March 17, 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. SA2005RF0067, Amdt. #1-NS). This measure makes changes to the California Constitution related to a new state spending limit, Proposition 98 funding, the budget process, Proposition 42 transfers, special fund loans and transfers, and payment of deferred mandate claims.

MAJOR PROVISIONS

Provisions Related to a New State Spending 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. 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. 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, such as debt service and capital outlay. Based on estimates in the *2005-06 Governor's Budget*, 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.

Reserve Provisions. The current limit requires that the state maintain a prudent reserve. Proposition 58 (approved by voters in March 2004) established a specific

General Fund reserve entitled the Budget Stabilization Account (BSA), 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 vote of the Legislature.

Proposal

This measure retains the existing appropriations limits, but adds a new limit on the annual growth in state expenditures. Specifically, annual state expenditures (General Fund and special funds) in a given fiscal year—beginning in 2006-07—would be limited to the prior-year expenditure level plus the average of the growth rates in combined General Fund and special funds revenues over the prior three years. Revenues received in excess of this annual limit would be allocated proportionally to the General Fund and to each of the state's special funds. The portion allocated to special funds would be held in reserve for expenditures in a subsequent year. The General Fund's share would be allocated in the following manner:

- Twenty-five percent to the BSA.
- Fifty percent through annual budget acts for the following areas: (1) to repay Proposition 98 maintenance factor outstanding as of June 30, 2005 at a rate of no more than one-fifteenth of the amount per year; (2) to repay deficit financing bonds; and (3) to repay loans made from the Transportation Investment Fund in 2003-04 through 2006-07, with annual amounts not to exceed one-fifteenth of the amount outstanding as of June 30, 2007.
- Twenty-five percent for highway and school construction projects.

Funds allocated for the above purposes would not be counted as expenditures for purposes of calculating the following year's spending limit.

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:

- 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) 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 remain in effect until a new budget is enacted.

Gubernatorial Reductions. Following the enactment of a budget, the measure permits the Governor to issue a proclamation declaring a fiscal emergency at the end of any quarter—and call the Legislature into special session to deal with the emergency—when the administration determines either of the following two conditions:

- General Fund revenues have fallen by at least 1.5 percent below the Department of Finance estimate.
- The balance of the BSA will decline by more than one-half between the beginning and the end of that fiscal year.

Once the emergency is declared by the Governor, the Legislature would have 45 days to enact legislation which addresses the shortfall. Absent such legislation, the Governor would be permitted to reduce most items in the budget (with the exception of the items discussed below), either proportionally or disproportionately, to eliminate the shortfall.

Language in the measure suggests that gubernatorial reductions could also occur at the beginning of the fiscal year in the event of a late budget—30 days after the issuance of an emergency proclamation and absent the enactment of legislation addressing the shortfall.

Application of Reductions. The reductions could apply to *all* General Fund spending except for (1) that required by federal laws and regulations, (2) appropriations where the result of a reduction would be in violation of contracts to which the state is a party, and (3) debt service. 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 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. The measure also permits the Legislature to authorize the issuance of bonds by the state or local agencies that are secured by the payments of suspended Proposition 42 transfers.

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.

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 unpaid noneducation mandate claims incurred prior to 2004-05 be paid within five years, and any education claims 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

Spending Limit Provisions

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 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 2005-06 and 2006-07 budgets. If the budget imbalances are eliminated through significant ongoing expenditure reductions, then the proposed limit would not have a major impact on allowable spending levels in 2006-07. However, if the shortfalls are not addressed in this manner, then the proposed limit could constrain spending in 2006-07.

Longer-Term Effects. Because the growth factors for this spending limit are based on an average of prior-years' revenue changes, it would have differing effects on spending over the course of an economic cycle. Specifically:

- During periods of accelerating revenue growth (such as often occurs during the early stages of a business expansion), the limit could constrain spending below what otherwise could occur. This is because the three-year average revenue growth would be *lower* than the budget-year revenue growth.
- During periods of decelerating revenue growth or revenue declines (such as often occurs during recessions) this limit could allow *more* spending than could be supported by annual revenues. This is because the average revenue growth would be *higher* than the budget-year revenue growth.

If the state were able to accumulate sufficient reserve funds during revenue expansions to maintain spending during periods of revenue softness, the main impact of the spending limit would be to smooth out spending over the course of economic cycles—restraining spending during economic expansions and permitting additional spending during revenue downturns.

If, however, the state were *not* able to accumulate sufficient reserves to provide such a cushion during periods of revenue weakness, the limit would likely result in less spending over time. This is because during periods of decelerating revenue growth, the state would not have the revenues available to spend up to its limit. As a result, spending could ratchet down below levels that otherwise would have occurred.

During years in which revenues exceeded the new limit, funds would be reallocated toward reserves, maintenance factor payments, Proposition 42 payments, and school and road construction.

Other Provisions

The numerous other 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, Test 3 would no longer be operative, and thus the minimum guarantee would not be reduced automatically. This could result in higher funding for K-14 education in certain years. (The Legislature, however, could still reduce K-14 education funding through suspension, and Proposition 98 would also be subject to gubernatorial reductions that could occur under the circumstances discussed above.)
- If K-14 funding were not reduced during revenue downturns, more of the solutions to any budget shortfall would need to come from either (1) deeper spending reductions to non-Proposition 98 programs or (2) new revenues to cover budgetary imbalances.
- The provisions 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 potential gubernatorial reductions that could occur under the circumstances 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.
- The gubernatorial reductions that would occur in the absence of legislation addressing 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.

Summary of Fiscal Effects

The measure would have the following major fiscal impacts:

- Spending limit could constrain state expenditures over time.

- Other provisions would have 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.
- Provisions allowing Governor to reduce appropriations 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