

## TAXES VS. FEES: WHAT WILL PROPOSITION 37 MEAN FOR CALIFORNIA?

### INTRODUCTION

Proposition 37, which will appear on the November ballot, reclassifies certain types of fees as taxes and thereby subjects them to approval by two-thirds, rather than a majority, vote of the Legislature at the state level; and voter approval, rather than approval by the governing body, at the local level. Proponents state that Proposition 37 is intended to overturn a June 1997 decision by the California Supreme Court in *Sinclair Paint Company v. State Board of Equalization*. The sponsors of Proposition 37 are the California Chamber of Commerce, California Taxpayers Association, and California Manufacturers and Technology Association.

The roots of Proposition 37 go back to Proposition 13 of 1978. Proposition 13 imposed a two-thirds vote requirement for legislative approval of new or increased taxes at the state level and a voter-approval requirement for new or increased "special" taxes at the local level. Proposition 218 of 1996 further limited elected officials' ability to raise revenues by instituting a voter approval requirement for all new or increased local taxes. The enactment of supermajority and/or voter approval requirements for taxes has created a distinction between "taxes" and "fees." The distinctions between taxes and fees and general and special taxes have been the subject of extensive litigation in the years since the passage of Proposition 13.

### WHAT DOES PROPOSITION 37 DO?

Proposition 37 amends the state constitution to redefine certain fees as taxes, thereby subjecting them to the two-thirds vote requirement at the state level and two-thirds voter approval at the local level. Specifically, Proposition 37 states that:

"Compulsory fees enacted after July 1, 1999 to monitor, study, or mitigate the societal or economic effects of an activity, and which impose no significant regulatory obligation on the fee payer's activity other than the payment of the fee, and regulatory fees that exceed the reasonable cost of regulating the activity for which the fee is charged, shall be deemed state taxes subject to the two-thirds vote requirement of this section."<sup>1</sup>

Proposition 37 would subject fees imposed for the purpose of studying or monitoring the impact of a particular activity or product or addressing adverse impacts associated with a product or activity to the supermajority vote requirements that currently apply to state and local taxes.

Proposition 37 exempts:

- Fees and assessments subject to the voter approval requirements enacted by Proposition 218 of 1996;
- Fees levied on developers;
- Fees imposed prior to July 1, 1999 and any increases to these fees attributable solely to increased

workload; or

- Damages, penalties, remedial events or other amounts collected in connection to a specific event (i.e., damages collected from a single entity in response to a toxic incident attributable to a specific act of negligence).

Proposition 37 also defines fees that exceed the cost of regulating the activity for which the fee is charged as taxes. This provision, however, is consistent with the standard used under existing law and thus reaffirms, rather than modifies current practice.

## WHAT IS A TAX? WHAT IS A FEE? WHY DOES IT MATTER?

In California, the distinctions between taxes and fees have evolved through a series of initiatives and subsequent litigation. Prior to Proposition 13, the distinction was essentially meaningless. The state Legislature could enact or increase taxes or fees by a majority vote of both houses of the Legislature. At the local level, charter cities could impose taxes or fees under authority granted by the state's constitution. General law cities, counties, and other local entities could impose taxes and fees by majority vote of a jurisdiction's governing body under statutory authority granted by the Legislature. Propositions 13 of 1978, 62 of 1986, and 218 of 1996 limited the authority of state and local governments to impose taxes and, in the case of 218, some fees and assessments. These limitations made the distinctions between taxes and fees important, since state fees could be imposed by majority vote of the Legislature and local fees could be approved without voter approval.<sup>2</sup>

| Tax and Fee Vote Requirements and the Initiative Process |   |
|--|---|
| <b>Proposition 13</b> (June 1978)                        | <ul style="list-style-type: none"><li>• Limited property tax rates to one percent.</li><li>• Allowed reassessment of property to market value only upon change of ownership.</li><li>• Transferred responsibility for allocating property tax revenues to the state Legislature.</li><li>• Required 2/3 voter approval of local taxes designated for a specific purpose.</li><li>• Required measures raising state taxes to be approved by a 2/3 vote of each house of the Legislature.</li></ul>   |
| <b>Proposition 62</b> (November 1986)                    | <ul style="list-style-type: none"><li>• Required approval of new local general-purpose taxes by a 2/3 vote of the governing body of a local agency and a majority of the voters. Largely invalidated by the courts.</li></ul>   |
| <b>Proposition 218</b> (November 1996)                   | <ul style="list-style-type: none"><li>• Required new general-purpose local taxes to be approved by a majority of the voters and special purpose taxes to be approved by a 2/3 vote of the voters.</li><li>• Prohibited school districts from imposing a general-purpose local tax.</li><li>• Limited the use of benefit assessments and imposed protest and notice provisions on governments attempting to impose benefit assessments.</li><li>• Restricted the use of property-related fees by local government and imposed new notice and protest provisions.</li><li>• Allowed voters to repeal any existing local tax, fee, or assessment by a majority vote.</li></ul> |

In the *Sinclair Paint* decision, the Supreme Court noted "that 'tax' has no fixed meaning and that the distinction between taxes and fees is frequently 'blurred,' taking on different meanings in different contexts. In general, taxes are imposed for revenue purposes, rather than in return for a specific benefit conferred or privilege granted."<sup>3</sup> In other words, there does not have to be a direct relation between an individual taxpayer's relative benefit from services or facilities and the tax he or she pays. Counties, school districts, and special districts can only impose taxes specifically authorized by the Legislature. Cities may impose any tax not otherwise prohibited by state law.<sup>4</sup> The state has "reserved" a number of

taxes for its own purposes, prohibiting local governments' use of these revenue sources. For example, the state reserves the right to tax cigarettes and alcoholic beverages.

There are two basic categories of taxes, general and special. General taxes are those that generate revenue for the general operation of government. The proceeds of a general tax may be used for any purpose the governing board chooses to spend them on. Proposition 13 of 1978 requires "any changes in state taxes enacted for the purpose of increasing revenues" to receive the approval of two-thirds of both houses of the Legislature. Proposition 218 of 1996 requires imposition, extension, or any increase of a general tax by local government to be approved by a majority vote of the electorate. Special taxes are local taxes where the revenues raised are dedicated to a specific purpose. For example, a city might levy a parcel tax on property to pay for library services, or a county could vote to levy a sales tax for jails. Proposition 218 requires a new, extended, or increased special tax to be approved by a two-thirds vote of local voters.

Fees are charges imposed to recover the cost of providing a service to the feepayer or to pay for the cost of regulating specific activities or industries. While distinctions between taxes and fees are sometimes drawn based on the voluntary nature of a fee (i.e., a feepayer can choose whether or not to purchase a particular service or engage in a regulated activity), the California Supreme Court found that "compulsory fees may be deemed legitimate fees rather than taxes."<sup>5</sup> A fee cannot exceed the reasonable cost of providing a service or regulatory activity without being considered a tax.

| Current Tax and Fee Vote Requirements |  |   |
|---------------------------------------|--|---|
|                                       | Taxes  | Fees  |
| State                                 | Two-thirds approval of the Legislature   | Majority of the Legislature   |
| Local                                 | Majority of the voters for general taxes and two-thirds of the voters for special (designated) taxes | In general, a majority of the governing body of the jurisdiction (special provisions apply to property-related fees). |

### WHAT IS THE *SINCLAIR PAINT* DECISION?

Proponents of Proposition 37 maintain that their primary goal is to overturn a unanimous decision of the California Supreme Court in *Sinclair Paint Company v. State Board of Equalization*. In this decision, the California Supreme Court upheld the constitutionality of a fee imposed on manufacturers of lead-containing gasoline and paint products by the Childhood Lead Poisoning Prevention Act of 1991.

The *Sinclair Paint* case challenged the imposition of a fee levied to provide a dedicated funding source for lead poisoning prevention and treatment program administered by the Department of Health Services. Services supported by this fee include 1) evaluating, screening, and providing case management services for children at risk of lead poisoning; 2) identifying sources of contamination responsible for lead poisoning; 3) providing services to children affected by lead poisoning; and 4) providing education on the detection and treatment of lead poisoning to state health care providers. The Department initially calculated the amount of fees owed by individual firms on the basis of 1991 market share. Firms that were able to show that they did not contribute to environmental lead contamination were exempt from the fee. The bill imposing the fee and creating the treatment and prevention program was passed by a majority, but not two-thirds, of the Legislature and signed into law by then Governor Pete Wilson.

The Sinclair Paint Company filed suit alleging that the fee imposed was actually a tax and thus was unconstitutional since it failed to receive the two-thirds vote needed to pass a bill raising state taxes. The plaintiff argued that the lead prevention fee should be considered a tax since it supported a program that did not provide a special benefit to paint producers or compensate the government for special

privileges granted to paint manufacturers. The plaintiffs also disputed the state's authority to impose an industry-wide fee to compensate for adverse consequences generated by an industry's products and, in particular, a fee imposed to provide compensation for an industry's *past* activities.

The plaintiffs did *not* contend that the amount raised by the fees exceeded the cost of providing lead prevention and treatment services or that there was no connection between lead paint and childhood lead poisoning.

## What Did the Court Say?

In a 7-0 decision, the Court ruled that lead paint fees should properly be considered a regulatory fee, rather than a tax, and thus could lawfully be enacted by majority vote of the Legislature. The Court cited a previous decision suggesting that expanded use of regulatory fees was a logical outcome of Proposition 13:

“Proposition 13’s goal of providing effective property tax relief is not subverted by the increase in fees or the emissions-based apportionment formula. A reasonable way to achieve Proposition 13’s goal of tax relief is to shift the costs of controlling stationary sources of pollution from the tax-paying public to the pollution-causing industries themselves.”<sup>6</sup>

The Court further stated that, “we see no reason why statutes or ordinances calling on polluters or producers of contaminating products to help in mitigation or cleanup efforts should be deemed less ‘regulatory’ in nature than the initial permit or licensing programs that allowed them to operate...Sinclair disputes the state’s authority to impose industry-wide ‘remediation fees’ to compensate for the adverse societal effects generated by an industry’s products. To the contrary, the case law previously cited or discussed clearly indicates that the police power is broad enough to include mandatory remedial measures to mitigate the past, present, or future adverse impact of the fee payer’s operations, at least where, as here, the measure requires a causal connection or nexus between the product and its adverse effects.”

## What are the Implications of the Decision?

The *Sinclair Paint* decision ratified the use of fees approved by a majority of the Legislature to address health or other social problems created by the use or production of a particular product. In order to pass judicial scrutiny, the Court suggests that: 1) a fee must not exceed the cost of providing services related to the remediation of the problem created by a particular product; and 2) a reasonable connection must exist between the social problems remedied by a fee and the payer of the fee.

The *Sinclair Paint* decision most directly addresses fees imposed to clean up environmental pollution and treat health conditions associated with exposure to or the use of a particular product. Decisions cited by the court in the *Sinclair* decision include cases upholding regulatory fees charged to alcoholic beverage sale licensees to support addressing public nuisances associated with those sales; landfill assessments based on land use to reduce illegal waste disposal; fees for inspecting and inventorying on-premises advertising; and emissions-based fees for recovering direct and indirect costs of pollution emission permit programs. The *Sinclair* decision does not affect property-related fees, which are subject to the limitations imposed by Proposition 218.

## FISCAL IMPACT

Proposition 37 would limit the ability of state and local governments to impose or increase certain types of fees. The result would be unknown revenue losses of an uncertain magnitude. Proposition 37 could

also invalidate fees enacted since July 1, 1999. However, it is unclear whether any fees fitting the measure's definition have been enacted. The measure's proponents and opponents disagree on the scope of fees that would be affected by Proposition 37. History suggests that these differences will likely be resolved through litigation over the scope and precise meaning of "monitor, study, or mitigate the societal or economics effects of an activity" and whether a fee imposes a "significant regulatory obligation."

## ARGUMENTS PRO AND CON

Proponents argue that Proposition 37 is necessary to avoid the abuse of a "loophole" in Proposition 13 that would allow lawmakers to subject businesses to unreasonable taxation. Proponents argue that the Supreme Court created an overly broad definition of a fee in the *Sinclair* decision and that amounts collected for the purpose of mitigating social and economic impacts should appropriately be considered taxes.

Opponents argue that lawmakers have been cautious in their use of fees and that the requirement for a clear connection between the product or activity on which a fee is imposed and the service provided with fees collected will limit the likelihood of abuse. Opponents of Proposition 37 agree with the Supreme Court's decision in *Sinclair* that fees are a logical source of funds to pay for mitigating social and economic problems associated with certain products or activities.

## POLICY ISSUES RAISED

Proposition 37 raises a basic policy issue of who should be required to pay costs related to monitoring, studying, and mitigating adverse social and economic impacts associated with a product or activity. In *Sinclair Paint v. Board of Equalization*, the California Supreme Court found that mitigation of adverse social and economic impacts was an appropriate use of governmental fee authority. If enacted, Proposition 37 would likely shift the burden of payment from fees imposed on a limited group of feepayers, to taxes paid by society as a whole. Related questions include whether it is desirable public policy to limit the already constrained ability of the state and local governments to raise revenues by imposing additional supermajority vote requirements.

## ENDNOTES

<sup>1</sup> Text of Proposition 37.

<sup>2</sup> Proposition 218 requires a vote on new or increased property-related fees other than those for water, sewer, or garbage collection. Property-related fees must be approved by a majority of property owners or two-thirds of the general electorate.

<sup>3</sup> Supreme Court of California, *Sinclair Paint v. State Board of Equalization* (June 26, 1997).

<sup>4</sup> Charter cities have this power under the home rule provision of the state constitution. The Legislature granted the same autonomy to general law cities in 1982 (Government Code Section 37100.5).

<sup>5</sup> Supreme Court of California, *Sinclair Paint v. State Board of Equalization* (June 26, 1997).

<sup>6</sup> Supreme Court of California, *Sinclair Paint v. State Board of Equalization* (June 26, 1997).

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*Jean Ross prepared this Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low and middle income Californians. Support for the CBP comes from foundation grants, publications and individual contributions.*

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