February 25, 2004

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 proposed initiative entitled "California Budget Deficit Prevention Act" (File No. SA2004RF0003 Amendment #1-S). This measure makes changes to the California Constitution related to the state and local appropriations limits, state balanced budget requirements, state debt, and local mandates.

PROVISIONS RELATED TO APPROPRIATION LIMIT

Current Law

Article XIII B of the Constitution places annual limits on the appropriations of tax proceeds that can be made by the state, school districts, and local governments in California.

Calculation of the Spending Limit. The annual spending limit for each jurisdiction is based on the amount of appropriations in 1978-79 (the base year), as adjusted each year for population growth and cost-of-living factors. For the state, "population" is equal to a weighted average of statewide population and K-14 school average daily attendance, and "inflation" is equal to the growth in California per-capita personal income.

Appropriations Subject to the Limit. In general, appropriations subject to the limit are equal to all appropriations funded from the proceeds of taxes, except for those which are specifically exempted under Article XIII B. Exempt appropriations include debt service, qualified capital outlay, local mandate subventions, retirement and unemployment insurance payments, transportation expenditures supported by a portion of the state excise tax on gasoline, and subventions to other levels of governments (the latter of which are counted against the recipient entities' spending limits).

Disposition of Excess Revenues. At the state level, revenues received above the appropriations limit over a two-year period are divided equally between taxpayer rebates and one-time appropriations to K-14 schools.

Current Room Under State's Limit. Based on estimates in the *2004-05 Governor's Budget*, the state is $13.4 billion below its appropriations limit in 2003-04 and $12.8 billion below the limit in 2004-05. This large gap opened up in 2001-02 following the steep revenue downturn in that year.

Reserve Provisions. Article XIII B requires that the Legislature establish a prudent state reserve fund. It does not, however, specify the conditions under which funds are placed into the reserve. Also, Article XIII B specifies that appropriations *to* reserve funds represent an appropriation subject to the limit in the year in which they are made. In contrast, appropriations *from* the reserve are exempt from the limit.

Proposition 98 Minimum Funding Guarantee. Proposition 98 establishes a funding priority for K-14 education in the Constitution. As modified in 1990, the Proposition 98 minimum funding guarantee is adjusted each year for changes in average daily attendance and per-capita personal income. The latter inflation factor is the same as that used for the state's appropriation limit. Thus, over time, the long-term school funding guarantee grows at a rate which is roughly similar to the appropriations limit.

Proposal

This measure eliminates the existing constitutional provisions relating to state and local appropriations limits and replaces them with a new, more comprehensive limit on state government spending. Local jurisdictions would no longer be subject to an appropriations limit. Some of the main provisions related to the coverage, the amount, and annual growth rates for the proposed limit are:

- The revised state limit would apply to *all* state General Fund and special funds *spending* (versus appropriations), with no exemptions.
- It would be based on the actual amount of spending in 2004-05 (assuming the measure is approved at the November 2004 election), and would be adjusted in subsequent years by the combined percent change in statewide population and the lesser of (1) the California Consumer Price Index and (2) California per-capita personal income. This change would

result in slower average annual growth rates in the limit relative to current law.

- If actual spending during a year falls below the limit, spending in the next year would be equal to the actual amount of current-year spending as adjusted for population and inflation, or the current-year's limit, whichever is greater.
- It does not modify the Proposition 98 minimum funding guarantee growth factors.

Disposition of Excess Revenues. In contrast to the current limit, where excess revenues are established over a two-year period, this measure requires excess revenues to be established annually. Any such excess revenues would be allocated in the following manner:

- Initially, 50 percent of any General Fund revenue that may not be expended due to the expenditure limit would be deposited into a newly created Special Reserve Account (SRA), until the account's balance reaches 10 percent of allowable expenditures for the year. (The measure is silent with respect to special fund revenues when the state exceeds the limit.) Money from the reserve account could be used for either an emergency (as defined in the measure), or to support spending in years that revenues fall below the expenditure limit.
- The other 50 percent would be used to accelerate the retirement of deficit bonds that are approved by the voters in 2004.

Revenues that exceed the amounts that could be deposited into the reserve and deficit-reduction accounts are then allocated equally between a newly created school construction fund and a taxpayer rebated fund.

- The monies in the school construction fund would be allocated to school districts by the State Allocation Board for construction and modernization projects.
- The monies in the Taxpayer Rebate Fund would accumulate until the monies are sufficient to allow for the reduction of the state sales tax rate by at least one-quarter cent for a 12-month period.

Proposition 98 Interactions. The measure would not affect the Proposition 98 minimum funding guarantee growth factors. As a result, total (that is, combined state and local) funding for K-14 education would generally grow faster than the proposed limit over time. General Fund support for Proposition 98, however, is influenced by both the overall growth in the guarantee and the growth rate in local property taxes (which offset, dollar-for-dollar, General Fund spending for K-14 education). We project that relatively high growth in property taxes will reduce General Fund spending growth for K-14 education during the next several years. In the longer term, however, we would expect that General Fund spending for Proposition 98 education will grow somewhat faster than the proposed limit.

Other Provisions and Definitions. The measure would allow spending in excess of the limit for an emergency. It defines "emergency" for this purpose to be a natural disaster or a condition of extreme peril to public safety. It states that emergency does not include fiscal peril caused by revenue shortfalls, excessive spending, or imprudent budgetary decisions. Finally, the measure provides that the limit could be increased for a four-year period upon approval by a two-thirds vote of each house of the Legislature and a majority of the voters in the following primary or general election.

Implementation Issues

Implementation of the measure may require legislative direction in several areas. For example, the measure removes all of Article XIII B—including its definition of "tax proceeds," which is in turn cross-referenced in Proposition 98. It would also be necessary to adopt specific dates for determining actual spending in each year.

OTHER PROVISIONS

Balanced Budget Provisions

Current Law. The Constitution requires the Governor to submit by January 10 of each year a state budget for the upcoming fiscal year which is balanced. However, there is no such requirement for the budget that is passed by the Legislature or ultimately signed by the Governor.

Proposal. This measure requires that the Legislature pass and that the Governor sign a budget in which General Fund appropriations do not exceed General Fund revenues.

Debt-Related Provisions

Current Situation. California issues general obligation (GO) and lease-revenue (LR) bonds to finance major capital outlay projects such as roads, educational facilities, prisons, parks, water projects, and office buildings. Annual General Fund debt service for these types of bonds is estimated to be about $3.6 billion in 2004-05, representing about 4.8 percent of projected General Fund revenues during the year. This does not include the debt-service impacts of proposed deficit-related borrowing—either that approved by the Legislature with the 2003-04 budget or the economic recovery bond placed before the voters in March 2004. Although financial markets consider debt-service ratios among many other factors when considering the creditworthiness of a state, there are no specific limitations on the amount of state indebtedness imposed by the credit markets or by state law.

Proposal. This measure prohibits the Treasurer from issuing GO and LR bonds whenever the projected debt-service ratio for the current year or any of the four subsequent fiscal years exceeds 6 percent of estimated General Fund revenues. It would also prohibit GO bond measures from being placed on the ballot in any year in which the General Fund debt-service ratio exceeds 6 percent. The debt-service ratio calculations would not take into account costs associated with deficit-reduction bonds issued in 2004.

Provisions Relating to Local Program Reimbursement

Current Law. The Constitution requires the state to reimburse local agencies (cities, counties, special districts, and K-14 school and community college districts) for the cost of implementing a state mandated "new program" or "higher level of service," unless the mandate pertains to a crime or infraction or other conditions apply. Local agencies are required to submit a claim for reimbursement for such mandates within three years of the time in which the mandate is first implemented. Under existing law, local agencies must implement state mandated requirements even if the state's reimbursement is delayed for prolonged periods.

Proposal. This measure does not change the basic mandate provisions of current law. It does: (1) require local agencies to claim reimbursements within two years of the effective date of the mandate and (2) provide local government with specific legal recourse when the state does not provide timely reimbursement.

FISCAL IMPACT

This measure would have potentially major impacts on state and local spending in both 2005-06 and in the longer term.

Effects of Spending Limit

Near-Term Effect. Since 2004-05 would be the base year for the new state spending limit (again assuming approval in November 2004), the manner in which the state resolves its major budget shortfall in that year would have a major impact on the proposed spending limit's effect. For example, to the extent that one-time measures such as borrowing are used to address part of the shortfall (such as those proposed in the *2004-05 Governor's Budget*), the level of spending in that year would understate the amount of ongoing expenditures. In order to hold spending to 2004-05 levels (adjusted for population and inflation) under this measure's spending limit, it would be necessary to significantly reduce spending in 2005-06 from levels that would be required to maintain current services. This reduction would need to occur even if growth in tax receipts under current law would otherwise have been sufficient to maintain existing service levels in the out-years.

Longer-Term Effects. Over the longer term, the proposed limit would grow more slowly than projected spending under existing law. This would result in further reductions in state spending over time. Because the Proposition 98 guarantee would not be altered, most of the spending reductions in the longer term would occur in the non-Proposition 98 portions of the budget. After the build up of a reserve and the payoff of deficit bonds, this could also lead to lower revenues in the future.

Potential Effects on Local Government Spending. Because most local governments are currently significantly below their appropriations limits, the repeal of these limits would have only a minor direct impact on local government spending. However, the combination of a tighter state limit and the repeal of local limits could result in increased pressure on local spending over time. This could occur, for example, if the revised spending limit caused the state to reduce support for local assistance programs in areas of health, social services, criminal justice, or other areas.

Effects of Reserve and Balanced Budget Requirements

These provisions could have a variety of fiscal effects over time, depending on future actions of governors and legislatures. For example, the reserve provisions could smooth out spending over time. This would occur if excess revenues were allowed to accumulate in the SRA during economic expansions. Such reserve funds could than then be used to cushion revenue reductions during economic downturns. The balanced budget provisions could require more immediate budgetary actions to bring the General Fund revenues and appropriations into line including spending reductions, to counter revenue shortfalls than otherwise.

Effects of Debt-Related Provisions

The prohibition on borrowing in circumstances where the debt-service ratio exceeds 6 percent would not have an immediate effect on capital outlay borrowing, since the state's current debt-service ratio is below the threshold. However, the limitation could restrict borrowing at some point in the future, depending on borrowing needs, interest rates, and revenue levels. In such cases, there would be both reduced capital outlay spending and debt-service costs.

Effects of Mandate-Related Provisions

The mandate-related provisions could result in more timely state reimbursement of local government mandate claims.

Summary of Fiscal Effects

The measure would have the following major fiscal impacts:

- Potentially major reduction in state spending in 2005-06.
- State spending restrained below current-law levels in future years, with reductions primarily in nonschool spending.
- Reserve provisions may "smooth out" state spending over time.

Sincerely,

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Elizabeth G. Hill
Legislative Analyst

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Donna Arduin
Director of Finance