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AN EXAMINATION OF THE

GOVERNOR'S STATE EXPENDITURE

LIMITATION PROGRAM

April 30, 1973

LEGISLATIVE ANALYST

STATE OF CALIFORNIA

STATE CAPITOL, SACRAMENTO

AN EXAMINATION OF THE GOVERNOR'S STATE EXPENDITURE LIMITATION PROGRAM

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TABLE OF CONTENTS

INTRODUCTION

This report is an examination of the Governor's initiative, which, if adopted by the electorate, would become effective in the 1974-75 fiscal year.

Although this measure is entitled "Revenue Control and Tax Reduction" it does not limit state revenues. It does limit state expenditures, based on a declining percentage of personal incomes of Californians.

Had this measure been adopted in 1966, the Governor's proposed budget for 1973-74 would have to be reduced by about $2.4 billion or 25.5 percent. Such a reduction would in effect eliminate all of the existing direct property tax relief programs and in addition require a 30 percent curtailment in state support for local schools.

If this measure is adopted by the electorate, 1974-75 workload expenditures will have to be reduced by either $79 million or $420 million, depending upon whether the Legislature approves the Governor's program (SB 238) which includes postponment of the date of the sales tax increase. By 1977-78, the required reductions in state workload expenditures will be either $672 million or $1,099 million. Reductions of this magnitude are equivalent to either 12.2 percent or 19.9 percent of Budget Act appropriations.

Under this initiative it is almost inevitable that reductions in state expenditures will be shifted to local governments and cause increases in local property and sales taxes.

The estimates and projections in this report, with one exception, are based on existing law and data available during April 1973. Future law or economic changes could affect our estimates, perhaps significantly.

We have already received one legal opinion (pertaining to the Veterans Farm and Home Loan Fund) from the Legislative Counsel which conflicts with the Governor's interpretation of his initiative. There is a strong probability that subsequent opinions also will contain interpretations which will affect our evaluation of this program.

The next section summarizes the main findings of our report, and it contains references to the detailed discussion in the text.

Summary of Findings

Chapter 1

1. We find no valid basis for the argument that Californians pay 44 percent of their incomes in federal, state and local taxes. (Pages 1 - 8)

2. The 44 percent tax burden estimate is misleading and highly inflated because many types of receipts have been erroneously classified as taxes, because the income base used to make this calculation is too small, and because the calculations ignore economic reality when they assume none of our tax collections is shifted to taxpayers in other states or nations. (Page 8).

3. The Governor has erroneously classified the following types of receipts as taxes in order to obtain his 44 percent burden figure:

   1) Admissions to University basketball and football games.
   2) University book store receipts and board and room charges.
   3) Private donations to the University.
   4) Highway bridge tolls.
   5) Employee retirement contributions.
   6) Local airport receipts.
   7) Local hospital charges.
   8) U. S. postal receipts.
   9) U. S. natural resource receipts.
   10) The sale of agricultural products by the federal government.

   (Pages 3 - 5)

4. The Governor's state tax burden estimate is 41 percent higher than the revenue figure in his own Budget. (Page 3)

5. The Governor's tax burden estimate has been grossly inflated by including corporate taxes in tax collections, while excluding undistributed corporate profits from the income base. (Page 5)

6. The Tax Foundation's estimate of total tax burden is 32.6 percent. (Pages 1,8)

7. The Governor's forecast that state revenues will total $47.1 billion by 1989-90 assumes that tax rates will be repeatedly increased in the future. (Pages 8 - 16)

8. During the 1960's, state expenditures increased faster than revenues due to rapid increases in higher education enrollments, expansion of medical assistance, and growing welfare costs. At the present time, these state expenditure programs are growing at more moderate rates. (Page 12)

9. Our workload projections of state costs for the next four years indicate that these expenditures can be financed without increasing state tax rates. (Page 12)

10. The Governor's report does not explain why he assumes repeated tax rate increases will be enacted in the future. (Page 14)

Chapter 2

11. The Governor's February 8, 1973, press release indicated that personal income taxes would be reduced ten percent on a permanent basis. The initiative proposes a 7.5 percent credit and allows the Legislature to modify (or eliminate) this credit. (Page 17)

12. The initiative proposes a one-time 20 percent income tax credit, but it also contains language which allows a lesser amount if the General Fund surplus is insufficient to fund the full credit. (Page 18)

13. The Governor's press release referred to the 1973-74 tax limit base as $9.8 billion, or 8.75 percent of personal income. These figures are obsolete. The Governor's office now estimates that the tax base is $9.3 billion, or 8.34 percent of personal income. (Page 18)

14. There are major inconsistencies between (a) the items used by the Governor to estimate tax burden on Californians, (b) the items included as revenue subject to the proposed expenditure limitation, and (c) the items included as revenue in the Governor's Budget. These inconsistencies have not been explained. (Pages 20 - 22)

Chapter 3

15. The Governor's constitutional initiative, which adds Article 29, does not limit state revenues. It does limit state expenditures, based on a declining percentage of personal incomes of Californians. To exceed the expenditure limitation, Article 29 requires the assent of the Governor and a two-thirds vote of each house of the Legislature. Without the assent of the Governor, this initiative prohibits the Legislature, on its own motion, from exceeding the expenditure limitation, even if it acts by a two-thirds vote of each house. (Pages 23, 36, and 37)
16. This initiative recommends, but does not require, the Legislature and the Governor to refund to the taxpayers those revenues which exceed the expenditure limitation. (Page 35)
17. Under emergency conditions, the Governor and the Legislature can increase taxes to fund expenditures in excess of the limitation, but such tax increases will expire two years after their enactment, unless in the interim they are approved by a majority vote of the electorate. (Page 37)
18. As a result of the restrictive language in Section 9 (a) of Article 29, there will be an incentive for the state to reduce the senior citizens' property tax assistance, and the renters' tax credits No parallel incentive will exist for the state to reduce the homeowners' exemption or the business inventory exemption, for, if the Legislature reduces them, the expenditure limitation will be commensurately decreased. (Pages 41,42)

19. Due to the restrictive language in Section 10 (a) of this initiative, the state will have no incentive for increasing senior citizens' property tax assistance, renters' tax credits, the business inventory and the homeowners' exemptions, because these property tax relief programs are within the expenditure limitation, and any increases would have to be funded by reducing other state programs. (Pages 42,43)

20. Article 29 does not authorize an increase in the expenditure limitation if the federal government shifts costs to the state. (Page 44)

21. Under Article 29, the Legislature has the option of reducing the gasoline tax rather than cutting General Fund expenditures in order to stay within the expenditure limitation. (Page 46)

22. Article 29 will provide an incentive for the Legislature to appropriate the least possible amount annually for capital outlay, because the appropriation counts towards the limitation for that year, even though the funds will be spent over several years. This in turn may lead to substantive inefficiencies in the planning, budgeting, and contracting process for construction needs. (Page 47)

23. Article 29 probably makes it possible for the Legislature, and does make it possible for local governing bodies, to increase, without a vote of the electorate, the maximum local property tax rates. Local government's authority in this regard is a substantial loosening of the maximum property tax rate limits established by Chapter 1406 of 1972 (SB 90). (Pages 49,50)

24. If the state authorizes local government to impose income taxes, Article 29 requires a two-thirds vote of the Legislature rather than a majority vote, but if the state authorizes local government to increase local sales taxes, or other excise taxes, only a majority vote of the Legislature is required. (Page 51)

25. The Governor's initiative makes several substantial policy changes in existing law (Chapter 1406 of 1972 - SB 90) regarding the reimbursement

of local governments for state mandated programs.

(a) If a state mandate applies to private persons, groups, or organizations as well as to local government, Article 29 does not require the state to reimburse local government for the mandate.

(b) The state is not required to reimburse local governments for all additional mandated costs under Article 29 because it excludes from the state's obligation additional costs caused by increases in workload.

(c) Article 29 does not require the state to reimburse local government for the cost of statutes defining a new crime or changing the definition of an existing crime. (Page 56)

26. The requirement in Article 29 that the state reimburse local governments for additional state mandated costs contains major flaws. (Pages 55,56)

27. Article 29 creates a strong possibility that government costs will be shifted from the state to the local taxpayer and in particular to the local property and sales taxpayer.

Chapter 4

28. If this limitation plan had been adopted in 1966, state expenditures in 1973-74 would be $2,351 million, or 25.5 percent, below the Governor's 1973-74 Budget. (Page 64)

29. This reduction can be assumed to have eliminated the following existing state programs:

(a) The homeowners' property tax exemption.

(b) The senior citizens' property tax assistance.

(c) The business inventory exemption.

(d) The renter tax credit.

(e) The sharing of cigarette tax revenues with cities and counties. (Pages 66,67)

30. In addition to these eliminations, the following reductions would have been made in other state programs:

(a) State support for local schools would have been reduced by $740 million, or 30.4 percent.

(b) Higher education support would have been reduced by $134 million, or 15.7 percent.

(c) Social welfare support would have been reduced by $125 million, or 14.6 percent.

(d) The Department of Health's budget would have been reduced by $147 million, or 15.3 percent.

(e) And, $123 million would have been cut from other state budgets. (Pages 71 - 73)

Chapter 5

31. If the Governor's expenditure limitation plan is adopted, then state workload expenditures will have to be reduced by either $79 million or $420 million in 1974-75, depending upon whether the Governor's program (SB 238) to return the current surplus is enacted. By 1977-78, the required reductions in expenditures will be either $672 million or $1,099 million. (Pages 82,83)

32. It would appear to be imprudent for the Legislature to enact the Governor's program (SB 238) to return the current surplus to the taxpayers, or any other measure (such as changes in revenue accruals) which significantly reduces the initiative's 1973-74 limitation base, because such actions will magnify expenditure reductions in the future to the point of impracticality. (Page 83)

33. State expenditures will be reduced to the 7.0 percent of personal income level much faster than the Governor predicted. The Governor's report indicated that it would take about 15 years to reach the initiative's goal. Our estimates indicate that this "goal" will be reached in either

the 8th or 11th year, which means that expenditures will decline faster than the Governor anticipated. (Page 83)

34. Budget Act expenditure categories will bear the brunt of reductions under the Governor's limitation. In 1977-78, workload expenditures in this category will be reduced by either 12.2 or 19.9 percent, depending upon whether SB 238 is adopted by the current Legislature. (Page 87)

Chapter I

Examination of the Arguments for a State Tax Revenue Limit/1

The two main arguments advanced by the proponents as the justification for the state tax revenue limit are as follows:

1. Californians pay 44 cents of every dollar in taxes. If left unchecked, in only 15 years our combined federal, state, and local taxes will be a staggering 54 cents of every dollar we earn./2

2. Without the proposed limit, state revenues will almost quintuple during the next 17 years, to a total of $47.1 billion by 1989-90./3

Note that these arguments use the terms "taxes" and "revenues" interchangeably, as if they had the same meaning.

I

This part of the chapter examines the statement that taxes take 44 percent of the personal income of Californians.

For many years we have relied upon reports of the Tax Foundation/4 regarding the magnitude of federal, state, and local tax burdens. The Foundation's 1973 report/5 shows that tax receipts were 32.6 percent of Net National

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/1 Although the proponents of this measure describe it as a revenue limit, it is a limit on expenditures, not revenues. See Chapter 3.

/2 Full page advertisement in the San Francisco Chronicle on April 16, 1973, by "Californians for Lower Taxes". Also, see Governor's March 12, 1973 report on "Revenue Control and Tax Reduction", page 1.

/3 Governor's report, page 39.

/4 A private, nonprofit organization, founded in 1937 to engage in nonpartisan research and public education on the fiscal and management aspects of government

/5 Facts and Figures on Government Finance, 17th Biennial Edition - 1973, page 34.

Product during calendar 1970. The Governor's estimate for fiscal year 1969-70 is about a third higher than this figure, and we were somewhat baffled by the magnitude of this discrepancy. To resolve this conflict, we contacted the Governor's office to ascertain how the 44 percent figure was calculated, and the answer is summarized in Table 1.

Table 1

Governor's Estimates of
Californians' Total Tax Burden

1969-70 Data

By Level of Government	Amount (millions)	As Percent of Californians' Personal Income
Federal	$21,584	25.94%
State	8,116	9.76%
Local	7,488	9.00%
Total	$37,188	44.70%

Table 1 is misleading for three reasons:

First, the dollar magnitude of the tax burden has been inflated by classifying as taxes many kinds of receipts which are not taxes and by double counting several categories of receipts.

For example, the Governor's state tax burden estimates are between 41 and 50 percent higher than those contained in his own Budget. This difference is summarized in Table 2.

Table 2

Comparison of State Taxes and Revenues

During 1969-70

(in millions)

	Governor's Budget (a)	Governor's Tax Burden Estimates	Difference	
			Amount	Percent
Total Taxes	$5,409	$8,116	+$2,707	+50.0%
Total Taxes and Revenues	5,742	8,116	+ 2,374	+41.3%

(a) Actual collections for 1969-70 as shown in Schedule 2 on page B-2 of the Governor's 1971-72 Budget.

Public Finance economists generally define a tax as "a compulsory payment by the taxpayer for the general support of government without any right to demand any particular service from the government."

The Governor's estimate of tax burden erroneously classifies the following types of state receipts (a partial list) as taxes, and this misclassification accounts for the difference between his tax burden and his Budget figures.

State Receipts Misclassified as Taxes

Millions

1. Higher education auxiliary enterprises: $ 89

Includes book store receipts, admissions to University basketball and football games, board and room charges, etc.

2. Other education charges: 116

Includes student tuition and fees.

3. Highway bridge tolls and other charges: 54

These receipts do not meet the definition of a tax because a specific service is provided for the payment of the fee.

		Millions
4.	Donations:	$ 31
	Consists mainly of gifts to the University.	
5.	Employee retirement contributions:	376
	Employees have the right to withdraw these funds when they leave government service.	
6.	Local government employer retirement contributions:	189
	Classifying these contributions as state taxes is erroneous because these same receipts are also included in local taxes.	
7.	Earnings on retirement investments:	268
	This is another example of double counting because a large share of these receipts consists of interest on securities issued by governments.	
8.	Unemployment compensation:	531
	This is an insurance system.	
9.	Workmen's compensation contributions:	105
	This is an insurance system.	

	Local Receipts Misclassified as Taxes	Millions
1.	Airport and miscellaneous commercial receipts:	$111
2.	School lunch receipts:	133
3.	Hospital charges:	431
4.	Water transportation terminal charges:	51
5.	Donations and insurance adjustments:	200

In apportioning the federal tax burden among Californians, the Governor erroneously included the following types of receipts (a partial list) as taxes:

Federal Receipts Misclassified as Taxes Paid by Californians

	Millions
1. Postal receipts:	$685
2. Natural resources:	251
3. Sale of agricultural products:	97

The Governor also double counted federal motor vehicle fuel taxes ($418 million) and other gross receipts taxes ($175 million) because they were included both in the excise tax category and in the "other revenue" category.

Another example of double counting is in the estimate for individual income taxes and insurance trust revenues (see Table D in the Appendix). Part ($124 million) of these trust receipts consist of state and local government employer contributions to OASDI.

The income tax total in the Governor's estimate of tax burden is overstated by about $1 billion, because only half of income tax refunds were deducted from gross collections.

Table A in the Appendix to this report contains a complete reconciliation between the estimates of state taxes and revenues as contained in the Governor's Budget and those used in his tax burden estimates. Tables B, C, and D in the Appendix contain the details of the Governor's tax burden estimates for state government, local government, and the federal government; these figures reconcile to the totals contained in his March 12, 1973 report on "Revenue Control and Tax Reduction."

Second, the Governor's estimate of tax burden has been grossly inflated by including corporate taxes in tax collections while excluding from income undistributed corporate profits.

The Governor's estimate of tax burden includes the following taxes paid by corporations: property taxes (corporations pay 40 percent or more of property taxes); state and local sales taxes (corporations pay about 20 percent of sales taxes); gasoline taxes, income taxes, and many other kinds of taxes. But, on the income side, the Governor's estimate excludes undistributed corporate profits. Thus, again, the percentage which taxes are represented to take out of income is artificially ballooned.

The Tax Foundation uses a different and more realistic income base for measuring tax burdens, namely, net national product which includes undistributed corporate profits.

For those not familiar with the components of personal income, Net National Product and Gross National Product (GNP), we have inserted Table 3 which summarizes these national economic data for calendar 1970.

Table 3

Comparison of U.S. Personal Income,
Net National Product and Gross National Product
1970 Data

	Billions
1. Components of Personal Income	
Wages and salaries	$541
Other labor income	31
Proprietors' income	67
Rental income	23
Dividends	25
Interest income	65
Net transfer payments	52
Total Personal Income	$804

Table 3 (cont'd)

	Billions
2. Additions for Net National Product	
Corporate profits after dividends	$ 46
Indirect business taxes	93
Net transfer payments	-18
Interest and other adjustments	-39
Net National Product	$886
Plus capital consumption allowances, equals	88
3. Gross National Product	$974

Separate estimates of net state product are not calculated for California, but the UCLA Business Forcasting Project does estimate Gross State Product (GSP) and in calendar 1969, it was $101.2 billion. This is 22 percent larger than the $83.2 billion personal income figure the Governor used to calculate tax burden.

This difference in income bases can radically affect the estimate of the total tax burden even if you do not question (and we do) the estimate of tax collections. This point is illustrated by the following calculations:

		Millions	
I.	Governor's estimates of total tax collections	($37,188)	= 44.70%
	California Personal Income	($83,192)	
II.	Total tax collections (Governor's estimate)	($37,188)	= 36.75%
	California Gross State Product	($101,200)	

Third, the Governor's estimate erroneously assumes that all taxes collected in California are paid by Californians from their personal incomes.

A substantial amount of these tax collections are shifted to taxpayers in other states and nations, either through higher prices or reduced corporate dividends. One example of this shifting occurs in the aerospace industry, which accounts for about 30 percent of total manufacturing employment in California. The February, 1973, newsletter of the Security Pacific Bank points out that the main customers of this industry are the federal government, interstate and foreign air carriers, and foreign nations which purchase our high technology systems.

In conclusion, we find no valid basis for the argument that Californians pay 44 percent of their incomes in federal, state, and local taxes. This estimate is misleading and highly inflated because many types of receipts have been erroneously classified as taxes, because the base used to make this calculation is too small, and because the calculations ignore economic reality when they assume that none of our tax collections are shifted to taxpayers in other states or nations. For the purposes intended it would be far more reasonable to use the 32.6 percent figure of the Tax Foundation.

II

This part of the chapter discusses the argument: "In only 15 years taxes will be a staggering 54 percent of Californians' personal income."

To reach that conclusion, the Governor estimated that state revenue will almost quintuple during the next 17 years, from $9.8 billion in 1973-74 [6/] to $47.1 billion in 1989-90. This forecast is not a projection of revenues under existing laws. The estimate assumes that tax rates will be increased every few years in the future. To support this assumption, the Governor relies upon the average annual increase in tax revenues over the last 13 years.

6/ Chapter 2 indicates that the tax revenue limit base for 1973-74 has been revised downwards from $9.8 billion to $9.3 billion.

During that period, personal income tax withholding and accrual accounting were adopted, tax collections were accelerated, and two major tax increases were enacted. Revenues from these increases were used to balance state budgets, to expand state school aid, and to implement a major new program of property tax relief.

It is highly speculative to assume that this pattern will be repeated over the next 17 years. The financial pressures on state government are not constant over time. To illustrate the differences in state expenditure and income trends, we will next examine three recent periods starting with the early 1960's, and then comment on our workload forecasts of state expenditures during the next four years.

1. Phase I, 1961-62 to 1966-67. During the early 1960's, most of the major expenditure categories increased faster than the growth in personal income. At the beginning of this period, the state fiscal condition was favorable, largely due to the enactment of the 1959 tax program. However, as expenditures increased faster than revenues, (see column I in Table 4) it became necessary to enact new revenue measures to balance the budgets. In 1963, the collection dates of several tax sources were accelerated to produce a one-time increase in revenues without increasing tax rates. In 1965, the sales tax was extended to include leases. In 1966, the state adopted accrual accounting, bringing about another one-time increase in revenues.

11

Table 4

Average Annual Increases in State Expenditures Compared to the Growth in California Personal Income

		I	II	III	IV
		1961-62 to 1966-67	1967-68 to 1971-72	1972-73 to 1973-74	1974-75 to 1977-78
1.	State Expenditures				
	Local education[1]	7.7%	6.7%	23.7%	5.1%
	Higher education	13.7	10.5	12.4[5]	6.5
	Social welfare	9.6[2]	14.7	7.0[6]	8.6[6]
	Medical assistance	157.9[3]	17.4	15.2	8.0[7]
	Mental hygiene	9.2	7.2	N/A	
	Property tax relief	N/A	25.7[4]	71.0	4.4
	Shared revenues	10.9	7.0	5.1	5.0
	Public works	3.4	2.0	4.8	5.0
	Total State Expenditures	8.8	9.4	18.7	7.6
2.	Calif. Personal Income	7.1%	7.7%	8.8%	7.7%

Footnotes:

[1] Excludes debt service of school building aid bonds.

[2] Excludes medical assistance to the aged.

[3] Includes medical assistance to the aged.

[4] 1968-69 to 1971-72.

[5] This percentage is distorted because it includes large salary increases in 1972-73 which compensate for the lack of salary increases in the prior two fiscal years.

[6] Includes potential cost of HR 1.

[7] Department of Health.

2. Phase II - 1967-68 to 1971-72. In the latter part of the 1960's, personal income grew at a faster pace due to a higher rate of inflation and faster economic growth. Nevertheless, a major program of permanent tax increases was enacted in 1967 and part of these funds was used to balance deficits created during the first half of the 1960's. This program raised over a billion dollars in new revenues, and enabled the General Fund to operate at a surplus from 1967-68 to 1969-70, despite increases in state school support, rapidly growing medical assistance payments, and the adoption of three new property tax relief programs: (1) the homeowners' exemption, (2) senior citizens' property tax assistance, and (3) the business inventory exemption. During this five-year period, State University and Community College enrollments increased by over ten percent a year, only slightly slower than the 11 percent annual growth rates during the first half of the decade, but still much faster than personal income.

The recession which developed late in 1969 and continued through 1970 and into 1971 had a severely adverse impact on state revenues. At the same time that revenues were declining, unemployment was increasing and the costs of social welfare were rapidly rising, increasing by 50 percent over the two-year period, 1969-70 and 1970-71. Income tax withholding was adopted to finance increased state expenditures and this measure set the stage for the current phase of our history.

3. Phase III. 1972-73 to 1973-74. During 1972 the economy recovered sharply from the recession and growth in revenues accelerated. At the same time financial pressures on the state eased, especially for higher education and social welfare. All three segments of higher education expect growth in

enrollments during this period to average five percent a year. The combination of the reduction in unemployment and the enactment of the Welfare Reform Act has resulted in social welfare costs increasing by less than four percent a year,[/7] compared to annual increases of about 15 percent during the previous period. From an ADA viewpoint, there was less pressure on the state for local education costs because the level of ADA actually declined during this period.

These easings of financial pressures, plus the enactment of federal revenue sharing, gave the state the flexibility to greatly expand aid to local school districts (in partial response to the Serrano v. Priest decision), and to substantially increase state property tax relief programs for homeowners, renters, business inventories, and schools. The financial condition of the state is such that despite these program increases, the General Fund will have a substantial surplus at the end of the current fiscal year.

4. Phase IV, 1974-75 to 1977-78. Table 4 contains our estimate of the increased annual rate of state expenditures over the next four budget years (after 1973-74). The most significant aspect of these estimates is that total expenditures will grow, on the average, by 7.6 percent compared to a 7.7 percent increase in California personal income. Because state taxes, both General and Special Funds, have about the same growth rate as personal income, this means that the state probably will be able to finance future increases in workload expenditures during the next four years without increasing tax rates. This situation is in direct contrast to California's financial history during the 1960's and the first part of the 1970's.

Despite the favorable outlook on the future growth rates of state expenditures and revenues, the Governor's estimates are predicated on the unsupported assumption that tax rates will have to be repeatedly increased in the future.

/7 Excluding the potential cost of HR 1. The average growth rate will be 7.0 percent with this potential HR 1 cost.

The data in Table 5 compares the annual and average growth rates of state tax receipts during the last 13 years with the Governor's estimates. This material indicates that the 11.2 percent average growth rate in the past resulted from the high annual increases in tax rates or accelerations, rather than expansion of the tax bases.

For example:

(a) The 1963-64 increase was due to the acceleration of tax receipts.

(b) The 1966-67 increase resulted from the adoption of accrual accounting.

(c) The 1967-68 increase was due to the Governor's tax program.

(d) The 1971-72 increase resulted from the adoption of withholding, and

(e) The projected increase for 1973-74 is due to SB 90 of the 1972 Session.

It is not possible for state revenues to increase at the magnitude projected by the Governor without having repeated increases in tax rates.

Table 5

Comparison of the Annual Percentage Increases in State Taxes in the Past with the Governor's Projections for the Future

	Past History/a		Governor's Future Projections/b
1961-62	5.5%	1974-75	11.2%
1962-63	8.1	75-76	10.7
1963-64	14.8	76-77	10.6
1964-65	7.7	77-78	10.5
1965-66	9.0	78-79	10.5
1966-67	13.9	79-80	10.4
1967-68	21.8	80-81	10.4
1968-69	10.6	81-82	10.3
1969-70	4.6	82-83	10.3
1970-71	3.5	83-84	10.2
1971-72	17.9	84-85	10.2
1972-73	12.0	85-86	10.1
1973-74	16.1	86-87	10.1
		87-88	10.0
Average	11.2%	88-89	10.0
		1989-90	10.0
		Average	10.3%

Sources:
/a Governor's 1973-74 Budget, page A-57.
/b Without his limitation, page 39 of Governor's report.

The Governor's report does not explain why he assumes repeated tax rate increases will be enacted in the future. Several demographic and economic trends run counter to that assumption: (1) K-12 ADA is declining, (2) higher education enrollments are growing at less than half of the 1960's growth rate, and (3) social welfare costs are increasing at a moderate rate. It would be illogical for the Governor to project rapid increases in social welfare costs because his forecast of an 8 percent annual growth in personal income assumes continued prosperity over the next 15 years.

During the last 13 years, California personal income increased by an average of 7.6 percent a year and this time period included the longest (9 years) business upturn in our economic history. The Governor estimates that personal incomes will grow by 8 percent a year in the future. Over the long-term, and especially after the phase down of the present inflationary cycle, the Governor's estimate is much higher than economic analysis will support. Our income estimates (Table 6), which were prepared by Professor Donald Ratajczak of the UCLA Business Forecasting Project, assume a slowdown in the 1974 economy, an upturn in 1975 and 1976, with a 6.5 percent growth rate in 1977. This latter figure includes the assumption that prices will be growing at about a 3 percent annual rate during that period, contrasted with an estimated 5 percent inflationary rate in 1973.

Table 6

Annual Increases in
California Personal Incomes

	Actual and Budget Estimates	Our Estimates	Governor's Estimates
1961	6.3%		
1962	7.3		
1963	7.3		
1964	7.5		
1965	6.4		
1966	8.1		
1967	7.4		
1968	9.9		
1969	8.3		
1970	7.0		
1971	5.9		
1972	8.6		
1973	9.1	9.4	
13-year average	7.6		
1974	8.5	7.5	8.5
1975		8.4	8.0
1976		8.6	8.0
1977		6.5	8.0
4-year average		7.7%	8.1%

Table 7 shows that the growth rates of personal income can drastically influence the levels of state revenues. For example, the Governor projected that 1989-90 state revenues would be $47.1 billion based on an eight percent annual increase in personal incomes, and tax rate increases. Without these rate increases, but still using the eight percent personal income growth rate, state revenues would be $33.6 billion in 1989-90. The Governor's estimate is 40 percent higher than this latter amount. If lower income growth rates are used, there will be a corresponding reduction in the levels of state revenues. At a seven percent personal income growth rate, state revenues would be $29.2 billion.

Table 7

Comparison of Future State Revenues Estimates, Based on Different Growth Rates of Personal Income

(in billions)

	Governor's Estimates (assuming tax rate increases)	Projections of the Existing Tax Base			
	Growth in Personal Income	Growth in Personal Income			
	8%	8%	7.5%	7.0%	6.5%
1979-80	$17.9	$15.5	$15.2	$14.9	$14.5
1984-85	29.2	22.9	21.8	20.8	19.9
1989-90	47.1	33.6	31.3	29.2	27.2

In conclusion, the forecast that state revenues in 1989-90 will be $47.1 billion is predicated on two historical happenings which, in our opinion are unlikely to be repeated. They are (1) that state tax rates will continue to be increased by the Legislature and approved by the Governor with the same frequency and in the same magnitudes as during the past 13 years, and (2) that the growth of personal income in California will exceed the exceptional rate experienced during this same period.

Chapter 2

Changes in the Governor's Expenditure Limitation Program Since February 8, 1973, and Reconciliation of Revenue Estimates

I. Changes in the Program

On February 8, 1973, the Governor issued a press release outlining the contents of his program. On March 12, he issued a 47-page report entitled "A Reasonable Program for Revenue Control and Tax Reduction." On April 2, the Governor's initiative petition was titled and submitted to the Secretary of State. Thus there are several bases for analysis of the Governor's proposal. The other chapters of this analysis relate only to the initiative petition and to the companion constitutional amendments, SCA 12 (Lagomarsino) and ACA 39 (Gonsalves). These measures are somewhat different from the Governor's press release and his report. The following is an explanation of those differences:

1. Permanent Income Tax Reduction

   The Governor's press release and report proposed a 10 percent permanent income tax reduction. The initiative proposes a 7.5 percent reduction by means of a credit, and provides that the Legislature may modify (or eliminate) the credit.

   Under the initiative, single persons with adjusted gross incomes /1 of less than $4,000, and married couples with incomes of less than $8,000 will be exempt from paying state income taxes, unless the Legislature modifies this provision. This provision was not in the Governor's press release or report.

/1 This exemption also applies to the tax on tax preference income. Thus a taxpayer with a low or a negative adjusted gross income will not have to pay the two percent tax on such items as capital gains income, depletion allowances, and special depreciation allowances.

2. One-time 20 Percent Income Tax Reduction

The Governor's report proposed a 20 percent one-time income tax credit. The initiative proposes the same magnitude of tax credit, but it also contains language which allows a lesser credit if the Director of Finance makes a finding that the magnitude of the General Fund surplus is not sufficient to allow the full credit.

3. State Tax Revenue Limit for 1973-74

The Governor's press release, his report, and the April 16 newspaper advertisement by "Californians for Lower Taxes", all referred to the 1973-74 tax limit base as $9.8 billion, or 8.75 percent of Californians' personal income. The Governor's office now informs us that it has changed these estimates to coincide with the initiative and, as a result, the revenue base is estimated to be $9.3 billion, or 8.34 percent of personal income. The main difference between this latest and the earlier estimates is the exclusion of about $500 million in higher education receipts from the tax limitation base.

4. Membership on Economic Estimates Commission

The Governor's press release indicated that the State Controller would be chairman of this commission and that the other members would be the Director of Finance and the Legislative Analyst. The initiative requires the Governor to designate the chairman of the commission and provides that the members will be (1) the State Controller, (2) the Director of Finance or an appointee of the Governor designated by him, and (3) a designee appointed by the Legislature who is not a member of the Legislature.

5. State Payments for Mandated Local Programs

The Governor's press release stated that the initiative would not include the provision in Chapter 1406 of 1972 (SB 90) requiring the state to reimburse local government for costs mandated by the state. The initiative includes this requirement, but in a modified form.

6. Vote Requirements for Changes in State Taxes

The press release and report stated that a two-thirds vote of the Legislature would be required for increases in state taxes. The initiative provides that any change in tax rates or tax base will require a two-thirds vote of the Legislature. This provision includes changes which increase or decrease state taxes. The initiative provides that tax reduction by appropriation may be enacted by a majority vote.

II. Reconciliation of Revenue Estimates

As a means of keeping the state tax burden within a specified percentage of personal income, the Governor's initiative proposes to enact an expenditure limitation on state government. The expenditure limitation proposed in the initiative covers most, but not all, of state revenues. For example, revenues received from the federal government are not included within the expenditure limitation.

To clarify discussion of the initiative proposal, it is useful to compare the definition of "taxes" used by the Governor in describing tax burden, with the initiative's definition of revenues subject to the expenditure limitation. The definition of "taxes" in the tax burden estimate is much larger than the definition of revenues subject to the expenditure limitation. The largest item included in "taxes" in the tax burden estimate, but excluded from the expenditure limit base, is "employee and insurance trust income." The main category left out of the tax burden estimate, but included in the expenditure limit base, is income to the Veterans Farm and Home Loan Building Fund. Table 8 shows the main differences between these two bases.

Table 8

Differences Between the Governor's State Tax Burden and Tax Limitation Bases

1969-70 Data

	Millions
1. State Receipts Included in Tax Burden Estimates but Excluded from Governor's Tax Revenue Limit Base.	
A. Employee and Insurance Trust Income	
1) Employee Retirement	
Employee Contributions	$376
Local Government Contributions	189
Earnings on Investments	268
2) Unemployment Compensation	
Employer Contributions	$531
Earnings on Investments	60
3) Workmen's Compensation	
Employer Contributions	$105
Earnings on Investments	13
4) Other Insurance Trust Activities	$312
B. Other Receipts	
1) Higher Education Auxiliary Enterprises	$ 89
2) Other Education Charges	116
3) Donations	31
4) Hunting and Fishing Licenses	14
5) Beach and Park Charges	9
6) Sale of State Property	21
Total Receipts Excluded from Tax Limitation Base	$2,134

	Millions
2. <u>State Receipts Excluded From Tax Burden Estimates but Included in Governor's Tax Revenue Limit Base</u>	
Income to Veterans Farm and Home Building Fund	$236

3. <u>State Receipts in Both Bases but at Different Amounts</u>

	In Millions	
	Tax Burden Base	Tax Limit Base
Interest Earnings	$173	$ 81
Hospital Charges	80	17
Highway Bridge Tolls	54	18

It is not clear why different interest estimates were used in the two bases. Intergovernmental transfers are included in the tax burden estimate of hospital charges, but are excluded from the tax limit base. All highway bridge tolls are included in the tax burden estimate, but the portion used to repay bonded obligations is excluded from the tax limit base. These significant differences in the composition of the <u>tax burden estimate</u> and the <u>tax limit estimate</u> raise serious questions as to the viability of the burden estimate. If it is not acceptable <u>as a base</u> for future tax limitation, why is it acceptable <u>as an argument</u> for future tax limitation?

Chapter 3

Analysis of Proposed Article 29 of the Constitution

The Governor's initiative petition, SCA 12 (Lagomarsino), and ACA 39 (Gonsalves), propose to add Article 29 to the State Constitution. This analysis treats this proposal under the following topics:

Part 1. State Expenditure Limitation.

Part 2. Maximum Property Tax Rates and Local Taxation.

Part 3. Reimbursements to Local Government for State Mandates.

Part 4. Income Tax Reductions and Exemptions.

Part 5. Change in Voting Requirements on Revenue Measures.

Part 6. Possible Shift of Costs from the State to Local Government.

Part 1. State Expenditure Limitation

Article 29 establishes a limit on state expenditures by defining, for each year's state budget, a maximum dollar amount and by making invalid all expenditures over that amount. Although Article 29 is entitled "Revenue Control and Tax Reduction", it does not limit state revenue. Article 29 establishes an expenditure limitation by formula as a percentage of state personal income; it creates an Economic Estimates Commission to set the expenditure limitation each year; it establishes a policy of refunding to taxpayers state surpluses which exceed the expenditure limitation; it provides for emergency expenditures in excess of the expenditure limitation; it provides for the adjustment of the expenditure limitation in defined circumstances; it provides new voting requirements relating to state taxation; and it establishes guidelines for dealing with bonds, special funds, and capital outlay appropriations.

I. Expenditure Limitation Formulas.

Article 29 contains three formulas for determining the annual expenditure limitation: (1) the declining percentage formula, (2) the absolute floor formula, and (3) the voted floor formula.

<u>The declining percentage formula.</u>

Article 29 contemplates that this formula will provide the basic expenditure limitation for 1974-75 and for future fiscal years. By April 1, 1974, or by July 1, 1974, if the earlier deadline cannot be met, Article 29 requires the Economic Estimates Commission (described below at page 34) to estimate state revenue for 1973-74 and state personal income for 1973. The commission must then express the estimated revenue amount as a percentage of the personal income amount and subtract from that percentage one-tenth of one percent. The commission must then estimate state personal income for 1974 and multiply that amount by the previously calculated percentage. The resulting dollar amount is the state expenditure limitation for 1974-75.

The following formula summarizes those steps:

$$\text{1974-75 Expenditure Limitation} = \left[\frac{\text{State Revenue 1973-74}^{/1}}{\text{State Personal Income 1973}} - .001\right] \times \text{State Personal Income 1974}$$

For example,[/2] assuming state revenue in 1973-74 is $9.3 billion and state personal income in 1973 is $112 billion, then revenue is 8.3 percent of personal

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/1 The one-time income tax credit of up to 20 percent of personal income taxes, provided for by Section 2 (b) (1) of Article 29, does not reduce state revenue for 1973-74 in this formula. See Section 2 (b) (4) of Article 29.

/2 The numbers in this example are based on the Governor's estimate of 1973-74 revenues. As explained elsewhere in this report, certain items included in the Governor's estimate probably will not be included in the estimate to be made by the Economic Estimates Commission. The chief item in question is payments made to the Veterans' Farm and Home Building Fund.

income. The formula requires that .1 percent be subtracted from that amount, resulting in the percentage 8.2. If state personal income in 1974 is $120 billion, the multiplication of $120 billion by 8.2 percent yields an expenditure limitation of $9.8 billion for 1974-75.

In 1975-76 and in subsequent fiscal years, the previous fiscal year's expenditure limitation becomes the basis for calculating the percentage in this formula. For example, the calculation of the 1975-76 expenditure limitation will be accomplished as follows:

$$\text{1975-76 Expenditure Limitation} = \left[\left(\frac{\text{1974-75 Expenditure Limitation}}{\text{State Personal Income 1974}} \right) - .001 \right] \times \text{State Personal Income 1975}$$

One characteristic of the formula is that it simplifies mathematically so that the fraction in the formula is constant except for the subtraction each year of 0.001. This results because Article 29 does not authorize the Economic Estimates Commission to substitute an actual State Personal Income amount for the estimated State Personal Income amount. A consequence of this characteristic of the formula is that the formula constantly authorizes a smaller percentage of personal income as the state's expenditure limitation. The expenditure limitation itself, however, can be increased in the various ways described below, at pages 40 - 44.

The following is an illustration of how this formula works over a three-year period (all dollar amounts in billions):

$$\begin{array}{l} \text{1974-75} \\ \text{Expenditure} \\ \text{Limitation} \end{array} = \left(\frac{\$\ 9.3}{\$112.0} - .001 \right) \text{ X } \$120$$

$$= (.083 - .001) \text{ X } \$120$$

$$= .082 \text{ X } \$120$$

$$= \$\ 9.8$$

$$\begin{array}{l} \text{1975-76} \\ \text{Expenditure} \\ \text{Limitation} \end{array} = \left(\frac{\$\ 9.8}{\$120.0} - .001 \right) \text{ X } \$129$$

$$= (.082 - .001) \text{ X } \$129$$

$$= .081 \text{ X } \$129$$

$$= \$\ 10.5$$

$$\begin{array}{l} \text{1976-77} \\ \text{Expenditure} \\ \text{Limitation} \end{array} = \left(\frac{\$\ 10.5}{\$129.0} - .001 \right) \text{ X } \$139$$

$$= (.081 - .001) \text{ X } \$139$$

$$= .080 \text{ X } \$139$$

$$= \$\ 11.1$$

In applying these formulas, the Economic Estimates Commission will have to estimate the 1973-74 revenue based on the latest information available to it before July 1, the final deadline for it to act in 1974. In subsequent

The following is an illustration of how this formula works over a three-year period (all dollar amounts in billions):

$$\text{1974-75 Expenditure Limitation} = \left(\frac{\$\ 9.3}{\$112.0} - .001\right) \text{ X } \$120$$

$$= (.083 - .001) \text{ X } \$120$$

$$= .082 \text{ X } \$120$$

$$= \$\ 9.8$$

$$\text{1975-76 Expenditure Limitation} = \left(\frac{\$\ 9.8}{\$120.0} - .001\right) \text{ X } \$129$$

$$= (.082 - .001) \text{ X } \$129$$

$$= .081 \text{ X } \$129$$

$$= \$\ 10.5$$

$$\text{1976-77 Expenditure Limitation} = \left(\frac{\$\ 10.5}{\$129.0} - .001\right) \text{ X } \$139$$

$$= (.081 - .001) \text{ X } \$139$$

$$= .080 \text{ X } \$139$$

$$= \$\ 11.1$$

In applying these formulas, the Economic Estimates Commission will have to estimate the 1973-74 revenue based on the latest information available to it before July 1, the final deadline for it to act in 1974. In subsequent years, the commission will not be required to estimate state revenue because the formula for 1975-76 and for subsequent years does not require a revenue estimate. The definition of 1973-74 "State Tax Revenue", as used in this measure, is very broad and includes both General and Special Fund revenue, fees, penalties, receipts, and other monetary exactions, except those specifically excluded by Section 16 of Article 29. Table 9 contains the Governor's estimate of the composition of these state tax revenues for 1973-74. These estimates are based on the 1973-74 Budget as submitted, and will have to be adjusted by the Economic Estimates Commission to take account of (1) changes in economic conditions, (2) the actual level of receipts, (3) new legislation adopted after January, 1973, and (4) legal interpretations regarding what is included in and what is excluded from State Tax Revenues.

The Governor's legislative proposal (SB 238 and AB 148) to dispose of the 1972-73 surplus has inconsistent results under the provisions of Article 29 dealing with the determination of 1973-74 revenues for purposes of the declining percentage formula. The Governor's proposal consists of two chief elements: a postponement of the sales tax increase to January 1, 1974, and a 20 percent income tax credit. Section 2 (b) (4) of Article 29 provides that this income tax reduction will not be subtracted from 1973-74 revenues in the calculation of the declining percentage formula. The 1973-74 reduction in sales tax revenue, on the other hand, will be subtracted from 1973-74 revenues in the calculation of the declining percentage formula. The Governor's sales tax postponement proposal will reduce 1973-74 revenue by $317 million.

A second means by which the Governor's estimate of 1973-74 revenue may be reduced is through a legal determination whether loan repayments and interest paid to the Veterans' Farm and Home Building Fund is included in 1973-74 revenues for the purpose of the declining percentage formula. The Governor has included them, but Legislative Counsel has issued an opinion that these payments are not within the revenue base provided in Article 29. (Appendix E.) If the Economic Estimates Commission accepts that interpretation, the 1973-74 revenue estimate will be reduced by $293 million.

If both of these reductions occur, 1973-74 revenues will be reduced from the Governor's estimate of $9.3 billion to $8.7 billion. Given this decrease in the 1973-74 base in the declining percentage formula, the percentage in that formula changes from the Governor's revised estimate of 8.3 percent to 7.8 percent. That is equivalent to a five-year decline in the operation of the formula. In short, the base will be starting out at a level it would not otherwise reach until 1978-79.

Table 9

Governor's Estimate of State Tax Revenue Limit Base for 1973-74

(Rounded to nearest million)

	General Fund	Special Funds	Non-Government Cost Funds	Total
1. Major taxes and licenses				
Alcoholic beverage	$ 127	$ 14		$ 141
Bank and corporation	995			995
Cigarette	179	76		255
Horseracing	63	12		75
Inheritance and gift	311			311
Insurance	203			203
Motor vehicle in lieu		297		297
Motor vehicle fuels		798		798
Motor vehicle registration		321		321
Personal income	2,175			2,175
Private car	6			6
Retail sales	3,000			3,000
Other		3		3
Total taxes and licenses	$7,059	$1,521	0	$8,580
2. Other budget revenues				
Corporate licenses	$ 7			$ 7
Business and regulatory fees	12	$ 42		54
Mental hygiene charges	17			17
Teacher credential fees		2		2
Interest income	64	10		74
Oil and gas revenues	4	66		70
Penalties	17	13		30
Unclaimed property	4			4
Other	8	10		18
Total other revenues	$ 133	$ 143	0	$ 276

Table 9 (cont'd)

	General Fund	Special Funds	Non-Government Cost Funds	Total
3. Non-Budget funds				
Vets Farm and Home Bldg. Fund			$293	$ 293
Water project income			93	93
Bridge tolls			40	40
Rental of public bldgs.			11	11
Harbor and watercraft fees			2	2
Income received as reimbursements				
State Fair Fund			2	2
DMV information sales			5	5
Resident fees in Vets Home			2	2
Dept. of Corporations			1	1
Dept. of Insurance exam fees			2	2
Calif. Highway Patrol			1	1
Other			1	1
Total non-budget funds	0	0	$453	$ 453
Total revenue limit - all funds	$7,192	$1,664	$453	$9,309

	General Fund	Special Funds	Non-Government Cost Funds	Total
4. Budget revenues excluded from limit				
Personalized license plates	$	$ 2		$ 2
Fish and game fees		21		21
Beach and park fees	9			9
Sale of state property	5			5
Receipts from Health Care Deposit Fund	45			45
County costs - mentally ill patients	5			5
Other intergovernmental transfers	2	4		6
Total excluded budget revenues	$- 66	$- 27	0	$- 93

Each time the commission applies the declining percentage formula, it will have to determine state personal income for the current calendar year. If the commission acts by April 1 each year, as Article 29 directs, the commission will have less than two months' actual data on state personal income for the current calendar year.

When the Governor presents the budget to the Legislature in January each year, he cannot be certain what expenditure limitation the Economic Estimates Commission will set on April 1. If the onset of a recession requires the EEC to set an expenditure limitation which is substantially lower than the Governor's forecast, then the Governor's spending plan will be obsolete when the EEC sets the expenditure limitation.

The absolute floor formula.

Article 29 requires the Economic Estimates Commission to use the absolute floor formula if the expenditure limitation resulting from the declining percentage formula is less than the expenditure limitation resulting from this formula.

The absolute floor formula provides that the state expenditure limitation will never fall below the per capita amount, adjusted for inflation and deflation, available for expenditure by the state in 1973-74.

The formula is as follows:

$$\text{Year Y Expenditure Limitation} = \text{State revenue for 1973-74} \times \frac{\text{State Population Year Y}}{\text{1973 State Population}} \times \frac{\text{Consumer Price Index in Year}}{\text{Consumer Price Index in 1974}}$$

The following is an illustration of how this formula might establish the expenditure limitation during the first three years of the life of the program (all dollar amounts in billions):

1974-75 Expenditure Limitation $= \$9.3 \times \dfrac{21{,}216{,}000 \text{ (1974 pop.)}}{20{,}800{,}000 \text{ (1973 pop.)}} \times \dfrac{134.3 \text{ (1974 CPI)}}{134.3 \text{ (1974 CPI)}}$

$= \$9.3 \times 1.02 \times 1$

$= \$9.5$

1975-76 Expenditure Limitation $= \$9.3 \times \dfrac{21{,}640{,}320 \text{ (1975 pop.)}}{20{,}800{,}000 \text{ (1973 pop.)}} \times \dfrac{138.3 \text{ (1975 CPI)}}{134.3 \text{ (1974 CPI)}}$

$= \$9.3 \times 1.04 \times 1.03$

$= \$10.0$

1976-77 Expenditure Limitation $= \$9.3 \times \dfrac{22{,}073{,}126 \text{ (1976 pop.)}}{20{,}800{,}000 \text{ (1973 pop.)}} \times \dfrac{142.5 \text{ (1976 CPI)}}{134.3 \text{ (1974 CPI)}}$

$= \$9.3 \times 1.06 \times 1.06$

$= \$10.5$

Article 29 does not prohibit the state from spending less than the amount provided by this limitation but authorizes the state always to spend at least this much.

The voted floor formula

Article 29 authorizes the Legislature to invoke this formula by a two-thirds vote under either of the following two conditions:

(1) When the budget for the fiscal year 1989-90 is being enacted, or

(2) When the calculated percentage in the declining percentage formula is 7 percent or less.

Thus the terms of the formula vary, depending on whether it is voted under condition (1) or condition (2).

To illustrate the voted floor formula under condition (1), assume that on April 1, 1988, the Economic Estimates Commission finds that the percentage in the declining percentage formula is 7.4 percent. Subtracting .1 percent, the expenditure limitation for 1988-89 is calculated by multiplying 7.3 percent by state personal income for 1988.

Under condition (1), Article 29 authorizes the Legislature to use 7.3 percent as the percentage for calculating the expenditure limitation in 1989-90 and in future fiscal years.

To illustrate the voted floor formula under condition (2), assume that on April 1, 1986, the Economic Estimates Commission finds that the percentage in the declining percentage formula is 7.1 percent. Subtracting .1 percent the expenditure limit is calculated, for 1986-87, by multiplying 7.0 percent by state personal income for 1986.

Article 29 gives the Legislature the option of voting this calculated 7.0 percent as the percentage for calculating the expenditure limitation for future fiscal years.

To invoke the voted floor formula, under either condition (1) or condition (2), Article 29 requires the Legislature to act by a two-thirds vote. Also, under either condition (1) or condition (2), Article 29 authorizes the Legislature by a two-thirds vote to reinstate the declining percentage formula.

II. Calculating the Annual Expenditure Limitations: Economic Estimates Commission

To calculate the annual expenditure limitation, Section 11 of Article 29 establishes an Economic Estimates Commission, composed as follows:

(1) The State Controller

(2) The Director of the Department of Finance or an appointee of the Governor

(3) A person appointed by the Legislature who is not a member of the Legislature.

Section 11 requires the Governor to designate the chairman of the commission and requires the commission to act by a two-thirds vote. The commission is required to use the resources of existing state agencies to carry out its duties.

The chief duty of the commission is to determine and publish, prior to April 1 of each year, the expenditure limitation for the following fiscal year. If the commission fails to determine the limit before July 1, the limit remains as it was in the previous year. If, for example, the expenditure limitation is $9.8 billion in 1974-75 and would be $10.5 billion in 1975-76, the limitation will be $9.8 billion in 1975-76 if the commission fails to act by July 1, 1975.

As a result, the 1975-76 budget will be $700 million less than it would be if the commission had acted.

III. Disposition of Revenues in Excess of the Expenditure Limitation.

If, in any year, state revenues, as defined by Article 29, exceed the expenditure limitation, Article 29 requires the excess to be transferred to the Tax Surplus Fund, which Article 29 establishes.

Article 29 authorizes the Legislature to appropriate money from the Tax Surplus Fund for two purposes:

(1) To provide tax refunds or tax reductions.

(2) To provide funds for emergency situations (discussed in the following section).

Article 29 authorizes the Legislature to minimize accumulations in the Tax Surplus Fund by making periodic tax refunds or reductions. However, Article 29 does not define "minimize," so the interpretation of that term will depend on legislative action.

The Tax Surplus Fund, as defined by Article 29, is not comparable to surpluses in the state budget. Those surpluses arise because revenues exceed expenditures. The Tax Surplus Fund arises because revenues exceed the expenditure limitation provided by Article 29. Surpluses or deficits in the state budget might come into existence independently of the fact that the Tax Surplus Fund contains money.

The following hypothetical situation illustrates the distinction between a budgetary surplus and a surplus requiring a transfer to the Tax Surplus Fund:

Expenditure limitation	$10 billion
Revenues	10.5
Expenditures	9.8
Budgetary surplus	.7
Transfer to the Tax Surplus Fund	.5
Excess of budgetary surplus over transfer to the Tax Surplus Fund	.2

IV. Exceptions to the Expenditure Limitation

Article 29 contains, expressly or by implication, four exceptions to the prohibition against spending money in excess of the expenditure limitation.

1. Section 3 expressly authorizes expenditures in excess of the limitation for tax refunds.

2. Section 3 expressly authorizes expenditures in excess of the limitation for Emergency Situations. An Emergency Situation is defined as "an extraordinary occurrence requiring unanticipated and immediate expenditures to preserve the health and safety of the people." Article 29 places the following limitations on the use of this exception to the expenditure limitation:

A. The Emergency Situation must be declared by the Governor. The Legislature does not have independent authority to find that an Emergency Situation exists.

This provision does more than increase the power of the Governor and decrease the power of the Legislature--it changes the nature of the two institutions. Under the present Constitution, the Legislature can initiate appropriations, and, although the Governor can veto any appropriation, his veto can be overridden by a two-thirds vote in each house. Under Article 29, the Legislature will not be able to authorize, on its own initiative, expenditures over the expenditure limitation, even if it acts unanimously. The effect of Article 29 is to provide that, whenever it is argued that the health, safety, or welfare of the people depend on the expenditure of money by state government, the Governor alone will have control over consideration of the issue. Neither the Legislature nor the courts will have the power to overrule his decision if it is against expenditure.

B. Section 6(b) of Article 29 requires expenditures for the Emergency Situation to be made from specified sources and in a specified order, as follows:

1. From emergency funds made available from the federal government;

2. From the Special Emergency Fund (discussed below at page 44);

3. From the Tax Surplus Fund or from a specific tax increase or from a specific new tax.

If the Legislature and the Governor enact a tax increase or a new tax to pay for the Emergency Situation, Article 29 imposes further limitations, as follows:

A. The increased tax or new tax must be enacted by a two-thirds vote of the Legislature.

B. The increased tax or new tax is repealed by operation of law two years after it is enacted, unless its continuation is approved by a majority vote at a statewide election.

Nothing in Article 29 prevents successive declarations of Emergency Situations, so it is theoretically possible for the Governor and the Legislature, acting by a two-thirds vote, to continue the existence of a tax increase even if it is disapproved by the electorate at a statewide election.

If the Legislature and the Governor enact a tax increase or a new tax to pay for the Emergency Situation, expenditures from that source do not count toward the expenditure limitation, to the extent that the money is used to meet the Emergency Situation.

3. The third exception to the prohibition against spending money in excess of the expenditure limitation, implied by Article 29, is that the Legislature and the Governor are authorized freely to make expenditures from Excluded State Revenues. Excluded State Revenues, defined in Section 16(b) of Article 29, include the following:

(1) Intergovernmental transfer payments.
(2) Contributions to, and income from, employment funds such as the Unemployment Administration Fund, the Public Employees' Retirement Fund, and the Teachers' Retirement Fund.
(3) Revenue from a tax levied to meet an Emergency Situation.
(4) Proceeds from the sale of state bonds. (But appropriations to repay the debt may be subject to the expenditure limitation. See discussion below at page 45 .)
(5) Grants and contract income for projects sponsored and funded by private agencies.
(6) Internal fund transfers.
(7) Proceeds from the sale of investments and the redemption of matured securities.
(8) Proceeds from the sale of property.
(9) Gifts to the state.
(10) Endowment income.
(11) Proceeds, including tuition, from activities of the University of California and the State University and College System.
(12) Fish and game fees.
(13) Park and recreation fees.
(14) Income from environmental license plates.
(15) Revenue from state-owned parking lots and garages.

Excluded State Revenues also include receipts from any facility financed by revenue bonds, but only to the extent that such receipts are used for the payment of principal and interest. Receipts from such a facility used for maintenance, under this provision, would be subject to the expenditure limitation. For example, tolls collected on toll bridges constructed by means of revenue bonds are Excluded State Revenues to the extent that the tolls are used to pay the principal and interest on the bonds. Tolls used for bridge maintenance, however, are included in State Revenues, and their expenditure counts toward the expenditure limitation.

Article 29, Section 16(b) (3) authorizes the Legislature to define "fees" as Excluded State Revenues if they meet each of the following criteria:

(1) The fee must be paid for a service or a product which is generally available from the private sector; or the fee must be charged to finance the regulation of a noncommercial, nonprofessional, noncriminal activity other than the regulation of activities associated with motor vehicles.

(2) The fee must be used to defray all or part of the costs of the state in providing the service. (Section 16(b) (3) fails to include "costs of providing a product" in this criteria.)

(3) The payer of the fee receives the benefit derived from payment of the fee.

This provision authorizing the Legislature to define some fees as Excluded State Revenues probably authorizes the Legislature to exclude fees paid to the state for Medi-Cal services. The provision does not authorize the Legislature to exclude fees paid by persons regulated by the Department of Consumer Affairs. Thus, the fees paid by licensees of the various agencies in that department are state tax revenues subject to the expenditure limitation.

A question exists whether the following payments are Excluded State Revenues: (1) payments of principal and interest to the Veterans' Farm and Home Building Fund; (2) utility service charges used to repay principal and interest on general obligation bonds issued to construct the State Water Project.

The Legislative Counsel has ruled that loan repayments and interest paid to the Veterans' Farm and Home Building Funds do not fall within the definition of "State Tax Revenue". Consequently, those payments probably will not enter into the calculation of 1973-74 revenue in the declining percentage formula, and the expenditure of those payments probably will not come within the expenditure limitation.

4. The fourth exception to the expenditure limitation--expenditures for the payment of principal and interest on state indebtedness--is discussed below at page 45.

V. Changing the Expenditure Limitation

Article 29 contains five methods by which the expenditure limitation can be increased or decreased. In each case, the dollar amount of the change is added or subtracted to the dollar amount of the expenditure limitation. In subsequent years, this change is incorporated into the declining percentage formula. This happens when the expenditure limitation is used as the numerator of the quotient that determines the next year's expenditure limitation.

The five methods of changing the expenditure limitation are as follows:

1. The expenditure limit may be increased or decreased by a designated dollar amount by a majority vote of the people at a statewide election. The proposal for such a change can be placed on the ballot by a two-thirds vote of the Legislature or by means of the initiative statute procedure provided in Article IV of the Constitution. Because Article 29 authorizes the use of the initiative statute procedure rather than the initiative constitutional amendment procedure, fewer signatures will be required to place on the ballot a change in the expenditure limitation. To place an initiative statute on the ballot requires a petition signed by electors equal in number to five percent of the votes cast for Governor at the last gubernatorial election. The comparable percentage for initiative constitutional amendments is eight percent.

2. Section 9 (a) of Article 29 requires the expenditure limitation to be decreased if the state decreases property tax relief payments to local government. The restrictive language of this section makes it inapplicable to property tax relief provided directly to individuals, including: senior citizens' property tax assistance, renters' credits provided in Section 17053.5 of the Revenue and Taxation Code, and the special welfare grant provided in Section 11006.1 of the Welfare and Institutions Code. Consequently, the Legislature could reduce these individual payments and credits without reducing the expenditure limitation. However, if the Legislature reduces the homeowners' exemption, the business inventory exemption, or other exemptions requiring payments to local government, Section 9 requires the expenditure limitation to be decreased by an equivalent amount.

As a result of these provisions, there will be an incentive to reduce senior citizens' property tax assistance; renters' credits in the personal income tax; and the special welfare grant provided in Chapter 1406 of 1972 (SB 90) to offset the one cent increase on June 1, 1973, in the state sales tax. That incentive is to make possible increased expenditures for other purposes within the expenditure limitation. On the other hand, the Legislature and the Governor will not have the same incentive to reduce the homeowners' exemption or the business inventory exemption, for Section 9 (a) requires the expenditure limit to be decreased if those exemptions are decreased.

Section 9 (a) requires the state expenditure limitation to be decreased if the state reduces "local property tax relief by decreasing the specific unit amount, rate or percentage . . .for payments made under formula" to local government. Whether this provision applies to state action decreasing or setting maximums on subventions such as school apportionments or Medi-Cal and shared revenues such as the cigarette tax, is an open question. See pages 47 - 48 below for further discussion.

3. Section 10 (a) of Article 29 authorizes the Legislature (sic)[/3] to increase the expenditure limitation if the state enacts a property tax relief measure and, at the same time, decreases commensurately the tax rates of local governments. The restrictive language of this section makes it inapplicable to property tax relief provided directly to individuals, including: senior citizens' proeprty tax assistance, renters' credits provided in Section 17053.5 of the Revenue and Taxation Code, and the special welfare grant provided in Section 11006.1 of the Welfare and Institutions Code. Consequently, if the

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[/3] At places in the proposed initiative, the Legislature is referred to as the sole agent in enacting legislation, including appropriations; this ignores the authority of the Governor to approve or veto legislation, including appropriations. We have assumed that the initiative does not modify the veto power of the Governor.

Legislature and the Governor were to increase any of those programs, or enact new programs of the same nature, Article 29 does not authorize an increase in the expenditure limit. Another result of the restrictive language of Section 10 (a) is that if an increase in the homeowners' exemption or the business inventory exemption is enacted, Article 29 does not authorize an increase in the expenditure limitation. This result flows from the fact that Section 10 (a) applies only to those property tax relief measures which reduce local tax rates. The homeowners' exemption and the business inventory exemption reduce the assessed value of property and do not affect tax rates.

As a result of these provisions, the Legislature will have a disincentive for expanding senior citizens' property tax assistance, or renters' credits in the personal income tax, or the special welfare grant provided in Chapter 1406 of 1972 (SB 90) to offset the June 1, 1973, one cent increase in the state sales tax, or the business inventory exemption, or the homeowners' exemption. The disincentive is that, if the Legislature increases any of these programs, expenditures for other programs must be decreased.

Section 10 (a) applies to any property tax relief measure applicable across-the-board to all property--for example, the school property tax roll-back enacted in Chapter 1406 of 1972 (SB 90).

4. Section 10 (b) requires the expenditure limitation to be decreased if the costs of a program are transferred from the state to the federal government.

5. Section 10 (e) authorizes the Legislature to increase the expenditure limitation if federal taxes are reduced on condition that the state increase expenditures by an amount equivalent to the federal reduction.

A sixth method of changing the expenditure limitation, which logically should have been included in Article 29, was not included. Article 29 does not provide for an increase in the expenditure limitation if the federal government shifts costs to the state. This has happened recently, for example, as a result of the enactment in 1972 of HR 1 by Congress. Unless the state repeals a cost-of-living increase in welfare grants, enacted in 1972, it will bear the full cost of those increases. Without the enactment of HR 1, the state would pay 50 percent of that cost-of-living increase. Article 29 does not provide for an increase in the state's expenditure limitation in this situation. Article 29 does provide for an increase in local maximum property tax rates if federal law or a court order requires the cost of a program to be imposed on local government.

VI. Operating Provisions

1. Emergency Fund. Section 6 (a) of Article 29 requires the Legislature to establish a Special Emergency Fund of not more than the 0.2 percent of the State Personal Income, or about $240 million in 1974-75. Section 6 (a) requires that money flowing into the fund shall come from revenue subject to the expenditure limitation and provides that the fund "shall be subject to" the expenditure limitation. This provision probably means that transfers to the Emergency Fund will count toward the expenditure limitation and will reduce the amount of money available for expenditure for other purposes. As explained above, under "Exceptions to the Expenditure Limitation", Section 6 (b) of Article 29 requires the Legislature to exhaust the Emergency Fund before money can be appropriated from the Tax Surplus Fund for an Emergency Situation. The combination of these requirements creates an inducement to the Legislature to keep the Emergency Fund as small as possible, if the Legislature wishes to maximize the level of permitted expenditures and to use the Tax Surplus Fund for Emergency Situations.

When the budget for 1974-75 is enacted, no Emergency Fund will exist, and no Tax Surplus Fund will exist until the end of the 1974-75 fiscal year, if it exists at all. Consequently, if an Emergency Situation arises in 1974-75, the Legislature's sole option will be to increase taxes or to impose a new tax to meet the Emergency Situation.

2. Bond Repayment. Section 3 of Article 29 establishes the expenditure limitation and provides, "The Legislature shall, prior to any other appropriation, first make provision for the payment of the principal and interest on the indebtedness of the State." Section 13 provides, "Nothing in Section 3 . . . shall limit the taxes levied . . . or appropriations made for the payment . . . of any indebtedness of the State . . . ."

Section 13 provides, without any ambiguity, that if the expenditure limitation is reached and debt repayment is due, the state may exceed the expenditure limitation to pay the debt. It leaves as a question, however, whether debt repayment is within the expenditure limitation. While that may be the implication of Section 3, the point is not free from doubt because of the "notwithstanding" clause of Section 13. As a result, the state may have the option of providing that expenditures for debt repayment are not within the expenditure limitation.

3. The relationship of special funds to the Tax Surplus Fund. Section 2 provides that, if revenues exceed the expenditure limit in any fiscal year, the excess shall be transferred to the Tax Surplus Fund. For example, if the expenditure limitation in 1974-74 is $9.8 billion and state revenues for that year amount to $9.9 billion, Article 29 requires $100 million to be transferred to the Tax Surplus Fund. This provision of Article 29 raises the questions, "From which state fund or funds shall revenue be transferred to the Tax Surplus Fund?"

Section 15 (b) deals with this question by providing, first, that, in the absence of legislative action, transfers to the Tax Surplus Fund shall be from the State General Fund. Second, Section 15 (b) authorizes the Legislature to determine the fund or funds from which transfers to the Tax Surplus Fund shall be made, "unless this Constitution restricts the use of a designated fund to other specified purposes."

These provisions will require the Legislature to resolve the following questions:

(a) Which if any of the special funds shall be used for transfers to the Tax Surplus Fund?

(b) How much of a Special Fund <u>may</u> be transferred to the Tax Surplus Fund?

(c) How much of a Special Fund <u>shall</u> be transferred to the Tax Surplus Fund?

Although Section 15 (b) prohibits the Legislature from making transfers to the Tax Surplus Fund from a Special Fund whose use is constitutionally restricted to specified purposes, nothing in Article 29 prevents the Legislature from cutting off or reducing the revenue flowing into a Special Fund. If the Legislature wishes to increase the amount of General Fund money available for expenditure within the Article 19 limitation, this is a possible option. For example, the Legislature might reduce the gasoline tax to make greater expenditures possible from other tax sources for education, welfare, or other General Fund purposes.

4. <u>Unexpended appropriations and Capital Outlay Appropriations</u>. Except for capital outlay appropriations, Sections 3 and 16 (e) of Article 29 provide that an amount is counted toward the expenditure limitation when it is expended,

and an expenditure is defined to occur when "a valid obligation against an appropriation is created." A capital outlay appropriation, however, is counted toward the expenditure limitation when the sum is appropriated. Given these provisions, if the Legislature wishes to maximize expenditures, then it will be desirable (1) to cut back as far as possible on appropriations which will not be expended in the budget year, and (2) to appropriate the minimum amount possible for capital outlay.

Cutting back on appropriations to prevent carryovers may also include the need to reorganize special funds to prevent carryover appropriations.

Appropriating the minimum amount for capital outlay may lead to a modification of the current three-year capital outlay budgeting procedure. Such changes are likely to cause substantive inefficiencies in the planning, budgeting, and contracting process for construction needs.

5. The local assistance budget. Section 9 (a) requires the expenditure limitation to be decreased in any year in which the state decreases "local property tax relief by decreasing the specific unit amount, rate or percentage established by statute for payments made under formula to Local Entities or School Districts from that in effect upon the effective date of this article."

Two different interpretations of this provision are possible. Under the first, and most probable interpretation, Section 9 (a) requires the expenditure limitation to be reduced if the Legislature reduces expenditures for such programs as the business inventory exemption and the school property tax roll-back in Chapter 1406 of 1972 (SB 90). This interpretation would allow the Legislature to make cuts in other kinds of local assistance programs as a means of staying within the expenditure limitation. This point is discussed below in Part 6, page 62.

Under the second, less probable, interpretation, Section 9 (a), requires the expenditure limitation to be reduced if the Legislature reduces expenditure for any local assistance program--for example, subventions for education, for welfare, or for Medi-Cal; and shared revenues such as cigarette tax revenue and gasoline tax revenue. This interpretation would prohibit the Legislature from reducing any part of the local assistance budget as a means of staying within the expenditure limitation. Such a result appears to be unworkable because 68.5 percent of the budget is for local assistance while only 31.5 percent of the budget is for state operations and capital outlay. It is entirely improbable that less than one-third of the budget can sustain the entire burden of the reductions called for by Article 29.

However, if this second interpretation is correct, upon the effective date of Article 29, the Legislature will not be able to reduce local assistance expenditure formulas as a means of keeping the budget from exceeding the expenditure limitation.

Part 2. Maximum Property Tax Rates and Local Taxation

Article 29 (1) places restrictions on increases in local property tax rates, (2) authorizes the Legislature to increase local property tax rates in special circumstances, and (3) enacts new Constitutional provisions regarding local income taxation.

I. Restrictions on Property Tax Rates.

Section 7 of Article 29 establishes a tax rate limitation for local government entities other than school districts.[4] The limit is defined as the tax rate in effect in 1971-72 or 1972-73, whichever is higher. Local government entities include cities, counties, and special districts. Tax rates are defined to include ad valorem special assessment rates.

Because a local government unit coming into existence after 1972-73 will not have a maximum tax rate as defined by Article 29, Section 7 provides that the maximum tax rate for such a unit of local government "shall be established by the electorate of the Local Entity at the time of its creation." Because many special districts are now created without a vote of an electorate, this provision in Article 7 will require a change in the methods by which special districts are established.

II. Legislative Power to Exempt Local Government from Maximum Property Tax Rates.

Article 29 makes it possible for both the Legislature and local government units to increase tax rates over the maximums established by the Article.

First, Section 7 (b) (1) of Article 29 authorizes the Legislature to permit local entities to increase property tax rates beyond the maximum rate

/4 The exclusion of school districts from this limitation does not mean that schools are left without property tax rate limits. Statutory law presently includes such provisions.

"to allow for . . . special circumstances creating hardship for individual Local Entities."

The extent of the authorization contained in this language is open to question. It might be interpreted restrictively to permit an exemption only to individual districts, or it might be interpreted to authorize the Legislature to exempt whole classes of local government units such as cities, counties, or special districts.

Second, Section 7 (b) (3) authorizes the governing board of any local government unit except a school district, by a four-fifths vote, to increase the maximum property tax rate to pay the cost of an Emergency Situation, defined as "an extraordinary occurrence requiring unanticipated and immediate expenditures to preserve the health and safety of the people." If a local government levies a tax to pay the cost of an Emergency Situation, Article 29 repeals the tax by operation of law two years after it goes into effect, unless the electorate votes to continue it.

This grant of power to local government is a substantial loosening of the tax rate restrictions imposed on local government by Chapter 1406 of 1972 (SB 90). Under that law, only the counties have emergency power to increase property tax rates, and that power is limited to an increase of one percent of the maximum tax rate for one year; to increase the emergency tax rate over that amount, the county must obtain the approval of the Governor and the Controller.

III. Exemptions from Maximum Property Tax Rates.

Section 13 (b) provides that revenue for the following expenditures can be raised from the property tax without regard to the maximum property tax rate imposed on local governments:

1. Expenditures required to pay indebtedness authorized by a vote of the electors of the local government. Expenditures to pay indebtedness not

approved by a vote, however, would be subject to the tax rate limitation.

2. Expenditures required by the obligation to levy taxes under the Improvement Bond Act of 1915.

3. Expenditures required to pay for retirement and pension benefits approved by the voters.

IV. Local Income Tax Provisions.

Section 7 (d) of Article 29 authorizes the Legislature, by a two-thirds vote, to permit local government units, including school districts, to impose corporate and personal income taxes. Nothing in the Constitution presently prevents the Legislature from authorizing local income taxes, so the effect of Section 7 (d) is to increase from a majority to two-thirds the voting requirement for the authorization of local income taxes. This leaves the Legislature free to authorize increases in local sales taxes by a majority vote.

One consequence of Section 7 (d) is to resolve the question whether charter cities have inherent power to levy an income tax regardless of state statutory law.

V. Adjustments to Maximum Property Tax Rates.

Article 29 contains six provisions authorizing adjustments to the maximum property tax rate established for local entities.

1. <u>Cost of Living or Population</u>. Chapter 1406, Statutes of 1972 (SB 90), established maximum property tax rates for local entities and authorized increases in the rates if growth in population and growth in prices, added together, is larger than growth in assessed value.

Section 7 (b) (1) of Article 29 requires the Legislature to enact this kind of provision, but makes a significant change from the concept in Chapter 1406. The change is to refer to cost-of-living <u>or</u> population rather than to population <u>and</u> cost-of-living. The Legislature may be able to interpret Section 7 (b) (1) to mean "cost-of-living or population, or both."

2. <u>Elections</u>. Section 7 (b) (2) authorizes the maximum property tax rates of local government to be increased or decreased by a vote of the electorate. This places in the Constitution a provision of Chapter 1406 of 1972 (SB 90).

3. <u>Program Transferred to the State</u>. Section 10 (a) authorizes the Legislature to decrease the maximum property tax rates of local government if the state enacts a "specific property tax relief measure" or if, by order of a court, the costs of a program are transferred from local government to the state.

4. <u>Programs transferred to the Federal Government</u>. Section 10 (b) authorizes the Legislature to decrease the maximum property tax rates of local government if the costs of a program are transferred from local government to the federal government.

5. <u>Programs transferred to local government</u>. Section 10 (c) authorizes the Legislature to increase the maximum property tax rates of local government if federal law or a court order requires the costs of a program to be imposed on a local government.

6. <u>Horizontal transfers of programs</u>. Section 10 (d) authorizes the Legislature to adjust the maximum property tax rates of local government if the costs of a program are transferred among units of local government.

VI. Operating Provision.

Section 7 (c) of Article 29 provides that, if the Legislature changes the 25 percent assessment ratio, maximum property tax rates shall be adjusted to compensate for the change in the ratio.