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**LIMITING THE FUTURE?:
WHAT WOULD THE “LIVE WITHIN OUR MEANS ACT” MEAN FOR
CALIFORNIA?**

INTRODUCTION

A business-backed coalition, Citizens for California, with the support of the Governor, has proposed an initiative that would radically restructure the rules governing the state’s budget process. The California Live Within Our Means (LWOM) Act would impose a new state spending limit, give the governor broad authority to cut spending if revenues fall below forecast levels, and make changes to the Proposition 98 school spending guarantee and to transportation funding authorized by Proposition 42.¹

In brief, the proposed initiative:

- Establishes a new limit on state spending that would be in addition to, not a substitute for, the existing State Appropriations Limit (SAL). The new limit would apply to expenditures supported by fees, as well as taxes, and to spending from special funds, as well as the state’s General Fund. The measure would also limit expenditures from voter-approved taxes, such as Proposition 10’s tobacco tax rate that supports early childhood programs. The measure also provides a formula for allocating the proceeds of any revenues that exceed the new limit.
- Allows the governor to declare a fiscal emergency and cut General Fund spending if revenues fall 1.5 percent or more below forecast levels or if the governor determines that the state will spend more than half of the funds in the Budget Stabilization Account unless legislation is enacted to address the emergency within a specified period.
- Continues spending at the prior year’s level if a budget is not enacted on a timely basis. In years when there is a shortfall at the beginning of the fiscal year, the governor would have the authority to reduce spending after a specified period.
- Provides limited exclusions from the governor’s spending reduction authority. The governor could reduce spending “notwithstanding any other provision of the constitution,” except for spending needed to comply with federal laws and regulations, fulfill the state’s debt service obligations, or fulfill contracts entered into before the effective date of the LWOM Act. Spending related to contracts signed after the effective date of the proposed measure could be reduced.

- Eliminates “test 3” and the maintenance factor provisions of the Proposition 98 school spending guarantee, as well as the state’s obligation to restore the guaranteed funding level to reflect repayment of outstanding maintenance factor obligations. Instead, the measure requires the state to make one-time payments totaling outstanding maintenance factor obligations over 15 years. The measure would also exclude any “overappropriations” from the base used to calculate future years’ funding guarantees.
- Eliminates the legislature’s ability to suspend the transfer of sales tax revenues paid on motor vehicle fuel sales – the Proposition 42 transfer – to the Transportation Investment Fund (TIF) and prohibits transfers from state special funds to the General Fund on other than a short-term, cash flow basis.
- Establishes a schedule for repaying amounts owed to local governments as reimbursement for mandated programs and services, to schools for so-called “settle-up” obligations, to state special funds as repayment for outstanding loans to the General Fund, and to the TIF as repayment for loans to the General Fund.

This paper examines the implications of the LWOM Act and raises a number of policy questions based on the text of the proposed initiative.

Major Findings

The LWOM Act would:

- Give the governor sweeping power to reduce spending, potentially including the ability to override state laws. The governor could declare a fiscal emergency and cut spending even in years when the state is running a surplus.
- Reduce the long-term Proposition 98 school spending guarantee by \$3.84 billion per year, a reduction of slightly less than \$600 per student for K – 12 education.
- Allow the state to spend more than it brings in when the state heads into an economic downturn, but less than it brings in during a recovery.
- Cap spending supported by voter-approved taxes, such as Proposition 111’s gas tax that supports transportation programs or Proposition 10’s tobacco tax for early childhood programs.
- Cap spending supported by regulatory and user fees, including student fees paid by California State University students. The LWOM Act would prohibit the state from spending fee revenues for their intended purposes in years when total state revenues exceed the new spending cap.
- Put more, not less, spending on “autopilot” by eliminating the legislature’s ability to defer certain transportation spending in bad budget years and by eliminating test 3 of the Proposition 98 guarantee.

THE PROPOSED MEASURE CREATES AN ADDITIONAL LIMITATION ON STATE SPENDING

The proposed measure continues the existing State Appropriations Limit (SAL) and establishes a new cap based on prior years' revenue growth.² The LWOM Act limits total spending to the amount spent in the prior year adjusted by the average annual percentage growth in General Fund and special fund revenues for the three prior years. Revenues in excess of the limit would be allocated to the Budget Stabilization Account (25 percent); maintenance factor repayment, TIF loan repayment, or deficit bond repayment as appropriated by the legislature (50 percent); and for school and road improvements (25 percent).

The proposed cap runs counter to the realities of the budget cycle. The new cap would limit spending based on revenue growth in the three prior years. This formula would have the effect of allowing deficit spending during an economic downturn when revenue growth slows or revenues decline. The same formula would prevent the state from restoring spending reductions made during a downturn when the economy shifts into recovery, since the cap would be based on years when revenue growth was slow or negative. The result is a spending cap that runs counter to the impact of a business cycle – allowing spending to increase during a downturn, while limiting the rise in spending when revenue growth improves.

Dueling limits could double the hit on the state budget. The new limit would be in addition to, not in place of, the state's existing appropriations limit. While the Legislative Analyst estimates that 2004-05 appropriations will be \$9.4 billion below the SAL, in the future, the state could exceed both the new and existing limits.³ The two limits use different formulas for allocating revenues that exceed the limit. In years when the state exceeds both limits, it appears that the state would be required to allocate funds in excess of the limit according to both formulas. This could require the state to allocate funds to fulfill two competing requirements with essentially the same dollars - once for the purposes outlined in the LWOM Act and once according to the formula in Article XIII B.

Establishing a second spending limit would also make the budget less transparent to the public and policymakers since the two limits apply to different revenues and different expenditures. The LWOM Act cap applies to spending supported by both taxes and fees, while the SAL only applies to spending supported by taxes. The LWOM Act would apply to virtually all state spending, while the SAL excludes spending for debt service, federal mandates, capital outlay, and spending supported by certain voter-approved taxes.

The new limit would apply to slow, as well as fast-growing, funds. The new spending cap would apply to spending supported by both the state's General Fund and special funds, including funds supported by user and regulatory fees. If total revenues exceed the LWOM spending limit, expenditures from *all* funds would be limited proportionately. This provision could limit expenditures from a fund where revenues are stagnant or even declining in years when revenues in the state's General Fund increase significantly. In 1999-00, for example, General Fund revenues increased by 22.7 percent, while special fund revenues declined by 0.4 percent. Had the LWOM Act been in effect, expenditures would have been limited, since growth in total revenues (17.8 percent) exceeded the average growth in the three prior years (11.8 percent). Thus, the state would not have been able to spend all of the proceeds of the gas taxes paid by consumers or license and regulatory fees paid to boards and regulatory agencies

because of the substantial increase in personal income taxes paid to the General Fund.

The new cap would apply to voter-approved taxes. The new cap would apply to voter-approved taxes, including Proposition 111's gas tax rate for transportation, Proposition 99's tobacco tax rate for health programs, and Proposition 10's tobacco tax rate for early childhood programs.⁴ Voters excluded spending from the proceeds of these taxes from the current SAL. As noted above, the LWOM cap would apply even in years in which there is little or negative growth in revenues from these taxes, which could force reductions in program spending. Proposition 99 tobacco tax revenues, for example, declined from \$405.1 million in 1998-99 to \$371.9 million in 1999-00.⁵ Had the LWOM Act been in effect in 1999-00, the spending cap would have applied, preventing the state from spending available funds, thus forcing even deeper cuts in Proposition 99-supported programs.

The new cap would apply to fees and fee-supported programs. The new spending cap would apply to revenues from fees, as well as taxes. In years when the cap applies, a portion of fees would be set aside in a special reserve. State parks, for example, would be prevented from using all of the monies raised by entrance fees. Licensing and regulatory boards could not spend all of the amounts raised by fees imposed on businesses and individuals. The new cap would also apply to fees paid by California State University students. In years when the state hits the new spending cap, the state would be prevented from spending a portion of the revenues received from student fees. The cap would apply regardless of the need for services, staffing requirements, or other cost factors.

The new cap would apply to revenues that support the 1991 shift of health, mental health, and human service programs from the state to county governments. In 1991, the state shifted increased responsibility for a variety of health, human service, and mental health programs to counties along with a ¼ cent sales tax rate and a portion of Vehicle License Fee revenues. The new cap would apply to the funds provided to counties to support these programs, which include In-Home Supportive Services, Foster Care, Child Protective Services, and basic mental health programs. This could leave counties with the responsibility to make up for a cut in state funds. Some observers argue that capping funding for realigned programs could violate the statutes governing realignment and that future litigation could shift responsibility for these programs from counties back to the state.

The state's ability to spend revenues in excess of the cap is unclear once the named obligations are repaid. Under the LWOM Act, half of the revenues above the new cap would be devoted to accelerating the repayment of various obligations incurred during the recent budget crisis. The measure does not, however, specify how this amount should be spent after these obligations are repaid. Proponents argue that any excess funds would remain in the General Fund as an unallocated reserve. However, an alternative analysis suggests that funds could not be spent for any other purpose absent a subsequent constitutional amendment.

THE GOVERNOR WOULD GAIN BROAD POWER TO CUT SPENDING WHEN REVENUES DECLINE

The LWOM Act allows the governor to declare a fiscal emergency in the event General Fund revenues fall 1.5 percent or more below forecast levels or when the balance in the state's Budget Stabilization Account is anticipated to fall by more than half during the fiscal year.

Upon the declaration of a fiscal emergency, the legislature would convene in a special session to act to resolve the emergency. If, after 45 days, one or more bills have not been enacted to remedy the situation, the governor would have the authority to cut spending to address the emergency. The governor could “reduce items of appropriation on an equally proportionate basis, or disproportionately, at his discretion.” Cuts could be made to any appropriation except for debt service, appropriations necessary to comply with federal laws and regulations, or appropriations that would result in the violation of a contract to which the state is a party. However, the governor would have the authority to cut appropriations supporting contracts signed after the effective date of the proposed measure.

The governor would have similar authority to reduce spending if the legislature fails to enact a budget by July 1. If a budget is not enacted by July 1, spending would continue at the level provided in the prior year’s budget. If a shortfall exists, the governor would have unilateral authority to cut spending if the legislature failed to take action within 30 days.

The governor would gain broad powers to cut even in years when there is a budget surplus. The governor would be allowed to cut spending any time revenues fall at least 1.5 percent below forecast levels or when the balance in the Budget Stabilization Account is anticipated to drop by more than half. The LWOM Act does *not* require that the budget be out of balance in order for the governor to reduce spending. Take the following example. A budget is signed into law providing a 3 percent reserve. During the year, revenues fall 2 percent below anticipated levels. The state would still be spending less than it brings in. In this example, the governor could still declare a fiscal emergency and use the authority to cut spending provided by the LWOM Act. This power could also apply if tax cuts enacted after the budget reduce state revenues, such as those passed at the end of the legislative session in 1996 and 1997.

Similarly, the governor would retain the power to declare a fiscal emergency and cut spending even if expenditures fall below anticipated levels, since the trigger looks only at the revenue side of the budget.

The legislature could be locked out of deliberations over future budget cuts. The proposed change would allow the governor to determine what spending would be cut to close future budget deficits. In bad budget years, the governor could circumvent the will of the legislature by vetoing any measure passed to address a budget shortfall and then use his or her authority to make spending reductions to craft a budget. In the current year, for example, the governor would have the authority to reduce spending for In-Home Supportive Services or K - 14 education regardless of the will of the legislature. The governor would also have the authority to unilaterally reduce wage and benefit payments subject to collective bargaining agreements signed after the effective date of the LWOM Act or to reduce appropriations that support payments to businesses that provide goods and services to the state pursuant to contracts signed after the effective date of the LWOM Act.

It is unclear which programs would be covered by the exclusion for spending required by federal law or regulations. The governor could not cut spending required by federal law or regulations; however, the breadth of this exclusion is unclear. Federal law, for example, establishes minimum standards and guidelines for states that participate in the Medicaid program. Federal law does not, however, require states to participate in Medicaid. California currently exceeds the program’s minimum requirements with respect to benefits offered and individuals covered. Similarly, the Temporary Assistance for Needy Families (TANF) block

grant, which supports the state's CalWORKs program, includes a maintenance of effort (MOE) requirement. While federal law allows states to spend below the MOE level, they lose federal funds when they do. The LWOM Act is silent on whether the governor could reduce spending counted toward this type of MOE.

It is unclear to what extent the governor could make spending reductions that are statutorily required. The LWOM Act allows the governor to reduce spending that is constitutionally required (i.e., by the Proposition 98 school spending guarantee or the requirement for the state to reimburse local governments for revenues lost due to the homeowners' property tax exemption). It also allows the governor to reduce spending that is "made with respect to any... other entitlement under law for which liability of the State to pay arises on or after the effective date of the measure that added this subparagraph." It is unclear whether this provision would grant the governor authority to cut spending that is required by state statute. For example, it is unclear whether the governor could unilaterally eliminate benefits that are not required by federal law from the Medi-Cal program or unilaterally reduce cash assistance payments that are set by statute.

The governor would gain the ability to suspend a mandate. The provisions of the LWOM Act governing the state's reimbursement of local governments for costs related to mandated programs and services are ambiguous and somewhat contradictory. On the one hand, the LWOM Act authorizes the governor to cut spending regardless of any other provision of the Constitution. This provision appears to allow the governor to reduce amounts paid to local governments, regardless of the requirement for the state to reimburse local governments.⁶ On the other hand, the LWOM Act refers to the full or partial suspension of a mandate in response to the governor's new authority to reduce spending. Current law, as enacted by Proposition 1A, requires an action of the legislature to suspend a mandate. The LWOM act would significantly broaden the governor's power and eliminate the legislature's ability to determine which laws should remain in force. Moreover, the governor's budget reduction authority could be used to eliminate local governments' reimbursement for services performed at the beginning of a fiscal year prior to the declaration of a fiscal emergency. This could leave local governments responsible for services provided in good faith with the assumption of future reimbursement.

One-time spending would continue. In the event of a budget stalemate, the LWOM Act would continue spending at the prior year's level. The continuation would apply to all spending authorized in the prior Budget Act, even if an appropriation was intended to be one-time in nature. Thus funding would continue for a one-year pilot project, even if the legislature intended to zero-out the program in the subsequent year's budget act. Similarly, a one-time appropriation to help a local government purchase a parcel of land for a park would be extended.

THE LWOM ACT MAKES SWEEPING CHANGES TO THE PROPOSITION 98 GUARANTEE

The LWOM Act makes significant changes to the Proposition 98 school funding guarantee. Specifically, the measure would:

- Eliminate "test 3;"
- Eliminate the state's current and any future maintenance factor obligations;

- Exclude appropriations that exceed the minimum required by Proposition 98 from calculation of future years' funding guarantees; and
- Extend the repayment period for outstanding "settle-up" and maintenance factor obligations to 15 years.

Current law provides two mechanisms for reducing school spending below the level required under "normal" or "test 2" years. The legislature can suspend the Proposition 98 guarantee and an alternative, "test 3" formula requires a smaller increase in school funding.⁷ These mechanisms are designed to prevent the non-education share of the budget from experiencing disproportionate cuts during bad budget years. The Constitution includes a formula that restores funding to its "normal" level in future years as the state's fiscal condition improves. The current formula is not a loan, but rather a restoration of the funding level. Schools do not receive the funds lost during the intervening years. Instead, funding is restored going forward to the level where it otherwise would have been.⁸

Elimination of the "maintenance factor" would significantly weaken the long-term value of the Proposition 98 guarantee. The LWOM Act would turn the state's existing maintenance factor obligation of approximately \$3.84 billion into a one-time obligation that would be repaid over 15 years. As a result, the long-term minimum school funding level would be \$3.84 billion lower than it would have been under current law.⁹ In the future, the state would not be required to repay amounts owed in years when the Proposition 98 guarantee is suspended or if the governor chooses to cut education using his or her new authority to reduce spending to remedy a fiscal emergency. The LWOM Act would allow the governor to cut school funding by any amount needed to eliminate all or part of a state shortfall, regardless of the funding levels specified by the current guarantee. Future years' funding level would be based on the funding level after any reductions made by the governor under the powers granted by the LWOM Act.

THE LWOM ACT PUTS MORE SPENDING ON AUTOPILOT

The LWOM Act would eliminate the legislature's ability to suspend the transfer of sales tax revenues paid on gasoline to the TIF and would eliminate "test 3" of the Proposition 98 guarantee. Test 3 was designed to limit spending on K - 14 education in years of slow or no revenue growth in order to prevent a deficit from having a disproportionate impact on the non-education share of the budget. These provisions would limit the legislature's ability to address future budget deficits and increase the share of the state budget that is on autopilot.

Schools would fall behind transportation and local governments with respect to constitutional spending protection. Taken in conjunction with the changes proposed in the Proposition 98 guarantee discussed above, funding for education would have less protection than that provided to transportation programs authorized by Proposition 42 or to local governments under Proposition 1A. The legislature would be prohibited from suspending the Proposition 42 transfer; under Proposition 1A, the state may only shift property tax revenues under limited circumstances and when it does, is required to repay amounts shifted as a loan. Reducing the protection afforded to education, while increasing the protection offered to other major spending programs, would increase the likelihood that school funding would be cut during future budget crises.

THE LWOM DOES NOT ALLOW FOR PUBLIC INPUT OR OVERSIGHT OF KEY BUDGET DECISIONS

The LWOM Act requires the Department of Finance to advise the governor at least quarterly regarding the status of state revenues and expenditures. The measure does not, however, require that this advice be made public, or provide a process for the legislature and/or public to review and comment on the forecast that would be used as the basis of a fiscal emergency. Studies show that the revenue and expenditure forecasts prepared by the Department of Finance are subject to considerable errors.¹⁰ The measure does not provide for a rescission of spending reductions should the forecast used to declare an emergency turn out to be in error. Similarly, the measure does not require the governor to provide an analysis of proposed spending reductions or their impact to the public or the legislature.

WHEN DOES A CONSTITUTIONAL AMENDMENT BECOME A CONSTITUTIONAL REVISION?

The state Constitution allows voters to amend it through the initiative process. The Constitution can only be revised by an amendment placed on the ballot by the legislature or through a constitutional convention. Measures that fundamentally change the structure of government, such as the balance of powers between the legislative and executive branches of government, can only be made through a revision to the Constitution. The Constitution can be amended, but not revised by initiative.¹¹ Some experts argue that giving the governor the authority to unilaterally reduce spending fundamentally shifts the balance of power over the budget and thus would require a constitutional revision, rather than a simple amendment. Similarly, allowing the governor to unilaterally suspend a mandate, which is contained in state statute, could be seen as substantially revising the roles of the legislature and the executive, thus requiring a revision, rather than an amendment.

Jean Ross prepared this Budget Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

¹ This paper is based on the "California Live Within Our Means Act" (SA 2005RF0067 Amdt. #1-NS) downloaded from http://ag.ca.gov/initiatives/pdf/sa2005rf0067_amdt_1_ns.pdf on April 8, 2005.

² The existing State Appropriations Limit (SAL) contained in Article XIII B of the California Constitution, applies to appropriations from the proceeds of taxes. The SAL does not apply to appropriations for debt service, appropriations required by federal law or court mandates, subventions for the use and operation of local government, and appropriations for qualified capital outlay projects. The SAL requires the state to exceed the limit in two consecutive years in order to trigger a reallocation of funds. When revenues exceed the SAL in two consecutive years, half of the amount over the limit goes to programs under the Proposition 98 school spending guarantee and half goes to taxpayers through a revision of tax rates or fee schedules.

³ Legislative Analyst's Office, *The 2005-06 Budget: Perspectives and Issues* (February 2005), p. 70.

⁴ The impact of the LWOM Act on Proposition 172's sales tax rate dedicated to local public safety programs is unclear. LWOM supporters claim that revenues from this tax rate are deposited in a non-governmental cost fund and would not be affected by LWOM. However, the constitutional language added by Proposition 172 suggests that

these revenues are more properly considered special fund revenues, and thus would be affected by the cap. Moreover, and perhaps more importantly, the LWOM Act does not define “total expenditures” for purposes of defining which expenditures are affected by the proposed spending cap. Thus, the cap may limit the stat’s ability to allocate these funds to local public safety agencies.

⁵ Department of Finance, *Governor’s Budget Summaries* for 2000-01 and 2001-02.

⁶ Proposition 1A of November 2004, which codified the Governor’s 2004 budget agreement with local governments, strengthened the language requiring the state to reimburse local governments for the cost of mandated programs and services.

⁷ For a detailed discussion of the Proposition 98 school funding guarantee, see California Budget Project, *Budget Backgrounder: School Finance in California and the Proposition 98 Guarantee* (April 2005).

⁸ Consider this analogy. An individual earns \$40,000 per year. Her employer falls on hard times and asks the worker to take a \$10,000 per year pay cut. If Proposition 98 applied to this situation, the worker’s salary would be returned to \$40,000 per year when the employer’s financial condition improved. The worker would be guaranteed a \$40,000 salary in the future, but would not be repaid for any amounts lost even if it took several years for the employer’s financial condition to improve. The LWOM Act would not require the employer to restore the worker’s salary to its former level. The worker would receive amounts owed prior to the effective date of the Act over 15 years, but these payments would be bonuses and would not increase his or her salary above \$30,000 per year.

⁹ \$3.84 billion represents the most recent estimate of the state’s outstanding maintenance factor obligation. In fact, the minimum guarantee would be even lower relative to current law, since the \$3.84 billion difference would not be adjusted for inflation and enrollment growth over time.

¹⁰ Sabrina Birnbaum Landreth, *Gubernatorial Spending Controls: Surviving State Revenue Shortfalls* (Goldman School of Public Policy, University of California, Berkeley: Spring 2004).

¹¹ Article XVIII of the Constitution specifies that the Constitution can only be revised by a measure(s) placed on the ballot by the legislature or through a constitutional convention called by the legislature by a two-thirds vote.