LAO
60 YEARS OF SERVICE

February 24, 2005

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 Spending Limit Restoration Act" (File No. SA2005RF0023).

## BACKGROUND

### Spending Limit

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. At the local level, "cost of living" is either the percentage change in per capita income or the percentage change in the local assessment roll for the jurisdiction due to the addition of local nonresidential new construction, with the choice being based on an annual vote of the entities' governing body. At the state level, cost of living is equal to the change in California per-capita personal income. Prior to 1990, cost-of-living for all levels of governments was defined as the lesser of the change in per-capita personal income or the U.S. consumer price index.

***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. Tax proceeds include taxes and the portion of fee revenues that are in excess of the cost of providing the fee-based service. Exempt appropriations include debt service, qualified capital outlay spending, retirement and unemployment insurance payments, transportation expenditures supported by a portion of the state excise tax on gasoline, appropriations resulting from natural disasters, and state subventions to local governments (counted against the local spending limits). The exemptions for capital outlay, transportation spending supported by a portion of gasoline taxes, and natural disasters were added in 1990.

***Disposition of Excess Revenues.*** Revenues are defined as "excess" if they exceed the appropriations limit over a two-year period. At the state level, such revenues are then divided equally between taxpayer rebates (to be made within two years) and one-time appropriations to K-14 schools. At the local level, excess revenues are returned to taxpayers within two years.

***Current Room Under the Limit.*** Based on estimates in the *2005-06 Budget Act*, the state is $9.4 billion below its appropriations limit in 2004-05 and, under the Governor's budget proposal, would be $9.7 billion below the limit in 2005-06. This large gap opened up in 2001-02 following the steep revenue downturn in that year. At the local level, most jurisdictions are substantially below their respective limits, but some jurisdictions are at or near their limits.

***State-Reimbursable Mandates.*** The California Constitution generally requires the state to reimburse schools and other local agencies when it mandates a new program or higher level of service. The state's voters recently approved Proposition 1A, adding constitutional provisions that:

- Require the state to annually fund most noneducation mandates in the annual budget—or suspend the mandate for the fiscal year.
- Allow the state to pay certain outstanding prior-year mandate claims over time.
- Define as a mandate certain transfers of financial responsibility between state and local governments.

## Debt-Service

California issues general obligation (GO) bonds to finance major capital outlay projects such as roads, educational facilities, prisons, parks, water projects, and office buildings. In March 2004, the voters approved Proposition 57, which authorized issuance of $15 billion in deficit financing bonds. The debt service on these bonds is currently about $4.2 billion, or about 5.3 percent of General Fund revenues.

## PROPOSAL

This measure repeals the current state and local spending limits and establishes a new but similar set of limits on these governments. Specifically:

- ***State Limit.*** Assuming the measure takes effect for the 2006-07 fiscal year, it rebenches the state limit at the level of appropriations subject to limitation in 2005-06 (as defined by this measure), and then adjusts it for the one-year change in population and cost of living. This has the effect of rebenching the limit down to current state spending, thereby eliminating the existing room under the current limit.
- ***Local Limits.*** For local growth, their new limits would be based on the level of appropriations subject to limitation in 2006-07 as determined under the existing constitutional provisions. This would result in spending for each local jurisdiction being equal to their respective limits in 2006-07. As with the state, this would have the effect of eliminating the room many local governments have between their limits and spending.
- ***Annual Growth in the Limit.*** The measure revises the population and cost-of-living adjustment factors for all levels of government back to those used prior to 1990—namely (1) population (as defined for each jurisdiction) and (2) the lesser of U.S. Consumer Price Index (CPI) and California per capita personal income. Over time, the proposed cost-of-living factor would grow more slowly than the current limit. As an example, over the past decade, the proposed cost-of-living factor increased at an average annual rate of about 1.6 percent less than per capita personal income.
- ***Appropriations Not Subject to Limitation.*** It eliminates the exclusions from the limit added in 1990 for capital outlay, certain transportation spending, and spending for natural disasters.
- ***Proceeds of Taxes.*** It defines "taxes" broadly to include (1) charges or fees for services that had been previously financed by tax revenues (except in the case of the judicial branch); (2) regulatory fees to the extent that the proceeds are used for purposes other than issuing licenses, permitting, and other forms of direct regulation; and (3) user fees for services where the service is provided to those not charged.

- ***Excess Revenues.*** Revenues in excess of the limit would be rebated to taxpayers within two years through a reduction in tax rates. Initially, 50 percent of excess revenues received by the state would be allocated to repayments of any outstanding loans from the state's Transportation Investment Fund.

***Proposition 98 Interaction.*** Proposition 98 establishes a funding mechanism for K-14 education. Under the main formula for determining the minimum funding guarantee ("Test 2"), the actual amount of prior-year K-14 appropriations are adjusted for changes in average daily attendance and the cost of living. The cost of living factor is tied to that used to adjust the state's spending limit—which is currently per capita personal income. By revising the cost-of-living factor for the state's appropriation, this measure would likewise revise the Proposition 98 Test 2 cost-of-living factor to be the lesser of the change in per capita personal income or the U.S. CPI.

***Legislative Spending Interaction.*** Under existing law, annual growth in the Legislature's budget is limited to the change in the state's appropriations limit. By changing the appropriation's limit growth factors, this measure would likewise revise the growth factor applied to the Legislature's spending limit.

***State-Reimbursable Mandates.*** Although the measure specifies that it is not intended to conflict with the mandate provisions of Proposition 1A, the measure eliminates all the mandate provisions added to the State Constitution by Proposition 1A.

***Bond Issuance.*** The measure would prohibit the State Treasurer from issuing GO bonds whenever the state's debt service ratio were greater than 5 percent.

## FISCAL EFFECT

### Impact on State

***Near-Term Effect on State.*** The measure's immediate impact would depend on the nature of budget-balancing actions taken during the next year.

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 faster than revenues in both 2005-06 and 2006-07, leading to a re-emergence 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 2005-06 and 2006-07. This is because the proposed limit would be roughly similar to the amount of appropriations that would be supported by current-law revenues in 2006-07. However, it would be substantially below the amount of appropriations that would be required to maintain current-law spending requirements in that year. Thus, if the budget imbalances are eliminated through ongoing expenditure reductions, then the proposed limit would only modestly constrain appropriations in 2006-07. However, if the shortfalls are not addressed in this manner, then the proposed limit could be substantially below projected appropriations. Similarly, if revenue growth proved 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 on State.*** Over the longer term, the proposed limit would grow somewhat more slowly than projected appropriations and revenues under existing law. This would result in lower spending and "excess revenues" (leading to repayment of transportation loans and lower taxes).

***Effects on Proposition 98 School Funding.*** Over the long term, the Proposition 98 guarantee would grow more slowly under this measure because of the change in the cost-of-living factor.

***Effects on Bond Issuance.*** The restriction on GO bond sales when the state's debt service ratio exceeds 5 percent would likely result in a reduced rate of bond sales, lower debt service costs, and less capital outlay spending compared to current law.

### Impact on Local Governments

The fiscal impact of this measure on local governments would be similar to that of the state. By rebenching the spending limits downward and imposing a new, slower-growing cost-of-living growth factor, the measure would constrain local government spending. In addition, local governments that receive significant funding from the types of revenues to be reclassified as "taxes" under this measure would experience even greater spending constraints in the near term.

### Summary of Fiscal Effects

The measure would have the following major fiscal impacts:

- Potentially significant reduction in annual state and local government spending.

- Reduction in the annual minimum funding requirement for K-12 schools and community colleges.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance