CHAPTER 1C

RESTRICTIONS ON THE TAXING POWER OF THE LEGISLATURE

HIGHLIGHTS

- California Constitutional Restrictions
- U.S. Constitutional Restrictions
- State Appropriations Limit
- Initiative Statutes
- Tax Increases
- Governor's Veto
- Public Opinion
- Limits on Local Government Taxing Authority

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1. INTRODUCTION

While the Legislature has broad powers to impose taxes, there are a number of restrictions on this power. The U.S. Constitution restricts the Legislature's ability to impose tax. Other factors also constrain the Legislature's ability to impose taxes, as described below.

2. CALIFORNIA CONSTITUTIONAL RESTRICTIONS

A number of features of California's tax law are established in the California Constitution. Modification or repeal of many of these features must be accomplished by a constitutional amendment approved by the voters of the state. The major constitutional provisions governing the power of taxation are described below.

General Taxes Not Subject to Referendum. Section 9 of Article II states that statutes providing for tax levies for the usual current expenses of California are not subject to referendum.

Vehicle License Fees Reserved for Cities and Counties. Section 15 of Article XI (the practice of subjecting the measure adopted by the Legislature to popular vote of the electorate) requires all revenues from Vehicle License Fees to be allocated to cities and counties.

Uniform Property Taxation. Section 1 of Article XIII specifies that all property is taxable and must be assessed and taxed at full market value. This provision is modified by the restrictions upon reassessment contained in Article XIIIA.

The State May Authorize, But Not Impose, Local Taxes. Section 24 of Article XIII specifies that the state may not impose taxes for local purposes, but may authorize local governments to impose them.

Insurers Are Exempt From Most Taxes. Section 28 of Article XIII exempts insurance companies or associations from all taxes other than the state insurance gross premiums tax, local property taxes, and motor vehicles fees. Only the rate of the gross premiums tax may be changed by the Legislature. (See Chapter 3C of this Reference Book for more information on the Insurance Gross Premiums Tax.)

Local Tax Sharing Requires Voter Approval. Section 29 of Article XIII requires any agreement to share sales or use tax revenues between local jurisdictions to receive majority voter approval.

Sales Tax for Public Safety. Section 35 of Article XIII, approved by the voters in November of 1993, imposes a 1/2 cent sales and use tax statewide with the revenues allocated to cities and counties to fund public safety services.

Property Tax Rate Limited. Section 1 of Article XIIIA (Proposition 13) limits ad valorem property tax revenues to 1% of full cash value. Section 2 of Article XIIIA defines full cash value and provides that property shall only be reassessed when it changes ownership. No state transaction taxes or real estate taxes may be imposed.

Vote Requirement for State Taxes. Section 3 of Article XIIIA provides that increases in state taxes must be approved by a two-thirds vote of both houses of the Legislature and prohibits imposition of new ad valorem property taxes or state transaction taxes.

Two-Thirds Vote for Local Special Taxes. Section 4 of Article XIIIA requires cities, counties, and special districts to receive two-thirds voter approval in order to impose a "special" tax (see below). Section 2(d) of Article XIIIC provides that no local government may impose, extend, or increase any special tax unless it is approved by a two-thirds vote of the electorate.

No Gifts of Public Funds. Section 6 of Article XVI prohibits the Legislature from making gifts or loans of public moneys. The interpretation of this prohibition constrains the Legislature to provide retroactive tax relief.

Redevelopment Areas. Section 16 of Article XVI specifies that an "increment" of tax revenues generated in a redevelopment area shall be allocated to redevelopment activities.

Use of Fuel Tax Revenues. Article XIX requires revenues from fuel taxes to be used for specified transportation-related purposes. (See Chapter 3E for more information on Fuel Taxes.)

3. U.S. CONSTITUTIONAL RESTRICTIONS

Some restrictions in the U.S. Constitution, which California adopted as a condition to admittance into the Union, further limit the power of the Legislature to tax.

For example, the state may not tax the U.S. government or its instrumentalities. The state is also prohibited from taxing imports or exports and from imposing taxes that violates either the Due Process or the Commerce Clauses.

4. STATE APPROPRIATIONS LIMIT

The California Constitution (Article XIIIB) imposes an indirect constraint on the level of taxation in the state by way of an appropriations limit.

Under Article XIIIB, most spending by the state from proceeds of taxes is subject to an annual appropriations limit. The limit is expressed as the level of its **appropriations** in the base year (1986-87), with annual adjustments for changes in population and the California's cost-of-living, as defined. Revenues collected that exceed this limit over a two-year period are divided between K-14 programs and rebates to taxpayers.

Proposition 111, approved by the voters in June 1990, substantially modified the provisions of the Article XIIIB appropriations limit. See Chapter 5 of this Reference Book for a detailed discussion of the existing appropriations limit.

5. INITIATIVE STATUTES

Generally, statutory tax law adopted by the voters through the initiative process may not be changed by the Legislature. Unless otherwise provided in the initiative statute, laws adopted through the initiative process may only be changed by a vote of the people. Amendments may be achieved through popular vote on one of the following two types of measures: (a) another initiative that is qualified for the ballot by the people, or (b) a bill that is passed by the Legislature and subsequently placed on the statewide ballot.

Examples of state tax laws adopted by initiative include:

- Repeal of the state inheritance tax (Proposition 6 of June 1982);
- Requirement to index personal income tax brackets (Proposition 7 of June 1982);

- Establishment of the state lottery, provisions that sales of lottery tickets are exempt from state sales taxes and that lottery winnings are exempt from state income taxes (Proposition 37 of November 1984);

- Increase in cigarette taxes and imposition of tobacco taxes and directs use of surtax revenue to treatment and research of tobacco-related diseases; school and community health education programs (Proposition 99 of November 1988);

- Increase in state motor vehicle fuel taxes (Proposition 111 of June 1990);

- Increase in cigarette and tobacco taxes and directs use of funds for early childhood development and smoking prevention programs (Proposition 10 of November 1998);

- Direct sales taxes on gasoline purchases to transportation purposes rather than being deposited into the General Fund (Proposition 42 of March 2002); and

- Impose a 1% surtax on taxable incomes in excess of $1 million and directs use of funds for mental health services (Proposition 63 of November 2004);

Some initiative statutes (e.g., Proposition 99) contain language specifying the types of changes the Legislature may make by statute and the vote requirements applicable to those changes.

6. VOTE REQUIREMENTS FOR TAX INCREASES

California is one of 14 states that require super-majority votes of the Legislature on tax increases. As noted in Chapter 1B, any change in state taxes for the purposes of increasing revenues must be passed by a two-thirds vote of each house of the Legislature (Article XIIIA, Section 3).

Legislative Counsel has opined that the super-majority vote requirement is not applicable to any bill whose overall fiscal impact as to changes in state taxes is neutral or negative (i.e., a bill that causes a revenue loss), even if the bill includes some provisions that increase revenues. Thus, for example, a bill with multiple provisions that increases revenues from some taxes but reduces revenues from others by an equivalent or greater amount may be passed by a majority vote. According to the Legislative Counsel, the fiscal effect of a bill during its first full fiscal, taxable, or calendar year of impact is controlling when determining vote requirements.

7. GOVERNOR'S VETO

In order to become law, bills must be passed by both houses of the Legislature and signed by the Governor or allowed to become law without the Governor's signature. If the Governor vetoes a bill, it may become law if the veto is overridden by a two-thirds vote of each house of the Legislature.

8. LIMITS ON LOCAL GOVERNMENT TAXING AUTHORITY

Three voter-approved initiatives limit the power of local government to impose taxes for local purposes.

Proposition 13 (California Constitution, Article XIIIA approved by the voters in 1988) limits the ability of local governments to impose special taxes. Under Proposition 13, cities, counties, and schools must receive two-thirds voter approval before imposing a "special tax". Local jurisdictions are prohibited from imposing property tax rates above 1%, except for specified rates for debt service. Proposition 13 did not, however, define what constitutes a "special" tax and courts have issued contradictory rulings on this matter (see below).

Proposition 62, a statutory initiative approved by the voters in 1986, prevents imposition of new general taxes by local agencies without voter approval. However, since Proposition 62 was a statutory, rather than a constitutional initiative, it does not restrict charter law cities' right to impose general taxes without a vote or prevail over any contradictory constitutional provisions. Appellate courts found Proposition 62's voter approval requirements for general taxes unconstitutional. In 1995, however, the California Supreme Court reversed earlier lower court decisions and found Proposition 62 constitutional.

Proposition 218 (California Constitution, Articles XIIIC and XIIID approved by the voters in 1996), requires a majority vote of the people in order to approve the imposition or increase of a general tax. In addition, it provides that any general tax imposed, extended, or increased after January 1, 1995 and before the effective date of Proposition 218 shall continue to be imposed only if approved by a majority vote of the people.

It further provides that no local government may impose, extend, or increase any special tax unless approved by a two-thirds vote. In addition, it provides that a special tax means, "any tax imposed for specific purposes, including a tax imposed for specific purposes which is placed into a general fund". Proposition 218 also provides that special purpose districts or agencies, including school districts, shall have no power to levy general taxes.

Proposition 218 established procedures and requirements for all assessments for special benefits. No assessment may be imposed on any parcel that exceeds the reasonable cost of the proportional special benefit conferred to that parcel. Further, the assessment may not be imposed if there is a majority protest. In general, a majority protest exists if the number of ballots submitted in opposition to the assessment exceed the number of ballots submitted in support to the assessment.

Proposition 218 requires a majority vote of property owners or a two-thirds vote of the electorate to impose or increase a property-related fee for any service other than water, sewer or refuse collection. It further specifies that no property-related fee may be:

- ° Levied to pay for a general governmental service, such as police or fire service;
- ° Imposed for a service not used by the property owner; or
- ° Used to finance programs unrelated to the property-related services.

9. LIMITS ON STATE INVOLVEMENT IN LOCAL TAXATION

Proposition 1A (California Constitution, Articles XI, XIII, and XIIIB, approved by the voters in 2004) significantly reduced the state's authority over major local government revenue sources and required the state to reimburse local governments for future revenue shifts approved at the state level. Among its many provisions, Proposition 1A prohibits the state from:

- Reducing any local sales tax rate;
- Limiting a local government's authority to levy a sales tax rate;
- Changing the allocation of local sales tax revenue;
- Shifting property tax revenues from local governments to schools or community colleges, over and above those shifts in effect prior to November 3, 2004;
- Reducing the property tax revenues provided to cities and counties as part of the so-called "triple-flip", an arrangement in which the state shifted property tax revenues for sales tax revenues and pledged the sales tax revenue to pay off deficit bonds approved by voters in March 2004.

Under Proposition 1A, any decision by the state to lower the Vehicle License Fee rate below the rate in effect on November 3, 2004 must be accompanied by a pledge to provide local governments with equal replacement revenues. Additionally, any change in how property tax revenues are shared among local governments within a county must be approved by two-thirds of both houses of the Legislature (prior law allowed such changes to be approved with a majority vote).

Proposition 1A does provide one major exception to its provisions. Beginning in 2008-09, the state may shift a limited amount of property tax revenue from local governments to schools for one fiscal year, provided that (1) the Governor declares that the shift is needed due to a severe state financial hardship, (2) the Legislature approves the shift with a two-thirds vote of both houses, and (3) the money is repaid with interest within three years. Shifts such as the one just described may not be performed more than twice during any 10 consecutive fiscal years.

Sales and Property Tax Swap – the "Triple Flip". The Legislature passed the 2003-04 Budget package with a specific feature to finance the deficit financing bonds. To facilitate repayment, sales tax revenues were swapped for property tax revenues. This three-step method, known as the "triple flip", contains the following:

1) Redirecting one-half of 1% of the local sales tax revenue to the state to repay the deficit reduction bonds. This temporary measure begins in fiscal year 2004-05;

2) Offset the loss of local sales tax revenues by redirecting an equal amount of property taxes to cities and counties from the Educational Revenue Augmentation Fund (ERAF); and

3) Increase state education apportionment to replace K-14 revenue losses related to redirected ERAF monies.

Although dependent upon state revenues received, analysts expect the bonds will be retired within five years. At that point, the tax swap will cease.

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