December 7, 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. SA2004RF0032). This measure makes changes to the California Constitution related to state and local appropriations limits, voting requirements relating to tax measures, state debt, fees, and local mandates.

PROVISIONS RELATED TO APPROPRIATIONS LIMITS

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 (ADA), 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 spending, 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 being counted against the recipient entities' spending limits).

Disposition of Excess Revenues. At the state level, revenues are defined as "excess" if they exceed the appropriations limit over a two-year period. Such revenues are then 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 Budget Act*, the state was $13.7 billion below its appropriations limit in 2003-04 and is $10.6 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. Proposition 58 (approved by voters in March of this year) established a Budget Stabilization Account in the General Fund, and requires that annual amounts of General Fund revenues be transferred to the account beginning in 2006-07. Each year, 50 percent of revenues allocated to the fund will be used to repay any outstanding deficit-financing bonds. The remainder is available to the General Fund upon a majority vote of the Legislature.

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 normally adjusted each year for changes in ADA and per-capita personal income. This adjustment is often referred to as the "Test 2" growth factor. This Test 2 factor is similar to 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.

Maintenance Factor. K-14 school funding can be reduced below the level required by Test 2 when either (1) an alternative funding formula becomes operative during low-revenue years ("Test 3"), or (2) the guarantee is suspended by the Legislature. When this occurs, a "maintenance factor" is established, which is equal to the difference between actual appropriations and the higher level required by Test 2. In subsequent years, the maintenance factor can be "paid off" (and actual spending rises toward the Test 2 level) through a formula that allocates extra funding to education in above-average revenue growth years. It can also be paid off through additional appropriations by the Legislature.

Legislative Spending. Annual growth in the Legislature's budget is limited to the change in the state's appropriations limit.

Proposal

Beginning in 2006-07, this measure would eliminate the existing constitutional provisions relating to state and local appropriations limits and replace them with a new, more comprehensive limit on state government spending. Local jurisdictions would no longer be subject to an appropriations limit. However, the measure prohibits a local government from spending in any year more than it received in revenues (including reserve funds). Some of the main provisions related to the coverage, level, and annual growth rates for the proposed limit are as follows:

- The revised state limit would generally apply to *all* state General Fund and special funds *spending* (versus appropriations), with only limited exemptions.
- The spending limit in the initial 2006-07 year would be equal to the actual amount of spending in 2004-05 (exclusive of the amounts supported by deficit-financing and pension-obligation bonds) as adjusted for the two-year increase in California population and the cost of living. The cost of living is defined as the lesser of growth in (1) the California Consumer Price Index or (2) California per-capita personal income.
- Spending in subsequent years would be based on actual spending in the prior year as adjusted for changes in population and the cost of living, as defined by the measure. This change would result in slower average annual growth rates in the limit relative to current law, mainly because the consumer price index grows more slowly than per-capita personal income (the current-law cost-of-living factor) in most years.
- The proposal 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 are allocated in the following manner:

- Twenty-five percent would be deposited into a newly created Special Reserve Account, until the account's balance reaches 5 percent of allowable expenditures for the year. 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.
- Up to 50 percent could be allocated through the annual budget acts to (1) repay outstanding deficit-financing bonds, (2) repay specified loans

from transportation funds, and (3) increase funding to schools (to the point where any outstanding maintenance factor is eliminated).

- Twenty-five percent could be used for local school or highway construction projects.

Any remaining funds would go to the Taxpayer Rebate Fund. Moneys in this fund would accumulate until there were sufficient amounts 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 requirements 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.

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. In addition, 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 statewide election.

OTHER PROVISIONS

Voting Requirements for State Tax-Related Legislation

Current Law. Legislation resulting in a *tax increase* must be approved by a two-thirds vote of both houses of the Legislature. Other tax-related legislation can be enacted with a simple majority vote of both houses. The determination of whether a measure constitutes a tax increase—and thus requires a two-thirds vote—is currently based on the *net* fiscal impact of its provisions. For example, a measure that results in higher taxes from some taxpayers but an equally large (or larger) reduction in taxes from other taxpayers would not result in an aggregate increase in taxes, and thus can be passed with majority vote.

Proposal. This measure requires that a tax measure be subject to the two-thirds vote requirement if it results in a tax increase for *any* individual taxpayer—regardless of whether it raises or lowers aggregate taxes.

Definition of Taxes

Current Law. In addition to taxes, the Legislature and local governments may impose fees, assessments, and other charges on individuals and businesses. While the constitutional requirements regarding imposition of these levies vary, the requirements generally involve lower approval thresholds by the governing body and/or voters than is the case for taxes. Current law generally defines fees to be charges related to *specific* services or regulatory activities. Past court decisions, however, have allowed levies imposed on businesses for remediation or mitigation of past damages to be classified as fees. As a result, these levies are subject to approval by (1) a majority vote of the Legislature (instead of a two-thirds vote that would be required for a state tax) or (2) the local governing board (instead of approval by the local governing board *and* local voters that would be required for a local tax).

Proposal. The measure expands the definition of what is considered a state or local tax. For example, fees imposed for certain remediation and mitigation purposes and fees for services previously financed by tax revenues would to be classified as taxes under this measure. As a result, these levies would be subject to a (1) two-thirds vote requirement of the Legislature in the case of a state levy or (2) a vote of the local electorate in the case of a local levy. While the scope of the measure is not clear, the measure may also recast as a tax assessments imposed by local governments and certain property development fees.

Provisions Affecting the Legislature and Governor

Annual Growth in Legislature's Budget. Currently, annual growth in the Legislature's budget is limited to the percentage change in the state's appropriations limit growth factor. Under this measure, the annual increases in the Legislature's budget would be tied to the revised spending limit growth factors. Thus, instead of increasing by the percentage change in population plus per-capita personal income, the revised growth factors would be the percentage change in population plus the lesser of per-capita personal income or the California Consumer Price Index.

Special Session—Pay and Per Diem. After a budget is signed into law and it falls out of balance, the Governor is permitted under current law to declare a fiscal emergency and call the Legislature into special session to consider proposals to deal with the fiscal imbalance. If the Legislature fails to pass and send to the Governor legislation to address the budget problem within 45 days after being called into special session, it is prohibited from acting on other bills or adjourning in joint recess. Under this measure, after the 45 day period, the Legislature and Governor would also give up their salary and per-diem payments until legislation addressing the budget problem is signed by the Governor. No forfeited salary, per diem, or expense allowance could be paid retroactively.

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 (excluding the Proposition 57 deficit-financing bonds) is estimated to be about $3.6 billion in 2004-05, representing about 4.6 percent of projected General Fund revenues during the year. 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 Department of Finance's projected debt-service ratio for the current year or any of the four subsequent fiscal years exceeds 6 percent of estimated General Fund revenues. The debt-service ratio calculations would not take into account costs associated with deficit-financing bonds.

Provisions Relating to Local Program Reimbursement

The Constitution generally requires the state to reimburse local governments for the cost of implementing state-mandated new programs, higher levels of service, and certain transfers of financial responsibility between the state and cities, counties, and special districts. The Constitution does not specify a deadline for reimbursing those mandates that pertain to K-14 school programs or employee rights. All other mandates, however, must be (1) fully funded in the annual budget act or (2) suspended for the fiscal year. Finally, state statutes detail requirements and procedures regarding mandates, including a one-year statute of limitations for local agencies to file test claims to determine if a state requirement constitutes a state-reimbursable mandate.

Proposal. This measure amends the Constitution to delete the provisions that require the state to (1) reimburse cities, counties, and special districts for transfers of financial responsibility for certain programs and (2) annually fund or suspend most mandates. Instead, the measure authorizes all local governments, including K-14 districts, to seek judicial relief from a mandate if the state fails to provide timely reimbursement. The measure also places into the Constitution a two-year statute of limitations for local agencies to file a mandate claim.

FISCAL IMPACT

This measure would have potentially major fiscal impacts on state and local governments, beginning in 2006-07.

Effects of Spending Limit

Near-Term Effect. Since 2001-02, the state has faced a large "structural" shortfall between revenues and expenditures. Recent budgets have covered this shortfall partly through spending deferrals, loans, and other one-time or limited-term solutions. As the savings from these limited-term solutions expire, spending under current law will increase much faster than revenues in both 2005-06 and 2006-07, leading to a reemergence of the structural shortfall in those years, absent corrective actions.

Given these circumstances, the impact of the proposed spending limit on the 2006-07 budget would depend in large part on how the state addresses the structural shortfall during the next two years. This is because the proposed limit will grow modestly less than state revenues, but by substantially less than current-law state expenditures during the next two years. Thus, if the budget imbalances are eliminated through ongoing expenditure reductions, then the proposed limit would be only modestly below estimated state spending in 2006-07. However, if the shortfalls are not addressed in this manner, then the proposed limit could be substantially below projected expenditures. Similarly, if revenue growth proves to be stronger than currently expected, this measure would preclude the state from using the added revenues to address the budget shortfall.

Longer-Term Effects. Over the longer term, the proposed limit would grow more slowly than projected spending and revenues under existing law. This would initially result in a reallocation of spending to repayment of deficit bonds, other budget loans, and local school or road construction. It would eventually result in state spending reductions relative to current law. 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 unless the guarantee were suspended. After the build up of a reserve and the payoff of loans, this measure could also lead to lower sales tax rates in the future.

Local Government Spending. 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 the areas of health, social services, criminal justice, or other programs.

Local Government Reimbursement

The net effect of the provisions related to local government reimbursements would depend on (1) future actions by the state and local governments and (2) court rulings regarding underfunded mandates and local agency eligibility for mandate reimbursements. For example, if the state transferred significant program financial responsibilities to cities, counties, and special districts in the future, this measure could result in decreased state reimbursement costs and increased local program costs than otherwise would be the case. The provisions in the measure changing the mandate funding process is not likely to have a significant fiscal effect on most local governments. It could, however, result in K-14 districts receiving state reimbursements faster than otherwise would be the case and/or being authorized to decrease their expenditures to implement mandates. The extent of these fiscal effects cannot be determined.

Other Effects

The initiative would also have a variety of other fiscal impacts.

- ***Voting Requirements.*** By increasing voting requirements for certain tax-law changes, this measure could result in a different distribution of taxes and tax burdens in the future compared to what would occur under current voting requirements. However, it is not possible to determine the aggregate impact of these changes on state and local government revenues.
- ***Determination of Fees.*** The tightening of the definition of which levies are classified as fees would increase the voting requirements for certain types of levies. This could result in a reduction in certain fee revenues to the state.
- ***Legislative Spending.*** Legislative spending could be reduced by the provisions which tie the maximum annual adjustments in the Legislature's budget to the revised spending limit.
- ***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 this 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 lower debt-service costs.

Summary of Fiscal Effects

The measure would have the following major fiscal impacts:

- Potential substantial reduction in state spending beginning in 2006-07.
- State spending restrained below current-law levels in future years.
- Potential reduction in certain state and local revenues.

Sincerely,

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Elizabeth G. Hill
Legislative Analyst

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Tom Campbell
Director of Finance