April 29, 2011

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

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative related to state and local appropriation limits (A.G. File No. 11-0006).

BACKGROUND

State Finance

The state spends money from two main types of accounts:

- ***General Fund.*** The General Fund is the state's core account that pays for most services. In the 2009-10 fiscal year, the state spent $87 billion from the General Fund, primarily on education, health and social services, and state prisons. The General Fund is supported primarily from income and sales taxes paid by individuals and businesses.
- ***Special Funds.*** Special funds are accounts where the revenue source is collected for a specific purpose such as a permit fee, a regulatory fee, or an entrance fee (such as a charge to enter a state park). Generally these funds can only be used for a purpose specified in state law or in the State Constitution. Types of programs that the state funds through special funds include transportation programs and environmental protection programs. In 2009-10, the state spent $23 billion from special fund accounts.

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 revenues 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 roughly 40 percent of 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. Also, in certain slow revenue growth years, Proposition 98 allows the guarantee to grow more slowly than the economy. In either of these situations, a "maintenance factor" is created. This maintenance factor is designed to return future levels of K-14 expenditures to the level it would have attained absent the earlier reduction. A formula linked to the health of the state General Fund condition determines how much of this obligation is paid in any given year moving forward.

State and Local Spending Limits

In November 1979, California voters approved Proposition 4. That measure established in the Constitution 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 later initiatives, including Proposition 98 in 1988 and Proposition 111 in 1990.

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 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. For example, in 2009-10 the state's spending limit is $81 billion. The state's Department of Finance (DOF) has estimated that the state appropriations subject to that limit were $56 billion, or $25 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 the districts' appropriations limits then reduce the spending limit of the state government by an equal amount.)

PROPOSAL

This measure makes major changes to the state and local spending limits as well as placing a limit on the amount of long-term debt that the state can owe at any one time. The measure places an annual limit on total state expenditure from the General Fund and special funds based on the growth of the state's population and inflation, and specifies how revenues that are in excess of this limit can be spent. The measure also places a limit on how much long-term debt the state can owe at any time as well as changing the way that local government spending limits are calculated. The changes made to the existing spending limits are described below.

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, 2012, the state's spending limit would be the state's General Fund and special funds expenditures in the 2011-12 fiscal year adjusted in each fiscal year thereafter for the state's cost of living and state's population growth. For each subsequent year, the spending limit would be the *actual* expenditures in the prior fiscal year adjusted for the growth factors rather than being tied to a fixed date in the past.
- ***Change in Growth Factors.*** This measure changes growth factors to be a combination of the increase in the state population and the state's Consumer Price Index (CA CPI) for the prior year. In addition, the measure specifies that if the CA CPI for the prior year is greater than the percentage change in per capita personal income, the latter is to be used in the growth factor.
- ***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 expenditures from the sale of bonds, as described in the state budget, to be exempt from the spending limit (subject to the cap described below).
- ***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.

Caps Bond Indebtedness. The measure places a new cap on the amount of long-term debt that the state can incur. The measure restricts the amount of debt service to no more than 6 percent of General Fund revenues in the current fiscal year and in each of the following four fiscal years. (Debt service is the annual payments made to investors that includes interest payments as well as repayment of the original loan amount.) This cap applies to the majority of the debt that the state uses to fund long-term infrastructure projects.

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 revenues (the combination of General Fund and special fund revenues that could not be expended under the expenditure cap) would be allocated, on an annual rather than biennial basis, to the General Fund and to special funds in proportion to expenditures from those sources. Special fund excess revenues would be returned to special funds. General Fund revenues would be allocated to the following purposes:

- ***25 Percent to the State Reserve.*** The measure creates a new account where 25 percent of the excess revenues would be placed, up to a limit of 5 percent of the allowable expenditures in any year. (Once that limit has been reached, additional funds are allocated for the two purposes noted in the next bullet.) Funds placed in this reserve could be used by the state in any year where state revenues are less than the allowable expenditure limit or to pay for costs associated with an emergency such as a natural disaster.
- ***50 Percent for Debts.*** The measure allows for excess revenues to be used to pay off any Proposition 98 maintenance factor and to pay off any voter-approved bonds.
- ***25 Percent for Schools and Roads Construction.*** The remaining funds would be allocated to local agencies and school districts for construction and modernization projects.

If there is further revenue that cannot be used for the above purposes (for example, if the maintenance factor has been paid off and further funds cannot be used for debt service), they would be placed into a new state account to fund sales tax reductions. The DOF would determine when the funds in this account had reached a level to replace the lost revenue from a one-quarter percent reduction in the sales and use tax (or further increments of one-quarter percent) for a 12-month period. At that point, the sales and use tax rate effective for the next fiscal year would be reduced by the number of one-quarter percent reductions that could be supported out of the fund.

Limits Local Government Spending. This measure replaces the existing cap on local government spending that is based on the growth factors described above and creates a new provision that limits expenditures for local entities to the level of revenues (from local taxes as well as other sources such as state funding) combined with any reserves carried in from the prior year. This is similar to the provision that already exists in the Constitution for state expenditures. The measure would not permit local residents to vote to increase their local jurisdiction's spending cap.

FISCAL EFFECTS

This measure would change the state government's spending limits in ways that could make the limit a much more prominent consideration in future budgetary decisions of the Legislature and the Governor. The measure could also affect the spending limit of some local governments. We discuss each of these fiscal effects below. The exact effects of the proposal for a government 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.

State Government

Change Would Likely Limit Spending. 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 2011-12. 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 spending for state-funded programs that could be approved in any given year by the Legislature and the Governor. In addition, allowable annual growth in the limit would over time be less than the growth in state revenues. This would also tend to constrain state spending below levels that would otherwise occur.

Mix of State Spending Could Change. The provisions in the measure, combined with the existing provisions of Proposition 98, would likely result in changes in the mix of annual state spending. For instance, the percentage of the state budget dedicated to education could increase over time. This is because the amount of funding guaranteed by Proposition 98 is linked to General Fund revenues, which would tend to grow faster than the total expenditures allowed under this measure. Furthermore, the measure may lead to increased funds going to the state's reserve, payment of debts (including the Proposition 98 maintenance factor), and school and transportation infrastructure. Finally, over time, the measure may lead to increased tax rebates.

May Reduce Ability to Sell Bonds in the Short-Term. Annual General Fund debt service that is covered by the cap in this measure is already around 6 percent of General Fund revenues. If the measure is construed to include debt service on transportation bonds ultimately reimbursed from non-General Fund sources, then annual debt service is already around 7 percent of General Fund revenues. These figures are forecast to grow. Under this measure, this means that in the short-term, the state would likely be unable to sell additional bonds to fund infrastructure projects. As the amount of debt service as a percent of General Fund revenues is reduced as the state pays off debt, new bonds would be able to be issued.

Local Governments

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 current local governments budgeting practices and on how the measure's terms are interpreted by the courts. For most local governments, the effects if this measure would probably not be substantial.

SUMMARY OF FISCAL EFFECTS

This measure would result in the following major fiscal effects:

- Revised spending limit likely would constrain state spending below levels that otherwise would have occurred. Also, over time the percentage of the state budget devoted to education expenses likely would increase, and the percentage devoted to most other areas likely would decrease. The measure would also likely increase the level of state resources going to the state reserves, payment of certain debts, infrastructure spending, and tax rebates.
- Possible reduction in the amount of new bond debt that could be sold to fund infrastructure projects, particularly in the short-term.

Sincerely,

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Legislative Analyst

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