December 4, 2009

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative related primarily to state authority over local government resources (A.G. File No. 09-0063, Amdt. #1-NS) and below is our revised analysis of the initiative's fiscal effects.

BACKGROUND

Local governments receive resources from various sources, including funding from state tax revenues that are then given to local governments, as well as from locally imposed taxes and fees.

Transportation Funding

State transportation resources are derived from several major sources including excise taxes and sales taxes on gasoline and diesel fuels that are deposited into various state transportation accounts. In general, as described below, the revenues from these taxes are required to be used for specified transportation purposes, including distribution to local governments. Current law generally allows these funds to be loaned temporarily on a cash flow basis between the state's various transportation accounts in order to pay monthly obligations, such as Caltrans' payroll and payments to construction contractors. While fuel tax revenues generally can be used only for transportation purposes, the California Constitution allows, under certain circumstances, for these revenues to be loaned for up to three years to the state's General Fund for non-transportation purposes.

State Excise Tax on Gasoline and Diesel Fuel

The state currently charges an excise tax of 18 cents per gallon of gasoline and diesel fuel sold in California, commonly known as the "gas tax." In 2008-09, this tax generated roughly $3 billion in revenues. The Constitution requires that revenues from the gas tax be used only for transportation purposes, mainly to fund highway and road repairs or improvements. Current law requires that these revenues be deposited into the state's Highway Users Tax Account (HUTA) and be allocated by formulas. Specifically, two-thirds of gas tax revenues in the HUTA are allocated to the state, mainly for Caltrans to maintain and repair the state's highways. The other one-third of the revenues is given to cities and counties for local street and road maintenance and improvement. The Legislature currently can amend this allocation through passage of a bill signed by the Governor.

State Sales Tax on Gasoline and Diesel Fuel

The state currently charges a sales tax on the purchase of gasoline and diesel fuel. State law requires that almost all of these sales tax revenues be used for transportation purposes. These purposes include local street and road improvements, projects that expand capacity on the state's highway and transit systems, planning, and transit and rail operations. A portion of the sales tax on gasoline and diesel fuel is deposited into the Public Transportation Account (PTA) for the specific purposes discussed below, with the rest of the revenues deposited into the General Fund.

PTA Funding. Current law requires that funds in the PTA be used only for transportation planning and mass transportation purposes. Funds in the PTA are statutorily allocated by formula to local transit operators and the state for mass transportation purposes. The Legislature currently can amend this formula through the passage of a bill signed by the Governor—subject to certain limitations as interpreted by the courts.

Proposition 42 (2002) Transfer. The Constitution requires that the gasoline sales tax revenues deposited into the General Fund be transferred to the Transportation Investment Fund (TIF). These funds have been counted as tax revenues for purposes of calculating the minimum amount of K-14 education funding required under Proposition 98. Over the past five years, these revenues have averaged roughly $1.4 billion per year. Under certain conditions, the Constitution allows this transfer to be suspended. Suspended amounts, however, must be repaid with interest within three years. The Legislature currently can change the allocation of TIF resources through the passage of a bill signed by the Governor.

Other Local Government Revenues

Property Tax

The Constitution establishes a 1 percent maximum property tax rate on real property and directs counties to collect these tax revenues and allocate them to local governments according to law. While the Legislature may modify property tax allocation laws, the Legislature generally may not do so if it would decrease the total countywide share of property taxes allocated to cities, counties, and special districts. An exception to this provision is known as a "Proposition 1A (2004) suspension," after the measure that established this procedure.

Proposition 1A (2004) Suspension. No more than twice in ten years, during a severe state fiscal hardship, the Legislature may modify property tax allocation laws to decrease for one year the percentage of property taxes allocated to cities, counties, and special districts. The Legislature must repay each local government's reduced property taxes, with interest, within three years. In 2009, the Legislature enacted a Proposition 1A (2004) suspension, shifting 8 percent of every city, county, and special district's 2008-09 property taxes to educational agencies—a total of $1.9 billion in shifted revenue. The state must repay each local government by June 30, 2013.

Tax Increment

The Constitution and other statutes authorize city and county redevelopment agencies to create "project areas" in blighted, urban areas. After a redevelopment agency creates a project area, it receives all the growth in property tax revenues (called "tax increment") generated in the area. Other local agencies serving the project area continue to receive the amount of property taxes they received before the agency created the project area.

To partially mitigate the fiscal effect of redevelopment on other local agencies, state law requires most redevelopment agencies to "pass through" a portion of their tax increment to other agencies serving the project area. In addition to these ongoing pass-through obligations, the state periodically has required redevelopment agencies to make payments to schools. Current law, for example, requires redevelopment agencies to contribute to schools $1.7 billion in May 2010 and $350 million in May 2011. These payments to schools offset a commensurate amount of required state spending. Redevelopment agencies currently are challenging in court the state's constitutional authority to require these payments.

Mandates and VLF

State-Reimbursable Mandates. The Constitution generally requires the state to reimburse local governments when the state "mandates" a new local program or higher level of service. In general, the state reimburses local governments for mandates through appropriations in the annual budget act.

Vehicle License Fee (VLF). State law imposes a 1.15 percent VLF on the depreciated value of cars and trucks. The Department of Motor Vehicles (DMV) collects the VLF at the time of vehicle registration. The 1.15 percent rate includes a temporary 0.5 percent rate and a base 0.65 percent rate. The Constitution identifies three broad uses for revenues from the base VLF rate: offsetting DMV's collection costs, supporting the Local Revenue Fund (used for certain county health and social service programs), and distributing to cities and counties.

Using Base VLF Revenues to Offset State Mandate Costs. The Legislature has broad authority to modify base VLF allocation statutes, including shifting revenues to local governments to offset their costs to implement a state mandate. In 1991-92, for example, the state (1) modified the VLF depreciation schedule to generate higher revenues and (2) changed VLF allocation statutes to distribute the new revenues to counties responsible for new health and social services mandates. Because the increased VLF revenues offset the counties' costs to implement the mandates, the state was not required to appropriate mandate reimbursements to counties in the annual budget.

Other Local Revenues

The Constitution authorizes local governments to impose local taxes for local purposes. Over the years, local governments have imposed a wide range of local taxes, including Bradley-Burns sales, business license, utility users, and transaction and use taxes. The Constitution generally does not authorize the state to use or reallocate revenues raised under these taxes.

PROPOSAL

This measure amends the Constitution to constrain the state's authority to redirect or make changes to state and local resources and their allocation after October 21, 2009. Under the measure, the State Controller would reimburse affected local governments or accounts within 30 days if the state were found to have violated any of its provisions. Funds for these reimbursements, including interest, would be continuously appropriated from the state General Fund and do not require legislative approval. Any statute enacted between October 21, 2009 and the effective date of this measure that would have been prohibited under this measure would be repealed.

Transportation Funding

Prohibits Borrowing or Redirection of Certain Transportation Resources. The measure prohibits gasoline and diesel excise tax revenues, gasoline sales tax revenues, and funds deposited into the PTA from being loaned temporarily, or permanently, to the General Fund, or any other state fund. This eliminates the state's ability to borrow transportation funds for non-transportation purposes. The measure also eliminates Caltrans' ability to make temporary loans between various transportation accounts to manage cash flow—such as to pay staff and to fund the construction of projects.

Requires Gasoline Sales Tax to Be Deposited Directly Into the TIF. The measure requires the revenues from the sales tax on gasoline to be deposited directly into the TIF, instead of first flowing through the General Fund. (It is not clear if this change would affect calculations related to K-14 education described above.) Unlike current law, this transfer could not be suspended.

Requires Public Process to Amend Allocations. This measure requires the California Transportation Commission to conduct public hearings and prepare a report before the Legislature could enact changes to the allocation of either gas tax revenues in the HUTA or gasoline sales tax revenues in the TIF.

Specifies Allocation of PTA Funds in Constitution. The measure specifies in the Constitution the portion of PTA funds that would be made available for various programs. Under the measure, about one-half of all PTA funding would be given to local transit agencies for operational support. These allocations could not be changed without a vote of the people.

Other Local Government Revenues

Property Tax. The measure eliminates the state's authority to shift property taxes from cities, counties, and special districts to schools during a severe state fiscal hardship. Under the measure, the state would continue to be responsible for the repaying of local governments for the 2009 Proposition 1A (2004) suspension, but could not shift property tax revenues to schools again.

Tax Increment. Under the measure, the Legislature could not enact laws after October 21, 2009 that require redevelopment agencies to shift funds to schools or other agencies beyond any amounts required by statutes in existence on January 1, 2008. The effect of the measure's provisions regarding the $2 billion 2009-10 and 2010-11 redevelopment shifts (enacted before October 21, 2009) is not clear. While the measure does not contain provisions directly repealing these payments, it declares these laws to be illegal under existing constitutional provisions. It is possible that this declaration could affect the outcome of the pending litigation regarding these payments.

VLF. The measure eliminates the Legislature's authority to reallocate VLF revenues to offset state mandate costs. This provision would not affect the 1991-92 VLF changes that reimburse local governments for health and social services costs.

Other Local Revenues. The measure specifies that the Legislature may not reallocate, borrow, or use revenues raised from locally imposed taxes.

FISCAL EFFECTS

This measure does not affect the total amount of state and local government revenues. Instead, it relates primarily to state authority over local government resources. While some elements of this measure would be subject to future interpretation by the courts, its overall effect is to constrain the state's ongoing authority to redirect or make changes to state and local resources and their allocation, beginning October 21, 2009. The measure would have significant immediate and long-term fiscal impacts on state and local governments, as described below.

Higher and More Stable Resources for Non-Education Local Governments

Long-Term Effect. Given the number and magnitude of past state actions affecting local tax revenues and resources, this measure's restrictions on state authority to enact such measures in the future would have potentially major beneficial fiscal effects on non-education local governments. For example, the state could not enact measures that require redevelopment agencies to pass through more revenues to schools. Similarly, the state could not suspend payments to local transit agencies to pay state costs. In these cases, this measure would result in non-education local government resources being more stable—and higher—than otherwise would be the case. The magnitude of increased local resources is unknown and would depend on future actions by the state. Given past actions by the state, however, this increase in local resources could be billions of dollars in some years. These increased local resources could result in higher spending on local programs or decreased local fees or taxes.

Near-Term Effect. Given past state actions during times of state fiscal difficulty, it is possible that this measure would invalidate some inconsistent state laws enacted between October 21, 2009 and the effective date of this measure. While the nature and terms of these state laws is not known, any such repeal likely would result in higher and/or more stable revenues to cities, counties, special districts, and redevelopment agencies (non-educations local governments) than otherwise would be the case. In addition, as noted above, the measure's fiscal effect on pending litigation regarding $2 billion of redevelopment funds is not clear.

Lower Resources for State Programs

In general, as we discuss below, the measure's effect on state finances would be the opposite of its effect on local finances. That is, this measure would result in *decreased* resources being available for state programs than otherwise would be the case.

Resources Available for State Budgetary Purposes. Under the measure, the state could not: (1) use redevelopment or other local funds to support education, (2) borrow or redirect fuel or property tax revenues as part of a state budget solution, or (3) reallocate VLF revenues to offset state mandate reimbursement obligations. As a result, the state would need to take alternative actions to balance the state budget in some years—such as increasing taxes or decreasing spending on state programs. Given current and previous actions by the state, we estimate that this decrease in state fiscal authority could reduce state resources by billions of dollars in some future years.

Transportation Project Resources. By eliminating Caltrans' authority to make temporary cash loans between the state's various transportation accounts, this measure would likely result in slower spending on construction projects, particularly in the near term. This is because Caltrans would need to accumulate a large enough balance in each account (potentially, in total affecting several hundred million dollars) to meet its monthly cash flow needs.

Summary of Fiscal Effects

The measure would have the following major fiscal effects:

- Significant constraints on state authority over city, county, special district, and redevelopment agency funds. As a result, higher and more stable local resources, potentially affecting billions of dollars in some years. Commensurate reductions in state resources, resulting in major decreases in state spending and/or increases in state revenues.

Sincerely,

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