December 22, 2009

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 and statutory amendment related to the budget process (A.G. File No. 09-0070, Amdt. #1-S).

## BACKGROUND

### The State Budget Process

The State Constitution gives the Legislature power to appropriate state funds and make midyear adjustments to those appropriations. The annual state budget act is the Legislature's primary method of authorizing expenses for a particular fiscal year. The Constitution requires that (1) the Governor propose a balanced budget by January 10 for the next fiscal year (beginning July 1) and (2) the Legislature pass the annual budget act by June 15. The Governor may then either sign or veto the budget bill. The Governor may also reduce or eliminate specific appropriations items using his or her "line-item veto" power. The Legislature may override a veto with a two-thirds (67 percent) vote in each house. Once the 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.

***Two-Thirds Vote Requirement for Passing the State Budget.*** The Constitution requires a two-thirds vote of each house of the Legislature for the passage of General Fund appropriations (except appropriations for public schools), urgency measures, and bills that change state taxes for the purpose of increasing state revenues. Certain budget actions (for example, a decision by the Legislature and the Governor to change the types of services that the state provides) require changing state law. Such changes in law often are included in "trailer bills" that accompany passage of the budget each year. In order for these trailer bills to take effect immediately rather than, as with most other bills, on January 1, they must be passed by a two-thirds vote of each house.

***Late Budgets.*** When a fiscal year begins without a state budget, most expenses do not have authorization to continue. Over time, however, a number of court decisions and interpretations of the Constitution by the State Controller and other officials have expanded the types of payments that may continue to be made when a state budget has not been passed. For example, state employee salaries currently continue to be made in this scenario with several notable exceptions—such as the salaries of the Governor, other elected state officials, Members of the Legislature, and their appointed staff, who receive no salaries after July 1 until a budget is passed. Any salary payments which are withheld from these officials then are paid upon passage of the budget.

## Budgeting and Reserve Requirements

***Spending Limitations.*** The 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 generally are able to decide how much General Fund money to spend in a given year. In some years, the Legislature and the Governor have used "one-time revenues"—tax and other revenues not likely to be collected in future years—to expand state budget commitments. (It was not always clear at the time if the revenues were one-time in nature.) This is one reason why the state now faces a recurring annual budget deficit.

***Rules for State's 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. The state may set aside a portion of these revenues into one of two rainy day reserve funds. Any money in these reserves can pay for unexpected expenses, cover drops in tax receipts, or be saved for future years. The two funds are:

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

- ***Budget Stabilization Account (BSA).*** Proposition 58 created the BSA. Each year, 3 percent of estimated General Fund state revenues are transferred into the BSA. The Governor, however, can stop the transfer in any year by issuing an executive order, as he has done in some recent years when the state has faced severe fiscal problems. In addition, the annual transfers are not made once the balance of the BSA reaches a specified "target"—the higher amount of $8 billion or 5 percent of revenues (currently about $4.5 billion). By passing a law, the state can transfer funds out of the BSA and use the funds for any purpose.

***Fiscal Emergencies.*** Proposition 58 also allows the Governor to declare a fiscal emergency if he or she determines after the budget has been enacted that the state is facing substantial revenue shortfalls or spending overruns. In such cases, the Governor must propose legislation to address the fiscal emergency, and call the Legislature into special session. If the Legislature fails to pass and send to the Governor legislation to address the budget problem within 45 days, it would be prohibited from (1) acting on any other bills or (2) adjourning until such legislation is passed.

***Requirements for Budget and Infrastructure Planning.*** State law provides that state departments should develop budgets that define their programs' objectives and budget for those objectives each year. The Governor is required to submit to the Legislature a five-year infrastructure plan each year.

## PROPOSAL

This measure makes significant changes to the state's budget process.

### Changes in Vote Thresholds for State Budget and Taxes

***Majority Vote May Pass Budget Bill and Related Legislation.*** Under this measure, appropriations made in the budget bill, amendments to the budget bill, and budget trailer bills may be passed by a majority vote in each house.

***Expands Two-Thirds Vote Requirement to More Revenue Actions.*** The measure amends the Constitution to provide explicitly that all measures that impose a new tax for the purpose of increasing state revenues must be approved by two-thirds of the Members of each house of the Legislature. The measure also provides that a fee "that replaces revenue that in the same or the prior fiscal year was generated by a tax" requires a two-thirds vote. These provisions would expand somewhat the existing constitutional two-thirds vote requirements related to state taxes.

### Governor Given Power to Reduce Spending and Other Budget Duties

***New Expenditure Reduction Authority for the Governor***. The proposed measure provides that if the Legislature has not sent bills to the Governor addressing a fiscal emergency by the 45$^{th}$ day following the issuance of the fiscal emergency proclamation, the Governor may reduce or eliminate any existing appropriation contained in the budget act for that fiscal year that is not otherwise required by the Constitution or federal law. The total amount reduced cannot exceed the amount necessary to balance the budget. The Legislature may override all or part of the reductions by a two-thirds vote of each house.

***Additional Information Required in Governor's Budget Proposals.*** Under this measure, in addition to submitting a balanced budget proposal and a five-year infrastructure plan to the Legislature in January, the Governor would have to submit performance standards for state agencies and programs, projections of nonrecurring state revenues, and state projections of anticipated expenditures and revenues for the next five fiscal years. The Governor's recommendations for expenditure reductions or additional revenues would have to include an estimate of the "long-term impact" the proposals would have on the California economy.

### New Requirements for One-Time State Revenues

***Definitions of "Nonrecurring" State Revenues.*** This measure establishes distinctions between recurring and nonrecurring state revenues. In general, nonrecurring revenue is defined as proceeds of taxes received by the state's General Fund in a fiscal year that exceed the amount that the state expected to receive in that fiscal year and that are *not* expected to be received in future fiscal years. Our two offices—the Legislative Analyst and the Director of Finance—would produce a joint estimate of the amount of nonrecurring revenue deposited in the General Fund by May 31 each year. A portion of the excess revenues would be deducted from the May 31 calculation of nonrecurring revenues, if necessary, to allow the state to meet its annual minimum funding guarantee for schools and community colleges.

***Use of Nonrecurring Revenues.*** The Legislature may then only use nonrecurring revenue for one-time expenditures. One-time expenditures include the following:

- Transfers to what the measure describes as the "Budget Stabilization Fund." (We assume this provision would be interpreted to allow transfer to the BSA established by Proposition 58.)
- Spending on one-time infrastructure or other capital outlay projects.
- Spending to retire outstanding state bond debt.
- One-time tax relief.
- Paying down unfunded liabilities for retired state employees' health and dental benefits.
- Spending necessary to meet specified outstanding payments to schools and community colleges.

### Requirements to Identify Funds to Pay for Program Expansions

The proposed measure contains several provisions to constrain the state's ability to create or expand state programs—particularly those that would result in a net increase in state costs or net decrease in state revenues of more than $25 million. With certain exceptions described in the measure, lawmakers would have to identify additional revenues or reductions in existing expenditures to cover any such net change in state costs or revenues. The Legislative Analyst would be required to analyze bills and constitutional amendments and determine whether the $25 million threshold (or related thresholds described in the measure) is applicable.

### Performance Standards for State Programs

This measure amends the Constitution to require the Legislature to establish a process to review the performance of state programs at least once every ten years. State departments would be required to develop and maintain data that track the outcomes of their programs and propose law changes to improve those outcomes.

### Late Budgets Would Result in Legislators Forfeiting Pay

This measure would extend the Legislature's deadline for passing the annual budget by ten days—from June 15 to June 25. In any year when the budget is not passed by the Legislature by the deadline, this initiative proposal would prohibit Members of the Legislature from collecting a portion of their annual salary or reimbursements for travel or living expenses. This prohibition would last for the period from midnight on June 25 until the day that the budget bill is presented to the Governor. Lost salaries and expenses could not be paid retroactively.

## FISCAL EFFECT

This measure likely would result in both *direct* fiscal effects for the state (additional spending and/or savings) as well as *indirect* changes to state and local government budgets.

### Direct Fiscal Effects

***Additional Spending.*** New state spending would likely be needed to develop and use new performance standards, analyze the fiscal implication of legislation, and implement other budget process requirements resulting from the measure. In particular, new information technology expenditures could result to address these new requirements. These costs could total in the tens of millions of dollars annually.

***Reduced Spending.*** In years when the budget bill is not passed by June 25, legislators would forfeit any salary or reimbursement for living and travel expenses. In any year that the Legislature does not pass a bill by June 25, the measure could reduce state costs by around $50,000 per day until the passage of a budget.

### Indirect Fiscal Effects

Indirect fiscal effects of this measure—while impossible to estimate precisely—could be much more significant than the direct fiscal effects described above. This measure makes significant changes to the way the state budgets its finances, considers legislation, and monitors the outcomes of its programs. These changes may result in a number of indirect fiscal effects, including:

- ***Making It Easier for the Legislature to Pass a Budget.*** By reducing the voting requirement from two-thirds to a majority, this measure would make it easier for the Legislature and the Governor to agree on a state budget in some years. In some cases, this could affect the content of the budget. For instance, spending priorities in a given budget could be different. The extent of the impacts would depend on a number of factors—including the state's financial circumstances and the composition of future Legislatures.

- ***Giving the Governor Midyear Authority to Reduce Spending.*** In some years, this measure would allow the Governor to reduce spending below the level that might result under existing constitutional provisions. This could result in some programs' share of total spending rising and others falling.

- ***Restricting Use of One-Time State Revenues.*** The measure, by dedicating one-time revenues to specified one-time expenses, could make it harder for the state to make new ongoing state spending commitments in some years. The measure, therefore, could increase spending on a variety of one-time activities—such as repaying budgetary borrowing and debt, infrastructure projects, and temporary tax relief. Over time, this could reduce the size of some ongoing state-funded programs.

- ***Requiring Identification of Funding for Certain Program Expansions.*** This measure could make creating or significantly expanding programs more difficult because it requires identification of funding sources for some such efforts. This could result in less state spending on ongoing programs in future years.

- ***Requiring New Efforts to Maintain Program Outcomes.*** The measure's requirements for new data concerning program outcomes could result in different spending decisions by future Legislatures. These requirements could result in greater or less state spending on particular programs.

Taken together, these changes have different fiscal effects, some of which may offset each other. On balance, however, the indirect effects of the measure could result in smaller annual state spending for ongoing programs and greater spending for one-time expenditures in years when the state collects more taxes than expected. In addition, the share of state spending dedicated to each program could change. The magnitude of these changes, however, is impossible to estimate and would depend on future actions of the Legislature, the Governor, and voters.

**Summary of Fiscal Effect**

This measure would have the following major fiscal effects:

- Direct increases in state spending—potentially tens of millions of dollars per year—to administer new budgeting process requirements.
- Potentially significant, but unknown, indirect fiscal effects for the state. Over time, these could include lower annual spending for ongoing state-funded programs and higher one-time expenditures (such as for infrastructure projects, debt reduction, or temporary tax relief).

Sincerely,

Mac Taylor
Legislative Analyst

Michael C. Genest
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