

CALTAX COMMENTARY: THE HISTORY AND PROVISIONS OF THE STATE SPENDING LIMIT, AND WHY IT'S BACK IN PLAY

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What a surprise! According to the Legislative Analyst's Office, the long-dormant state spending limit (embedded in Article XIII B of the California Constitution) could have an impact on the 2017-18 budget now under discussion at the Capitol. "What spending limit?" is the reaction of most observers. The limit, known as the "Gann Limit" after one of the authors and cosigner of the ballot argument, has been almost relegated to the dustbin of history. The Gann Limit puts a cap on the spending of "proceeds of taxes," but after changes in 1988 and 1990, "proceeds of taxes" have not exceeded the limit for any two-year period, and thus the limit generally has been forgotten.

The Birth of the Spending Limit

In 1978, shortly after passage of Proposition 13 (which has not been forgotten!), several organizations feared that overspending by the Legislature might create a deficit that could cause cuts in the Proposition 13 state assistance package that replaced much of the local governments' lost property tax revenue. The answer, they believed, was a state spending limit.

Drafters of the proposed limit were Kirk West, representing CalTax; Jim Kennedy, representing the California Chamber of Commerce; Paul Gann, representing the People's Advocate; W. Craig Stubblebine, who had a hand in drafting a spending limit proposal for Governor Ronald Reagan; Dugald Gillies, representing the California Association of Realtors, and Lew Uhler, representing the National Tax Limitation Committee.

In general, the plan they conceived limited state and local spending of the "proceeds of taxes," adjusted for inflation and changes in population. As it turned out, the proposed limit turned out to be less controversial than expected. After meeting with legislative staff, Assembly Speaker Leo McCarthy endorsed the plan and signed the ballot argument in favor. "No government should have an unrestricted right to spend the taxpayers' money," Speaker McCarthy said.

Opposition came from Jonathan Lewis, executive director of the California Tax Reform Association.

Proponents quickly gathered signatures to put the spending limit on the ballot, and it became Proposition 4 of 1979. Voters responded to the bipartisan nature of the campaign, and Proposition 4 passed with 75 percent of the vote. (Note: Article XIII B also requires the state to reimburse local governments for most state mandates. An entire article would be needed to cover that aspect of the measure.)

After approval, several provisions required legislative implementation. Following the same process used to implement Proposition 13, Speaker McCarthy asked me, then

chief consultant to the Assembly Revenue and Taxation Committee, to develop recommendations, working with Assembly staff. Fred Silva and Martin Helmke were asked by Senate leaders asked to do the same.

A joint plan was developed and amended into SB 1352 (Marks) of 1980. It defined "proceeds of taxes" more fully, and clarified a number of provisions. A part of the state subvention to schools was placed in the state limit, and part was placed in the schools' limit. Perhaps the most controversial part of the plan was the inclusion of gas tax revenue, which is special fund revenue, within the definition of "proceeds of taxes." Proponents of highway construction feared that this would curtail future growth for transportation (because, under the limit, if transportation spending increased, other spending would have to be cut).

Spending Limit Creates a Tax Rebate

In 1987, Governor George Deukmejian announced that state revenue would exceed the limit by \$1.1 billion. The surge in revenue was caused by the federal tax reform act of 1986.

A political firefight ensued. Democrats wanted to spend the entire revenue increase. The governor offered to transfer \$400 million to schools. As there was no agreement, after the beginning of the new fiscal year, the entire \$1.1 billion had to be returned to taxpayers.

AB 2609 (Condit) of 1987 required the state to provide an income tax rebate of 15 percent (with a minimum of \$64 and a maximum of \$236) for all who filed a 1986 tax return. The amounts were paid by check to all those who filed a return, whether they owed any tax or not.

The rebate was both ill-advised and unconstitutional, but the Legislature passed it anyway. The spending limit requires the amounts over the limit to be returned by "a reduction of tax rates or fee schedules." Rebates are not authorized. Also, the state had to spend \$7.6 million to send out the checks, and more than 150,000 rebate checks were returned by the post office.

Emasculation of the Spending Limit

By 1988, changes to the spending limit were being proposed. Two measures were placed on the June ballot.

Public employee unions, miffed by the tax rebate, wanted to loosen the limit. They sponsored Proposition 71, to use a higher measure of inflation. It would have increased the state limit by \$800 million and local limits by a like amount. Voters rejected it in a close vote, with 51.1 percent of voters voting no.

Even the limit's namesake wanted to loosen it. Paul Gann joined with transportation interests to place such taxes as the gas tax, weight "fees" and the sales tax on gasoline

outside the definition of "proceeds of taxes." As Proposition 72, this proposal was rejected by 62 percent of the voters.

In a much more audacious move, the California Teachers Association (CTA) placed on the November 1988 ballot an initiative (Proposition 98) that carved out a growing percentage of the state's general fund for schools. It is not clear whether it was the intent of the proponents, or an error in drafting, but over time, schools would get a larger and larger percentage of the general fund, squeezing out state spending for everything else.

Proposition 98 also contained a provision that emasculated the state spending limit by providing that 100 percent of amounts over the limit (up to 4 percent of general fund appropriations) would be used for K-14 spending. These amounts would be built into the school spending base, and would grow with the inflation factor. Thus, the limit as revised by Proposition 98 would serve simply as a computational device that would increase spending even more than if the limit was not in place at all.

Almost all of the state's newspapers came out against Proposition 98, and Governor Deukmejian signed the ballot argument against it, but the teachers' union spent lavishly – outspending opponents 10-to-1 – and the proposal passed with 50.7 percent of the vote.

Partial Restoration of the Limit

It was obvious almost immediately that Proposition 98 was so defective that it had to be revised. A coalition of taxpayer groups, local government, the university system and unions representing public employees (other than teachers) joined forces to push through a constitutional amendment with some needed changes. Because of the CTA's influence in the Legislature, some compromises had to be made to secure votes for passage. The reforms were incorporated into SCA 1 (Garamendi) and put on the June 1990 ballot as Proposition 111.

Proposition 111's provisions:

- Only half of the revenue over the limit would go to schools, and the other half would be returned to taxpayers. Only part of the schools' share would be included in the base for future school appropriations under certain conditions.
- The limit was changed so that revenue over the limit in a two-year period, rather than a one-year period, would trigger rebates and school subventions.
- The inflation factor was changed to use a higher definition of inflation (growth in per capita personal income and population and school attendance growth). This added more room for spending under the cap.
- Gas tax and sales tax revenue from the portion of the gas tax rate in excess of the existing rate would be outside the limit, as would weight fees above 1990

levels, allowing greater growth in transportation spending. Proposition 111 also included a doubling of the gas tax.

- The formula giving schools a larger and larger share of the state budget was revised to limit the amounts in years of low state revenue growth (known as "test three").

Another change in the limit was the revision of the base year for the limit from 1978-79 to 1986-87. (The spending limit is based on the prior year computed limit, not the actual spending in the prior year, so the limit computed in the base year controls the computation for all subsequent years.) The fiscal impact of this change was not well understood, and was the reason, along with the change in the inflation factor, that caused the limit to be substantially higher than spending for twenty-five of the next twenty-six years. (Note: the state had revenue over the limit in 1999-00, but due to the change to the two-year requirement, and revenues were under the limit in 2000-01, no rebate and school appropriations were required.)

Proposition 111 was a tough sell, but after polls showed it trailing early, it was approved by 52.4 percent.

How the Limit Works

The limit is deceptively simple in concept, but very complicated in practice. State and local government spending, with exceptions, is limited to the prior year's "proceeds of taxes," adjusted to reflect changes in inflation and population. Key questions: What spending is excluded? What revenue is included in the definition of "proceeds of taxes"? How does the inflation factor work, and what are its benchmarks?

The end result is that the dollar amount of the spending limit looks nothing like the actual level of state spending, which is far higher.

For example, total state spending – including special funds and bond funds – for the 2016-17 fiscal year will be \$177.5 billion, according to the governor's most recent budget summary. But the appropriations subject to the Gann Limit totaled just \$95.9 billion, according to the legislative analyst, with \$3.9 billion in additional spending that could be approved before the limit would be reached.

Excluded from appropriations subject to the state limit are state subventions to local government (they are put in the local limit), federal and court mandates, debt service, qualified capital outlay, gas and transportation tax revenue in excess of 9 cents per gallon, appropriations for certain natural disasters and spending of certain cigarette tax revenue.

Excluded from proceeds of taxes are revenues from investments, certain user fees that pay for a cost of a service (but parts of fees exceeding the cost of a service are within the limit), prior-year surplus revenue (to avoid government employees from adopting a "spend it or lose it" philosophy), etc.

If the financial responsibility for providing a service is transferred between entities, the spending limit for the transferee agency is increased by that amount, and the limit for the transferor agency is reduced by the same amount.

The per capita inflation factor is determined by the change in fourth-quarter personal income and the change in the civilian population of the state. The change-in-population factor is determined by using school attendance for the schools' share of the state budget, and civilian population change for the rest.

Governor Brown Changes Computation to Create More Spending Space

In his 2017-18 state budget proposal, Governor Jerry Brown changes the way the spending limit is computed. According to the legislative analyst, this creates room for \$22 billion in additional spending. The analyst said the change appears to conflict with the state constitution, and "violates the spirit of the Gann limit."

What the governor has done is to remove certain school subventions that have been included in the state limit, without taking the additional step of counting them in the schools' limit. The analyst said this creates "nowhere income" that is not permitted by Article XIII B.

Additionally, the governor excludes from the limit his proposed \$65 additional charge on motor vehicles. There is a strong argument that this is a tax, the analyst said.

As calculated by the analyst, the room under the spending limit is \$3.3 billion for 2015-16, \$3.9 billion for 2016-17 and \$2.8 billion for 2017-18.

An increase in revenue – caused by faulty revenue estimates (a frequent occurrence) or actual revenue growth resulting from changes in the federal tax structure and increased economic activity – could put the state above the limit.

The recent surge in the stock market and increases in the value of California property might generate enough of an increase in capital gains taxes to crack the limit. Stay tuned.