March 2, 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 "The California Live Within Our Means Act" (File No. SA2005RF0046). This measure makes changes to the California Constitution related to Proposition 98 funding, the budget process, Proposition 42 transfers, special fund loans and transfers, payment of deferred mandate claims, voting requirements relating to tax measures, and definition of taxes.

MAJOR PROVISIONS

Provisions Related to Proposition 98 Funding

Current Law

Proposition 98 Minimum Funding Guarantee. Proposition 98 establishes a minimum funding guarantee for K-14 education in the state Constitution. Under this proposition, K-14 spending is based on the interaction of three different "tests." Under the test that is normally operative, total spending for K-14 education is based on the actual amount of K-14 spending in the prior year, as adjusted for changes in average daily attendance and per capita personal income. This adjustment is often referred to as the "Test 2" growth factor.

Suspension, Test 3, and Maintenance Factor. K-14 school funding can be reduced below the level required by Test 2 when either (1) the guarantee is suspended through a two-thirds vote of the Legislature or (2) an alternative funding formula becomes operative during a low-revenue year ("Test 3"). When the reduction 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 is restored (thereby causing spending to rise up toward the Test 2 level) through a formula that allocates extra funding to education in above-average revenue growth years. The maintenance factor can also be paid off through overappropriations by the Legislature. The operation of Test 3 and maintenance factors allows K-14 education funding to automatically slow down during "bad times" and rise again during "good times."

Treatment of Overappropriations. If the Governor and Legislature fund Proposition 98 above the minimum guarantee in a given year, the higher spending level becomes the "base" from which future minimum funding guarantee calculations are made. In this regard, an overappropriation in one year raises minimum requirements in subsequent years.

Settle-Up Obligations. The minimum funding guarantee for a particular fiscal year will sometimes change after the end of the fiscal year due to changes in the various factors used to calculate the guarantee. If these changes result in a higher guarantee calculation, the gap created between the guarantee and the actual level of appropriations becomes an additional K-14 education funding obligation, referred to as "settle up." Existing settle-up obligations total approximately $1 billion. Under current law, these will be repaid at $150 million per year beginning in 2006-07.

Proposal

This measure:

- Prohibits the Legislature from suspending Proposition 98 after 2005-06.
- Eliminates the operation of Test 3 and maintenance factors.
- Provides that future overappropriations may be counted as one-time funding, which would not raise the base upon which future Proposition 98 calculations are made.
- Requires the payment of settle-up obligations for years prior to 2004-05 to be paid within 15 years.
- Converts the 2005-06 outstanding maintenance factor to a one-time obligation that is required to be paid within 15 years.

As noted above, maintenance factor repayments presently count toward Proposition 98 spending and thus raise the base funding level from which future minimum guarantees are calculated. The repayment of the maintenance factor obligation required by this measure, however, would not raise the Proposition 98 minimum guarantee.

Provisions Related to Budget Process

Current Law

Background. The Constitution vests the Legislature with the sole power to appropriate funds (and make midyear adjustments to appropriations). The annual state budget is the Legislature's primary method of authorizing expenses for a particular year. Specifically, the Constitution requires that (1) the Governor propose a budget by January 10 for the next fiscal year (beginning July 1), and (2) that the Legislature pass a budget by June 15. The Governor may then either sign or veto the budget bill. The Governor may also reduce certain individual appropriations in the budget before signing the measure. However, this line-item veto authority cannot be applied to many local assistance programs where expenditures are governed by separate laws. Also, once the budget is signed, the Governor may not unilaterally reduce any appropriations.

Balanced Budget Requirements. Proposition 58 (approved by the voters in March 2004) requires that budgets passed by the Legislature and ultimately signed into law must be balanced, meaning expenditures cannot exceed available resources.

Late Budgets. When a fiscal year begins without a state budget, most expenses do not have authorization to continue. Over time, however, a number of court decisions and legal interpretations of the Constitution have expanded the types of payments that may continue to be made when a state budget has not been passed. Consequently, when there is not a state budget, payments now continue for: a portion of state employees' pay; debt service; and various programs authorized by the Constitution, federal law, or initiatives.

Midyear Adjustments. After a budget is signed into law and it falls out of balance, the Governor may 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.

Proposal

This measure makes changes to the budget process relating to late budgets, midyear adjustments, and reporting requirements.

- ***Late Budgets.*** If a budget is not enacted prior to the beginning of a new fiscal year, this measure requires that the appropriation levels in the prior year's budget shall remain in effect until a new budget is enacted. If the Department of Finance finds that the continuing budget is out of balance by more than $250 million, then the Legislature would be required to send to the Governor legislation within 30 days which addresses the shortfall. Absent such legislation within the 30-day period, all General Fund appropriations (with the exceptions noted below) would be reduced proportionally by an amount sufficient to eliminate the projected shortfall. It is uncertain how the measure would be implemented with respect to, for example, appropriations for one-time activities in the prior year, or appropriations for entitlement programs with changing caseload levels.

- ***Midyear Adjustments.*** Following the enactment of a budget, if the Governor finds that the budget is falling out of balance by more than $250 million, the Governor is required to issue a proclamation of fiscal emergency and call the Legislature into special session to deal with the emergency. If the Legislature fails to send to the Governor legislation to address the shortfall within 45 days, all General Fund appropriations (with the exceptions noted below) would be reduced proportionally by an amount sufficient to eliminate the shortfall.

Application of Proportional Reductions. The proportional reductions would apply to *all* General Fund spending except for (1) that required by federal constitutional law and (2) state bonded indebtedness. It is not clear how broadly federal constitutional law requirements would be interpreted by policymakers and the courts. Thus, it is not possible to determine which program spending would be subject to the across-the-board reductions and which would be exempt. Any General Fund spending related to contracts, collective bargaining agreements, or laws signed after the effective date of this measure would be subject to these across-the-board reductions.

Reporting Requirements. The measure requires the Director of Finance to advise the Governor on the current status of state revenues at least quarterly, and at the beginning of a year when a budget has not been enacted.

Proposition 42 Transfers

Current Law

Under Proposition 42 (approved by the voters in March 2002), sales taxes on motor vehicle fuel are transferred to the Transportation Investment Fund (TIF) for public transit, capital improvement projects, and maintenance projects. Proposition 42 included a provision allowing for its suspension when the Governor finds (and the Legislature concurs) that the transfer will have a significant negative effect on General Fund programs. To help address the state's major budget shortfalls, the Governor and

Legislature suspended Proposition 42 transfers in 2003-04 ($868 million) and 2004-05 ($1.2 billion). Legislation passed with the 2003-04 and 2004-05 budgets designated the suspensions as "loans" from the TIF, which will be repaid in 2007-08 and 2008-09.

Proposal

This measure prohibits the suspension of Proposition 42 transfers after 2006-07. The total amount of transfers that were suspended through June 30, 2007 would be paid within 15 years, at an annual rate of no less than one-fifteenth of the cumulative amount owed.

Loans From Special Funds

In past years, the Governor and Legislature have borrowed balances in special funds to cover General Fund shortfalls. The amount of these loans currently outstanding is $2.4 billion. Under this measure, such loans would be prohibited beginning in 2006-07 (except for short-term cash-flow borrowing purposes). Outstanding loans from special funds as of July 1, 2006 would be repaid within 15 years.

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 equal (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. 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 tax. For example, fees imposed for certain remediation and mitigation purposes and fees for services previously financed by tax revenues would be classified as taxes under this measure. As a result, such levies enacted after January 1, 2005 would be subject to a two-thirds vote requirement of the Legislature.

Payment of Past Mandate Claims

In past years, the Governor and Legislature have deferred payments for mandate claims filed by local school districts and noneducation local governments. The measure requires that any such mandate claims outstanding as of June 30, 2006 be paid within 15 years. The measure also states that Proposition 98 funds allocated to schools "shall first be expended . . .to pay the costs for state mandates incurred during that year."

FISCAL IMPACT

Budget-Related Provisions

The numerous budget-related provisions of this measure could lead to a variety of fiscal outcomes. Their individual and collective impacts would depend on future directions in the state's economy and revenues, as well as policy preferences of future Governors and Legislatures. For example:

- In years in which revenues increased sharply, the elimination of the maintenance factor provisions would result in less growth in the minimum funding guarantee for K-14 education than would be the case under current law. (The Legislature could, however, choose to raise funding for schools by overappropriating the minimum guarantee.)
- In years in which revenues fell, however, Proposition 98 would be exempt from legislative reductions (since the measure eliminates both suspension and Test 3). This could result in more spending for Proposition 98 than

otherwise. At the same time, with roughly 45 percent of the state budget devoted to K-14 education "off the table," the Legislature would need to look to either (1) deeper spending reductions to non-Proposition 98 programs or (2) new revenues to cover budgetary imbalances. Proposition 98 appropriations would, however, be subject to any across-the-board reductions.

- The across-the-board reductions that would occur when the Legislature could not agree on how to cover a budget shortfall could result in more spending reductions when budgets fall out of balance or are not approved by the beginning of a fiscal year. The scope and distribution of these spending reductions would depend in part on which programs were determined to be exempt from the cuts under the provisions of this initiative.

Other Provisions

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

- ***Proposition 42 Suspensions.*** The provision eliminating the ability to suspend Proposition 42 transfers would result in a more certain funding stream for transportation. (This certainty would be offset, however, by the proportional across-the-board reductions discussed above.) At the same time, these provisions would require that future budget shortfalls be covered with either (1) larger spending reductions in other General Fund-supported programs or (2) additional revenues.
- ***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.
- ***Definition of Taxes.*** The broadening of the definition of which levies are classified as taxes would increase the voting requirements for certain types of levies. This could result in lower revenues to the state from sources that are currently considered fees.

Summary of Fiscal Effects

The measure would have the following major fiscal impacts:

- Major impacts on state budget decision making, which could lead to varying outcomes regarding the level of state spending and on the composition of that spending among education, transportation, and other state programs.

- Across-the-board reductions could result in lower state spending in certain years when the state was facing unresolved budget shortfalls.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance