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Date: December 1, 2003

To: Members of the California Legislature

From: Elizabeth G. Hill
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Subject: Comments on the Administration's Spending Limit Proposal

During the November 25, 2003 hearings of the Assembly Budget and Senate Budget and Fiscal Review Committees, our office was asked for comments on the administration's spending limit proposal. This memo (with attachment) responds to those requests.

Please feel free to contact me with any questions at 445-4656.

Attachment

THE ADMINISTRATION'S SPENDING LIMIT AND BUDGETARY RESERVE PROPOSAL

On November 24, 2003, the administration released a draft of its expenditure limit and budgetary reserve fund proposal. In order to assist the Legislature in reviewing the proposal, we have prepared the following initial comments regarding its provisions and key issues associated with it.

KEY PROVISIONS OF THE MEASURE

Scope and Coverage

- The proposal adds an article to the State Constitution which creates (1) a more stringent General Fund spending cap, (2) a budget stabilization fund, and (3) expanded fiscal powers for the Governor.
- It generally leaves intact the existing Gann spending limit, which would continue to apply to special funds and local governments.

General Fund Spending Cap

- 2004-05 spending would be based on the amount of General Fund revenues from sources other than borrowing or prior-year reserves. This amount would be estimated by the Director of Finance and fixed as of the 2004 May Revision.
- Spending thereafter would be limited to the 2004-05 level, as adjusted annually for population and per capita personal income. These growth factors are the same as those used for the state's current spending limit.

Budget Stabilization Fund

- Revenues above the spending cap would be placed into this fund.
- Spending from this fund would be allowed for tax rebates, debt-service on deficit bonds, emergencies decreed by the Governor (see below), or revenue shortfalls.

Gubernatorial Powers

- Allows the Governor to implement midyear fiscal changes to eliminate deficits unless alternatives are adopted by the Legislature with a two-thirds vote in 30 days.
- Allows money above the limit to be spent from the reserve for any emergency the Governor declares, with legislative approval.

Proposition 98 Interactions

The proposed spending cap would have the following three interactions with Proposition 98:

- ***Maintenance Factor.*** Generally, the minimum guarantee calculation would no longer restore any outstanding "maintenance factor" after 2004-05. We estimate that this would reduce Proposition 98 spending by hundreds of millions of dollars annually in the first couple of years, and by around $2 billion annually in the long run absent over-appropriations of the minimum guarantee.
- ***Funding Stability.*** Currently, the minimum guarantee is susceptible to both upward and downward fluctuations in General Fund revenues that tend to be more volatile than per capita personal income. If funds from the measure's stabilization account were used to assist the General Fund in bad fiscal years, the proposal could smooth out the volatility in minimum guarantee funding. If the stabilization funds were used for other purposes, the proposal would require less Proposition 98 funding than would be the case under current law.
- ***Funding Share.*** Under current law or under the spending cap, the minimum guarantee is likely to require a declining share of General Fund revenues for the foreseeable future because (1) student attendance is growing at a slower rate than the general population (and is projected to decline by 2008-09) and (2) local property tax revenues are forecasted to grow at a faster rate than General Fund revenues. Proposition 98 would only "crowd out" non-Proposition 98 funding under the proposed limit if (1) local property tax revenues slowed significantly, (2) the state chose to over-appropriate the minimum guarantee, or (3) the student population started to grow faster than state population.

Effects on Special Funds

- As noted above, this measure does not alter the treatment of special funds under the existing spending limit. For example, the current exemptions for transportation funding and certain tobacco tax-supported expenditures would remain. Thus, spending in these areas would not be directly affected by the measure.
- In addition, because the state has considerable room under its existing spending limit, it would still be possible for new and expanded programs to be financed from increased special funds revenues under the measure.

LEGISLATIVE ISSUES AND CONSIDERATIONS

Are the New Gubernatorial and Administrative Powers Excessive?

- The measure gives the administration and the Director of Finance very broad and expanded powers, including defining what constitutes an emergency for the State of California.
- The Director of Finance is solely responsible for determining (1) the initial revenue estimate for 2004-05 that ultimately determines the spending cap, (2) whether expenditures exceed the limit, and (3) whether there is a revenue shortfall that will precipitate a fiscal emergency.
- The Governor can declare a fiscal emergency, and implement a plan to address it involving either spending reductions or tax increases, without legislative concurrence. Specifically, the Governor can submit a plan that will take effect within 30 days unless alternative legislation is passed with a two-thirds vote that addresses the problem.
- The above provisions have the potential to fundamentally shift the balance of power between the Executive and Legislative branches of government. *Given this, does the measure eliminate important checks and balances in our system regarding spending or taxation decisions?*

Is the Base Spending Amount the Right One?

- The measure sets the base from which future expenditures can grow as the level of revenues projected for 2004-05—roughly $75 billion by our estimate. However, this is $15 billion below our estimate of current-law expenditures for that year.
- Actions taken to close this gap in 2004-05 will—to a large degree—"lock in" future revenue and expenditure levels.
- For example, if the 2004-05 shortfall were addressed partly through borrowing or other one-time measures, an unresolved funding gap would remain in future years, absent other actions. The proposed limit would largely preclude the state from raising taxes after 2004-05 to cover any such remaining gap.
- In addition, the economy and revenues are still in the early stages of recovering from the recession. Typically, the state experiences above-average revenue growth as the economy continues to recover. Use of these "additional" revenues to resolve remaining portions of the budget gap would be restricted under the measure.
- This raises the question: *Is the 2004-05 revenue level reasonable for locking-in future expenditures?*

Other Issues

- ***Which Expenditures Are Subject to the Limit?*** The measure states, "for the 2004-05 fiscal year, total expenditures of General Fund revenues may not exceed the amount of General Fund revenues . . .," where revenues are defined as *excluding* borrowed funds and carry-over reserves.

  — The measure would appear to allow expenditure of these excluded funds, without regard to the limit.

  — If this is the case, loans—whether from within and/or outside of state government—could be used to support spending above the limit in future years.

- ***Should Loan Repayments Be Exempt?*** The measure allows spending from the reserve to retire deficit bonds to be exempt from the limit, but does not provide similar exemptions for repayment of other types of budgetary borrowing, such as loans from transportation funds or local governments. *Should repayment on these alternative forms of debt also be specifically exempt?*

- ***Treatment of Fees.*** The measure requires that the General Fund spending limit be reduced when funding responsibilities are shifted from General Fund taxes to other sources. This would appear to limit the state's ability to utilize fee increases to replace General Fund support for such things as higher education and fire protection.