January 6, 2010

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 to state and local appropriation limits (A.G. File No. 09-0090).

BACKGROUND

State and Local Spending Limits

In November 1979, California voters approved Proposition 4. That measure amended the State Constitution to establish an appropriations limit (referred to below as the "spending limit" or the "limit") for the state government, as well as a limit for each city, county, school district, and other local government entity. The limit for each government constrains the amount of funds that can be spent (appropriated) by that government each year. The spending limit was modified by several later initiatives, including Proposition 98 in 1988 and Proposition 111 in 1990. This section describes the current version of the spending limit, as modified by those two initiatives.

Calculation of the Spending Limit. The annual spending limit is based on the amount of appropriations in the 1978-79 fiscal year (referred to as the "base year"), as adjusted each year for population growth and cost-of-living factors. The existing spending limit for the state government, school districts, and community college districts measures the cost of living as equal to the change in per capita (that is, per person) personal income in California. The state government's existing limit measures population growth based on a blended average of (1) the growth in the state's population and (2) the change in enrollment of the state's school and community college districts (known as "K-14 schools"). The Constitution provides for different population and cost-of-living factors for other governmental entities.

Appropriations Subject to the Limit. In general, government spending subject to the spending limit is equal to all appropriations funded from the "proceeds of taxes," except for the types of spending that are specifically exempted. Proceeds of taxes include taxes and the portion of fee revenues that are in excess of the cost of providing fee-based services. Some of the *specific exemptions* to the spending limit include:

- Principal and interest payments (debt-service payments) on bonds issued by a governmental entity.
- Spending resulting from natural disasters, such as fires, floods, droughts, and earthquakes.
- Retirement benefit payments.
- Unemployment and disability insurance payments.
- Certain court-mandated or federally mandated expenses.
- For the state limit, certain state payments known as "subventions" to local governments.
- Spending from the increased tobacco taxes approved by voters in Proposition 99 (1988) and Proposition 10 (1998).
- Qualified capital outlay spending—defined in state law as funds spent on fixed assets (such as land or construction projects) with an expected life of ten or more years and a value over $100,000.
- Transportation expenditures from the portion of gas taxes and commercial vehicle weight fees above the levels that were in place in January 1990 (prior to the passage of Proposition 111, which raised those taxes and fees).

In addition to the specific exemptions from the spending limit, the Constitution also allows the spending limit to be changed by voters in a particular jurisdiction. The duration of any such change cannot exceed four years.

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

Current State Spending Compared to the Spending Limit. In recent years, state spending subject to the spending limit generally has been far below that spending limit. Accordingly, the spending limit has not been a factor when the Legislature and the Governor have determined the size of the state budget each year. Based on estimates developed at the time the state's *2009-10 Budget Act* was passed, the state's spending limit is $81 billion. The state's Department of Finance has estimated that the state appropriations subject to that limit were $51.4 billion, or $29.6 billion below the limit. (Total state appropriations were much higher, but tens of billions of dollars of state spending are exempted from the limit, as described above.) The amount by which the state is under the spending limit has increased significantly due to budget reductions approved by the Legislature and the Governor over the last two years. Given current economic and revenue projections, the spending limit—unless changed by voters—is not likely to be a factor in state budget decisions for many years to come. Similarly, most cities, counties, and special districts are below their spending limits. (State law allows school and community college district governing boards to increase their spending limits to an amount equal to their proceeds of taxes; such increases in districts' appropriations limits then reduces the spending limit of the state government by an equal amount.)

School and Community College District Funding

Proposition 98 Minimum Annual Funding Guarantee. In 1988, voters approved Proposition 98. Including later amendments, Proposition 98 establishes a guaranteed minimum annual amount of state and local funding for K-14 schools. Generally, Proposition 98 provides K-14 schools with guaranteed funding sources that grow each year with the economy and the number of students. The guaranteed funding is provided through a combination of state General Fund appropriations and local property tax revenues. Proposition 98 expenditures are the largest category of spending in the state's budget—totaling $35 billion in the 2009-10 fiscal year, for example, which is equal to 41 percent of annual state General Fund expenditures. With a two-thirds vote, the Legislature can suspend the Proposition 98 guarantee for one year and provide any level of K-14 schools funding it chooses. The Legislature has suspended Proposition 98's guaranteed funding requirements only once—in conjunction with passage of the state's budget in 2004.

PROPOSAL

This measure makes major changes to the state's constitutional spending limit. It also makes one change affecting local governments' spending limits.

State Spending Limit

Changes How State's Spending Limit Is Calculated. This measure makes substantial changes to how the state government's annual spending limit is calculated, including the following:

- ***Change in Base Year.*** Effective July 1, 2011, the state's spending limit would be the state's spending from proceeds of taxes in the 2009-10 fiscal year adjusted in each fiscal year thereafter for cost-of-living and population growth. (The 2009-10 fiscal year, in other words, would replace 1978-79 as the base year in the state's spending limit calculation.)
- ***Change in Cost-of-Living Factors.*** Under this measure, the cost-of-living factor used to calculate the state's spending limit is changed to the U.S. Consumer Price Index (CPI) or per capita personal income, whichever is less. The CPI is a measure of inflation.
- ***Change in Population Growth Factors.*** Under this measure, the population growth factors used to calculate the state's spending limit would be "determined by a method prescribed by the Legislature." The measure specifies that this determination would have to be "revised, as necessary," every ten years to reflect the results of the U.S. Census.
- ***Change in How Capital Outlay and Bond Funds Are Counted.*** The measure deletes the constitutional provision that allows spending for qualified capital outlay projects to be exempt from the spending limit. Instead, this measure would allow only "appropriations from bond funds approved by the voters" pursuant to two sections of the Constitution to be exempt.
- ***Change in How Certain Transportation Expenditures Are Counted.*** This measure repeals the constitutional provision that now exempts from the spending limit certain transportation expenditures paid for by taxes and fees that are above the levels that were in place in January 1990.

Use of "Excess" State Revenues

New Provisions for Excess Revenues. This measure repeals the existing constitutional provisions that establish how excess state revenues (described above) will be divided between educational entities and tax rebates. Under this measure, excess state revenues (as defined by the spending limit provisions of the Constitution) generally would have to be spent for the "reduction of state debt." (The measure would allow state debt reduction to be achieved by retiring existing bonded debt obligations, paying bond interest costs, or using excess revenues—instead of previously approved bonds—to build infrastructure projects.) If, however, the state's debt-service costs for two consecutive fiscal years are less than 6 percent of state spending subject to the spending limit, the Legislature could appropriate excess revenues for one or more of the following purposes:

- Debt reduction.
- One-time appropriations to public school and community college districts.
- Transfers to build up the state's reserve funds.
- Taxpayer rebates.

Local Government Spending Limits

Change in How Capital Outlay and Bond Funds Are Counted. The change described above for the state government in how capital outlay and bond funds are counted in the spending limit also applies to local governments under this measure.

FISCAL EFFECTS

This measure would change the state government's spending limit in ways that could make that limit a much more prominent consideration in future budgetary decisions of the Legislature and the Governor. The measure also could affect the spending limits of some local governments. We discuss these fiscal effects below. The exact effects of the proposal for a governmental entity in any given fiscal year, however, would depend on spending choices made by governments and trends in inflation, per capita personal income, and population growth. Interpretations of this measure by elected policymakers and the courts also would play a major role in determining how the amended spending limits would affect each governmental entity.

State Government

Change in Base Year. Currently, there is a large gap between the state's spending limit and the amount of its annual spending subject to the limit. This measure would "reset" the state's spending limit base year to 2009-10, effective on July 1, 2011. This reset provision would reduce substantially the large gap referenced above. Accordingly, particularly in the near term, the spending limit would be much more likely to constrain the amount of appropriations (not otherwise exempt) for state-funded programs that could be approved in any given year by the Legislature and the Governor.

Cost-of-Living and Population Growth Factors. Over the last two decades, as shown in Figure 1, CPI usually has increased at a slower annual rate than per capita personal income in California. Because the measure requires the lower growth of the two measures to be used each year, the annual cost-of-living component of the state's spending limit would rise more slowly over time under this measure, as compared to what would occur if the existing state spending limit remained in place. The change in the state's population growth factors also could affect state spending, although the effects of this measure in that regard are much harder to estimate.

Figure 1

U.S. Consumer Price Index Tends to Grow More Slowly Than California Per Capita Personal Income

	Change in California Per Capita Personal Income (PCPI)[a]	Change in U.S. Consumer Price Index (CPI)[b]	Change in California PCPI Faster/(Slower) Than Change in CPI
1988	5.3%	4.0%	1.3%
1989	4.7	4.8	(0.1)
1990	4.0	5.2	(1.2)
1991	1.5	4.1	(2.6)
1992	4.1	2.9	1.2
1993	1.1	2.8	(1.7)
1994	3.0	2.5	0.5
1995	4.3	2.8	1.5
1996	5.9	2.9	3.0
1997	5.3	2.3	3.1
1998	8.0	1.3	6.7
1999	5.7	2.2	3.6
2000	6.2	3.5	2.7
2001	(0.9)	2.7	(3.6)
2002	1.1	1.4	(0.2)
2003	3.5	2.2	1.3
2004	5.6	2.6	3.0
2005	4.4	3.5	0.9
2006	5.9	3.2	2.7
2007	3.9	2.9	1.0
2008	(1.4)	4.1	(5.5)

[a] Consistent with method prescribed in Section 7901(a) of the Government Code, data listed reflect total California personal income for the fourth quarter of the relevant calendar years (as estimated by the U.S. Department of Commerce), divided by the Department of Finance's California population estimate for January 1 of the subsequent year.

[b] Reflects U.S. CPI for all urban consumers, as estimated by the U.S. Department of Labor and compiled by the Department of Finance as of November 2009.

More State Spending on Debt Expenses a Possible Result of This Measure. For all of the reasons described above, this measure would make it more likely that the limit would constrain state spending in future years and therefore generate excess state revenues. Currently, state debt-service costs exceed 6 percent of total state appropriations subject to limitation. Under current budget projections, it is likely these costs will continue to exceed 6 percent of the state budget for many years to come. Accordingly, under this measure, any excess revenues, probably would have to be spent on state debt reduction in the near term. If annual state debt-service costs fell below 6 percent of spending subject to the limit at some point in the future, any excess revenues would have to be used for debt reduction, appropriations to educational entities, transfers to the state's reserve funds, or one-time tax or fee reductions.

Mix of State Spending Could Change. This measure does not repeal the existing minimum annual guarantee for funding of school and community college districts. Accordingly, the amount required to be provided to these districts could continue growing at a faster rate. This, as well as other provisions in the measure, would likely result in the mix of annual state spending—the percentage of the total state budget devoted to each program area—changing over time. We would expect spending on K-14 education and debt expenses (as described above) to occupy a greater percentage of the state budget in the near future—reducing spending in other areas. It is impossible to predict these changes precisely, as they would depend on future decisions of the Legislature, the Governor, and voters.

Effects Harder to Estimate, but Perhaps Not Significant. The fiscal effects of this measure on local governments are harder to estimate and would depend in part on how the measure is interpreted and implemented. The changes to the existing capital outlay provisions of the spending limit could alter how some local governments approach infrastructure spending. For most local governments, it does not appear that the effects of this measure would be substantial.

This measure would result in the following major fiscal effects:

- Revised spending limit likely would alter state spending. In the near future, the percentage of the state budget devoted to K-14 education and debt expenses likely would increase, and the percentage devoted to other areas likely would decrease. Over the longer term, state reserves, tax rebates, and other one-time spending also could increase.

Sincerely,

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Legislative Analyst

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