Proposition 1A
State Finance.

OVERVIEW OF THE PROPOSAL

Measure Changes the State's Budgeting. This measure would make major changes to the way in which the state sets aside money in one of its "rainy day" reserve accounts and how this money is spent. As a result, Proposition 1A could have significant impacts on the state's budgeting practices in the future. The measure would tend to increase the amount of money set aside in the state's rainy day account by increasing how much money is put into this account and restricting the withdrawal of these funds.

Measure Results in Tax Increases. If this measure is approved, several tax increases passed as part of the February 2009 budget package would be extended by one to two years. State tax revenues would increase by about $16 billion from 2010-11 through 2012-13.

BACKGROUND

Restrictions on Annual State Budget

Currently, the State Constitution has two main provisions related to the state's overall level of spending:

- ***Spending Limit.*** There is a limit on the amount of tax revenues that the state can spend each year. In recent years, however, the limit has been well above the state's level of spending and has not been a factor in budgeting decisions.
- ***Balanced Budget.*** In March 2004, the state's voters passed Proposition 58. Among other changes, the measure requires that the Legislature pass a balanced budget each year.

Outside of these requirements, the Legislature and Governor are generally able to decide how much General Fund money to spend in a given year.

Rainy Day Reserve Funds

When the state passes its annual budget, it estimates the amount of revenues that it expects to receive in the upcoming year. Typically, the state sets aside a portion of these revenues into one of two rainy day reserve funds. Money in these reserves is set aside to pay for unexpected expenses, cover any drops in tax receipts, or save for future years. The two funds are described below.

- ***Special Fund for Economic Uncertainties (SFEU).*** The SFEU is the state's traditional reserve fund. Funds can be spent for any purpose with approval by the Legislature. Any unexpected monies received during a year are automatically deposited into the SFEU.

- ***Budget Stabilization Account/Budget Stabilization Fund (BSA/BSF).*** The state's voters created the BSA/BSF through the passage of Proposition 58 in 2004. (Under current law, this reserve is known as the BSA. Proposition 1A would rename it the BSF. For simplicity, we refer to the reserve as the BSF throughout this analysis.) Each year, 3 percent of estimated General Fund state revenues are transferred into the BSF. The Governor, however, can stop the transfer in any year by issuing an executive order. For instance, the transfer this year was stopped due to the state's budget problems. Similarly, it is expected that the transfers will be suspended over the next few years as the state continues to face budget problems. In addition, the annual transfers are not made once the balance of the BSF reaches a specified "target"—the higher amount of $8 billion or 5 percent of revenues (currently about $5 billion). By passing a law, the state can transfer funds out of the BSF and use the funds for any purpose. (Currently, this is accomplished through the annual budget act, which allows transfers out of the BSF each year.)

Economic Recovery Bonds (ERBs). In 2004, the state's voters passed Proposition 57, which allowed the state to issue $15 billion in ERBs. These bonds were used to pay off budgetary debt that had accumulated in the early part of this decade. A portion of the sales and use tax (SUT) is the primary mechanism to pay off the ERBs. However, one-half of the funds deposited into the BSF—up to a total of $5 billion—are used to make extra payments on the ERBs to pay them off faster. To date, $1.5 billion in BSF funds have been used in this manner.

Authority to Reduce Spending

Once the annual budget has been approved by the Legislature and the Governor, the Governor has only limited authority to reduce spending during the year without legislative approval.

Recent Tax Increases

As discussed in the "Overview of the State Budget" section of this guide, the Legislature and Governor passed a plan in February 2009 to balance the state's 2008-09 and 2009-10 budgets. The plan included a number of tax increases that are scheduled to remain in effect for about two years (unless the voters approve this measure). Specifically:

- ***Sales and Use Tax.*** The SUT is charged on the purchase of goods. The budget package raised the tax by one cent for every dollar of goods purchased. This raised the average SUT rate in the state from about 8 percent to 9 percent through 2010-11.

- ***Vehicle License Fee (VLF).*** The VLF is based on the value of a vehicle and is paid annually as part of an owner's registration. The budget package raised the tax rate from 0.65 percent to 1.15 percent of a vehicle's value through 2010-11.
- ***Personal Income Tax (PIT).*** The PIT is based on an individual's income. Tax rates range from 1 percent to 10.3 percent depending on a taxpayer's income. Higher tax rates are charged as income increases. Numerous exemptions and credits may be applied to an individual's income to lower the amount of the tax owed. The budget package raises each tax rate by a 0.25 percentage point. (This rate increase will be reduced by one-half if it is determined by April 1, 2009 that the state will receive a certain level of federal funds to help balance the state budget.) For instance, the 9.3 percent tax rate was raised to 9.55 percent. The package also reduces the value of the credit for having a dependent (such as a child) by about $210. These changes would affect the 2009 and 2010 tax years.

PROPOSAL

This measure amends the Constitution to change the state's budgeting practices. Based on other components of the 2009-10 budget package, passage of this measure would also give the Governor more authority to cut spending and would extend recent tax increases by up to two years.

Use of Extra Revenues in Certain Years

Proposition 1A establishes a process to determine which revenues are "unanticipated." The measure generally defines unanticipated revenues to mean those that exceed the amount expected based on the revenues received by the state over the past ten years. The ten-year trend would be adjusted to exclude the impact of shorter-term tax changes. (In other cases, unanticipated revenues could be defined as any revenues above the amount needed to pay for spending equal to the prior year's level of spending grown for changes in population and inflation.) Beginning in 2010-11, any extra revenues would be directed to the following purposes (in priority order):

- Meet funding obligations under the Constitution for K-14 education not already paid. (An existing formula established by Proposition 98 determines how much of higher revenues go to education.)
- Transfer to the BSF to fill the reserve up to its target.
- Pay off any budgetary borrowing and debt, such as certain loans and ERBs.

Once all of these types of payments were made, any other extra revenues could be spent on a variety of purposes, including further building up of the BSF, paying for infrastructure (such as constructing roads, schools, or state buildings), providing one-time tax relief, or paying off unfunded health care liabilities for state employees.

Revenues Into the BSF

Increased Reserve Target. This measure increases the amount of the BSF reserve target to 12.5 percent of state revenues. This percentage is currently equal to about $12 billion, but would grow over time. This compares to the existing target of the higher of $8 billion or 5 percent of revenues.

Suspension of Transfers More Restricted. Under the measure, the circumstances in which the Governor may stop a transfer to the BSF would be limited. Beginning in the 2011-12 fiscal year, the Governor could only stop the BSF transfer in years when the state did not have enough revenues to pay for state spending equal to the prior year's level of spending grown for changes in population and inflation.

Extra Revenues to Reserve in Certain Years. As noted above, one of the priorities for extra revenues would be to build up the BSF.

Spending Out of the BSF

New Spending Requirements. As described above, funds in the BSF currently can be transferred out of the fund to the General Fund for spending for any purpose through the passage of a law. Under this measure, some revenues in the BSF would be spent on particular purposes:

- ***Increased Education Spending, if Proposition 1B Passes.*** If both Proposition 1A and Proposition 1B on this ballot pass, the state would be required to pay K-12 schools and community colleges $9.3 billion in supplemental funds to address recent funding reductions. This measure establishes the way in which these payments would be made. Each year beginning in 2011-12, 1.5 percent of state revenues (currently about $1.5 billion) would be taken from the BSF and paid to schools and colleges until the entire $9.3 billion was paid. Regardless of the state's financial situation, these payments could not be suspended by the Governor. As a result, at least 1.5 percent of General Fund revenues would be transferred into the BSF every year until the entire amount was paid.
- ***Spending on Infrastructure and State Bond Debt.*** After the $9.3 billion in educational payments were made (or if Proposition 1B does not pass), 1.5 percent of state revenues each year would be dedicated to paying for infrastructure or state bond debt. These payments could be used to reduce obligations that would otherwise fall on the General Fund.

Smaller Payments to Pay Off ERBs. Under current law, one-half of transfers into the BSF—up to $5 billion total—is used to make extra ERB payments. This measure excludes the supplemental education funding transfers from this calculation. In years when transfers are made into the BSF (assuming Proposition 1B passes), therefore, the extra ERB payments would be smaller than otherwise.

Limits on Other Withdrawals. The ability of the state to transfer funds out of the BSF for other purposes would be significantly limited under the measure. Specifically, transfers out of the BSF would be limited to the following two situations:

- Funds in the BSF could be used to cover any costs associated with an emergency, such as a fire, earthquake, or flood.
- If revenues were not high enough to cover state spending equal to the prior year's level of expenses (grown for population and inflation), then BSF funds could be used to meet that level of spending.

Governor's Authority to Reduce Spending

If Proposition 1A passes, the Governor would be given new authority to reduce certain types of spending during a fiscal year without additional legislative approval. (This authority is included in a part of a new law that will only go into effect if Proposition 1A passes.) Specifically, the Governor could reduce:

- Many types of spending for general state operations (such as equipment purchases) or capital outlay by up to 7 percent.
- Cost-of-living adjustments (COLAs)—provided to account for inflation—for any programs specified in the annual budget. This would not apply to any increases for most state employees' salaries.

Tax Increases Extended

If Proposition 1A passes, the tax increases included in the February 2009 budget package would be extended for one or two additional years. (The extensions of the tax increases are included in a part of a law that will only go into effect if Proposition 1A passes.) The SUT increase of 1 cent would be extended for one year through 2011-12. The VLF tax increase would be extended for two years through 2012-13. The PIT-related tax increases would also be extended for two more years, through the 2012 tax year.

FISCAL EFFECTS

Uncertainty About the Effect of the Measure

The fiscal effects of Proposition 1A are particularly difficult to assess. This is because the measure's effects would depend on a variety of factors that will change over time and cannot be accurately predicted. Consequently, the measure's effects may be very different from one year to the next. The key factors determining the impact of Proposition 1A in any given year are:

- ***Future Budget Decisions by the Legislature and Governor.*** Key decisions made on the annual budget include the total level of spending and the mix of spending between one-time and ongoing purposes. These decisions would affect the state's fiscal condition and how much money is deposited or withdrawn from the BSF in a given year.

- ***Revenue Trends and Volatility.*** The level of revenues available for spending in a given year would depend on the previous ten years of revenue growth. The state's revenues are very volatile and can have big swings from year to year. Using the trend from ten years of revenues would reduce—but not eliminate—year-to-year changes.

Despite this uncertainty, we describe the more likely outcomes of the measure below—focusing first on nearer-term effects and then on a longer-term outlook.

Nearer-Term Budgets

Proposition 1A would have major effects on the state budget over the next few years. Although Proposition 1A was passed as part of the package to balance the 2009-10 budget, it would not significantly affect this year's budget. Most of its provisions go into effect starting with the 2010-11 budget or later, as described below.

Increased Tax Revenues. If Proposition 1A is approved, tax increases adopted as part of the 2009-10 budget package would be extended by one to two years. In total, this extension of higher taxes is projected to increase revenues by a total of roughly $16 billion from 2010-11 through 2012-13. (This total would be about $2.5 billion lower if a certain level of federal stimulus funds is available to the state.)

Governor's Ability to Reduce Some Spending. Effective upon passage of this measure, the Governor would have new authority to unilaterally reduce some spending for state operations and capital outlay and eliminate some COLAs. This authority could potentially be used to reduce spending within a fiscal year if the budget goes out of balance after it is passed.

Higher Payments to Education. If Proposition 1B also passes, the state would divert 1.5 percent of annual General Fund revenues beginning in 2011-12 to make supplemental payments for education. These payments would be made until a total of $9.3 billion had been spent, likely in five or six years. These payments could not be suspended. The fiscal effect of these payments is discussed in more detail in the analysis of Proposition 1B.

Altered Pay Off of ERBs. As described above, this measure could alter the speed at which the state pays off its outstanding ERBs (bonds related to prior budgetary debt). In years when the only transfers made into the BSF were the base 3 percent of revenues (and assuming Proposition 1B also passes), the measure would reduce the amount of the extra ERB payments made from the BSF by one-half (reducing state costs in that year by more than $700 million). On the other hand, to the extent that additional transfers to the BSF were made related to unanticipated revenues, extra BSF payments to ERBs could be made compared to current law. These changes would affect the timing of the final payoff of the ERBs. Once the ERBs are paid off, the state would experience reduced General Fund costs on an annual basis.

Limited Ability to Suspend BSF Transfers. Under current law, the Governor may suspend BSF transfers in any year and, therefore, allow 3 percent of revenues to be available to help balance a budget immediately. In contrast, beginning in 2011-12 (if Proposition 1B also passes), this measure would eliminate the ability to suspend one-half of the transfer related to supplemental educational payments. For the remaining amount of the transfer, the transfer could only be suspended in more restricted cases.

Transfer of Extra Revenues to BSF. Beginning in 2010-11, this measure would require transfers of General Fund revenues into the BSF of amounts that exceed the ten-year revenue trend. It is difficult to predict what this calculation would require in future years. It is possible, however, that this provision would require billions of dollars in the next few years to be transferred to the BSF.

Net Result of These Factors. Some of these factors—such as the higher tax revenues—would make it easier to balance the state budget in the coming years. Other factors—such as the limited ability to suspend the annual transfers to the BSF—could make it more difficult. The net result of these factors is difficult to determine in any particular year. In 2011-12, the size of the tax increases connected to this measure would likely make that year's budget easier to balance. In other years, however, the effect of the measure on the ability of the state to balance the budget is unknown.

Longer-Term Outlook

As described above, this measure has a number of effects that would last for less than a decade—including higher taxes, supplemental payments to education, and altered payoff of the ERBs. Once these effects have run their course, Proposition 1A could continue to have a substantial effect on the state's budgeting practices. In this section, we describe the possible long-term effects of this measure.

Restrictions on Revenues and Spending. In any given year, Proposition 1A does not strictly limit the amount of revenues that could be collected by the state or the amount of spending that could occur. The measure does not restrict the ability of the Legislature and the Governor to approve tax increases to collect on top of existing revenues. Regarding spending, while the measure could make it harder to approve spending increases in some years by restricting the access to revenues, it would not cap the total level of spending that could be authorized in any year if alternative revenues were approved.

More Money in the BSF. In some years, the measure could lower the amount of money in the BSF rainy day reserve by allowing 1.5 percent of General Fund revenues to be spent on infrastructure. In many other cases, however, the measure would increase the amount of money in the state's BSF rainy day reserve by:

- Restricting the ability of the Governor to stop the annual transfer into the reserve.
- Restricting the purposes for which funds can be taken out.
- Requiring revenues above a decade-long trend to be deposited into the fund.
- Raising the target cap on funds in the BSF (from 5 percent or $8 billion) to 12.5 percent of revenues.

On net, we expect that the balance of the BSF would be greater than under current law in many future years. The net amount of additional money in the BSF would depend on a number of factors, including future budgeting decisions by the Legislature and Governor and the rate and volatility of revenue growth.

Effect on State Budgeting. The precise effect of having more rainy day funds is unknown. However, it could lead to the following primary types of results:

- ***Revenues Determined by Prior Ten Years.*** Currently, the state's revenues available for spending in a year is determined by the state's economic condition at that point in time. A poor economy means less revenues, and a booming economy means extra revenues. Under the measure, however, revenues available generally would be based on the past decade. As a result, the amount of revenues available may no longer reflect the state's economy at that time.
- ***Smoother State Spending.*** The level of state spending would be reduced to the extent the BSF was built up to a higher level than would exist under current law. These funds would then be available in later years when revenues fell short. This could help cushion the level of spending reductions in lower-revenue years. Over time, this measure could help limit the ups and downs of state spending and smooth out spending from year to year.
- ***Changes in Types of Spending.*** The state would spend money on different types of programs than otherwise would be the case. The measure, for example, could increase spending on a variety of one-time activities—such as repaying budgetary borrowing and debt, infrastructure projects, and temporary tax relief. In some cases, this would mean less money was available to spend on ongoing spending increases.