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PROPOSITION 76'S NEW SPENDING CAP COULD REQUIRE SUBSTANTIAL SPENDING CUTS

Governor Schwarzenegger's California Recovery Team, a business-backed coalition, is supporting an initiative on the November special election ballot that would dramatically change the rules governing the state's budget process. Proponents of Proposition 76 argue that the new cap is designed to "smooth" state spending. This *Brief* examines the provisions of Proposition 76 that would establish a new limit on state spending and finds that the proposed cap could lead to a significant reduction in state spending over time.

This finding is supported by the Legislative Analyst's Office analysis of Proposition 76, which concludes that, "Over time, we believe that the operation of this limit would likely reduce state expenditures relative to current law."[1]

This *Brief* finds that Proposition 76 could:

- Lead to a significant reduction in state spending. If Proposition 76 had been enacted in 1990, for example, allowable spending would be $12.6 billion below the level signed into law by Governor Schwarzenegger in the 2005-06 Budget. This exceeds 2005-06 General Fund spending for Higher Education ($10.2 billion), or combined General Fund spending for Business, Transportation and Housing; Resources; Environmental Protection; and Social Services ($11.8 billion).
- Limit spending to less than the level of revenue collections over the course of the state's typical boom-bust budget cycle.
- Result in the accumulation of large reserves in the state's General Fund and special funds. The magnitude of these reserves could lead to pressure for tax reductions that, in turn, would further reduce the allowable spending, even if the state has sizeable reserves.
- Lead to large balances in funds supported by voter-approved taxes.

How Would the Proposed Cap Work?

Proposition 76 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.[2] The new spending cap:

- **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.
- **Applies to "total expenditures."** However, Proposition 76 does not define the term "total expenditures." Thus, it is unclear whether bond funds, trust funds, or nongovernmental cost funds, such as Proposition 172's sales tax rate dedicated to local public safety programs, would be subject to the cap. Spending could exceed the cap for one year only in specified emergencies, generally in the event of a natural disaster. However, any amount spent

in excess of the cap would not count toward the calculation of future years' limits.

- **Limits growth in spending to no more than the average revenue growth in the three prior years.** Allowable spending would be calculated by adjusting the prior year's actual expenditures by the percent change in General Fund and special fund revenues. In the event the state spends less than the allowable amount in any year, that lower level of actual expenditures would become the base for calculating the spending cap for the next fiscal year. The adjustment factor would exclude revenues received by "(N)ongovernmental Cost Funds, including federal funds, trust and agency funds, enterprise funds, or selected bond funds."

- **Applies the cap "proportionately" to the General Fund and special funds in years when revenues exceed the cap.**[3] General Fund revenues in excess of the cap would be allocated to the Budget Stabilization Account (25 percent); maintenance factor repayment, repayment of certain loans to transportation funds, or deficit bond repayment as appropriated by the Legislature (50 percent); and for school and road improvements as appropriated by the Legislature (25 percent). Special fund revenues in excess of the cap would be held in a reserve in each special fund. Funds in the reserves, both General Fund and special fund, could be spent in years when revenues are below the cap. The measure does not state how the share of excess General Fund revenues dedicated to the repayment of outstanding debts would be allocated once those debts are repaid.

How Might Proposition 76 Affect State Spending Over Time?

Proponents argue that the new cap is designed to "smooth" state spending by limiting the growth in spending to the average change in state revenues for the three prior years. Analysis of historical spending and revenue data suggests that Proposition 76 would, in fact, substantially reduce spending over time.

In order to assess the potential impact of Proposition 76, the CBP modeled how the proposed limit would have affected state spending if it had been enacted in 1987, 1990, and 1995.[4] These three years illustrate three points in past budget cycles:

- 1987, when the state experienced relatively strong revenue growth, followed by slow growth during the recession of the early 1990s.

- 1990, when the state experienced one year of revenue growth, followed by slow growth during the recession of the early 1990s.

- 1995, as the state emerged from the downturn of the early 1990s.

This analysis found that allowable 2005-06 spending would have been significantly below that provided by the budget signed into law by the Governor under all three base year scenarios (Table 1). If Proposition 76 had been enacted in 1990, for example, allowable 2005-06 spending would be $12.6 billion below the level in the budget signed into law by Governor Schwarzenegger and $7.8 billion below anticipated 2005-06 revenues. Reductions needed to reach the allowed spending level under this scenario would exceed 2005-06 General Fund spending for Higher Education ($10.2 billion) or combined General Fund spending for Business, Transportation, and Housing; Resources; Environmental Protection; and Social Services ($11.8 billion).

The Cap Could Require Sizeable Spending Cuts

As noted above, the 2005-06 Budget spends substantially more than would be allowed by Proposition 76 under any of the three base year scenarios. Reductions equal to 11.1 percent of 2005-06 spending would be required to reach the cap under the 1987 and 1990 scenarios, while reductions equal to 5.2 percent of 2005-06 spending would be needed to reach the cap under the 1995 base year scenario. Assuming that reductions were made across-the-board, this translates, for example, into a $1.6 billion reduction in Department of Health Services spending, which includes payments for Medi-Cal benefits, under the 1987 and 1990 scenarios, or a $735 million reduction under the 1995 base year scenario (Table 2). Similarly, under the 1987 and 1990 scenarios, K–12 Education would be reduced by $4.1 billion if spending were reduced across-the-board to reflect the cap.

Table 1: 2005-06 Spending Compared to Hypothetical Spending Cap

Base Year	2005-06 Budgeted Spending	2005-06 Allowable Spending If Proposition 76 Had Been Enacted in Base Year	2005-06 Spending Exceeds Allowable Spending By	Percentage Reduction Needed to Meet Cap
1987	$113,358,784,000	$100,773,663,905	$12,585,120,095	11.1%
1990	$113,358,784,000	$100,773,663,905	$12,585,120,095	11.1%
1995	$113,358,784,000	$107,466,722,637	$5,892,061,363	5.2%

Table 2: What Level of Cuts Would Be Needed to Reduce Spending to the Cap? (Dollars in Millions, Assumes Across-the-Board Reductions)	1987 or 1990 Base Year	1995 Base Year
Legislative, Judicial, Executive	$533	$249
Office of Emergency Services	$18	$9
State and Consumer Services	$142	$66
Environmental Protection	$118	$55
Resources	$334	$156
Department of Parks and Recreation	$36	$17
Department of Forestry and Fire Protection	$62	$29
Health and Human Services	$3,634	$1,701
Department of Health Services	$1,571	$735
Realignment: Local Health, Mental Health, and Social Services	$484	$227
Labor and Workforce Development	$42	$20
General Government	$724	$339
K - 12 Education	$4,068	$1,904
Corrections and Rehabilitation	$824	$386
Higher Education	$1,273	$596
University of California	$319	$149
California State University	$425	$199
Community Colleges	$386	$181
Business, Transportation, and Housing	$894	$418
Department of Transportation	$568	$266
TOTAL	$12,585	$5,892

In Most Years, the Cap, Not Available Revenues, Would Limit Spending

As part of the analysis described above, the CBP compared allowable spending to actual spending for each of the three base periods. For all three base period scenarios, the cap was below actual revenues for a majority of years (Table 3). Moreover, the cap was below actual revenue collections in a majority of the years examined. The cap was below actual revenues throughout the recent budget crisis using 1987 and 1990 as base years and below actual revenues in the current year using 1995 as the base year.

Table 3: New Cap Would Not Allow the State to Spend Available Revenues in a Majority of Years

Base Year	Total Number of Years Since Base Year	Number of Years Actual Spending Exceeded the Cap	Number of Years Actual Revenues Exceeded the Cap
1987	18	14	15
1990	15	13	13
1995	10	8	6

Proposition 76 Would Lock in Bad Times

Proposition 76's tendency to reduce spending over time results from the formula used to calculate the spending cap and specifically the provision that ties future spending to past years' spending. In years when available revenues, plus any amounts available in the Budget Stabilization Account (BSA), are below the spending cap, subsequent years' caps would be based on the lower amount available during the downturn.[5]

While Proposition 76 would allow taxes to be increased and the resulting revenues to be spent up to the maximum allowed under the spending cap, the two-thirds vote requirement for approval of state tax increases severely limits the Legislature's ability to enact a tax increase. Absent a tax increase, the failure to spend the maximum allowed under the cap would result in a permanent reduction in future years' allowable state spending.

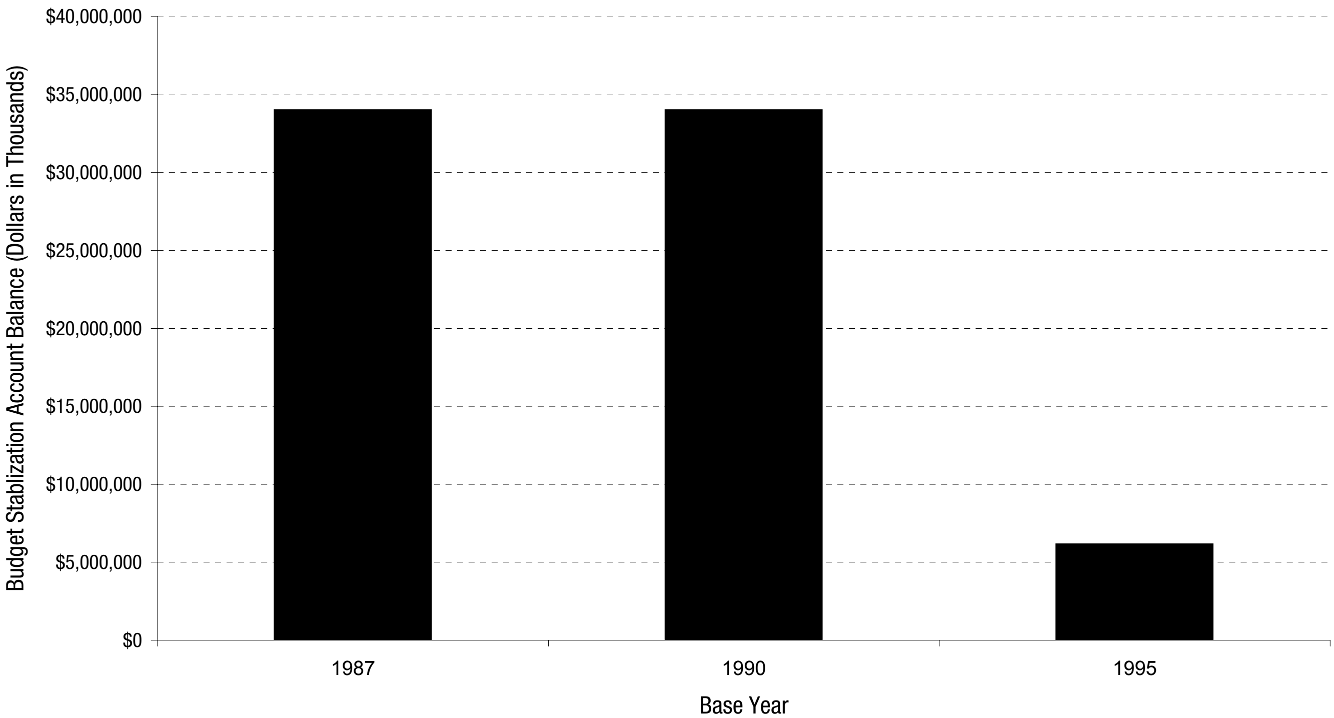
Table 4: Allocation to a Reserve in 2005-06 Under Various Base Year Scenarios (Dollars in Thousands)

	Base Year		
	1987	1990	1995
Fuel Taxes	$246,469	$246,469	$41,165
Realignment Sales Tax	$193,553	$193,553	$32,327
Proposition 10 Tobacco Tax	$43,104	$43,104	$7,199
Proposition 99 Tobacco Tax	$21,552	$21,552	$3,600
CSU Fees	$86,852	$86,852	$14,506
Emergency Telephone User Surcharge	$9,348	$9,348	$1,561

Large BSA Balances Could Encourage Tax Cuts, but Tax Cuts Would Further Limit Allowable Spending

Over time, Proposition 76 could generate substantial balances in the BSA and the state's special funds. (Figure 1). Had Proposition 76 been enacted in 1990, for example, the balance in the BSA would have reached $34.0 billion by 2005-06. Balances of this magnitude would likely generate political pressure for tax reductions. Tax cuts would, however, reduce the state's spending authority. This would occur since a tax cut would reduce the percentage growth in revenue that would, in turn, reduce the level of allowable spending in future years. The impact of even a one-year tax cut on spending would be permanent, since each year's spending cap is based on revenue growth in the three prior years,

Figure 1: Cap Could Result in the Accumulation of Sizeable BSA Balances



and the reduction in allowable spending would lower the base used to calculate future years' caps.

Large Balances Could Also Mount in Special Funds

To the extent revenues repeatedly exceed the spending cap, as occurred in the three scenarios examined in this report, large reserves would also accumulate in special funds. Proposition 76 imposes a cap "proportionately" on all funds in years when revenues exceed allowable spending. The proportionate application of the cap could require the state to set aside a significant fraction of special fund revenues in a dedicated reserve (Table 4).[6] Under the 1987 and 1990 base year scenarios described above, for example, $247 million in fuel taxes would have been placed in a reserve in 2005-06, rather than made available for transportation-related purposes. Similarly, $194 million in realignment sales tax revenues would have been placed in a reserve in 2005-06. These reserves could only be spent by cutting other expenditures to free up room under the cap or in years when revenues fall below the state's spending cap.

While many voter-approved taxes are exempt from the current State Appropriations Limit, Proposition 76's cap would apply to voter-approved taxes, such as the tobacco taxes enacted by Proposition 99 and Proposition 10 and the tax on high-income earners that supports mental health programs enacted by Proposition 63. In years when total revenues exceed the spending cap, the excess amount attributable to funds supported by these taxes would be allocated proportionately to a reserve in each special fund. To the extent that revenues exceed the cap for a number of years, as they do in the scenarios examined above, these reserves would grow, and the state would be limited in its ability to spend available revenues. Excess revenues would remain in these reserves absent subsequent action by the voters.

Conclusion

Historical analysis provides an indication, but no guarantee, of how Proposition 76 might affect future spending. This analysis strongly suggests that over the state's typical boom-bust spending cycles, the allowable level of state spending would be significantly reduced over time. Moreover, allowable spending would likely be less than the revenues raised by the state's current tax system. To the extent the state accumulates reserves that exceed an amount deemed prudent to protect against a drop in revenue collections that might occur during a recession, pressure to cut taxes could increase. Tax reductions, however, would reduce allowable spending by reducing the inflation factor used to adjust the spending cap, regardless of the revenues available to support ongoing spending.

Jean Ross prepared this Budget Brief. The California Budget Project (CBP) neither supports nor opposes Proposition 76. This Budget Brief is designed to help voters reach an informed decision based on the merits of the issues. The 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] Legislative Analyst's Office, *Proposition 76. School Funding. State Spending. Initiative Constitutional Amendment.* (July 21, 2005) downloaded from http://www.ss.ca.gov/elections/bp_nov05/analysis76.pdf on July 26, 2005.

[2] For a detailed examination of Proposition 76, see California Budget Project, *Limiting the Future?: What Would the "Live Within Our Means Act" Mean for California?* (Revised June 17, 2005).

[3] Proposition 76 states that any revenues in excess of the cap would be allocated "proportionately" between the General Fund and special funds. However, the measure does not specify how this allocation would be made. See Legislative Analyst, *Proposition 76: State Spending and School Funding Limits. Initiative Constitutional Amendment.* downloaded from http://www.ss.ca.gov/elections/vig_2005.htm on September 16, 2005.

[4] In this analysis, the CBP assumed that Proposition 76 had been passed in each of the three years. Base year expenditures are the sum of state General Fund and special fund expenditures. The annual adjustment factor was calculated based on actual state General Fund and special fund revenues. In years when allowable spending exceeded actual spending, the CBP assumed that the hypothetical spending level equaled actual spending, plus any available balance in the Budget Stabilization Account up to the level allowed by the spending cap.

[5] The state would be limited in its ability to borrow to maintain spending since Proposition 58 limits the state's ability to borrow absent voter approval.

[6] Amounts in the reserve could only be spent for the purposes for which the funds were originally intended in years when total spending was below the level allowed by the spending cap.