Revenue and Taxation Policy Committee
Thursday, April 28, 2022
1:00pm – 4:00pm

Register for this meeting:
https://us06web.zoom.us/meeting/register/tZwtd-mupzoqGtG-RQG4XJgSeFzlmtLDogjY
Immediately after registering, you will receive a link and confirmation email to join the meeting.

AGENDA

I. Welcome and Introductions
Speakers: Chair Norma Martinez-Rubin, Council Member, Pinole
Vice Chair Charles Bourbequ, Mayor Pro Tem, Atascadero
Cal Cities President Cindy Silva, Mayor Pro Tem, Walnut Creek

II. Public Comment

III. General Briefing *Informational*

IV. State Legislative and Budget Update (Attachment A) *Informational*
LAO: "Governor's Budget Likely Unsustainable" (Attachment B)

V. California State and Local Cannabis Tax Policy *Informational*
Speaker: Dustin McDonald, Founder and Partner; Square Root Group

VI. City Managers Sales Tax Working Group Update (Attachment C) *Informational*

VII. *2022 Ballot Proposition Update* Informational

VIII. Adjourn

Next Virtual Meeting: Thursday, June 9, 2022, 1:00pm – 4:00pm

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.

ATTACHMENT A

Revenue and Taxation Policy Committee
2022 Legislation Tracker

AB 1702 (**Levine** D) **Sales and Use Tax Law: exemptions: COVID-19 prevention and response goods.**

Current Text: Amended: 3/22/2022 html pdf
Current Analysis: 03/18/2022 Assembly Revenue And Taxation *(text 1/26/2022)*
Introduced: 1/26/2022
Last Amended: 3/22/2022
Status: 3/23/2022-Re-referred to Com. on REV. & TAX.
Is Urgency: Y
Is Fiscal: Y
Location: 2/3/2022-A. REV. & TAX

Desk	Policy	Fiscal	Floor	Desk	Policy	Fiscal	Floor	Conf. Conc.	Enrolled	Vetoed	Chaptered
1st House				2nd House							

Attachments:
AB 1702 (Levine) OUA Cal Cities Asm RT 3.10.22

Primary Lobbyist: Nick Romo
Cal Cities Position: Oppose Unless Amend
Policy Committee (primary): Revenue and Taxation
Subject Area Interests: RT Interest, RT PC, Sales Tax

AB 1951 (**Grayson** D) **Sales and use tax: exemptions: manufacturing.**

Current Text: Introduced: 2/10/2022 html pdf
Current Analysis: 04/22/2022 Assembly Revenue And Taxation *(text 2/10/2022)*
Introduced: 2/10/2022
Status: 2/18/2022-Referred to Com. on REV. & TAX.
Is Urgency: Y
Is Fiscal: Y
Location: 2/18/2022-A. REV. & TAX

Desk	Policy	Fiscal	Floor	Desk	Policy	Fiscal	Floor	Conf. Conc.	Enrolled	Vetoed	Chaptered
1st House				2nd House							

Primary Lobbyist: Nick Romo
Cal Cities Position: Concerns
Hot/Priority: Hot
Policy Committee (primary): Revenue and Taxation
Subject Area Interests: RT Interest, RT PC
Bill Summary: The measure would apply the existing state sales and use tax exemption for large manufacturing to city and county sales tax rates (converting a partial sales and use tax exemption to a full exemption). The measure would also extend the program until 2033.

AB 2328 (**Flora** R) **Local ordinances: home experience sharing.**

Current Text: Introduced: 2/16/2022 html pdf
Introduced: 2/16/2022
Status: 3/3/2022-Referred to Coms. on L. GOV. and JUD.
Is Urgency: N
Is Fiscal: N
Location: 3/3/2022-A. L. GOV.

Desk	Policy	Fiscal	Floor	Desk	Policy	Fiscal	Floor	Conf. Conc.	Enrolled	Vetoed	Chaptered
1st House				2nd House							

Attachments:
AB 2328 (Flora) Asm Local Gov. Oppose. 4.21.2022

Primary Lobbyist: Nick Romo

Cal Cities Position: Oppose
Hot/Priority: Hot
Policy Committee (primary): Revenue and Taxation
2nd Lobbyist: Jason Rhine
Subject Area Interests: RT Interest, RT PC
Bill Summary: This measure preempts explicit or implicit local prohibitions on "home experience sharing units." A home sharing unit is noncommercial property that is rented for no more than 18 continuous hours. Experiences include renting a pool, backyard, and docked boats for large gatherings.

AB 2622 (Mullin D) Sales and use taxes: exemptions: California Hybrid and Zero-Emission Truck and Bus Voucher Incentive Project: transit buses.
Current Text: Amended: 4/7/2022 html pdf
Current Analysis: 03/31/2022 Assembly Revenue And Taxation *(text 2/18/2022)*
Introduced: 2/18/2022
Last Amended: 4/7/2022
Status: 4/18/2022-Re-referred to Com. on REV. & TAX.
Is Urgency: Y
Is Fiscal: Y
Location: 3/10/2022-A. REV. & TAX

Desk	Policy	Fiscal	Floor	Desk	Policy	Fiscal	Floor	Conf. Conc.	Enrolled	Vetoed	Chaptered
1st House				2nd House							

Primary Lobbyist: Nick Romo
Cal Cities Position: Support
Policy Committee (primary): Revenue and Taxation
2nd Lobbyist: Damon Conklin
Subject Area Interests: Electric Vehicles, RT Interest, RT PC

AB 2835 (Fong R) Sales and use taxes: exemptions: nonprofit blood centers.
Current Text: Introduced: 2/18/2022 html pdf
Current Analysis: 04/15/2022 Assembly Revenue And Taxation *(text 2/18/2022)*
Introduced: 2/18/2022
Status: 4/18/2022-In committee: Hearing for testimony only.
Is Urgency: Y
Is Fiscal: Y
Location: 3/17/2022-A. REV. & TAX

Desk	Policy	Fiscal	Floor	Desk	Policy	Fiscal	Floor	Conf. Conc.	Enrolled	Vetoed	Chaptered
1st House				2nd House							

Primary Lobbyist: Nick Romo
Cal Cities Position: Oppose Unless Amend
Policy Committee (primary): Revenue and Taxation
Subject Area Interests: RT Interest, RT PC

AB 2887 (Garcia, Eduardo D) Public resources: Sales and Use Tax Law: exclusions.
Current Text: Amended: 3/24/2022 html pdf
Introduced: 2/18/2022
Last Amended: 3/24/2022
Status: 3/28/2022-Re-referred to Com. on REV. & TAX.
Is Urgency: Y
Is Fiscal: Y
Location: 3/24/2022-A. REV. & TAX

Desk	Policy	Fiscal	Floor	Desk	Policy	Fiscal	Floor	Conf. Conc.	Enrolled	Vetoed	Chaptered
1st House				2nd House							

Primary Lobbyist: Nick Romo
Cal Cities Position: Concerns
Hot/Priority: Hot
Policy Committee (primary): Revenue and Taxation
Subject Area Interests: RT Interest, RT PC
Bill Summary: The measure would increase the existing limit on sales and use tax exclusions to $150,000,000 each year for manufacturers that promote alternative energy and advanced

transportation.

AB 2890 (**Bloom** D) **Property and business improvement districts.**
Current Text: Amended: 4/19/2022 html pdf
Introduced: 2/18/2022
Last Amended: 4/19/2022
Status: 4/20/2022-Re-referred to Com. on L. GOV.
Is Urgency: N
Is Fiscal: N
Location: 3/24/2022-A. L. GOV.

Desk	**Policy**	**Fiscal**	**Floor**	**Desk**	**Policy**	**Fiscal**	**Floor**	**Conf. Conc.**	**Enrolled**	**Vetoed**	**Chaptered**
1st House				**2nd House**							

Primary Lobbyist: Nick Romo
Cal Cities Position: Watch
Policy Committee (primary): Revenue and Taxation
2nd Lobbyist: Jason Rhine
Subject Area Interests: RT Interest, RT PC

SB 843 (**Glazer** D) **Taxation: renters' credit.**
Current Text: Amended: 3/21/2022 html pdf
Current Analysis: 04/15/2022 Senate Appropriations *(text 3/21/2022)*
Introduced: 1/11/2022
Last Amended: 3/21/2022
Status: 4/18/2022-April 18 hearing: Placed on APPR suspense file.
Is Urgency: Y
Is Fiscal: Y
Location: 4/18/2022-S. APPR. SUSPENSE FILE

Desk	Policy	**Fiscal**	**Floor**	**Desk**	**Policy**	**Fiscal**	**Floor**	**Conf. Conc.**	**Enrolled**	**Vetoed**	**Chaptered**
1st House				**2nd House**							

Attachments:
SB 843 (Glazer) Cal Cities Support Sen. Gov.Finance 3.24.2022

Primary Lobbyist: Nick Romo
Cal Cities Position: Support
Policy Committee (primary): Revenue and Taxation
2nd Lobbyist: Jason Rhine
Subject Area Interests: Housing, RT Interest, RT PC

SB 852 (**Dodd** D) **Climate resilience districts: formation: funding mechanisms.**
Current Text: Amended: 4/19/2022 html pdf
Current Analysis: 04/21/2022 Senate Natural Resources And Water *(text 4/19/2022)*
Introduced: 1/18/2022
Last Amended: 4/19/2022
Status: 4/22/2022-Set for hearing April 26.
Is Urgency: N
Is Fiscal: Y
Location: 4/7/2022-S. N.R. & W.

Desk	**Policy**	**Fiscal**	**Floor**	**Desk**	**Policy**	**Fiscal**	**Floor**	**Conf. Conc.**	**Enrolled**	**Vetoed**	**Chaptered**
1st House				**2nd House**							

Primary Lobbyist: Nick Romo
Cal Cities Position: Pending
Policy Committee (primary): Revenue and Taxation
2nd Lobbyist: Derek Dolfie
Subject Area Interests: Climate Change, EQ Interest, RT Interest, RT PC
Bill Summary: This bill would authorize a city, county, city and county, special district, or a combination of any of those entities to form a climate resilience district for the purposes of raising and allocating funding for eligible projects and the operating expenses of eligible projects. Eligible projects would include mean projects that address sea level rise, extreme heat, extreme cold, the risk of wildfire, drought, and the risk of flooding.

SB 938 (**Hertzberg** D) **The Cortese-Knox-Hertzberg Local Government Reorganization Act of 2000: protest proceedings: procedural consolidation.**

Current Text: Amended: 4/4/2022 html pdf
Current Analysis: 04/06/2022 Senate Floor Analyses *(text 4/4/2022)*
Introduced: 2/8/2022
Last Amended: 4/4/2022
Status: 4/4/2022-Read second time and amended. Ordered to third reading.
Is Urgency: N
Is Fiscal: N
Location: 4/4/2022-S. THIRD READING

Desk	Policy	Fiscal	**Floor**	**Desk**	**Policy**	**Fiscal**	**Floor**	**Conf. Conc.**	**Enrolled**	**Vetoed**	**Chaptered**
1st House				**2nd House**							

Primary Lobbyist: Nick Romo
Cal Cities Position: Watch
Policy Committee (primary): Revenue and Taxation
Subject Area Interests: RT Interest, RT PC

SB 1312 (**Ochoa Bogh** R) **Marketplace facilitators: passenger vehicle rental companies.**

Current Text: Amended: 4/4/2022 html pdf
Current Analysis: 04/20/2022 Senate Floor Analyses *(text 4/4/2022)*
Introduced: 2/18/2022
Last Amended: 4/4/2022
Status: 4/19/2022-Read second time. Ordered to third reading.
Is Urgency: N
Is Fiscal: Y
Location: 4/19/2022-S. THIRD READING

Desk	Policy	Fiscal	**Floor**	**Desk**	**Policy**	**Fiscal**	**Floor**	**Conf. Conc.**	**Enrolled**	**Vetoed**	**Chaptered**
1st House				**2nd House**							

Primary Lobbyist: Nick Romo
Cal Cities Position: Watch
Policy Committee (primary): Revenue and Taxation
Subject Area Interests: RT Interest, RT PC

SB 1449 (**Caballero** D) **Office of Planning and Research: grant program: annexation of unincorporated areas.**

Current Text: Amended: 4/19/2022 html pdf
Current Analysis: 04/22/2022 Senate Appropriations *(text 4/19/2022)*
Introduced: 2/18/2022
Last Amended: 4/19/2022
Status: 4/21/2022-Set for hearing April 25.
Is Urgency: N
Is Fiscal: Y
Location: 4/7/2022-S. APPR.

Desk	Policy	**Fiscal**	**Floor**	**Desk**	**Policy**	**Fiscal**	**Floor**	**Conf. Conc.**	**Enrolled**	**Vetoed**	**Chaptered**
1st House				**2nd House**							

Primary Lobbyist: Nick Romo
Cal Cities Position: Support
Policy Committee (primary): Revenue and Taxation
Subject Area Interests: RT Interest, RT PC

SB 1496 (**Committee on Governance and Finance**) **California Department of Tax and Fee Administration: tax, fee, and surcharge administration.**

Current Text: Introduced: 3/16/2022 html pdf
Current Analysis: 04/18/2022 Senate Governance And Finance *(text 3/16/2022)*
Introduced: 3/16/2022
Status: 4/22/2022-Set for hearing May 2.
Is Urgency: N
Is Fiscal: Y
Location: 4/20/2022-S. APPR.

Desk	Policy	**Fiscal**	**Floor**	**Desk**	**Policy**	**Fiscal**	**Floor**	**Conf. Conc.**	**Enrolled**	**Vetoed**	**Chaptered**
1st House				**2nd House**							

Primary Lobbyist: Nick Romo
Cal Cities Position: Pending
Policy Committee (primary): Revenue and Taxation
Subject Area Interests: RT Interest, RT PC

Total Measures: 13
Total Tracking Forms: 13

The 2022-23 Budget:

State Appropriations Limit Implications

Summary

SAL Will Constrain the Legislature's Choices This Year; State Likely to Face Challenges Balancing the Budget in the Next Couple Years. Based on recent tax revenue collection data, the state will face a significant state appropriations limit (SAL) requirement—possibly in the tens of billions of dollars—at the time of the May Revision. The Legislature and Governor can address that requirement with tax reductions and/or with more spending on specific purposes, such as capital outlay. This year, the surplus likely will be large enough to cover those requirements. In future years, however, it is very unlikely this would be the case, requiring the Legislature to make reductions to existing spending. Under our estimates, this could happen as soon as next year.

Under the Governor's Budget, the State Is Very Likely to Face Future, Serious Budget Challenges. If the Legislature adopts the Governor's budget proposals and the economy continues to grow, the state would not have surpluses large enough to pay for large and growing SAL requirements in future years. If the economy does not continue to grow, the state would face budget problems due to revenue shortfalls. For this analysis we examined 10,000 possible revenue and economic scenarios. In over 95 percent of scenarios, the state faces a budget problem by 2025-26 either due to constitutional spending requirements or a recession. In these scenarios, the state would need to make cuts to existing services to bring the budget back into balance.

Options for Avoiding Budget Problems in Future Years. The Legislature has options to avoid budget problems from arising over the next few years. For example, the Legislature can delay paying SAL requirements (for up to two years), change the definition of subventions, and/or reject nearly $10 billion in Governor's budget proposals and save those funds to meet future SAL requirements. In fact, we recommend all, or nearly all, of the Governor's budget proposals that do not help the state meet SAL requirements be rejected. However, all of these options are short-term remedies, not long-term solutions. Over the long term, as long as the economy continues to grow, the Legislature has two choices: (1) reduce taxes in order to slow revenue growth or (2) request the voters change the SAL.

LAO

GABRIEL PETEK | LEGISLATIVE ANALYST

MARCH 2022

GOVERNOR'S BUDGET LIKELY UNSUSTAINABLE

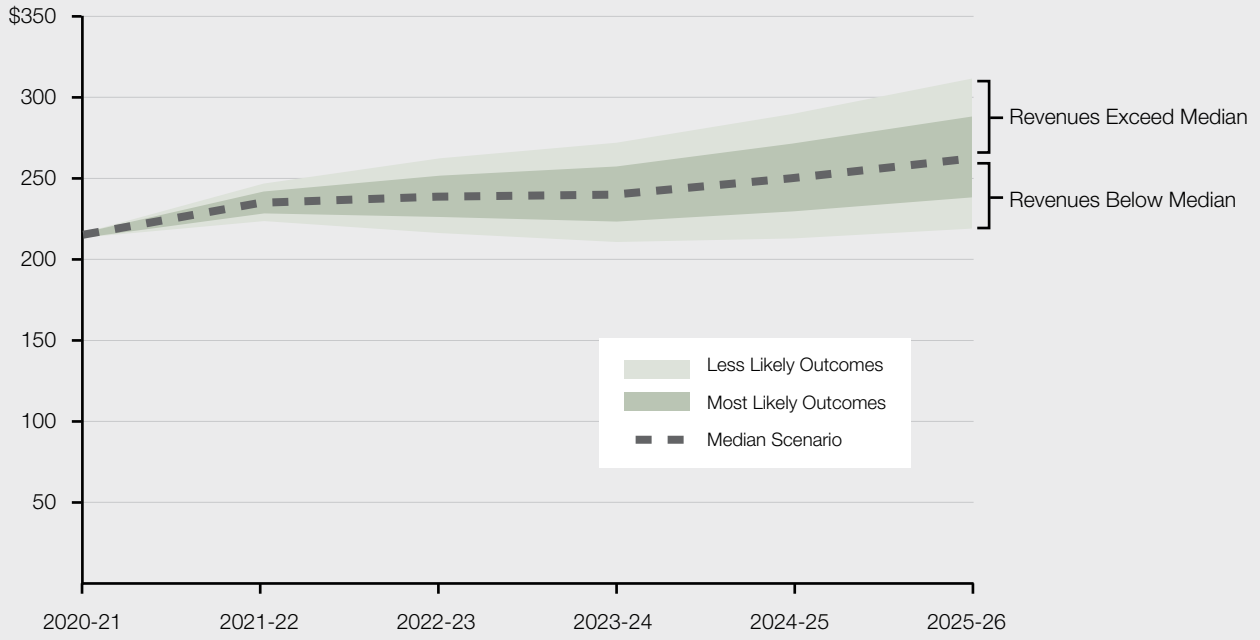
A budget problem occurs when state spending under current law exceeds state resources available. Because the state must pass a balanced budget, when a budget problem occurs, the Legislature must take actions to bring the budget into balance, like cutting spending or raising revenues. Budget problems most commonly occur during recessions. Now, however, we have determined that future budget problems are likely to occur whether revenues grow slower, *faster,* or as expected. The remainder of this section explains these dynamics assuming the Governor's budget proposals are adopted.

Revenue Growth Can Vary Widely. The budget is based on a projection of revenues. Our projections aim to represent the median revenue outcome—in which there is an equal chance that actual revenue collections fall above or below our projection. However, revenues could differ substantially from this median (dotted line in **Figure 1**)—either higher or lower. Figure 1 shows the range of likely outcomes. The most likely outcomes are shown in the darker shaded area. Less likely outcomes are shown in the lighter shaded region. Some scenarios outside these shaded areas also are possible, but would be outcomes associated with major unforeseen events that dramatically shift the state's economic situation.

If Revenue Growth Falls Below Median, State Likely to Have a Budget Problem. Because the state usually plans to spend all or nearly all of its forecasted revenues, the state typically faces a budget problem if revenues grow slower than expected. **Figure 2** shows the size of annual budget problems under an average recession (assuming the Legislature adopted the Governor's budget).

Figure 1

SAL Revenue Growth Can Vary Widely
(In Billions)



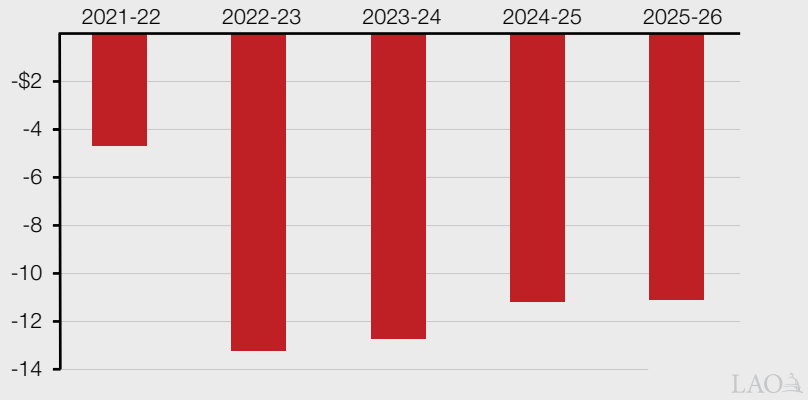
SAL = state appropriations limit.

If Revenue Growth at or Above Median, SAL Requirements Grow Significantly... In contrast, if revenues grow at or above the median, the state would have growing state appropriations limit (SAL) requirements. As described in more detail in other publications (see *The State Appropriations Limit*), the SAL restricts the use of revenue above a certain threshold. We refer to the restrictions on the use of those revenues as SAL requirements. (See the nearby box for more information on key terms and concepts used in this report, including how SAL requirements work.)

Figure 2

If Revenue Growth Is Slower Than Expected, The State Faces Significant Operating Deficits

Median Operating Deficits (In Billions)



Key Terms and Concepts in This Report

State Appropriations Limit (SAL) Requirements. Amounts the state is required to allocate to meet its constitutional requirements under Proposition 4 (1979). In short, a SAL requirement arises when the state's appropriations subject to the limit are expected to exceed the limit itself. The Legislature can meet SAL requirements in one of three key ways: (1) lowering proceeds of taxes (for example, by providing taxpayer rebates), (2) spending more on excluded purposes (for example capital outlay or money to local governments), or (3) issuing taxpayer rebates and providing more funding to schools and community colleges.

How Does the State Pay for SAL Requirements? This brief assumes that the Legislature uses General Fund discretionary funds to meet its SAL requirements. That is, we assume the state: (1) meets all of its commitments under current law and policy, including its constitutional requirements; (2) pays for the Governor's budget proposals; and (3) uses General Fund monies to pay for any SAL requirements that arise as a result of the calculation described above. If the state's General Fund resources are insufficient to cover these three categories of costs, the result is a budget deficit.

Proposals That Do Not Meet a SAL Requirement. Any budget proposals that do not meet one of the three categories listed in the first paragraph do not help the state meet its SAL requirements. This includes, for example, most spending on program benefits, such as for health and human services programs; required or voluntary contributions to the state's retirement systems; and deposits into the state's reserves.

The SAL and Budget Surpluses. The state has a surplus when spending under current law is lower than resources available in a single year. SAL requirements can exist in tandem with a surplus, but need not. For example, the state can have a surplus that is larger than its SAL requirements (as it likely will this year) or smaller than its SAL requirements (as is the case for many of the scenarios shown in this brief). In fact, the state can even have a SAL requirement and no surplus at all. That is because these calculations are wholly separate—the availability of a surplus depends on how much the state has committed to spending over time, while SAL requirements exist because revenues exceed a limit established by voters in 1979.

As **Figure 3** shows, if revenues grow faster than the median (as shown in figure 1) the state is very likely to face large—and growing—SAL requirements, reaching somewhere between $20 billion and $45 billion by 2025-26. (Note that these scenarios assume the state addresses the 2021-22 SAL requirement. That is, the estimates already assume the state takes some action similar to the various tax rebate proposals introduced by the Legislature and Governor in recent weeks.)

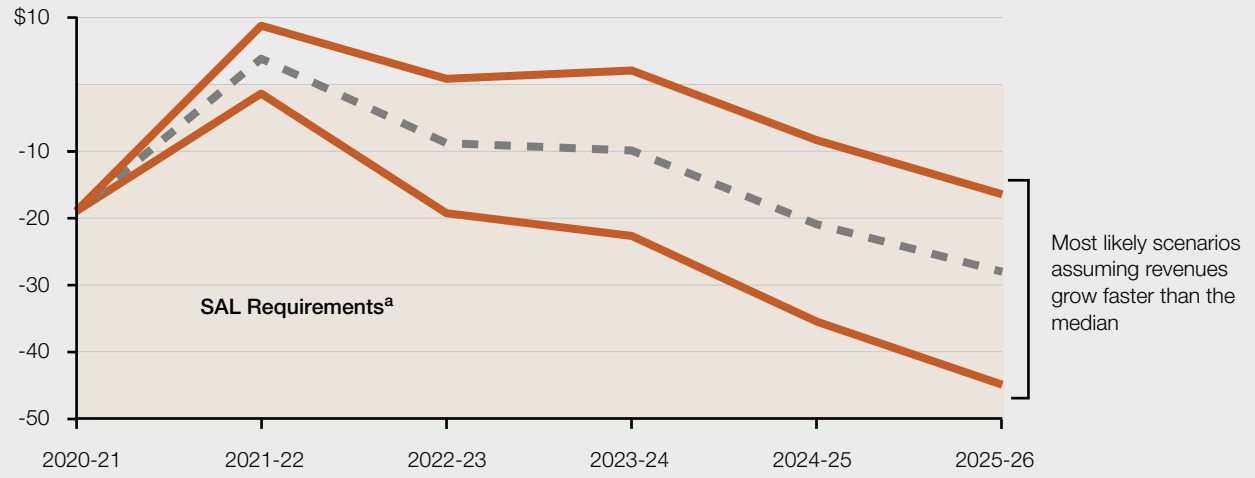
...As Do Budget Problems. For each dollar of General Fund revenue, the state is required to provide a certain amount to schools and community colleges and a certain amount to reserves and debt payments. Once tax revenues reach the appropriations limit, the state not only faces a dollar-for-dollar SAL requirement, but also continues to be required to spend a portion of each General Fund dollar on schools and community colleges and reserves and debt payments. As a result, for each dollar collected once the state reaches the appropriations limit, the state faces roughly $1.60 in constitutional requirements. (We describe this dynamic in more detail in our post *The 2022-23 Budget: Initial Comments on the State Appropriations Limit Proposal*.) Consequently, if revenues grow at or above the median, constitutional spending requirements would grow faster than available resources, causing potentially significant budget problems. In this scenario, the state would be required to cut non-constitutionally required spending to solve the budget problems.

Regardless of Revenue Growth, Future Budget Problems Are Very Likely Under the Governor's Budget. As a result of these two dynamics—either slower revenue growth resulting in operating deficits or faster revenue growth resulting in larger constitutional spending requirements—the budget is very likely to face budget problems in the coming years. **Figure 4** shows the range of likely budget problems assuming the Legislature approved all of the Governor's budget proposals. As the figure shows, the state most likely would face budget deficits ranging from $5 billion to $20 billion as soon as next fiscal year regardless of revenue growth. By 2025-26, those deficits would most likely grow to $20 billion to $60 billion.

Figure 3

If the Economy Continues to Grow, The State Faces (Large and Growing) SAL Requirements

(In Billions)



[a] This figure shows the annual difference in appropriations subject to the limit and the limit itself. When this amount is negative, the state has a SAL requirement, which it must meet by: (1) spending more on excluded purposes, (2) lowering taxes, or (3) making taxpayer rebates and additional payments to schools.

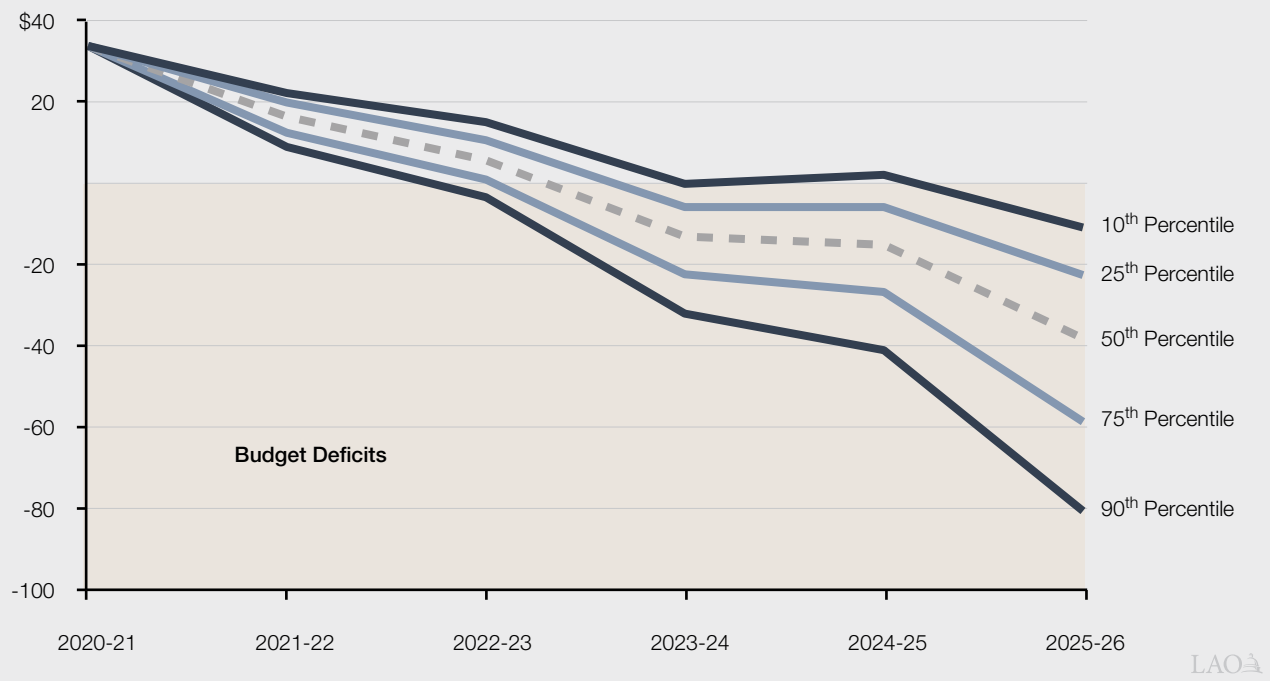
SAL = state appropriations limit.

LAO

Figure 4

If the Legislature Approves the Governor's Budget, The State Is Very Likey to Face Future Deficits

(In Billions)



The State Cannot "Grow Its Way Out" of Budget Problems. Higher revenues do not increase the state's ability to meet SAL requirements. In fact, the opposite is true. As described above, because of the state's constitutional spending requirements—including that the SAL requires the state to dedicate *all* revenues above a certain threshold for SAL requirements, no matter how much revenues grow—higher revenue growth means each $1 collected results in $1.60 of spending requirements. This dynamic puts the state in an untenable fiscal situation.

HOW CAN THE LEGISLATURE RESPOND IN THE SHORT TERM?

While the budget could face problems either as a result of a recession or continued economic growth—both on the upside and downside—this post focuses on the steps the Legislature can take to mitigate the budget's upside risk. That is, how the Legislature can promote the chances that budget stays balanced if revenues come in at or above expectations. This section outlines three steps the Legislature can take to mitigate risks in the short term.

Reject a Significant Share of the Governor's Budget Proposals

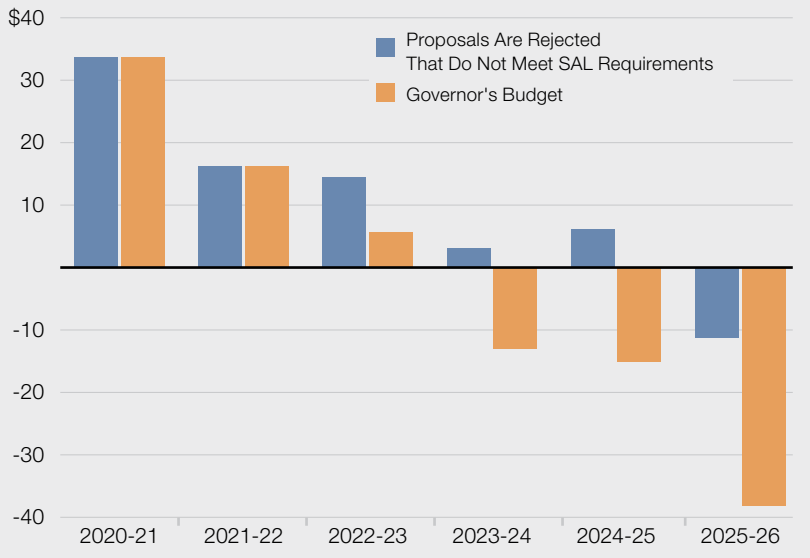
Reject All of the Governor's Proposals That Do Not Meet a SAL Requirement... The Legislature can forestall budget deficits for a few years by rejecting all of the nearly $10 billion in Governor's budget proposals that do not meet a SAL requirement and then *saving those funds* in order to meet future SAL requirements.

(The Governor's proposals that meet SAL requirements could be adopted. However, the Legislature could adopt alternative proposals as long as they meet the SAL requirements.) **Figure 5** shows how this action would change the budget outlook. As the figure shows, under the Governor's budget policies (orange bars), the state is most likely to face large and growing budget deficits as soon as 2023-24. If the Governor's budget proposals that do not meet a SAL requirement are rejected (and those funds are saved instead [blue bars]), the state can most likely delay those deficits until 2025-26. (We list the Governor's budget discretionary spending proposals that do not help the state meet its SAL requirements in our post *The 2022-23 Budget: Initial Comments on the State Appropriations Limit Proposal*. We also describe this concept—proposals that do not meet a SAL requirement—in the box on page 3.) Consequently, we recommend rejecting these proposals.

Figure 5

Budget Risks Mitigated if Legislature Rejects All of the Governor's Proposals That Do Not Meet SAL Requirements

Median SFEU Balance (In Billions)



SAL = state appropriations limit and SFEU = Special Fund for Economic Uncertainties.

...And Save Funds to Meet Future SAL Requirements. The scenario shown in Figure 5 assumes the state saves $10 billion in 2022-23 and then uses those funds to pay for SAL requirements in 2023-24 and/or 2024-25. As such, the nearly $10 billion in funds available as a result of rejecting these proposals must be saved to help balance the budget in the future. That is because, in the coming years, the state is likely to face large SAL requirements without a surplus large enough to pay for them. (The box on page 3 also described the relationship between the surplus and SAL requirements.) The Legislature would not get the same benefit if it rejects these proposals and then spends the funds on excluded purposes because such an action would not help it meet these future requirements.

Delay SAL-Required Payments

State Also Can Ease Some Short-Term Pressure by Pushing Out Payments... Another way the state can manage this risk in the short term is by delaying when SAL requirements are paid. Under the Constitution, when state revenues exceed the limit over two years, the Legislature has an additional two years to return the excess to taxpayers and make additional payments to schools. Delaying these payments can ease some of the short-term pressure because the state has an additional year or two of revenue growth—and therefore more resources available—to meet the requirements.

...But the State Must Set Aside Funds for Future Requirements or Risk Very Severe Budget Deficits. However, if the Legislature chooses to continuously delay making these payments, but does not set aside as much as it can to pay for those requirements in the future, it eventually will face the worst-case scenario:

a future, unfinanced SAL requirement coupled with a recession. Consequently, delaying action on the current-year requirement without setting aside funds to meet the requirement in future years would be unwise.

Change the Definition of Subvention

The Legislature Also Could Change the Definition of Subvention. Another way to address this issue in the short term is to change the definition of subvention. Under the Constitution and statute, subventions—funding provided to local governments on an unrestricted basis—meet SAL requirements and are counted, instead, at the local level. The state could amend the definition of subvention in order to count more funding provided at the local level. For example, instead of specifying that only unrestricted funds provided to local governments should count as subventions, statute could state that any funds provided to local government count as subventions. We understand that courts generally uphold legislative interpretations of constitutional amendments so long as they are reasonable and consistent with the purpose of the statute. We think both of those criteria would apply in the case of this change. Counting more subventions at the local level would maintain the spirit of Proposition 4 (1979). The aim of that measure was to keep government appropriations, at all levels of government, below the adjusted 1978-79 level. This change would still adhere to that basic principal, but would count some spending within local government limits, instead of the state's limit.

This Change Would Provide a Short-Term Reduction in Appropriations Subject to the Limit. If the state excluded all funds to local governments, regardless of restriction and/or method of distribution, we estimate there is around $10 billion in existing spending that would no longer count toward the state's limit, but rather count at the county, city, or special district level. (As of 2018-19, cities and counties had over $150 billion in collective room under their limits. As a result, changing this definition is unlikely to result in very many local governments exceeding their limits. However, the Legislature could also adopt a mechanism to ensure the change in policy does not cause any single entity to exceed their limits.)

HOW CAN THE LEGISLATURE RESPOND IN THE LONG TERM?

Under Current Law, State Government Very Likely Cannot Grow More. In the previous section, we outlined three options to address the short-term budgetary risks currently faced by the state. However, none of these, even all together, would indefinitely forestall the long-term reality of the state's constitutional constraints. The reality is that state tax revenues are growing faster than the limit and the size of state government has reached the limit set by voters in the 1970s. Revenue growth has exceeded growth in the limit for a variety of reasons, including faster income growth among higher-income earners, policy decisions by the Legislature, and growth in school spending. As a result of this differential growth, over the long term the Legislature has only two choices: (1) reduce taxes in order to slow revenue growth or (2) request the voters change the limit. (If the economy does not continue to grow, the Legislature will have other, even more difficult, budget choices to make.)

Reduce Taxes on an Ongoing Basis. The first long-term alternative for the Legislature is to reduce taxes so that they no longer are growing faster than the limit. Under this alternative, tax revenues and associated spending could still grow, but they could not grow faster than the limit itself. As a result, the Legislature's ability to make new program expansions would be severely constrained. While the Legislature could still reallocate funds among programs—for example, by spending less in one area, it could make expansions in another—further expansions to programs not coupled with such reductions would not be feasible.

Alternatively, the Legislature Could Request the Voters Change the Limit. The Legislature's second long-term option is to ask the voters to approve changes to the SAL. As we noted in a 2021 report on the SAL, there are policy justifications for requesting that the voters change school districts' limits. For instance, asking for a change to the calculation of districts' limits—like the changes made to city, county, and special district limits under Proposition 111—would maintain spending limits for schools while providing greater flexibility in the calculation of those limits. However, the voters are permitted to make any changes to the SAL that they deem appropriate. Instead of a narrower change like this, the Legislature also could request more far-reaching or permanent changes, increases, or modifications to the SAL.

TECHNICAL APPENDIX

In this section, we describe the basic assumptions and specifications of our methodology for arriving at the estimates in this post.

Examined Many Possible Combinations of Key Variables. Several key variables in our analysis—particularly General Fund revenues, special fund revenues, capital gains tax revenues, and personal income growth—cannot be forecasted precisely. Many possible future values of these variables are plausible. Variation in these variables could lead to vastly different budget situations for the state. To account for this variation, we examined 10,000 scenarios comprised of unique combinations of these key variables. Our method seeks to mimic how these variables have varied from year to year historically, as well as how these variables move together over time. Specifically, we modeled these variables (with transformations applied in some cases) using a multivariate normal distribution, with standard deviations and covariances set to match historical levels over the last 40 years. Our analysis does not include variation in some parameters, such as non-Proposition 98 spending, non-tax revenue, or state appropriations limit (SAL) exclusions. These parameters reflect the policy choices of the Governor's budget and therefore leaving them fixed reflects the best estimate of the state's budget position given those policies. Moreover, variation in any of these parameters would be very narrow compared to variation in tax revenue.

For Each Scenario, Calculated SAL Requirements and SFEU Balance. For each of these 10,000 scenarios, we calculated SAL requirements based on General Fund and special fund tax revenues and holding exclusions fixed. Using those calculated SAL requirements, we estimated Special Fund for Economic Uncertainties (SFEU) balances for each scenario that:

- ***Assumed Proposition 98 Spending Would Remain in Test 1.*** We assumed Proposition 98 spending was a fixed share of General Fund taxes (38.028 percent), with slight variation by year to account for the effects of the state's Transitional Kindergarten policy. Under our current average daily attendance forecasts, this is a reasonable assumption.
- ***Assumed SAL Requirements Were Paid in the Second Year of a Two-Year Net Overage.*** This analysis assumes SAL requirements are paid in the second year of a net two-year overage. That is, each time the state has negative room in one year, and a second year of room or negative room that results in net excess revenues across the two-year period, we assume the state pays for those excess revenues in that second year.
- ***Assumed Proposition 2 (2014) Infrastructure Spending Offsets Baseline Costs.*** For each scenario, we calculate a Proposition 2 requirement—including Budget Stabilization Account deposit, debt payments, and infrastructure spending, if applicable—based on General Fund tax revenues, total General Fund revenues, and capital gains revenues. For years in which infrastructure spending was required, we assumed that spending would offset baseline non-Proposition 98 spending (consistent with the administration's treatment in their multiyear forecast). This slightly improves the budget bottom line compared to the alternative assumption.

Used Governor's Budget Non-Proposition 98 Spending Estimates. We took the Governor's budget estimates of other spending as given and did not vary these, up or down, with economic and revenue conditions. While this could mean we understated the severity of budget problems during a recession or slightly overstated the severity of budget problems as a result of constitutional spending constraints, these effects generally would be small compared to the figures in this report. For context, in our *2019-20 Fiscal Outlook* analysis, we estimated that non-Proposition 98 spending would increase about $1 billion at the height of a moderate recession. Meanwhile, the median operating deficits shown in Figure 2 averaged around $10 billion to $12 billion.

LAO PUBLICATIONS

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

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ATTACHMENT C

City Managers Sales Tax Working Group
City Managers Department

Past and Present: City Managers Sales Tax Working Group

Introduction
Modernization of the sales tax system, designed in the early twentieth century, has been a policy goal of state, federal, and local government leaders for decades to meet the rapidly changing landscape of commercial activity and ensure that all communities can sustainably provide critical services.

A major force changing the sales tax system is increased online (remote) purchasing by general consumers and businesses. While the growth of e-commerce has been occurring for more than two decades, led by some of the largest and most popular retailers in the world, the dramatic increase in online shopping during the COVID-19 pandemic has provided significant revenue to California cities as well as a clearer picture of disparate growth of revenues amongst cities. While additional taxable activities are also of interest for allocation reform, in-state online purchase activity garners the highest interest and concern.

In the backdrop of booming online sales has been the steady decline of brick-and-mortar retail and shopping malls. For cities with heavy reliance on in-person retail shopping, the value of the current sales tax allocation system has been diminished as their residents shop online more or are incentivized to do so by retailers (during the COVID-19 pandemic, many consumers had no other option but to shop online for certain goods). However, the demands to provide city services remain and continue to grow.

City leaders have long been concerned about the loosening of the nexus between what their residents purchase and the revenues they receive. Under existing sales tax sourcing rules, significant online shopping activity has led to a growing concentration of sales tax revenue to an increasingly smaller number of cities and counties. As more medium and large online retailers take title to fulfillment centers or determine specific sales locations in California (in some instances as a result of tax rebate agreements), online sales tax revenue may continue to be concentrated to fewer cities and counties. Furthermore, local governments are already experiencing the declining power of the sales tax to support services as more money is being spent on non-taxable goods and services.

City officials across the state urged Cal Cities to support the reconvening of a working group of city managers and other relevant city officials to study and recommend actions regarding sales tax modernization that a) equitably benefits all cities, b) broadly furthers fiscal sustainability and service reliability, and c) improves the future viability of the sales tax.

Prior Relevant Efforts and Actions
In 2015 and 2016, Cal Cities' Revenue and Taxation policy committee held extensive discussions on potential modernization of tax policy affecting cities, with a special emphasis on sales tax. The issues were identified by Cal Cities leadership as a strategic priority given concerns in the membership about the declining sales tax base and the desire for the organization to take a leadership role in addressing the associated issues. The committee ultimately adopted a series of policies that were approved by the board In June 2016. Among its changes was a recommended change to existing sales tax sourcing rules (determining where a sale occurs), so that the point of sale (situs) is where the customer receives the product.

Following the adoption of revised sales and use tax policies in June 2016, Cal Cities staff met with the leadership of the City Manager's Department at the 2016 Annual Conference to discuss the need to have city managers involved in an internal discussion on the updated Cal Cities Revenue and Taxation policies.

2017-2018 Working Group
As a follow-up to prior discussions, a working group (Group) of city managers, representing a diverse array of cities, was organized in fall 2017 by the City Manager's Department to review the Cal Cities' policies and identify internal common ground on how the organization could move forward in response to rapidly evolving e-commerce trends and their effects on the allocation of local sales and use tax revenue.

The Group's efforts became more relevant in March2018, when SCA 20 (Glazer) was introduced, proposing a shift of local sales tax to destination allocation by January 1, 2020.

The Group explored the issues and options related to allocation of local Bradley-Burns Sales and Use Tax revenues derived from online sales, which included:

- Information on online retail trends.
- Potential impacts of sales tax rebate agreements between cities and online retailers.
- Existing "use tax" allocations from online retailers via county pools, including affiliate-nexus transactions (e.g., Amazon, etc.) and use tax now reported and paid by business and consumer purchasers.
- Estimates of additional sales (use) tax collection (that under current rules flow through county pools) from implementation of the recent *South Dakota v Wayfair* decision.
- Reviewing various (limited) analyses on possible budgetary impacts of a switch to destination allocation.
- Infrastructure demands faced by cities serving as logistics centers, with warehouses and fulfillment centers, for the distribution of e-commerce goods, and impacts of a shift to destination sourcing and allocation on these communities.
- Effects of sales tax sourcing and allocation rules on different types of land use development (e.g., affordable housing, market rate housing, warehouse, and commercial) to generate sufficient added revenue to cover added service costs.

- Impacts on cities with significant business-to-business sales, including whether they were less impacted by e-commerce trends affecting traditional consumer goods, and whether they should be exempted or otherwise treated differently.
- Evaluating possible phase-in formulas (between origin and destination) for sales tax sourcing.

Adopted 2017-2018 Work Group Recommendations
The Group recommended approaching the evolving issues associated with e-commerce and sales and use tax in two steps:

Step One:

- Further Limiting Rebate Agreements: The consensus of the Group was that:
    - Sales tax rebate agreements involving online retailers should be prohibited going forward as they have the effect of encouraging revenue to be shifted away from numerous communities and concentrated to the benefit of one.
    - Any type of agreement that seeks to move a retailer from one community to another within a market area should also be prohibited going forward. Existing law already prohibits such agreements for auto dealers and big box stores.
- Shift Use Tax from Online Sales, including from the *South Dakota v Wayfair* Decision Out of County Pools: The Group's recommendation is based first on the principle of "situs" that revenue should be allocated to the jurisdiction where the use occurs. Each city and county in California imposed a Bradley Burns sales and use tax rate under state law in the 1950s. The use tax on a transaction is the rate imposed where the purchaser resides (the destination). These use tax dollars, including new revenue from the *South Dakota v Wayfair* decision, should be allocated to the destination jurisdiction whose Bradley Burns tax applies and not throughout the entire county.[1]
    - Shift of these revenues, from purchases from out-of-state retailers including transactions captured by the *South Dakota v Wayfair* decision, out of county pools to full destination allocation on and after January 1, 2020.[2]
    - Allow more direct reporting of use taxes related to construction projects to jurisdiction where the construction activity is located by reducing existing regulatory threshold from $5 million to $100,000.
- Request/Require California Department of Tax and Fee Administration (CDTFA) Analysis on Impacts of Sales Tax Destination Shifts: After discussion of numerous phase-in options for destination sourcing and allocation for sales taxes, the

[1] Dated (former BOE) policies have allocated these use tax dollars into county wide pools. Revenues in county pools are distributed in accordance with a jurisdiction's pro-rata share of sales tax within a county.
[2] Reflects working group agreement to shift these use taxes to destination more immediately, while the CDTFA looks at sales tax allocation issues. The group was also concerned about the corporate plans of Amazon which accounts for nearly half of all online revenues. The fulfillment centers located in state were not yet legally owned by Amazon, and thus Amazon continued to collect use and report use taxes under "affiliate nexus" rules. These revenues were distributed via county pools in proportion to other taxable sales among the agencies within each county. Since the group last met, Amazon has taken title to these fulfillment centers.

Group ultimately decided a more complete analysis was needed to sufficiently determine impacts. Since the two companies most cities rely on for sales tax analysis, HdL and MuniServices, were constrained to modeling with transaction and use tax (district tax) data, concerns centered on the problem of making decisions without adequate information.[3] Since CDTFA administers the allocation of local sales and use taxes, it is in the best position to produce an analysis that examines:

- Impacts on individual agencies of a change in sourcing rules. This would likely be accomplished by developing a model to examine 100% destination sourcing with a report to the Legislature early in 2020.
- The model should attempt to distinguish between business-to-consumer transactions versus business-to-business transactions.
- The model should analyze the current number and financial effects of city and county sales tax rebate agreements with online retailers and how destination sourcing might affect revenues under these agreements.

Step Two:

Conditions for considering a Constitutional Amendment that moves toward destination allocation: Absent better data on the impacts on individual agencies associated with a shift to destination allocation of sales taxes from CDTFA, the Group declined to prescribe if/how a transition to destination would be accomplished; the sentiment was the issue should be revisited once better data was available. In anticipation that the data would reveal significant negative impacts on some agencies, the group desired that any such shift should be accompanied by legislation broadening of the base of sales taxes, including as supported by existing Cal Cities policy including:

- Broadening the tax base on goods, which includes reviewing existing exemptions on certain goods and expanding to digital forms of goods that are otherwise taxed; and
- Expanding the sales tax base to services, such as those commonly taxed in other states.

2021 Annual Conference Resolution

Following multiple unsuccessful attempts towards progress on the prior adopted recommendations, it was clear that additional stakeholder engagement and study is needed to make meaningful, collective advancement on modernized sales tax policy. During the 2021 Cal Cities Annual Conference, a proposed resolution by the City of Rancho Cucamonga, called on the Legislature to work with Cal Cities to pass legislation, that has first been developed and vetted by city officials and put forward by the Cal Cities Board of Directors, that provides for a fair and equitable distribution of the Bradley Burns one percent local sales tax from in-state online purchases, based on data where products are shipped to, and that takes into consideration the impacts that warehouses and fulfillment centers have on host cities but also provides a fair share to

[3] While all members of the group wanted to avoid undue harm to specific agencies, some were also concerned that some prior phase-in proposals were not aggressive enough and the changing economy required faster transition. The group also discussed allowing those under existing rebate agreements to "opt out" and remain on full origin sourcing rules until when they expired or by a fixed date at the end of a phase-in period.

California cities that do not and/or cannot have a fulfillment center such facilities within their jurisdiction.

The General Resolution Committee referred *Resolution 1: Online Sales Tax Equity* back to the Revenue and Taxation Policy Committee and strongly recommended that the Committee **support the reconvening of the city managers sales tax working group.** The General Assembly concurred.

More Data is Needed to Achieve an Equity Based Approach
A major challenge is the lack of adequate data to model the results of shifting in-state online sale tax revenues. Local government tax consultants and state departments have limited data to model the effects of changes to sales tax distribution because their information is derived only from cities that have a local transactions and use tax (TUT). Tax experts are able to model proposed tax shifts using TUTs since they are allocated on a destination basis (where a purchaser receives the product, usually a home or business). However, more than half of all cities, including some larger cities, do not have a local TUT therefore modeling is constrained and incomplete.

Efforts to collect relevant sales tax information on the destination of products purchased online are ongoing. The most recent effort is encapsulated in SB 792 (Glazer, 2021), which would have required retailers with online sales exceeding $50 million a year to report to CDTFA the gross receipts from online sales that resulted in a product being shipped or delivered in each city. The availability of this data would have allowed for a much more complete understanding of online consumer behavior and the impacts of future proposed changes to distribution. SB 792 (Glazer) was vetoed by Governor Newsom in fall 2021.

Cal Cities staff has requested additional data from CDTFA to support understanding of the impacts of shifting online sales to customer locations. This is an ongoing effort.

Impacts of Goods Movement Must Be Considered
City leaders and practitioners across the state acknowledge that the hosting of fulfillment centers and goods movement infrastructure pose major burdens on local communities including detrimental health, safety, and infrastructure impacts. Not least of which is the issue of air pollution from diesel exhaust. According to California Environmental Protection Agency (Cal EPA):

"Children and those with existing respiratory disease, particularly asthma, appear to be especially susceptible to the harmful effects of exposure to airborne PM from diesel exhaust, resulting in increased asthma symptoms and attacks along with decreases in lung function (McCreanor et al., 2007; Wargo, 2002). People that live or work near heavily-traveled roadways, ports, railyards, bus yards, or trucking distribution centers may experience a high level of exposure (US EPA, 2002; Krivoshto et al., 2008). People that spend a significant amount of time near heavily traveled roadways may also experience a high level of exposure."

The founded health impacts of the ubiquitous presence of medium and heavy-duty diesel trucks used to transport good to and from fulfillment centers and warehouses

require host cities to meet increased needs of their residents including the building and maintenance of buffer zones, parks, and open space. However, pollution impacts may decline with the introduction of zero-emission vehicles as wide scale adoption by large distribution fleets progresses. Nonetheless, the impacts of heavy road use necessitate increased spending on local streets and roads upgrades and maintenance.

Reconvening: Purpose, Principles, And Goals
Following the actions taken at the 2021 Annual Conference, the City Manager's Department began preparing for a convening of a sales tax working group to review rapidly evolving trends, explore policy implications, and identify additional data to support reform discussions. This iteration of the working group aims to be more representative, transparent, and data driven.

Purpose
To convene a diverse and representative group of California city officials dedicated to examining local government sales tax issues and providing recommendations that equitably benefit California cities, further fiscal sustainability, and strengthen the viability of the sales tax.

Guiding Principles
- Identify solutions that are fair, equitable, and beneficial to California cities.
- Advance the fiscal sustainability and service reliability of city governments including through improved clarity and certainty in the sales tax system.
- Strengthen the viability and adaptability of the sales tax for the next generation.
- Prioritize consensus building, inclusive engagement and respect for the sensitivity of the discussions.

Goals
- Establish a transparent and inclusive process for member cities to participate in the activities of the working group to present to the Board of Directors in February 2022.
- Form a group of city officials that represent the in-state diversity of fiscal and policy interests, geographies, economies, demographics, and expertise.
- Regularly convene and provide the group with organizational assistance. Meetings will commence in Spring 2022.
- Improve understanding of existing sales tax laws, regulations, and policies.
- Improve communication and understanding amongst member cities regarding sales tax generation and its relationship to infrastructure, land use, environmental, health, and safety, amongst other matters across the state.
- Deliberate policy changes and reforms to the sales tax law.
- Regularly update relevant Cal Cities policy committees and the Board of Directors.