March 16, 2012

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative related to state appropriation limits and legislative vote requirements for certain tax measures (A.G. File No. 12-0007).

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 state government's 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.

Both the base year and these growth factors are important elements in a governmental spending limit. The base year effectively can "lock in" a relatively high or low amount of allowed spending, and the growth factors can allow either limited or expansive growth thereafter.

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 (this exemption covers most state payments to school districts).
- 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.

State statutes contain various guidelines for administration of state and local spending limits. One such statute, for example, specifies that state subventions to a school district above a certain level shall *not* be considered as proceeds of taxes for that district. When the state calculates its spending limit each year, it effectively counts this portion of school district funding as state spending subject to the spending limit (unlike most other such subventions to school districts)—thereby reducing the capacity for other state spending within the limit.

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. For local governments, excess revenues are to be refunded to taxpayers within two years.

Current State Spending Compared to the Spending Limit. In recent years, state spending subject to the spending limit generally has been far below that limit. Accordingly, the spending limit typically has not been a factor when the Legislature and the Governor have determined the size of the state budget each year. In 2000-01, for example, the state's appropriations subject to the existing spending limit were $52.2 billion ($1.8 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.) In 2007-08, appropriations subject to the limit were $59.2 billion ($16.9 billion below that year's limit). By 2009-10, as state revenues were affected by the recession, appropriations subject to the limit had declined to $56 billion ($25 billion below that year's limit), and in 2010-11, appropriations subject to the limit were $61.7 billion ($17.4 billion below that year's limit).

Based on recent estimates by the Department of Finance, state appropriations subject to the spending limit in 2011-12 (the current fiscal year) are $64.6 billion, or $17.2 billion below the current limit. Given current economic and revenue projections, the spending limit—unless changed by voters—is not likely to be a major factor in state budget decisions for many years to come. Similarly, we understand that most cities, counties, and special districts are below their spending limits.

Legislative Vote Requirements for Increasing Taxes

State Tax Increases. The Constitution describes what constitutes a tax. State tax increases require approval either by the voters through the initiative process or by a two-thirds vote of each house of the Legislature. In 2010, voters approved Proposition 26, a constitutional amendment that broadened the definition of state and local taxes. Among other things, Proposition 26 specified that laws passed by the Legislature that result in *any* taxpayer paying a higher tax must be approved by two-thirds of each house of the Legislature.

State Legislative Approval for Local Taxes. In some instances, the Legislature considers and acts upon legislation that authorizes local governments to impose new or increased taxes in their jurisdictions. Under the Constitution, these state measures may be approved by a majority of each house's members. Local governments may not impose the new or increased taxes, however, unless they are approved by local voters.

PROPOSAL

This measure makes changes to the state's constitutional spending limit and legislative vote requirements for certain tax increases.

State and Local Spending Limit Changes

Changes Base Year for State Spending Limit. Effective in 2013-14, this measure changes the base year for the state government's spending limit to 2010-11. The state's spending limit would be its spending subject to limitation (that is, proceeds of taxes less exempted spending) in 2010-11—estimated to be about $62 billion—adjusted in each fiscal year thereafter for cost-of-living and population growth.

Changes How State Excess Revenues Are to Be Used. This measure changes the Constitution's requirements for how any state government excess revenues are to be used. The uses of excess revenues under this measure would depend on the amount of the annual excess and the proportion of the state government budget spent on voter-authorized bond debt service, as described below:

- ***When Annual Debt-Service Costs Are Under 5 Percent of the Limit.*** In any fiscal year when the state's excess revenues total less than $2 billion and the state's total amount of bond debt service is less than 5 percent of the spending limit, excess revenues are to be divided equally between one-time appropriations to K-14 schools and a state budget reserve fund. If, however, the excess revenues total more than $2 billion and the state's debt service is less than 5 percent of the limit, excess revenues are to be refunded to taxpayers by a reduction of tax rates or fees within the next two fiscal years.
- ***When Annual Debt-Service Costs Are More Than 5 Percent of the Limit.*** Under this measure, in any fiscal year when the state has excess revenues and its debt-service costs are more than 5 percent of the limit, the excess revenue is to be spent to reduce the total amount of the state's outstanding voter-approved bond debt, including interest and redemption charges.

Changes How Local Excess Revenues Are to Be Used. This measure also changes the requirements for how any local government excess revenues are to be used. Similar to the proposed requirements for state excess revenues, the local government would be required to use excess revenues in any fiscal year to reduce bond debt when its annual debt-service costs exceed 5 percent of its local spending limit. When such debt-service costs are less than 5 percent of the local limit, excess revenue would be required to be returned to taxpayers by a reduction of tax rates or fees within the next two fiscal years.

Changes Other Spending Limit Provisions. The measure changes certain other provisions related to the calculation of California's constitutional spending limits, including the following changes:

- ***Capital Outlay.*** As described above, qualified capital outlay projects are exempt from spending limits. State statutes currently include a definition of qualified capital outlay projects. This measure inserts the same definition into the Constitution.
- ***Definition of Population Change.*** For local governments (not including schools or community college districts), the Constitution specifies that the change of population included in local spending limits shall be determined by a method prescribed by the Legislature. The Legislature has prescribed such a method in state statutes. This measure amends the Constitution to require that these local government population calculations be revised every ten years to reflect the results of the U.S. Census.
- ***Explicitly Prohibits Statutory Exemptions.*** This measure amends the Constitution to explicitly prohibit statutes enacted through the initiative process or by the Legislature

from exempting any appropriations or proceeds of taxes from state or local spending limit calculations.

Legislative and Initiative Measures

Requirements for Two-Thirds Votes of the Senate and Assembly. This measure changes the Constitution to require the votes of two-thirds of the members of each house of the Legislature to approve bills that authorize local governments to impose new or increased taxes in their jurisdictions. Local governments still would not be able to impose the new or increased taxes, however, unless they are approved by local voters. The measure also specifies that certain other additions, amendments, or repeals of state law that result in the imposition of increased taxes require the votes of two-thirds of the members of each legislative house.

Repeals Unspecified Laws. This measure repeals any state statutory changes passed by the Legislature between December 1, 2011, and the effective date of this initiative (the day after it is approved by the state's voters) that conflict with this measure's provisions.

Covers Taxes Adopted on Same Ballot. The measure specifies that the use of proceeds of any taxes adopted on the same statewide election ballot as this measure would be covered by this initiative's spending limit.

FISCAL EFFECTS

State Government

Change in Base Year. Currently, there is a significant 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 2010-11, essentially eliminating the gap between the limit and spending subject to the limit. Accordingly, the spending limit would be much more likely to restrain the amount of state appropriations subject to limitation.

If so restrained, the state would have to reduce the funding provided for programs covered under the limit. Alternatively, the state could redirect spending to exempt items (such as eligible subventions or debt service), reduce state revenues, and/or implement the excess revenue provisions under the revised spending limit. The constraints of this measure's new base year may be more pronounced when state revenues grow substantially due, for example, to "spikes" in revenue from stock market-related increases in capital gains income or tax rate increases.

Change in Excess Revenue Requirements. The state is likely to spend nearly $7 billion on voter-approved bond debt service in 2013-14, which would equal around 10 percent of the revised spending limit. Accordingly, in the near term, if excess revenues emerge for the state, they are likely to be used to reduce state indebtedness under this measure. Over the longer run, excess revenues also could result in additional one-time funding for schools and community colleges, the state's budget reserve, and taxpayer refunds. To the extent that such excess revenues emerge, therefore, these changes could affect the overall level, composition, and stability of the state budget over time.

The requirements to use excess revenues for these one-time purposes means that they would not be available for ongoing state programs. There are many scenarios that could occur in the event that excess revenues emerge. In one scenario, for instance, required funding for schools and community colleges under Proposition 98 could equal a growing portion of revenues able to be spent on ongoing state programs under the revised limit. This scenario could result in less ongoing state spending than otherwise would be the case for purposes funded with tax proceeds outside of Proposition 98, including health, social services, corrections, and university programs (funding for which generally is constrained by the spending limit). In another scenario, the Legislature could suspend the Proposition 98 minimum funding guarantee to continue other spending. In other scenarios, the revised limit could be more constraining based on relationships between state subventions and school spending limits in some circumstances when tax revenue growth causes state school funding requirements under Proposition 98 to rise. The exact amounts of these funding changes would depend on whether excess revenues emerge, how much, when, and decisions of the Legislature and Governor in each fiscal year to allocate allowable spending to various state-funded programs.

Local Government

Because this measure does not change local government base years under the constitutional spending limit, its fiscal effects may be less significant for local governments.

Changes in Excess Revenue Requirements. To the extent that local governments receive excess revenues in the future, this measure would direct them to reduce bond debt in certain instances.

Funding for Schools and Community Colleges. The changes in the state spending limit described above would make it somewhat more likely that schools and community colleges would receive one-time funding from excess state revenues in the future.

Other effects on budgets of local governments, including school districts, are possible, but difficult to project at this time.

Taxes

This measure's changes to legislative vote requirements for certain tax measures would decrease the likelihood that certain tax increases would be authorized or imposed. Because it is unknown which tax measures would be approved in the future—either with or without this change—the exact fiscal effect of these changes cannot be determined.

Summary of Fiscal Effects

This measure would result in the following major fiscal effects:

- For state government, a much greater likelihood that spending will be constrained by the constitutional spending limit. Consequently, state spending for ongoing programs—such as schools, community colleges, universities, health and social services, and corrections—may have to be reduced in certain years, potentially by billions of dollars. In addition, the measure could result in more state funding for reduction of bond debt, particularly in the near term, and in the future, more one-time funding for schools and community colleges, budget reserves, and taxpayer refunds.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance