legislature for approval. State fees are generally of two types—*user* fees (such as state park entrance fees) and *regulatory* fees (such as smog check fees). In the case of regulatory fees, the State Supreme Court in the *Sinclair Paint* decision ruled that such fees may include the costs of not only specific regulatory and enforcement activities, but also more generalized impacts of particular activities.

Provisions of the Initiative

The initiative adds Article XIII E to the Constitution establishing the definition of taxes to include any governmental monetary exaction *except* for: (1) fees for a service or benefit not exceeding the costs of providing this service or benefit (for example, state park fees); (2) fees imposed for the purposes of direct regulation of the activity; (3) local property-related assessments, fees, and charges as defined by Article XIII D of the Constitution; (4) a charge imposed as a condition of property development; and (5) fines or penalties imposed by the judicial branch of government.

Through this provision, the definition of what constitutes a fee would be narrowed with respect to regulatory fees (item 2 above). Thus, some charges which are currently treated as fees would be considered taxes under the measure and therefore require a two-thirds vote of each house of the Legislature for approval. This constitutional change would essentially narrow the definition of fees as established in the *Sinclair Paint* decision.

Fiscal Effects of the Initiative

The measure would have the following fiscal effects on state and local governments.

Vehicle License Fee

Vehicle Owners' Savings. The measure would result in tax relief for vehicle owners by eliminating the VLF. Thus, the basic rate for the VLF would decline from 0.65 percent to 0 percent. However, during years in which the insufficient moneys provision would have been in effect, this measure would reduce the effective rate from as much as 2 percent to 0 percent. Thus, annual savings to vehicle owners in 2004-05 could range from approximately $2 billion (in normal budgetary times) to as much as $6.5 billion (in difficult budgetary times).

State Expenditure Decreases. With elimination of the VLF backfill, the state would realize expenditure savings. Under current law, the state is required in normal years to backfill the difference between the 2 percent statutory VLF rate and the 0.65 percent rate paid by vehicle owners—or approximately $4.5 billion in 2004-05. Thus, under this measure the state would realize annual savings of that amount. By comparison, in difficult budgetary times, the VLF rate can return to 2 percent, thereby eliminating all state backfill expenditures. In such cases, this measure would result in no savings to the state.

State Revenue Changes. Offsetting the state's expenditure savings would be annual revenue decreases due to a shift of sales tax revenue (that we assume would otherwise go to the State General Fund) from the RSTF to the LGIF to be used for local government fiscal relief. These amounts would be designed to compensate local governments for revenue losses incurred due to the elimination of the VLF. Assuming the measure were to go into effect during the 2004-05 fiscal year, the state would realize an annual decline in General Fund revenues of approximately $6.5 billion. The decline in state SUT revenues would be partially offset by an increase of roughly $200 million annually in personal income tax and corporation tax revenues. This would result from a decrease in VLF-related deductions and the corresponding increase in taxable income.

Net State Fiscal Impacts. The net fiscal impact to the state would result from the combination of decreased state expenditures (due to the elimination of the VLF backfill) and decreased revenues (due to the redirection of sales tax revenues partially offset by income tax gains). The net impact to the state would be negative, but would depend on budgetary conditions. In normal budgetary times, the net loss to the state would be roughly $1.8 billion. This net loss would rise to $6.3 billion during difficult budgetary times.

Impact on Local Governments. Local governments' loss of VLF revenues would be offset by a comparable gain in sales tax revenues. The net impact on individual local governments, however, could be positive or negative depending on the relative growth rates of the sales tax allocations under this measure versus the VLF allocations under current law.

Definition of Taxes and Fees

The measure establishes that any regulatory fees would be required not to exceed the direct costs of regulation. Thus, fees that exceeded this amount would be deemed a tax and require a two-thirds vote of the Legislature or governing body for their enactment. This would make it more difficult for the state or local governments to impose certain regulatory fees. To the extent that this increased voting requirement resulted in rejection of fee-related proposals which would have been approved under a majority vote, the measure would result in lower revenues. The revenue impact could be significant but would depend on future actions of the Legislature and local governments.

Summary

The measure would have the following major fiscal effects:

- Net state loss annually of $1.8 billion under normal budgetary conditions, ranging up to $6.3 billion under difficult budgetary conditions.

- Potentially significant decrease in state and local revenues from certain regulatory fees, depending upon future actions taken by the Legislature or local governing bodies.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Steve Peace
Director of Finance