COMMENTARY

IS THIS REALLY NECESSARY?

INDIRECT TAXATION THROUGH EXPROPRIATION OF REGULATORY AGENCY SPECIAL FUNDS: THE BUDGET GETS UGLY AND THE LEGISLATURE GETS MEAN

The regulatory agencies of California, with few exceptions, are financed from "special funds." The industry or trade regulated is assessed license or other fees to finance the public agency overseeing it. The nature of these funds should not be misunderstood; they operate as indirect taxes on the consumers of the services regulated. A fee imposed across an industry by state assessment is passed on to the consumers of that industry. However, a case can be made that if a trade or industry requires regulation, it probably inures to the benefit of consumers using the services involved (at least in theory) and they are therefore the appropriate parties to pay for it.

During each of the past two years, the legislature and the Governor—through the budget process—have required the transfer of special fund monies to the general fund, to assist the state in ameliorating its huge budget deficit. The state has robbed Peter and Paul to pay itself.

"Special Funds" Means Special Funds

Most of the agencies monitored in this publication are "special-funded" agencies—that is, they are supported solely by fees collected from their licensees and applicants for licensure, fines, and reimbursement for investigative costs. They are created in an "enabling act" and, in almost every case, authorized to collect fees from their licensees for deposit into a special fund which is to be used "to carry out the provisions of *this* chapter" or "for support of *this* board" (emphasis added).[1]

The legal status of special funds has been discussed in two California Supreme Court cases addressing diversion of special-fund money by the legislature for purposes arguably unrelated to the subject agency's function,[2] and a 1976 Attorney General's Opinion addressing the authority of the Department of Consumer Affairs (DCA) to assess the special funds of its constituent agencies for use by its Division of Consumer Services for activities "reasonably related" to the activities of the agencies.[3]

In *Daugherty v. Riley*,[4] the California Supreme Court invalidated a legislative diversion from the Corporations Commissioner's special fund, noting that monies in the Commissioner's fund were collected from "fees for permits and licenses required by law to be issued as a prerequisite to the initiation or the carrying on of business."[5] Further, these fees, which constituted the "sole support" of the Department of Corporations,[6] were collected pursuant to a statute providing that they were to be deposited into the corporation commission fund "'to be used by the commissioner in carrying out this act.'"[7] The Supreme Court likened the Commissioner's special fund to "a trust fund raised for a particular purpose in the exercise by the state of its police power."[8] The Court noted:

> They are not state revenues in the sense that they may be used for any state purpose so long as the department is not in need of them, and the justification for their collection is to make the department self-supporting....That these special funds are raised for regulatory purposes and are set apart for the exclusive use of the state departments and agencies for which they are imposed and collected cannot be doubted. That these funds may not be permanently diverted from their specific purposes and to such an extent as to render the department or agency unable to function is likewise clear.[9]

In *Urban v. Riley*,[10] the Supreme Court was asked to rule on the validity of a similar legislative diversion from the Real Estate Commissioner's special fund. The language of the Real Estate Act differed from the language of the Corporate Securities Act at issue in *Daugherty*, however, in that the Real Estate Act expressly provided for an annual transfer of excess funds from the Real Estate Commissioner's fund to the general fund. Thus, the Court distinguished *Daugherty* and its "trust fund" concept. With regard to the constitutionality of a statute mandating regular transfer of excess special fund monies to the general fund, the Court "assume[d], without deciding," that the legislature is not precluded from enacting such a law, noting that "the mere fact that an enactment providing for regulatory fees may incidentally produce some revenue does not render such enactment unconstitutional."[11]

In a 1976 opinion, the Attorney General ruled that DCA may assess the special funds of its constituent agencies for its activities which are "reasonably related" to the activities of its agencies.[12] Funding for anything unrelated properly comes from the general fund. Hence, since DCA is an umbrella agency over 38 boards, commissions, and bureaus, and performs numerous administrative and other tasks for them, it may extract a pro rata charge to finance its overhead, its Division of Consumer Services, and its Division of Administration. Although the Attorney General opined that the "trust fund" language in *Daugherty* has been "substantially qualified" since its issuance (with which we do not necessarily agree), and that *Urban v. Riley* appears to hold that the legislature is not constitutionally precluded from diverting excess fees from special funds so long as the fees imposed do not arbitrarily or unreasonably burden licensees, the AG also found:

> To the extent that monies derived from pro rata assessment are used for activities *unrelated* to the individual funds, under the principles set forth in *Urban v. Riley*, *supra*, support of such activities from the individual funds would be unconstitutional in that the monies collected to support such activities would be disproportionate to the contemplated expense of regulation of the boards, bureaus, and commissions within the Department of Consumer Affairs.[13]

The Budget Crisis Hits: Thou Shalt Not Tax; No, Thou Shalt Not CALL It Taxes

During early 1991, the California legislature faced a fiscal crisis of unprece-

dented scope. The state had estimated revenues at levels 10–20% above those likely to accrue. The shortfall was staggering. Eventual estimates reached $14 billion out of a $55 billion total budget. Further, most of the state budget is earmarked, meaning that the actual cuts as applied only to the discretionary part of the budget could eviscerate the public sector. That is, a 20% overall funding cut would perhaps require a 30–40% cut in many programs, including law enforcement and justice, services for the very poor, and—most critically—efforts to assist children. The accounts for children had already been quietly cut by the state, which never has properly factored indices of need, or even population increases of children, in calculating budgets year to year.[14] The infrastructure, safety net, and societal investment in our collective future had been undercut for years—and now this.

The legislature faced a profound dilemma. Of course, there was an answer. What does a family do when an emergency strikes? It does not place its infants in paper bags and toss them off bridges. It digs deep. In a recession, we try to stimulate business and employment, and we may delay space projects, defense spending, park acquisition, and many other things—but we do not forsake our children. The members who have extra contribute. The recession means that many are worse off, but some are desperate; there are priorities and there are choices. Indeed, all things are relative, and for the state of California—one of the wealthiest political jurisdictions in the history of the world—to forswear the ability to immunize its children, or to provide elementary medical care, or to feed the hungry, is pathetic. But the "taxes are too high, business will leave" nonsense precluded the modest increases required, notwithstanding a list of billions of dollars of existing tax subsidies for the powerful (*e.g.*, oil depletion, bank and insurance breaks). Ending these indirect "tax" expenditures would not drive out business in any debilitating way.

The legislature and Governor faced the issue to a limited extent in 1991, producing some needed revenues. And at the same time they started thrashing around looking for money where it might not be called "taxes"; the special funds of the agencies became a target. During the summer of 1991, Governor Wilson signed AB 222 (Vasconcellos). Section 14 of this bill required the transfer of all "excess fees incidentally produced" by state regulatory agencies to the general fund on June 30, 1992. Such "excess fees" were defined to mean that an agency could keep the funds it needed to meet its 1991–92 fiscal year budget, plus that needed for three additional months—all monies over this amount were taken by the general fund. Predictably, agencies responded to this by delaying planned fee increases, or by spending money quickly, to avoid having their funds taken. Nevertheless, the short notice produced some remarkable grabs. The Contractors State License Board, an agency relied upon to enforce standards affecting many consumers, lost almost $23 million to the general fund. The immediate consequence of this legislative taking was the indirect taxation of consumers for general fund purposes, the agencies' avoidance of needed fee increases to assure consumer protection out of fear of general fund expropriation, and a decline in enforcement.

The Auctioneer Commission's Challenge to Legislative Illegality

Only one agency attempted to challenge this taking in court. Lo and behold, in May 1992 the humble Auctioneer Commission filed a lawsuit challenging the validity of section 14 of AB 222 to block the taking of its excess reserve fund. At this point, the legislature was embroiled in Stage Two of the budget crisis: The shortfall of 1991–92 was substantially replicated for 1992–93, except now the Republican Governor was determined to stand on principle. Read his lips; down in the polls, he would not tax. Well, he would not tax where it would be called taxes. Amid much wringing of hands by the legislature and Governor, the special interests continued to ply the halls of Sacramento to preserve billions in special tax subsidies and perks for the oil, alcohol, banking, and insurance industries, and to preserve inequitable property tax windfalls for businesses paying at 1978 assessments, business lunch and yacht club deductions, law student and medical student education for wealthy students at publicly financed schools, and...well, you get the idea.

The search was on for the weak and uninformed. How to get money and not call it taxation—special fund expropriation was again irresistible. There is the money; it is in hand. We have to be a bit careful in stealing the state pension trust money, but here—in the arena of these almost invisible regulatory agencies—we can take by stealth and bury it all in accounting mumbo-jumbo. Except those pesky Auctioneers have the gall to avail themselves of the checks and balances which assure the rule of law; they've gone and filed suit.

The Legislature's Response to The Auctioneers' Challenge: The Bully Retaliates, or "Going...Going...Gone"

Well, there is a predictable consequence to the enragement of a bully who lacks conscience. The legislature completely defunded the Auctioneer Commission in the 1992–93 budget. One might argue that criminally buttressed standards might suffice to regulate the state's auctioneers, and perhaps the Auctioneer Commission is a legitimate object of deregulation. Except the legislature did not make a deregulation analysis, and deregulation of a special-funded agency does not produce revenue or effectuate savings. Nor has the legislature considered the defunding (or deregulation) of any number of other agencies equally deserving of merciful death (the Board of Landscape Architects, the Engineers board, and many others). The legislature simply decided it had to destroy an adversary to prevent the issue from reaching the courts, to cloak its illegality, to get away scot-free. And it worked. Although the suit is still pending technically, there is no plaintiff to pursue it.

Amazingly, the legislature did not change the relevant statute. You still must have an auctioneer's license to be an auctioneer, but there is no one to license you; you still have to post a bond, but there is no one to post it with. Judge Roy Bean was more sagacious; at least he didn't shoot the plaintiff—and before the trial commenced.

1992: The Tiger is Loose; Grab Your Children

Having avoided comeuppance by literally destroying the objector, the legislature and the Governor were feeling desperation from the continuing shortfall and their inability to tax, but they had found an opening into one source of money and now were ready to pounce hard. Yes, it's illegal, but this is politics. The newly signed 1992–93 budget requires almost all special-funded agencies to cut their 1992–93 expenditures (from 1991–92 levels) by 10%, and to transfer that 10% to the general fund on June 30, 1993. That is a huge cut, especially for the smaller agencies. For many, meaningful discipline to protect the public is precluded. *Query* whether such agencies should exist at all where relied upon to provide a measure of protection they cannot physically provide? But they had a use for the legislature and the Governor: They had money and the ability to assess fees ("fees," not "taxes").

The new budget does not authorize cuts in license fees, just in expenditures, across the board and without regard to need or justification or consequence. The savings produced by this reduction become excess funds which will be taken next June. Last year, our lawmakers stripped these special-funded agencies of "excess" reserve funds. This time, the taking is the equivalent of a direct assessment on the operating budgets of special-funded agencies. The legislature may be able to alter its statutes to permit such a contribution, but it cannot do so solely through the budget process (which is bound by existing law) nor can it do so retroactively. Even if we generously concede to the bare legality of the 1991 move under *Urban*, the 1992 theft directly from the special funds of these regulatory agencies for purposes wholly unrelated to the agencies' functions falls squarely into the unconstitutional hole identified by the California Supreme Court in *Daugherty* and grudgingly admitted by the Attorney General in his 1976 opinion.

The Legacy of Special Fund Taking: Agency Impotence

This official "theft" of money gathered for a specific purpose allows the special interests who largely control the agencies purportedly regulating them to object to any further increases in fees. "The last time we agreed to a fee increase, the legislature took it for the general fund. We aren't going to do it again," they will argue. They will then wax self-righteous all over the Capitol and stop any fee increase for years thereafter, using the general fund leakage as their rationale. This will accomplish two purposes for them: It allows them to tell their membership that they have stood up for their economic interests, and it allows them to prevent any meaningful reform or strengthening of the discipline systems financed by those fees.

You might ask what difference it makes how an industry trade association or political action committee feels about a fee assessment to finance the regulation of its members. You might ask, but you won't if you know anything about state government. Unless there are unusual circumstances, the industry or trade must sign off on a fee increase or it will not happen. Those who hold fast to ninth-grade civics principles (and God bless you) will rightly ask, "Wait a second! How did they get this veto power? Have the inmates taken over the asylum?" The answer is that they have taken over the whole town.

Why would the trade association lobbyists who speak for an industry care about a fee which is passed on to consumers? Not because they care about consumers. Nor is it much of a burden for most licensees. For example, the extra $100 per year needed to finance a decent system of physician discipline is not much to ask from doctors. The total dues of the California Medical Association are at least four times greater than the license and related fees paid by physicians. If proper regulation reduces medical malpractice claims by but 3%, much more than $100 per physician would be saved on the $25,000–$50,000 in annual malpractice insurance premiums many of them pay.

The next question is why a trade association would object to a minor increase of this amount to finance the protection of the public from incompetent or dishonest practitioners. After all, aren't most physicians (or other professionals) competent and honest and desirous of excising those who are not from their profession? Yes, most are. But their trade associations and PACs do not represent those instincts. Rather, they tend to represent the "territory" of the profession or trade, including the interests of those who abuse the public. This predilection is an empirical constant of trade association behavior.

Conclusion

Okay, there is an emergency. But where there is an emergency, take emergency action. Tax the wealthy; they have benefitted from tremendous tax cuts over the past ten years. Tax oil; California is one of the few states which does not tax the oil taken from its soil. Tax insurance and banking; they are both now cross-subsidized by other taxpayers. There are many alternatives. Interestingly, a recent poll commissioned by Children's Hospitals found that even the heavily taxed middle class would be willing to pay a bit more if the money were to go for the benefit of children—who are the ones disproportionately suffering from the current shortfall. In fact, the margin of public concern about underfunding those most in need is remarkable, with almost 70% willing to pay more in taxes for these purposes. But, rather than presenting such an alternative or engaging in honest discourse, both the legislature and Governor are skulking around and stealing money from funds dedicated to a particular use, violating the rule of law in doing so, and retaliating against one legitimately attempting to invoke court judgment. These are not the methods of responsible or honest government.

ENDNOTES

1. *See, e.g.*, Business and Professions Code sections 2682 (Physical Therapy Fund), 2814 (Board of Registered Nursing Fund), 2894 (Vocational Nurse and Psychiatric Technician Examiners Fund), 2981 (Psychology Fund), 3150 (Optometry Fund), 3455 (Hearing Aid Dispensers Fund), 4842.2 (Animal Health Technician Examining Committee Fund), 4904 (Board of Examiners in Veterinary Medicine Contingent Fund), 4994 (Behavioral Science Examiners Fund), 5133 (Accountancy Fund), 5602 (Board of Architectural Examiners Fund), 6797 (Professional Engineer's and Land Surveyor's Fund), 8030 (Shorthand Reporters' Fund), 8676 (Structural Pest Control Fund), 9770 (Cemetery Fund).

The physicians of California, politically able to insist upon somewhat more assiduous guardianship of their money, are exceedingly explicit in protecting the Contingent Fund of the Medical Board of California. Business and Professions Code section 2445 currently provides, in pertinent part: "The contingent fund shall be for the use of the board and from it shall be paid all salaries and all other expenses necessarily incurred in carrying into effect the provisions of this chapter. If there is any surplus in these receipts after the board's salaries and expenses are paid, such surplus shall be applied *solely* to expenses incurred under the provisions of this chapter. *No surplus in these receipts shall be deposited in or transferred to the General Fund*" (emphasis added).

2. *Urban v. Riley*, 21 Cal. 2d 232 (1942); *Daugherty v. Riley*, 1 Cal. 2d 298 (1934).

3. 59 Op. Att'y Gen. 282, No. CV 75-334 (Apr. 30, 1976).

4. 1 Cal. 2d 298 (1934).

5. *Id.* at 303.

6. *Id.*

7. *Id.* at 305, citing section 28 of the Corporate Securities Act.

8. *Id.* at 308.

9. *Id.* at 308–09.

10. 21 Cal. 2d 232 (1942).

11. *Id.* at 237.

12. 59 Op. Att'y Gen. 282 (1976).

13. *Id.* at 292 (emphasis original).

14. A study by the Children's Advocacy Institute has determined that per capita inflation-adjusted spending for children has been declining steadily from at least the 1980s, long before the 1991 emergency. Children's Advocacy Institute, *1988–1992 California Children's Budget: Some Preliminary Findings* (July 2, 1992).