



Revenue and Taxation Policy Committee
Friday, January 27, 2023
10:00am – 2:00pm

Register for this meeting:

https://us06web.zoom.us/j/85877655637?pwd=RDhoeVhqbNjINGVjMkJXNjR0QmYxdz09

Immediately after registering, you will receive a link and confirmation email to join the meeting.

AGENDA

- I. Welcome
Speakers: Chair Charles Bourbeau, Council Member, Atascadero
Vice Chair Kuldip Thusu, Council Member, Dinuba
Cal Cities President Ali Sajjad Taj, Council Member, Artesia
Cal Cities Executive Director and CEO Carolyn Coleman

II. Public Comment

III. General Briefing Informational

IV. Cal Cities 2023 Advocacy Priorities (Attachment A) Informational

V. 2023-24 State Legislative and Budget Review Informational
Guest Speaker: Lourdes Morales, Principal Fiscal & Policy Analyst, Legislative Analyst's Office
Cal Cities 2023 Revenue and Taxation Bills (Attachment B)
Cal Cities 2023-24 State Budget Request Letter (Attachment C)
LAO: The 2023-24 Budget: Overview of the Governor's Budget (Attachment D)

Meeting Lunch Break – 12:00pm -12:30pm

VI. Business Roundtable Ballot Measure Update (Attachment E) Informational

VII. City Managers Sales Tax Working Group Update (Attachments F, G) Action

VIII. Adoption of 2023 Policy Committee Work Plan (Attachment H) Action

IX. Adjourn

Next Virtual Meeting: Friday, March 17, 2023, 10:00am – 2:00pm

Brown Act Reminder: The League of California Cities' Board of Directors has a policy of complying with the spirit of open meeting laws. Generally, off-agenda items may be taken up only if:

- 1) Two-thirds of the policy committee members find a need for immediate action exists and the need to take action came to the attention of the policy committee after the agenda was prepared (Note: If fewer than two-thirds of policy committee members are present, taking up an off-agenda item requires a unanimous vote); or
2) A majority of the policy committee finds an emergency (for example: work stoppage or disaster) exists.

A majority of a city council may not, consistent with the Brown Act, discuss specific substantive issues among themselves at League meetings. Any such discussion is subject to the Brown Act and must occur in a meeting that complies with its requirements.

League of California Cities 2023 Advocacy Priorities

- 1. Protect and expand investments to prevent and reduce homelessness.** Secure sustainable state funding that bolsters cities' efforts to support individuals experiencing, or at risk of, homelessness. While protecting existing resources, strengthen state and local partnerships to connect individuals with the care they need through coordinated care systems that provide access to wraparound services, including mental health and substance use treatment.
- 2. Increase the supply and affordability of housing while retaining local decision-making.** Secure long-term, sustainable funding tools for cities to jumpstart the construction of housing at all income levels and ensure cities retain flexibility to achieve local and state housing goals.
- 3. Improve public safety in California communities.** Pursue strategies and resources to address crime and its underlying causes. Partner with all levels of government and diverse organizations to improve community safety through prevention and early intervention programming, workforce recruitment and retention, and improved re-entry services.
- 4. Safeguard essential local revenues and support fiscal sustainability.** Protect, increase, and modernize revenue streams for local priorities. Oppose efforts that would reduce or eliminate funding for cities, including unfunded mandates.

Measure/ Author	Location	Title	Summary	Cal Cities Position
AB 26 (Fong, Mike D)	12/5/2022- A. PRINT	Personal Income Tax Law: exclusion: federal student loan debt relief plan.	<p>The Personal Income Tax Law, in modified conformity with federal income tax law, generally defines "gross income" as income from whatever source derived, except as specifically excluded, including an exclusion for the amount of student loan indebtedness repaid or canceled pursuant to a specified federal law.</p> <p>Current law requires any bill authorizing a new tax expenditure to contain, among other things, specific goals, purposes, and objectives that the tax expenditure will achieve, detailed performance indicators, and data collection requirements.</p> <p>This bill would exclude from an individual's gross income, for taxable years beginning on or after January 1, 2022, any amount of qualified student loan debt, as defined, that is discharged under the federal student loan debt relief plan, as specified. The bill would specify that its provisions shall only become operative upon the enactment of legislation that would conform to specified federal law.</p>	Watch
AB 39 (Grayson D)	12/5/2022- A. PRINT	Digital financial asset market: regulatory oversight.	Would make legislative findings and declarations relating to state oversight of the digital financial asset market.	Watch

<p>AB 52 (Grayson D)</p>	<p>12/5/2022- A. PRINT</p>	<p>Sales and Use Tax Law: manufacturing equipment: research and development equipment.</p>	<p>Current law provides various exemptions from sales and use taxes, including an exemption from those taxes, on and after July 1, 2014, and before July 1, 2030, for the gross receipts from the sale of, and the storage, use, or other consumption of, qualified tangible personal property, as defined, that is, among other things, purchased by a qualified person for purchases for use primarily in manufacturing, processing, refining, fabricating, or recycling of tangible personal property, as specified, or purchased for use by a qualified person to be used primarily in research and development.</p> <p>Current law prohibits the exemption described above from applying with respect to any tax levied by a county, city, or district pursuant to, or in accordance with, the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law, sales and use taxes imposed pursuant to certain provisions of the Sales and Use Tax Law, and sales and use taxes imposed pursuant to certain provisions of the California Constitution.</p> <p>This bill would express the intent of the Legislature to expand the sales and use tax exemption for manufacturing and research and development equipment to preserve California's status as a hub of innovation and technology and to encourage greater investment in California.</p>	<p>Watch</p>
<p>AB 53 (Fong, Vince R)</p>	<p>12/5/2022- A. PRINT</p>	<p>Motor Vehicle Fuel Tax Law: suspension of tax.</p>	<p>Would suspend the imposition of the tax on motor vehicle fuels for one year. The bill would require that all savings realized based on the suspension of the motor vehicle fuels tax by a person other than an end consumer, as defined, be passed on to the end consumer, and would make the violation of this requirement an unfair business practice, in violation of unfair competition laws, as provided.</p> <p>The bill would require a seller of motor vehicle fuels to provide a receipt to a purchaser that indicates the amount of tax that would have otherwise applied to the transaction.</p>	<p>Watch</p>

<p>AB 84 (Ward D)</p>	<p>12/16/2022 -A. PRINT</p>	<p>Property tax: welfare exemption: affordable housing.</p>	<p>Current property tax law, in accordance with the California Constitution, provides for a “welfare exemption” for property used exclusively for religious, hospital, scientific, or charitable purposes and that is owned or operated by certain types of nonprofit entities, if certain qualifying criteria are met.</p> <p>Under current property tax law, property that meets these requirements that is used exclusively for rental housing and related facilities is entitled to a partial exemption, equal to that percentage of the value of the property that is equal to the percentage that the number of units serving lower income households represents of the total number of residential units, in any year that any of certain criteria apply, including that the property be subject to a legal restriction that provides that units designated for use by lower income households are continuously available to or occupied by lower income households, at rents not exceeding specified limits.</p> <p>For the 2018–19 fiscal year through the 2027–28 fiscal year, in the case of an eligible owner of property receiving a low-income housing tax credit under specified federal law, existing property tax law requires that a unit continue to be treated as occupied by a lower income household for these purposes if the occupants were lower income households on the lien date in the fiscal year in which their occupancy of the unit commenced and the unit continues to be rent restricted, notwithstanding an increase in the income of the occupants of the unit to 140% of area median income, adjusted for family size.</p> <p>This bill, beginning with the 2024—25 fiscal year, would remove the requirement that an eligible owner of property receive a low-income housing tax credit and would instead require that a unit continue to be treated as occupied by a lower income household, as described above, if the property is subject to a legal restriction that provides that units designated for use by lower income households are continuously available to or occupied by lower income households, at rents not exceeding specified limits.</p>	<p>Watch</p>
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<p>SB 1 (Glazer D)</p>	<p>1/18/2023-S. GOV. & F.</p>	<p>Personal Income Tax Law: exclusions: student loan forgiveness.</p>	<p>The Personal Income Tax Law, in modified conformity with federal law, generally defines "gross income" as income from whatever source derived, except as specifically excluded, and provides various exclusions from gross income for purposes of computing tax liability.</p> <p>This bill would, for taxable years beginning on or after January 1, 2022, and before January 1, 2026, exclude from gross income any student loan amount waived, canceled, or otherwise forgiven by the United States Department of Education pursuant to a specified federal student debt relief plan.</p>	<p>Watch</p>
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December 14, 2022

The Honorable Gavin Newsom
Governor, State of California
1021 O Street, Suite 9000
Sacramento, CA 95814

Dear Governor Newsom,

In the spirit of a strong state and local government partnership that benefits all Californians, the League of California Cities respectfully calls on the state to take action to bolster local government efforts to support our most vulnerable residents and ensure California's economic strength.

City officials are on the front lines delivering essential services to more than 80% of the state's residents. They rely on collaborative partnerships to meet the challenges facing our communities and the state. Every day, local leaders connect individuals experiencing homelessness with wraparound services, deliver permanent supportive housing, and jumpstart the construction of housing in their communities. Our residents depend on these core services, which cannot be successfully delivered without fiscal sustainability.

In the face of a looming economic recession, a period of elevated inflation, and rising costs, Cal Cities calls on the state to create a permanent funding stream of \$3 billion annually to help cities keep Californians in their homes and prevent more Californians from having to live on the street, under bridges, or in their cars. Cal Cities also calls on the state to honor funding commitments to local governments made in the 2022 Budget that support essential local programs and to finally pay down its growing unfunded mandate debt of \$1 billion to local governments so they can continue to deliver on a wide range of state-required programs.

Find a permanent home in the budget for homelessness and affordable housing

Every community is impacted by the state's affordable housing and homelessness challenges. Real solutions will require a genuine partnership between all levels of government, as well as a state investment that matches the scale of these crises. While cities appreciate the funding included in previous state budgets, one-time funding with limited access inhibits cities' long-term planning efforts and stifles more ambitious goals.

An ongoing, sustainable \$3 billion investment from the state can spur much-needed housing production, ensure that thousands more Californians experiencing homelessness get the support they need, and more importantly, prevent thousands more from losing their homes. This funding will further our state-local partnership to advance practical, data-driven, and effective strategies that jumpstart construction, support residents experiencing homelessness, and meet our shared goals.

Tougher fiscal times can exacerbate the challenges our communities face by contributing to a downturn in the production of affordable housing, an increase in the struggle for resources for unhoused residents, and ever-increasing economic inequity. In the face of another potential recession, we cannot afford for these gaps to widen.

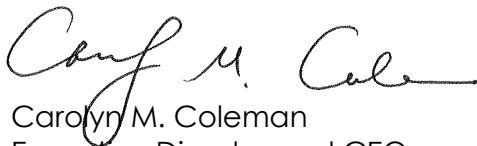
Safeguard local revenues and support local governments' fiscal sustainability

Despite the state's economic uncertainty, Cal Cities strongly opposes any action that would reduce or eliminate funding for local governments as a short-term solution to balance the 2023-24 state budget. Diverting funding would only compound cities' financial challenges and jeopardize the delivery of critical resources to our most vulnerable residents. Cal Cities urges the state to honor funding commitments made in the 2022 Budget Act that support local governments' financial sustainability, including funding for organic waste recycling, disaster preparedness, homelessness, housing production, and broadband access.

Cities are also still waiting for the state to reimburse the nearly \$1 billion it owes to cities, counties, and special districts for state-mandated programs. Local governments have diligently carried out crucial, unfunded programs for many years, and failing to pay for these costs will only create greater financial instability and threaten the ability of local governments to fund essential services to communities.

Cal Cities will be seeking additional resources for cities throughout the budget development process. We look forward to engaging with you to realize an even stronger partnership for the benefit of all Californians.

Sincerely,



Carolyn M. Coleman
Executive Director and CEO
League of California Cities

Cc: Members of the Senate Budget and Fiscal Review Committee
Members of the Assembly Budget Committee
Christy Bouma, Legislative Affairs Secretary, Office of the Governor
Ann Patterson, Cabinet Secretary, Office of the Governor
Joe Stephenshaw, Director, California Department of Finance
Gabriel Petek, Legislative Analyst, Legislative Analyst's Office



The 2023-24 Budget:

Overview of the Governor's Budget



Executive Summary

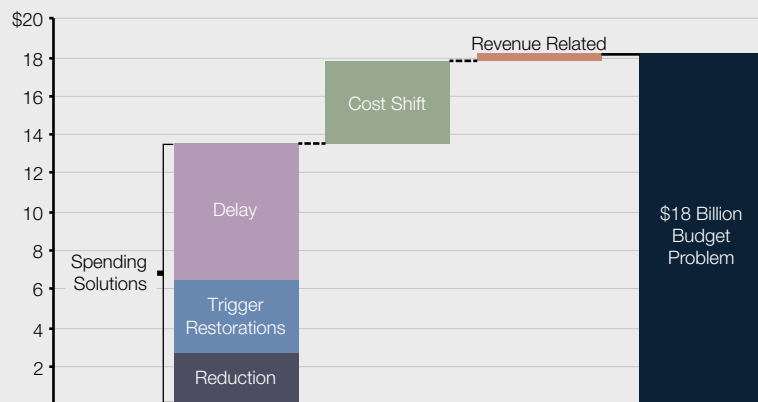
Governor’s Emphasis on Spending Solutions to Address Budget Problem Is Prudent.

Both our office and the administration project that the state faces a manageable budget problem this year. The Governor addresses the budget problem primarily with spending-related solutions, as shown in the figure below. Notably, the Governor does not propose using any reserves. This approach is prudent given the downside risk to revenues posed by the current heightened risk of recession. We recommend the Legislature maintain this approach during its own planning process.

Recommend Legislature Plan for Larger Budget Problem. Our estimates suggest that there is a good chance that revenues will be lower than the administration’s projections for the budget window, particularly in 2022-23 and 2023-24. Given this risk, we recommend the Legislature: (1) plan for a larger budget problem and (2) address that larger problem by reducing more one-time and temporary spending. Taking these steps would allow the state to mitigate the heightened risk of revenue shortfalls. The Legislature need not adopt the Governor’s spending solutions, however. Recent budgets have allocated or planned tens of billions of dollars for one-time or temporary spending purposes in 2021-22, 2022-23, and 2023-24. The Legislature can select an entirely different set of spending solutions to address the budget problem. To develop its budget, we recommend the Legislature evaluate recently approved augmentations and only maintain those augmentations that meet certain criteria.

Governor’s Budget Includes \$18 Billion in Budget Solutions

(In Billions)



LAO

Recommend the Legislature’s Budget Not Include Future Deficits. While the Governor’s budget is balanced under the administration’s estimates for 2023-24, this is not the case for future years. Specifically, the administration forecasts operating deficits ranging from \$4 billion to \$9 billion over the multiyear period. We recommend the Legislature avoid enacting a budget that plans for future deficits. To maintain budget balance, the Legislature could convert some spending-related delays to reductions instead. Alternatively, the Legislature could add new out-year trigger reductions—in which spending triggers off under certain conditions—or by using other budget solutions, such as revenue increases or cost shifts.

Chapter 1

INTRODUCTION

On January 10, 2023, Governor Newsom presented his proposed state budget to the Legislature. In this report, we provide a brief summary of the Governor’s budget based on our

initial review as of January 12. In the coming weeks, we will analyze the plan in more detail and release several additional budget analyses.

THE BUDGET PROBLEM

A budget problem—also called a deficit—occurs when resources for the upcoming budget are insufficient to cover the costs of currently authorized services. Because the State Constitution requires the state to pass a balanced budget, the Governor must propose solutions when the administration estimates the state faces a budget problem. The state has many types of solutions—or tools—for addressing a budget problem, but the most important include: reserve withdrawals, spending reductions, revenue increases, and cost shifts (for example, between funds). Due to a deteriorating revenue picture relative to expectations from June 2022, both our office and the administration have anticipated the state faces a budget problem in 2023-24.

WHAT IS THE BUDGET PROBLEM?

We Estimate the Governor Solved an \$18 Billion Budget Problem. We estimate the Governor’s budget addressed an \$18 billion budget problem. This is somewhat lower than the \$22 billion budget problem the administration has referenced. There are two main sources of this difference. In both cases, the difference stems from what is considered baseline spending—that is, what spending was approved in prior budgets. Specifically, the administration views the following as baseline spending: a \$3 billion unallocated set-aside for inflation-related costs and a shift of \$1.4 billion in authorized capital outlay projects from lease revenue bonds to cash. In contrast, we do not view these items as baseline spending because they

were not approved in any budget-related legislation. Consequently, we do not consider withdrawing the inflation set-aside or shifting back to lease revenue bonds from cash to be budget solutions. (That is, in our view, these costs would not have occurred absent legislative action and as a result do not contribute to the budget problem the Legislature faces today.)

Comparison to LAO November Outlook. In our *Fiscal Outlook* released in November 2022, we anticipated the state would face a \$24 billion budget problem, somewhat higher than the \$18 billion budget problem we estimate the Governor addressed. Relative to our November outlook, the administration’s estimates include:

- ***\$14 Billion in Higher Revenues.*** The administration’s estimates of revenues (excluding transfers, both between state funds and from the federal government) are \$13.6 billion higher across the three-year budget window compared to our estimates in November. This reduces the size of the budget problem.
- ***\$3 Billion in Higher School and Community College Spending.*** Reflecting these higher revenue estimates, the administration’s estimates of constitutionally required General Fund spending on K-14 education is about \$2.6 billion higher than our November estimates. This partially offsets the revenue increase described above, increasing the size of the budget problem.

- A \$4 Billion Set-Aside in the SFEU.**
 The Governor proposes the Legislature enact a year-end balance in the Special Fund for Economic Uncertainties (SFEU) of \$3.8 billion. The Legislature can choose to set the SFEU balance at any level above zero and so our *Fiscal Outlook* did not assume a specific balance. (Recent budgets have enacted SFEU balances around \$2 billion to \$4 billion. The SFEU is used to cover costs of unanticipated expenditures.) Relative to our November estimates, this set-aside increases the size of the budget problem.
- \$2 Billion in Discretionary Spending.**
 The Governor’s budget also includes \$2 billion in discretionary spending proposals that are not currently reflected under current law or policy. **Figure 1** shows how these proposals are distributed by program area. (Appendix 3 [online], also provides a list of these proposals.) As the figure shows, most of the discretionary increases are to finance some capital outlay projects with cash instead of lease revenue bonds. This increases the size of the budget problem.

- \$800 Million in Other Differences.** Across the rest of the budget, our estimates of baseline spending—for example, for caseload growth, federal reimbursements, and statutory cost increases—and constitutional requirements—for example, for infrastructure and deposits into reserves—differ, on net, by \$800 million. Relative to our estimates, this reduces the size of the budget problem.

HOW DOES THE GOVERNOR PROPOSE SOLVING THE BUDGET PROBLEM?

Figure 2 summarizes the budget solutions that this section describes in detail. The Governor’s budget solutions focus on spending. They total \$13.6 billion and represent nearly three-quarters of the total solutions. In addition, the Governor’s budget includes \$4.3 billion in cost shifts, which represent nearly one-quarter of the total. Notably, the Governor’s budget does not propose using any reserves to address the budget problem.

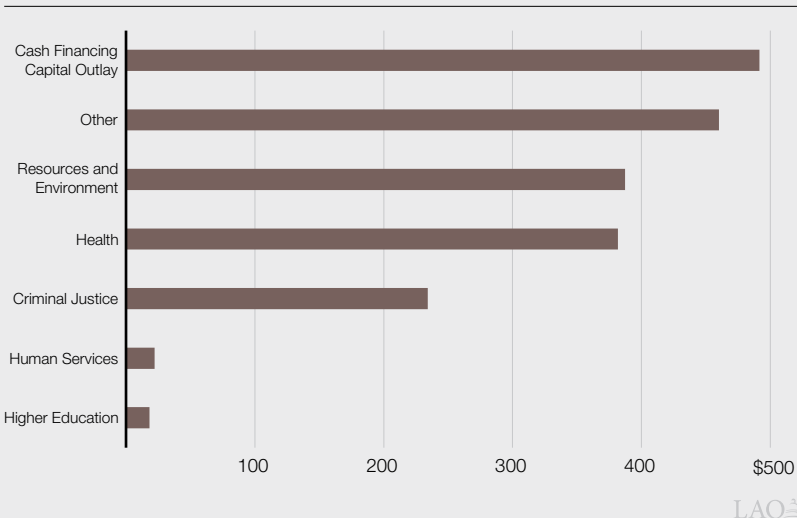
Spending-Related Solutions

The Governor’s \$13.6 billion in spending-related budget solutions can be categorized into three types: reductions, delays, and trigger restoration. Nearly all of these solutions would apply to one-time and temporary spending. **Figure 3** shows how the spending solutions are broken out across program area and type. Appendix 1 (online) provides a list of these proposed solutions. The remainder of this section describes each of these types in turn.

\$7.1 Billion in Delayed Spending. We define a delay as an expenditure reduction that occurs in the budget window (2021-22 through 2023-24), but has an associated expenditure increase in a future year of the multiyear window (2024-25 through 2026-27). That is, the spending is moved to a future year.

Figure 1

Governor’s Budget Includes \$2 Billion in Discretionary Proposals (In Millions)



About half of the Governor’s spending-related solutions are delays. Most of the spending delays are in higher education, health, and broadband. They result in net cost increases by 2024-25, with the largest cost increases occurring in 2025-26.

\$3.8 Billion in Spending Reductions Subject to Trigger Restoration. The Governor’s budget proposes making nearly one-third of all spending-related solutions subject to trigger restoration language. Under this proposed language, program spending that otherwise would have occurred in 2023-24 would not be allocated as part of the June budget act. However, if in January 2024 the administration estimates there are sufficient

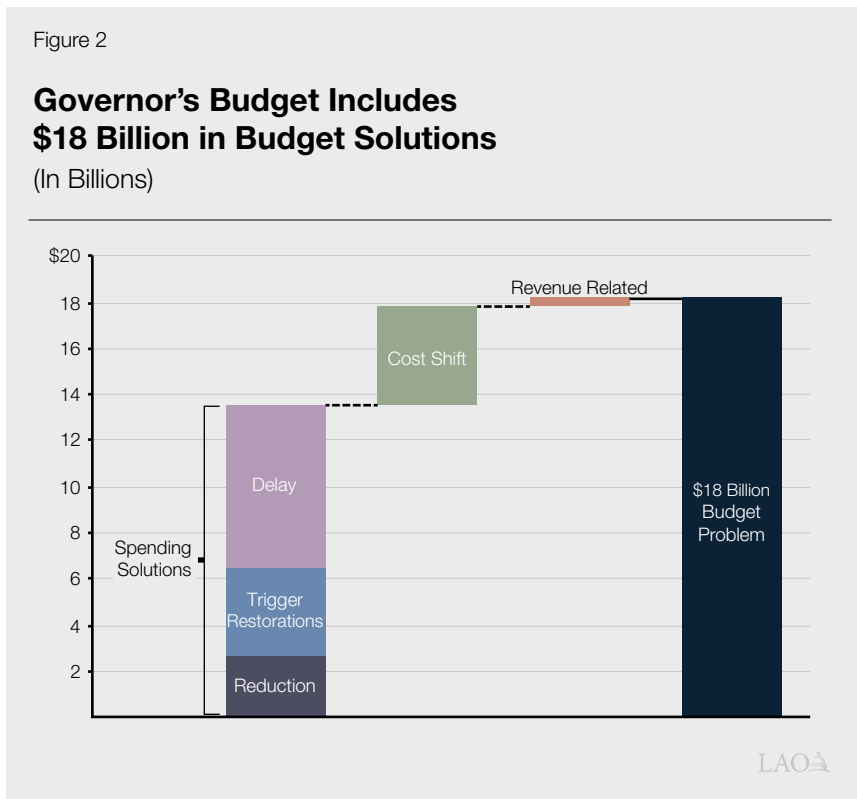
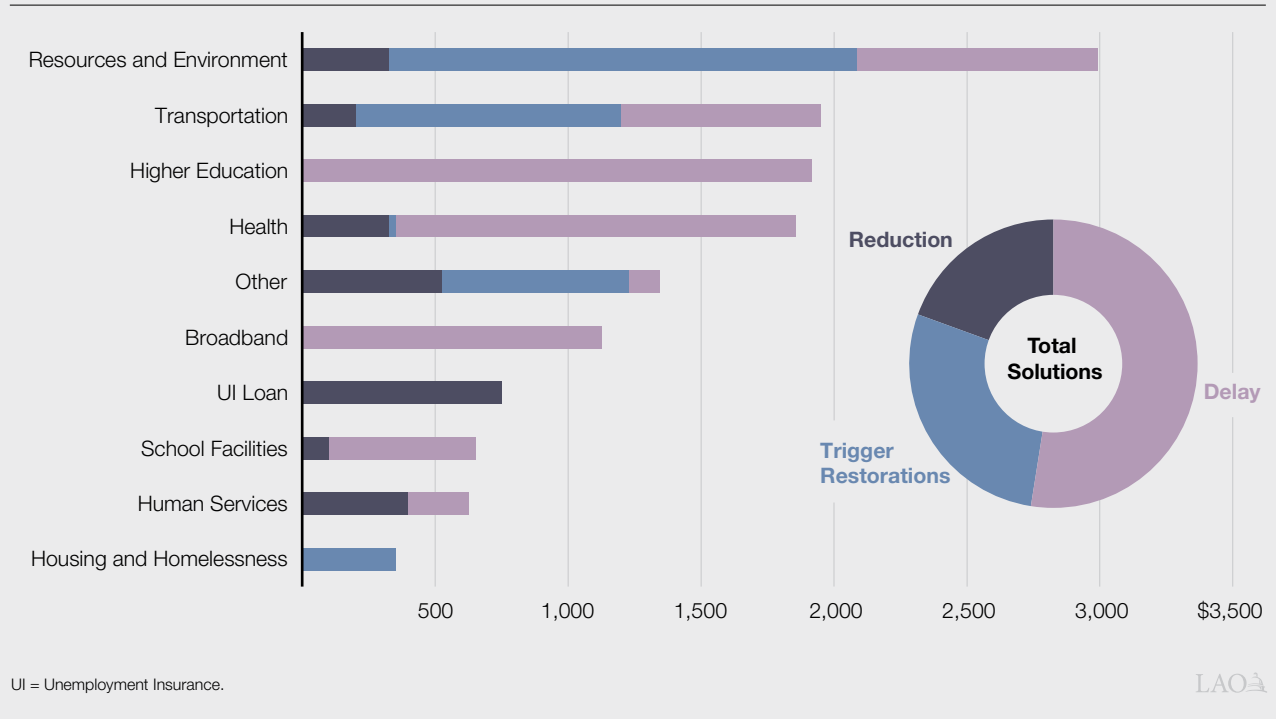


Figure 3

Most Spending Solutions Are Trigger Restorations or Delays



resources available to fund these expenditures, those programs would be restored halfway through the fiscal year. Many of the spending solutions in natural resources and environment, transportation, and housing and homelessness are subject to this trigger restoration language.

\$2.6 Billion in Spending Reductions. We define a spending reduction as the elimination of an augmentation previously approved under current law or policy. The Governor’s budget includes nearly \$3 billion in reductions, the largest of which is withdrawing a discretionary principal payment on state’s unemployment insurance loan (which otherwise is paid by employers’ payroll taxes). Less than 20 percent of the total spending solutions are reductions.

Cost Shifts

In addition to spending solutions, we estimate the Governor’s budget includes \$4.3 billion in cost shifts. Cost shifts occur when the state moves costs between entities or fund sources. For example, shifting spending from the General Fund to special funds or, as has been done in prior budgets, shifting costs from the state to local governments. Major cost shift proposals in the

Governor’s budget include: (1) shifting \$1.5 billion in costs for zero-emission vehicles from the General Fund to the Greenhouse Gas Reduction Fund, (2) making \$850 million in loans from special funds to the General Fund, (3) temporarily transferring \$300 million from the health care affordability reserve fund to the General Fund, and (4) shifting \$500 million in transportation-related costs from the General Fund to transportation-related special funds. Appendix 2 (online) provides a full list of these proposed cost shifts.

Revenue Related

We estimate the Governor’s budget includes about \$350 million in revenue-related solutions. The key item in this category is a proposal for the state to reauthorize a tax on managed care organizations that draws down additional federal funds and offsets costs in Medi-Cal. While the fiscal impact of this reauthorization would be small in the budget window—an estimated \$300 million in 2023-24—the effect would be much larger in future years, rising to roughly \$2 billion in General Fund savings as early as 2024-25. (Reauthorizing this tax would require federal approval.) (Appendix 2 [online] also includes a list of proposed revenue-related solutions.)

BUDGET CONDITION

In this section, we describe the overall condition of the General Fund budget after accounting for the Governor’s budget proposals and solutions. We also describe the condition of the school and community college budget.

General Fund Budget

Figure 4 shows the General Fund condition based on the Governor’s proposals and using the administration’s estimates and assumptions. Under these estimates and assumptions, the state would end 2023-24 with \$3.8 billion in the SFEU.

Figure 4

General Fund Condition Summary
(In Millions)

	2021-22 Revised	2022-23 Revised	2023-24 Proposed
Prior-year fund balance	\$41,102	\$52,713	\$21,521
Revenues and transfers	233,891	208,883	210,174
Expenditures	222,280	240,076	223,614
Ending fund balance	\$52,713	\$21,521	\$8,081
Encumbrances	4,276	4,276	4,276
SFEU balance	48,437	17,245	3,805
Reserves			
BSA	\$19,867	\$21,487	\$22,398
SFEU	48,437	17,245	3,805
Safety net	900	900	900
Total Reserves	\$69,204	\$39,632	\$27,103

BSA = Budget Stabilization Account and SFEU = Special Fund for Economic Uncertainties.

Under Governor’s Budget, Reserves Would Total \$27 Billion by End of 2023-24. Under the Governor’s budget, general purpose reserves would total \$27 billion by the end of 2023-24. In addition, the state would have \$8.5 billion in the School Reserve, available only for school and community college programs. Under the Governor’s proposals, the state would continue to make its otherwise constitutionally required deposits, including a deposit of \$911 million into the Budget Stabilization Account (BSA) and \$365 million into the School Reserve in 2023-24. The deposits could be suspended if the Governor declared a budget emergency, as we describe in the nearby box.

Administration Plans for Multiyear Operating Deficits. The Governor’s budget also includes estimates of multiyear revenues and spending. Under those projections, and the Governor’s budget proposals, the state faces operating deficits of \$9 billion in 2024-25, \$9 billion in 2025-26, and \$4 billion in 2026-27. These figures represent future budget problems. That is, if the Governor’s budget projections are accurate, the state would have to address deficits of these amounts in each of these future years.

State Appropriations Limit (SAL) Estimates Still Unknown. In recent years, the SAL has placed constraints on the Legislature’s budget choices. (For more information about the SAL, see our report, [The 2022-23 Budget: Initial Comments on the State Appropriations Limit Proposal](#).) Under our November estimates of revenues and spending, the state would have a good amount of room under the limit in the budget window. However, the administration’s revenue and spending estimates are different than ours, which is likely to yield differences in the SAL calculation. As of this writing, we have not yet received information from the administration on these estimates.

School and Community College Budget

Proposition 98 Minimum Guarantee Down Over Budget Window. The State Constitution sets a minimum annual funding requirement for schools and community colleges. The minimum guarantee is met with a combination of General Fund and local property tax revenue. Compared with the estimates included in the June 2022 budget plan, the administration revises its estimates of the minimum guarantee up \$178 million in 2021-22 and down \$3.4 billion in 2022-23. The increase in 2021-22 is primarily attributable to higher local property tax

Budget Emergency Calculation Under Governor’s Budget

Legislature Can Make a BSA Withdrawal Under Two Conditions. The Legislature can only suspend mandatory deposits or make withdrawals from either of its two constitutional reserves—the Budget Stabilization Account (BSA) and the School Reserve—if the Governor declares a budget emergency. The Governor may declare a budget emergency in two cases: (1) if estimated resources in the current or upcoming fiscal year are insufficient to keep spending at the level of the highest of the prior three budgets, adjusted for inflation and population (a “fiscal budget emergency”), or (2) in response to a natural or man-made disaster.

Legislature Cannot Access Most of Its Constitutional Reserves Without a Fiscal Emergency Declaration by the Governor. Under our interpretation of the constitutional rules and our estimates using the administration’s revenue and economic projections, a fiscal emergency would be available in 2023-24, but not for 2022-23. (In the case of a fiscal emergency, the Legislature only can withdraw the lesser of: [1] the amount of the budget emergency, or [2] 50 percent of the BSA balance.) However, because the Governor did not declare a fiscal emergency, the Legislature cannot make these withdrawals to address the budget problem. That said, there is a small “optional” balance in the BSA (which was not deposited pursuant to the constitutional rules), which mostly likely could be accessed by the Legislature without a fiscal emergency declaration by the Governor. This optional balance totals \$1.8 billion.

revenue, while the decrease in 2022-23 primarily reflects lower General Fund revenue estimates. For 2023-24, the administration estimates the minimum guarantee is \$108.8 billion—\$1.5 billion below the 2022-23 level enacted last June.

Budget Includes Additional School and Community College Proposition 98 Spending.

Although the minimum guarantee decreases over the budget period, funding is available for spending increases due to the expiration of one-time initiatives and lower-than-anticipated program costs. The Governor’s budget includes a net of \$6 billion in new Proposition 98 spending—a total of \$7.4 billion in spending increases, offset by

\$1.4 billion in spending reductions. Most of the spending increases are to (1) cover the cost of providing an 8.13 percent statutory cost-of-living adjustment (COLA) for school and community college programs (\$5.5 billion) and (2) continue planned program expansions (\$920 million). The cost of this new spending is offset by the Governor’s proposals to reduce previously approved one-time funding for (1) the Arts, Music, and Instructional Materials Discretionary Block Grant by \$1.2 billion and (2) community college facilities maintenance and instructional equipment by \$213 million.

COMMENTS

Budget Year

Governor’s Emphasis on Spending Solutions, Instead of Reserves, Is Prudent. The Governor’s budget addresses the estimated budget problem without using funds from the state’s reserves. Moreover, the Governor does not suspend the 2023-24 deposit into the BSA, which could otherwise occur if a fiscal emergency were declared (see box on page 7). The administration noted that, if revenues decline further, using reserves would be considered, but for now relies only on other types of budget solutions—particularly spending-related reductions and delays. This approach is warranted given: (1) the manageable size of the budget problem and (2) the downside risk to revenues posed by the presently heightened risk of recession. (For a more on this issue, see our report: [The 2023-24 Budget: California’s Fiscal Outlook](#).) We recommend the Legislature maintain this approach during its own planning process.

Recommend the Legislature Plan for a Larger Budget Problem by Identifying More Spending Reductions. Our estimates suggest that there is a good chance that revenues will be lower than the administration’s projections for the budget window, particularly 2022-23 and 2023-24. Nonetheless, the Governor’s budget trigger restoration proposals implicitly place more emphasis on revenue upside—suggesting the administration anticipates that

revenues are more likely to be higher, not lower, than their current projections. Given the greater downside risk, however, we recommend the Legislature: (1) plan for a larger budget problem and (2) address that larger problem by reducing more one-time and temporary spending. If the Legislature wanted to, it could make these spending reductions subject to trigger restorations. Taking these steps would allow the state to mitigate the heightened risk of revenue shortfalls. Moreover, developing a larger set of potential budget solutions now allows the Legislature to do so deliberately rather than under the pressure of the May Revision.

Proposal Generally Maintains Spending on Health and Human Services, but Reduces Other Legislative Priorities. In general, the Governor’s budget does not make large reductions to health and human services programs. Rather, the Governor’s spending-related reductions, including reductions with trigger restorations, are concentrated in natural resources, environmental protection, and transportation, areas which also received large one-time and temporary augmentations in recent budgets. (For more information on recent augmentations, please see: [How Program Spending Grew in Recent Years](#).) Spending solutions in these areas might be warranted because these programs: (1) have other funding to at least partially accomplish some of

the intended outcomes and (2) still would receive sizeable augmentations. However, some of the specific reductions the Governor is proposing are in areas where the Legislature has signaled clear priorities.

Due to Budget Problem, New Proposals Require Reductions to Planned Spending.

In addition to addressing a budget problem, the Governor's budget proposes \$2 billion in new discretionary spending mainly in capital outlay financing, resources and environment, and other miscellaneous program areas. Because of revenue shortfalls, these new spending amounts contribute to a larger budget problem and necessitate additional budget solutions. That is, for each dollar of new proposals, another dollar of solutions would be required. While the Legislature might share some of these priorities, it need not adopt all, or even any, of the associated proposals. Rejecting them would reduce the budget problem and the number of solutions necessary.

Recommend Legislature Evaluate Recent Augmentations and Consider Other Budget Solutions.

Recent budgets have allocated or planned tens of billions of dollars for one-time and temporary spending purposes in 2021-22, 2022-23, and 2023-24. The Governor's budget identifies one set of recent augmentations to reduce or delay in order to address the budget problem. The Legislature can select entirely different spending solutions. To assist the Legislature in this effort, we have provided a list of large augmentations provided in recent budgets in Appendix 4 (online) and a set of criteria for evaluating them for reduction or delay in "Chapter 2" of this report. The Legislature could apply these criteria through its budget oversight hearings throughout the next few months.

Proposal Maintains Statutory COLA Adjustments, but Does Not Include Other Inflation-Related Augmentations.

Due to differences in law and policy across the budget, the state accounts for inflation differently in the school and community college budget versus the other programs. In particular, school and community college programs receive an annual COLA under statute—8.13 percent this year.

Across the rest of the budget, statutory and other automatic inflation adjustments for programmatic spending are more limited. While the Governor's budget funds those inflation adjustments that exist under current law, in many program areas, there are no such automatic adjustments. As the Legislature works to address the budget problem, we suggest policymakers consider the unique impacts of inflation on each of the state's major spending programs in conjunction with possible budget solutions. (See our report, [The 2023-24 Budget: Considering Inflation's Effect on State Programs](#), for more information.)

Multiyear

Although Timing Differs, LAO and Department of Finance Revenue Estimates Very Close...

The Governor's budget downgrade to the revenue outlook over the next several years is very similar to the one in our *Fiscal Outlook*. Although the timing of revenue shortfalls is somewhat different, the overall revenue decline through 2026-27 is very similar. Across all six years of the budget window and multiyear period, the administration's estimates of revenues from the state's three largest taxes are \$108 billion lower than the budget act, very similar to our *Fiscal Outlook* estimate of \$101 billion.

...But Governor's Spending Plan Relies on More Resources Being Available.

The Governor's budget includes operating deficits ranging from \$4 billion to \$9 billion over the multiyear period. This means that, if the administration's revenue estimates are accurate, further budget solutions in these amounts will be required in those years. If revenues are lower than the administration currently projects, even more reductions would be needed.

Recommend the Legislature's Budget Not Include Future Deficits.

In contrast to the Governor's approach, we recommend the Legislature avoid enacting a budget that plans for future deficits. A key way to accomplish this would be by reducing proposed spending delays and making more spending-related reductions instead. However, the Legislature also could address future year deficits by adding trigger *reductions* (rather than restorations)—to trigger off more multiyear spending if needed—or by using other budget solutions, such as revenue increases or cost shifts.

Chapter 2

EVALUATING RECENT AUGMENTATIONS FOR REDUCTION OR DELAY

The Governor's budget proposes one possible list of spending-related solutions, but there are many other choices the Legislature could make. In developing an alternative approach, we recommend the Legislature treat all recent one-time or temporary General Fund augmentations (outside of the school and community college budget) like new proposals and reevaluate them in light of the budget problem. To determine which augmentations to maintain, we recommend the Legislature use the criteria laid out below. Specifically, the Legislature could direct the administration to justify these proposals according to these criteria in its presentations to the budget committees. Under this approach, only those proposals that meet most of the criteria would be appropriated as part of this year's budget package.

In Appendix 4 (online) we list all of the large one-time and temporary augmentations provided by prior budgets in 2021-22, 2022-23, and 2023-24. The Legislature can use this list as a starting place for creating its own proposed solutions.

Start With 2023-24 Augmentations...

We recommend the Legislature first review augmentations planned for 2023-24 as these funds have not been disbursed to departments or other entities, like local governments. Consequently, reducing or pausing the funding would not impact ongoing services. Moreover, while some of these augmentations continue temporary programs from recent years, many of them start entirely new programs and initiatives. Delaying or reducing funding for these initiatives would cause limited disruption.

After reviewing 2023-24 augmentations, we recommend the Legislature also reevaluate certain 2021-22 and 2022-23 augmentations. In some cases, funding may not yet be disbursed or the total amount required may be less than anticipated. (In many cases, however, the funds may not be available for reversion.)

...Identify More Solutions Than the Governor's Budget. We recommend the Legislature identify more than \$14 billion in spending reductions and delays. To hedge against possible lower revenues in May, we also recommend the Legislature plan for a larger budget problem by identifying more than \$6 billion in spending reductions. Identifying these solutions now gives the Legislature more time to weigh these difficult choices carefully.

Criteria

This section lays out the criteria we recommend the Legislature use to evaluate whether recent augmentations should be maintained in light of the budget problem. (These criteria are intended to apply to General Fund discretionary augmentations outside of the school and community college budget.)

- ***The Augmentation Has a Clear Goal That Aligns With Legislative Priorities.***
Assess whether the augmentation targets a well-defined policy problem that is a priority of the Legislature to address.
- ***The Projects or Activities Are Specific and Address the Legislature's Goal.***
Assess whether prior budget plans aligned the specific projects and activities with the Legislature's policy goals. If not, the Legislature could consider whether to delay or reduce this spending until more planning can be done.
- ***The Underlying Needs Have Not Changed.***
In some cases, since the augmentation was approved, the state might have new information or events might have developed such that the underlying need for the program or policy has changed and funding could be reduced.

- **Early Indications Show That the Projects or Activities Are Meeting Their Goals.**
In cases where one-time or temporary spending in 2023-24 continues prior similar efforts, evaluate whether the funding has been effective and whether the administration has been implementing the program with fidelity toward the Legislature’s vision.
- **The Involved Entities Have the Capacity to Administer the Initiative.** There are a few reasons that capacity concerns might arise, creating opportunities for reevaluating spending. Some departments or other entities received multiple rounds of funding for the same purpose over several years. In cases where an entity has encountered issues distributing early rounds of funding, the later rounds likely could be paused without much near-term impact on the program. In other cases, departments and other entities have received multiple rounds of funding for different programs and projects, straining capacity across program areas. These also could provide cases where the Legislature might wish to pull back program funding, allowing the entity to focus on the highest-priority areas.
- **Pausing or Delaying the Appropriation Would Have Significant Negative Distributional Impacts on Populations of Concern.** In some cases, pausing or delaying an augmentation could raise equity concerns, for instance if doing so would disproportionately reduce services or assistance to populations of concern. In these cases, pausing or delaying the augmentation could exacerbate an underlying disparity.
- **The Augmentation Does Not Duplicate Federal or Special Fund Activities.** In some cases, legislative action might have supplemented, or even duplicated, federal funding provided at other points in time. These too might provide cases for reevaluation. (That said, if the state dollars are pulling down additional federal resources, greater scrutiny should be applied in considering a pause.) In other cases, the Legislature might have the flexibility and funding capacity to redirect special fund revenues to a General Fund purpose.
- **The Projects or Activities Primarily Meet an Acute Need.** To the extent a program only has longer-term benefits, there might be an argument for pausing or delaying it while the opportunity costs of those funds are higher—and could be directed toward serving the state’s more acute needs.

APPENDICES

Note: In the online version of this report, we plan to include a series of Appendix tables that have detailed information on the Governor’s proposed solutions and discretionary spending choices in the *2023-24 Governor’s Budget*. In addition, we include tables that identify large one-time and temporary augmentations included in recent budgets.

LAO PUBLICATIONS

This report was prepared by Ann Hollingshead, with contributions from analysts across the office, and reviewed by Carolyn Chu and Anthony Simbol. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

To request publications call (916) 445-4656. This report and others, as well as an e-mail subscription service, are available on the LAO's website at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, California 95814.

The Taxpayer Protection and Government Accountability Act
Initiative No. 21-0042A1

October 21, 2022

Effective date: Any new or increased tax or fee adopted by the Legislature, a city council, or the local voters after **January 1, 2022**, must comply with the Act's new rules.

State taxes

- All new and increases in state taxes will require majority voter approval.
- Prohibits property tax “surcharge” (increase). Prohibits allocation of property tax to the state.

Local taxes

- New requirements for voter approval
 - when applied to territory is annexed.
 - when existing tax is applied to a new service or product, for example utility user tax (UUT) to new service.
- New or increased taxes adopted after January 1, 2022, must include a sunset date.

Fees and charges

- State and cities have burden of proving by “clear and convincing evidence” that a fee/charge is not a tax; that the amount is reasonable; and that it does not exceed “actual cost.”
- Elimination of the “specific benefit conferred” or “privilege granted” exception makes it more likely that franchise fees will be considered taxes. The state and cities issue franchises to oil companies, utilities, gas companies, railroads, garbage companies, cable companies, and other corporations.
- Fees and charges for services and permits may not exceed the “actual cost” of providing the product or service for which the fee is charged. “Actual cost” is the “minimum amount necessary.” Examples include planning services, excavation and encroachment permits, preparation of candidate statement, and permit parking.
- No fee or charge or exaction regulating vehicle miles traveled can be imposed as a condition of property development or occupancy.

Fines and penalties [administrative enforcement of state law and municipal codes]

- Requires voter approval of fines and penalties for corporations and property owners that violate state and local laws unless a new, undefined adjudicatory process is used to impose the fines and penalties. Examples include nuisance abatement, organic waste reduction requirements, and failure to maintain a vacant property.

Voters

- Local advisory measures are prohibited. No measure may appear on the ballot asking for approval for a general tax that would indicate that the revenue from the general tax will, could, or should be used for a specific purpose.
- Overturns *Upland* decision so taxes proposed by initiative are subject to the same rules as taxes placed on the ballot by a city council.
- Voters may not amend a City Charter to impose, extend, or increase a tax or fee.

**Revenue and Taxation Policy Committee
Legislative Agenda
January 2023**

Staff: Nick Romo, Legislative Representative, (916) 658-8232
Jessica Sankus, Senior Policy & Legislative Affairs Analyst, (916) 658-8283

Policy Recommendation: *Definition of Equitable E-Commerce Sales Tax Revenue Distribution*

Summary:

In January 2023, the City Managers Sales Tax Working Group adopted a guiding definition of equitable e-commerce sales tax revenue distribution for the Revenue and Taxation policy committee and Board of Directors consideration. This guiding definition contextualizes equity within the evolving landscape of consumer preferences, technological advances, and the needs of cities. The proposed framework is considered critical to forming recommendations that further fiscal sustainability and strengthen the viability of the sales tax.

Background:

The Sales Tax Working Group of the City Managers Department is convened to review evolving trends, explore policy implications, and identify additional data to support reform discussions. The 2022 working group convenes a diverse and representative group of California city officials dedicated to examining local government sales tax issues to provide recommendations that equitably benefit California cities, further fiscal sustainability, and strengthen the viability of the sales tax.

Throughout 2022, the group explored existing law, regulations and practices regarding tax sourcing rules including state and national trends. The group has given significant attention to reforming tax sourcing rules and tax rebate agreements. The group has also identified additional issues within county pool allocation policy.

Given the growing consensus to develop recommendations on several matters, while more time is needed to support a robust discussion on broader tax sourcing rules, the group has identified two phases for its work – short- and long-term actions. As part of the first phase of group's work plan it has recommended a guiding definition of equitable e-commerce sales tax revenue distribution.

Equity is distributing resources and access to opportunities based on the needs of the recipients in order to reach fair and just outcomes for all.

The City Managers Sales Tax Working Group adopts this guiding definition of equitable e-commerce sales tax revenue distribution to contextualize equity within the evolving landscape of consumer preferences, technological advances, and the needs of cities. This context is critical to forming recommendations that further fiscal sustainability and strengthen the viability of the sales tax.

This equity statement is the lens by which the working group will explore and answer the following questions: 1) Does the existing sales and use tax system equitably distribute revenues?, 2) Given significant transformations in commerce and how consumers access the marketplace, are changes to the local Bradley Burns 1 percent sales and use tax distribution needed?, and 3) What are the outcomes of any changes and how can they be equitably and fairly implemented?

Proposed Equity Statement Adopted by the Working Group:

The working group adopts the following statement on equity:

The equitable allocation of remote revenues from e-commerce recognizes both sides of the transaction and their contribution to sales tax generation. Allocation of the Bradley Burns 1 percent local sales tax revenue from in-state online purchases should proportionately benefit those communities that provide the infrastructure and incentives that facilitate the transaction and delivery of those goods and the communities that are the destinations for the goods. The regional impacts to infrastructure, land use, environmental quality, and public health stemming from e-commerce as well as the financial dependence of communities on the resulting revenues must be recognized. Changes to consumer behavior, which consists of more online shopping, must also be considered as to the fiscal sustainability of all cities.

City officials should account for these factors in the evolving marketplace and continuously strive for prospective fair and equitable revenue sharing based on data, as available. City officials should also employ their best judgement to support policies that benefit the sustainability of all cities.

Staff Recommendation:

Staff recommends **support** of the group's recommendation.

Committee Recommendation:

Board Recommendation:

**Revenue and Taxation Policy Committee
Legislative Agenda
January 2023**

Staff: Nick Romo, Legislative Representative, (916) 658-8232
Jessica Sankus, Senior Policy & Legislative Affairs Analyst, (916) 658-8283

Policy Recommendation: *Require direct reporting of use taxes related to construction projects (as applicable) and lower the threshold to trigger this requirement, and, lower the threshold for reporting of taxes for single out-of-state transactions.*

Summary:

In January 2023, the City Managers Sales Tax Working Group convened a subcommittee to workshop a proposal to allow for more direct reporting of use taxes related to construction projects to jurisdictions where the construction activity is located. The group recommends lowering the existing monetary and regulatory requirements to direct more allocations of tax to the jurisdiction in which the jobsite is located rather than indirect allocations through the countywide pool system.

The group has also proposed an additional change, regarding reporting of taxes for single out-of-state transactions of \$500,000 or more, because these transactions are largely correlated with large construction jobsites. The recommendation is to lower this threshold to \$100,000.

Background:

The Sales Tax Working Group of the City Managers Department is convened to review evolving trends, explore policy implications, and identify additional data to support reform discussions. The 2022 working group convenes a diverse and representative group of California city officials dedicated to examining local government sales tax issues to provide recommendations that equitably benefit California cities, further fiscal sustainability, and strengthen the viability of the sales tax.

Within the suite of recommendations adopted by the previous working group in 2018, the previous group recommended allowing more direct reporting of use taxes related to construction projects to jurisdictions where the construction activity is located by reducing the existing regulatory threshold.

Throughout 2022, the reconvened group explored existing law, regulations and practices regarding tax sourcing rules including national trends. The group has given significant attention to reforming tax sourcing rules and tax rebate agreements. The group has also identified additional issues within county pool allocation policy.

Given the growing consensus to develop recommendations on several matters, while more time is needed to support a robust discussion on broader tax sourcing rules, the group has identified two phases for its work – short- and long-term actions. As part of

the first phase of group's work plan it has identified and adopted changes related to the following topics:

Construction Jobsite Sub-Permit Allocations

Pursuant to Local Sales and Use Tax [Regulation 1806](#), the jobsite is the place of sale for fixtures that a construction contractor purchases for resale and the place of use for the consumption of materials. Local tax generated by the sale or use of tangible personal property at construction sites is added to the countywide pool.

There are special allocation procedures for use taxes collected on certain products. Generally, these special allocation rules allow use tax revenue that would otherwise be shared via the countywide and statewide pools to be directly allocated to the jurisdiction of use. Existing California Department of Tax and Fee Administration policy provides that contractors who enter into contracts equal to or greater than \$5 million may elect to obtain a sub-permit for the jobsite.

Large Out-of-State Transactions

Pursuant to Local Sales and Use Tax Regulation 1802(d)(1), retailers shall report the local use tax for transactions of \$500,000 or more to the participating jurisdiction where the first functional use is made.

The policy recommendations took into consideration the conversations, feedback, and survey responses of the group members conducted throughout 2022. The working group benefited from the research and guidance of Cal Cities partners HdL Companies and Avenu Insights and Analytics.

Proposed Changes Developed by the Working Group:

The changes proposed by the group are as follows:

Construction Jobsite Sub-Permit Allocations

- *Require, rather than optionally permit, contractors to submit appropriate documentation for direct allocation when eligible.*
- *Lower the \$5 million threshold to \$1 million.*

Large Out-of-State Transactions

- *Lower the \$500,000 threshold to \$100,000.*

Staff Recommendation:

Staff recommends **support** of the group's proposed changes.

Committee Recommendation:

Board Recommendation:

**Revenue and Taxation Policy Committee
Draft Work Program Report – January 2023**

Submitted By: Charles Bourbeau, Council Member, Atascadero
Cal Cities Staff: Jessica Sankus, Senior Policy & Legislative Affairs Analyst

1) Protect and expand investments to prevent and reduce homelessness.

- The Committee will defer to the Cal Cities Housing, Community, and Economic Development and Community Services Policy Committees to play the lead role in policy development associated with this advocacy priority. The Committee will remain informed and support Cal Cities advocacy efforts in this area.
- The Committee will partner with relevant committees to review, through a fiscal lens, state and federal legislation, budget proposals, and explore existing and new mechanisms for funding programs to prevent or reduce homelessness and assist individuals experiencing homelessness.

2) Increase the supply and affordability of housing while retaining local decision-making.

- The Committee will defer to Cal Cities Housing, Community, and Economic Development Policy Committee to play the lead role in policy development associated with this advocacy priority. The Committee will remain informed and support Cal Cities advocacy efforts in this area.
- The Committee will partner with relevant committees to review, through a fiscal lens, state and federal legislation, budget proposals, and explore existing and new mechanisms for funding housing development for all income levels.

3) Improve public safety in California communities.

- The Committee will defer to Cal Cities Public Safety Policy Committees to play the lead role in policy development associated with this advocacy priority. The Committee will remain informed and support Cal Cities advocacy efforts in this area.

4) Safeguard essential local revenues and support fiscal sustainability.

- The Committee will take the lead on policy development to protect, increase, and modernize revenue streams for local governments. This includes supporting Cal Cities advocacy efforts and funding requests for the 2023-24 State Budget, including reimbursement of the nearly \$1 billion the state owes to cities, counties, and special districts for state-mandated programs.
- The Committee will remain informed and engaged with the work and progress of the City Managers Sales Tax Working Group.

Additional information:

The Revenue and Taxation Policy Committee will also focus on its work program to better understand and discuss the following issues:

- *Infrastructure Funding*
- *Sales Tax*
- *Streamlining of State Grant Funding Opportunities*