

Memorandum

To: Interested Parties

From: Brian Galle (UC Berkeley), David Gamage (University of Missouri), and Darien Shanske (UC Davis)¹

Re: Analysis of the Impacts of Propositions 41 and 42 on California's Public Finance

Date: August 20, 2026

Introduction

In this memorandum, we will discuss the potential impacts of Propositions 41 and 42 on current and future initiatives and legislation, as well as on current California Medicaid tax programs, starting with possible impacts on Proposition 3, the measure on November's ballot to extend personal income tax rate increases.

The purpose of the memo is to identify legal risks raised by the propositions that prudent citizens should be aware of given the high stakes. We are not arguing how a court *should* decide these issues and we do not claim that we are offering the best or most persuasive legal arguments. We do, however, believe that there is a real risk courts could reach these outcomes.

Our bottom line is that both propositions are poorly drafted in a manner that could pose serious threats to California's fiscal future, with the potential to undermine key spending programs and potentially cause or worsen future budget crises. That is not surprising. These are deceptive measures that were drafted quickly to trick voters that support the billionaire wealth tax (Prop 40) into voting for competing measures that could undermine that tax. The billionaire funders of these initiatives are acting with reckless disregard for the collateral damage to California's fiscal system and indeed they may even benefit from weakening California's existing taxes affecting the most wealthy.

Executive Summary

- The audit requirements of Proposition 41 could hamstring Proposition 3 (the teacher-sponsored measure to fund education with taxes on million-dollar earners) or invalidate it outright.

¹ Institutional affiliations are listed for identification purposes only.

- The audit requirements of Proposition 41 could similarly hamstring many other revenue raising measures, such as (for example) a tax on large employers who have many employees on Medi-Cal.
- The prohibition on easing the state appropriation limit in Proposition 41 could undermine many existing and proposed taxes to fund California's contributions to Medi-Cal, including current MCO taxes and the Hospital Quality Assurance Fee (HQAF).
- The limitations on taxing personal property in Proposition 42 could impact the ability of the state to tax capital gains income, whether as part of Proposition 3 or otherwise.
- The limitation on taxing personal property in Proposition 42 could frustrate any future attempt to reform California's Vehicle License Fee, a backbone tool for financing a wide array of local services.

Proposition 41

Proposition 41 makes two significant changes to California law. First, it adds many new audit requirements, specifically pre-election audits of programs that would receive funds from a proposed special tax initiative; and recurring audits, every four years, of programs receiving moneys from special taxes enacted on or after January 1, 2026, whether enacted by the Legislature or by initiative.² Second, the proposition prohibits collecting any state tax enacted or taking effect on or after January 1, 2026 that is exempted or excluded from the appropriations limit of Article XIII B, the so-called Gann limit, whether the exemption comes from an outside-the-General-Fund special fund whose spending is not counted or from raising the limit itself. Proposition 41, secs. 3, 4(b). The obvious point of this second change, hidden deep in the Proposition 41 text, is to nullify Proposition 40. But both changes would likely weaken California public finance by threatening California's ability to raise revenues and fund spending programs.

On the Merits

Prop 41 targets the primary (and, in many cases, the only plausible remaining) way that state tax policy can be done and that state services can be adequately funded. Any increase in taxes enacted by the Legislature requires a two-thirds supermajority of each house.³ Statewide initiatives, by contrast, can raise taxes by majority vote. Not surprisingly, most major tax policy changes over recent decades have therefore occurred via initiative. Since voters are unlikely to support tax increases for unspecified purposes, the limits on

² Prop. 41, Secs. 1, 2.

³ Art. XIII A, Sec. 3(a).

measures adopting taxes for specified purposes tilts the deck against most of those measures. Even if there were eventually an attempt to change Prop 41 through another ballot measure, the pre-election audit requirement would still apply to any special tax initiatives on *that* ballot.

The audits that Prop 41 would impose are slanted to make it more difficult to adopt and fund new programs. Consider, for example, that a pre-election audit must consider: “How the program’s costs compare to any analogous programs in the non-government sector”; and also: “Recommendations on how the program could achieve a budgetary savings of at least 10% annually.” The audits would thus institutionalize a cost-cutting, private-sector-comparison framework, and the executive summary of the pre-election audit would be printed in the voter guide immediately after the Legislative Analyst’s impartial analysis.⁴

In sum, every proposed special tax initiative would come before the voters bundled with an official analysis oriented toward finding savings and private alternatives. These expensive, burdensome and largely redundant⁵ requirements would hinder special tax initiatives, making them more difficult to pass and less effective if passed.

The second provision regarding the Gann limit would double down on what has proven to be a disastrous set of fiscal policies. The existing Gann limit works by capping government expenditures over a given two-year period. Excess amounts must be split between taxpayer rebates and education.⁶ The cap increases only to the extent of growth in California population and cost of living.⁷ Given the increasing demands on the state government, future uncertainties, and the changing nature of federal assistance, the limit does not act so much as a ceiling as a vise squeezing out funds for core services.⁸ For example, what happens if the state government needs to spend more on (say) wildfires? Or,

⁴ Sec. 1(e)(2).

⁵ California law is already full of audit requirements and indeed has a powerful and independent state auditor (Govt Code 8543 et seq, see especially GC 8546.1) that issues regular, <https://www.auditor.ca.gov/reports/>, and, often critical, reports about state operations. See, e.g., <https://www.auditor.ca.gov/reports/reponses-2025-108-all/>. And sometimes the state requires particular audits. See, e.g., Bus. And Prof. Code 6145(b). As further discussed, the income tax extensions authorized by Proposition 3 are already subject to audit. Art. XIII, Sec. 36(g).

⁶ Art. XIII B, Sec. 2.

⁷ Art. XIII B, Secs. 8(e), (f).

⁸ Making a similar point, here is Jason Sisney (an Assembly budget insider): “Therefore, if revenues push the state to its Gann limit, non-Proposition 98 programmatic spending (such as annual tax-supported spending on health and human services (HHS), housing, universities, prisons, state employees and natural resources programs) probably would have to be cut more in this situation.” <https://jasonsisney.substack.com/p/state-moving-closer-to-its-appropriation>

what if the state government must spend more to backfill vicious cuts from the federal government?

The state has hit the Gann limit recently (2022) and is about \$30 billion under the Gann limit currently. Suppose Prop 3 passes without incident and the AI boom does lead to substantial increases in revenue. At that point, the state will be close to the limit. Any possible new initiatives for education, child care, housing or wildfire abatement could then well go over the limit.

Threats to Proposition 3

The audit requirements of Proposition 41 arguably apply to Proposition 3 because Proposition 3 would seem to impose a “special tax” enacted “by a statewide initiative measure on or after January 1, 2026.” Sec. 2(a)(1). Proposition 3 makes permanent the existing 1% tax surcharge on income above \$1 million that is set to expire in 2030; all of its revenues are earmarked primarily for education. It thus likely involves a “special tax,” which is “a tax that can only be used to fund specific, as opposed to unlimited, purposes” (according to Prop 41), because the Education Protection Account revenues added by Prop 3 may be used only for specified education and health care purposes. Sec. 4(d) of Proposition 41; Article XIII, Sec. 36(e) of Proposition 3.

As for whether Proposition 3 was enacted after January 1, 2026, a court could plausibly find that a tax first approved in 2012 is “enacted” in 2026 when the voters delete its sunset. The new provision is different than the old in that it will never expire; the post-2030 tax will exist only because of the 2026 vote; and the adoption of the extension is itself literally an enactment.⁹

Thus, Proposition 41 might plausibly be interpreted by courts as applying to Proposition 3. If so, Proposition 41 would require onerous and burdensome audits of the programs it funds.

Further, if both measures pass and Proposition 41 receives more affirmative votes, every provision of Proposition 3, including the rate extension itself, could be ruled void. The terms of Proposition 41 state that it nullifies other conflicting 2026 initiatives if it receives more votes. Prop 41 defines conflicting measures as “another initiative measure

⁹ Notably, neither Prop 41’s prohibition nor its grandfather clause discusses extensions, even though California drafters know how to address extensions expressly. For instance, Proposition 218 reaches taxes that governments “impose, extend, or increase,” and the Proposition 218 implementation statute treats removal of a sunset as an extension. Art. XIII C, Sec. 2(b); Gov. Code Sec. 53750(e).

that ...imposes different audit rules on special taxes.” Sec. 5(a). Proposition 3 carries forward Proposition 30’s audit rules, and those rules are different from Proposition 41’s.¹⁰

Threats to the MCO Tax

The sloppy drafting of Proposition 41 implicates policies far beyond Proposition 3. We will briefly consider spending on health care.

Start with the Managed Care Organization (MCO) tax, which California expects to generate [as much as \\$8 billion annually](#) in federal matching funds. There are now arguably two separate MCO provisions that will take effect after 2026 authorization, both of them threatened by Prop 41.

The first is SB 125, enacted in June 2026, which imposes a tax of \$8.85 per enrollee per month for 2027 through 2029 and deposits the proceeds in the new Medi-Cal Stability Fund, dedicated to specified Medi-Cal purposes.¹¹ SB 125 is a special tax enacted after January 1, 2026, so under Prop 41 each Medi-Cal program receiving its moneys would face recurring State Auditor financial and performance audits, with the private-sector comparisons and ten percent savings recommendations, and with the Auditor reimbursed from the tax revenues themselves.¹² As explained above, this would be very burdensome and problematic. And because the Stability Fund broadly co-funds managed care payments and rates, there is a further risk that a court would rule that the auditable “programs” include major portions of Medi-Cal managed care, rather than just the marginal SB 125 dollars. Thus Prop 41 could require the state to pay for audits recommending how to privatize Medi-Cal and slash it by 10%.

Proposition 41 also deprives the state of flexibility to keep SB 125 effective in the future. As enacted, the SB 125 tax uses up capacity under the Gann limit, narrowing room for other revenue needs. SB 125 also sunsets in 2030, at a time when there might not be room under the Gann limit available for renewal. In both cases, the state could be left choosing between crowding out other priorities under the limit or losing the tax—and the

¹⁰ Indeed, on one point the two measures give seemingly incompatible commands about the same dollars. Proposition 41 provides that the State Auditor “shall be reimbursed from the revenue generated by the special tax” for the reasonable costs of its audits. Sec. 2(d). Section 36 (Proposition 3), however, provides that moneys deposited in the Education Protection Account for education “shall not be used to pay any costs incurred by the Legislature, the Governor, or any agency of state government,” and it separately bars using Account funds for administrative costs. Art. XIII, Sec. 36(e)(5), (6).

¹¹ Ch. 24, Stats. 2026 (SB 125), adding a new Article 7.2 to the Welfare and Institutions Code; the new tax is expressly made not subject to Proposition 35’s chapter. See Dept. of Finance, Manual of State Funds, Fund 3492 (Medi-Cal Stability Fund classified as included).

¹² Sec. 2.

federal matching grants it secures— altogether. This would of course have major negative implications for state funding of Medi-Cal.

In addition, in 2024, Proposition 35 implemented a permanent MCO tax starting in 2027.¹³ Proposition 35 also used a provision of the Gann limit, Art. XIII B, Sec. 4, to lift the ceiling for four years in order to accommodate the new spending.¹⁴ Recall that Prop 41 prohibits collecting any tax that modifies the Gann limit if the tax takes effect on or after January 1, 2026.¹⁵ There is thus a significant risk Prop 41 would prevent Proposition 35 from taking effect.

Threats to the Hospital Quality Assurance Fee (HQAF)

Prop 41 could also bar modifications to the Hospital Quality Assurance Fee (HQAF), including modifications that might be required by the federal government in order for the HQAF to remain in effect. The HQAF draws down billions of dollars in federal matching funds for hospital payments, and the federal government approved the 2025 program in June 2026. HQAF funds are exempt from the Gann limit.¹⁶ A court might conclude that an HQAF modified after January 1, 2026 “takes effect” after that date for purposes of Prop 41. That would prevent California from modifying or improving the HQAF, even if required by federal rule changes, such as those now pending. A Trump or other hostile HHS aware of this dilemma might go out of its way to require HQAF changes that it knows California cannot implement.¹⁷

We expect that California would argue the HQAF is not subject to Prop 41 limits because it is a “fee,” not a “tax,” but a court might well rule otherwise. This is because Proposition 41 does not define “state tax” and because California generally interprets “taxes” quite broadly. See Art. XIII A, Sec. 3(b). A multibillion dollar charge that funds not only services for the payors but also transfers to others, as the HQAF does, will be quite likely to face a plausible challenge that it constitutes a tax and not a fee.

Note that the stakes of these threats are further magnified because the statute makes it so that the hospital fee becomes inoperative if a lawsuit is filed and a preliminary

¹³ Welf. & Inst. Code § 14199.123(b).

¹⁴ Proposition 35, Sec. 2.

¹⁵ Prop. 41, Secs. 3, 4(b)(2).

¹⁶ Cal. Const., art. XVI, § 3.5(d); Dept. of Finance, Manual of State Funds (Hospital Quality Assurance Revenue Fund classified as excluded from the state appropriations limit). The Finance fund record predates Proposition 52 and is based on the notion that the revenues are not proceeds of taxes; Proposition 52 is the source of the constitutional exclusion.

¹⁷ It could also be argued that the HQAF takes effect after Jan. 1, 2026 even if it is not modified after that date. This is because its mechanics operate through discrete, numbered program periods, and each of these has its own fee model and its own federal approval. Thus, a period beginning after January 1, 2026 could well be characterized as the tax taking effect after that date.

injunction or other order results in a loss of federal financial participation or any net General Fund cost.¹⁸ A qualifying preliminary injunction or other order could thus obstruct the program well before any final judgment, even if the challenge might ultimately fail on the merits.

Threats to the Skilled Nursing Facility Fees

Yet another health funding source at risk from Proposition 41 is the skilled nursing facility quality assurance fee (SNF-QAF). Like the HQAF, this is a provision intended to generate federal matching funds, and it is expected to bring in several billion dollars over the next 5 years. The SNF-QAF was extended by the Legislature in July 2026 through the end of 2027,¹⁹ and its revenues are also classified as exempt from the Gann limit. Thus, a court could well decide based on these arguments that collection of the fee should be barred, thereby cutting off the federal matching funds and supplemental payments to nursing facilities that the program exists to generate.

Single-Subject Threats

It is also possible that Prop 41 could make it impossible for *any* future initiative to be exempt from the Gann limit, yoking California to the fiscal system of the distant 1970s in perpetuity. The California Constitution requires that an initiative “embracing more than one subject” may not be submitted to the voters or have any effect.²⁰ Because Proposition 41's restrictions would be added to the Constitution (if they pass), a future revenue measure could escape the restrictions only by pairing its new tax with a constitutional override of Proposition 41. This thus gives opponents of any future revenue measure a powerful new tool for challenging such measures through litigation. That is, future initiatives would have to have what are arguably two subjects: their own goals, and also disabling the Prop 41 rules.

It might be objected in regard to this that provisions suspending Prop 41 rules that would frustrate a future initiative are part of a single subject, much as today many initiatives suspend the Gann limit. But would such a structure be effective? The initiative would now both impose a tax and change the separate constitutional rule that Prop 41 added as to the Gann limit. Arguably, a court could find that these are two separate subjects that would require two separate measures. Although California's single-subject test is lenient, and a combined measure could thus potentially survive challenge, even just the

¹⁸ Welf. & Inst. Code § 14169.72.

¹⁹ SB 165, signed July 6, 2026; see Dept. of Finance, Manual of State Funds, Fund 3213 (Long-Term Care Quality Assurance Fund classified as excluded).

²⁰ Art. II, Sec. 8(d).

prospects of litigation and the increased potential for challenges could add uncertainty, substantial and burdensome costs, and delays to any future revenue measures.

Relatedly, this same single-subject concern suggests (to us) that Proposition 41 (and also 42) might be constitutionally infirm themselves as violating the single-subject rule. We might suggest that a court should strike them down if they should pass.

Proposition 42

Proposition 42 does at least three things: 1) it offers unneeded²¹ protection of retirement assets; 2) it prohibits a tax “on the ownership or control of . . . individually-owned assets” and 3) it prohibits retroactive taxes. As with Proposition 41, though, Prop 42’s deceptive framing and sloppy language has the potential to cause great collateral harm.

Threats to Proposition 3

Because of Proposition 42’s broad language, taxpayers will likely argue that it shields them from the effects of Prop 3. Again, Prop 3 extends the existing but temporary 1% additional income tax on incomes above \$1 million, which is set to expire in 2030. Like Proposition 41, Proposition 42 exempts taxes “in effect, imposed, and first collected” before 2026, and it is uncertain whether a court would find that Proposition 3 qualifies for that exemption. A court might deem the permanent post-2030 additional income tax on incomes above \$1 million as a new tax because the existing additional income tax is temporary and will not continue post-2030 unless voters remove its sunset. Notably, Proposition 42 does not specify how its exemption clause applies to extensions of this sort.

Taxpayers thus may be able to argue that Proposition 41 prohibits the tax imposed by Proposition 3 because the latter is a tax “on the ownership or control” of property. Because Proposition 42 never defines “ownership or control,” its protected category potentially encompasses all income-producing personal property; it is a longstanding income tax principle that income from a property is taxed “to the one who controls it.” For example, consider the current treatment of stock options one earns as part of one’s job. Such options are treated as labor income and, if exercised years later, a formula is used to assess how much of their appreciation should be attributed to California.²² A court might

²¹ California broadly conforms to the positive tax benefits given to retirement savings by the federal tax code. See generally Ca. Rev. and Tax Code 17501 et seq. Further, any reduction in these benefits granted by California tax law would require a 2/3 supermajority. Cal. Const. Art. XIII A, Sec. 3(a). Proposition 40 does not change any of this and, in fact, explicitly exempts true retirement assets. See Proposition 40, Proposed Section 50303(c)(7).

²² See Cal. Code Regs. tit. 18, section 17951-5(b).

treat the post-2030 taxation of that option appreciation, or even of capital gains generally, as a tax on the ownership or control of “financial assets” that is grandfathered only through 2030.

Proposition 42 could also arguably void Proposition 3 entirely if Proposition 42 gets more votes. Proposition 42 has a sweeping conflicts provision (Sec. 5(a)) that could be read to trigger if Proposition 3 were interpreted as permitting *any* form of taxation prohibited by Proposition 42. Note further in regard to this that California adjudicators have recently read formal tax terms, such as “unitary business,”²³ “gross receipts,”²⁴ and “agricultural business activity,”²⁵ in ways the drafters of those terms plainly did not anticipate, and “personal property” could well follow a similar pattern.²⁶

Moreover, Proposition 42 separately prohibits a post-2025 tax that “operates retroactively to result in tax liability based on conduct, activities, or a status that occurred or was present prior to the effective date” of the law. Sec. 2(a)(1). A court could hold that this clause applies where post-2030 taxes fall on gains that accrued, or on equity compensation earned, in earlier years. If so, the post-2030 rates could not be collected with respect to income deemed attributable to earlier years, such as gain reflecting appreciation that accrued before 2031 or compensation from services performed earlier. This could substantially undermine the revenue-raising capacity of Prop 3. And a ruling of this kind would also satisfy the second trigger of Proposition 42's conflicts provision, and so (as discussed above), could result in all of Prop 3 being nullified.

Other Taxes

Proposition 42's restrictions as to the taxation of other assets are very broad and might impact a variety of current taxes or those that might reasonably be proposed. For example, consider the bar on taxing “personal property.” This would, on its face, seem to apply to the Vehicle License Fee, which is a tax on personal property.²⁷ This fee is so important to local governments that it was guaranteed to them by Prop 30 (Art. XIII, Sec. 36(b)(2)) and the allocation of its revenues to local governments is protected elsewhere in

²³ *Garcia-Rojas et al. v. Franchise Tax Board*, A172054 (Cal. Ct. App. May 1, 2026).

²⁴ *Appeal of Microsoft Corp. and Subsidiaries*, 2024-OTA-130 (Cal. Off. Tax App. July 27, 2023).

²⁵ *Smithfield Packaged Meats Corp. v. California Franchise Tax Board*, No. 21STCV39637 (Cal. Super. Ct. 2026) (final statement of decision).

²⁶ We do not mean to imply here that we agree with these decisions, but the fact remains that a certain rigid formalism seems appealing to the California judiciary sometimes.

²⁷ Now, there is some complexity here because the VLF was held in 1936 not to be a tax on personal property but a tax on a privilege. See *Ingels v. Riley*, 5 Cal. 2d. 154 (1936). But Prop 42 would seem to apply to a privilege tax.

the constitution, which requires the state to backfill localities if the rate falls below 0.65% (Art. XI, Sec. 15). Given that the current rate of the VLF (0.65%) is lower than the rate that it was long before, and the sound policy reasons why the rate should at least be the same as the rate for real property (1%), Prop 42 will interfere with the Legislature or the people increasing this tax. While Prop 13 doesn't leave much room for maneuver on real estate taxes, Proposition 42 would constrict that freedom even further by apparently prohibiting any future state changes, absent a constitutional amendment.

Retroactivity

Prop 42's limit on retroactive taxes will also make future tax reform harder and less effective. Again, the only real policy payoff of this provision is to sink the billionaire tax; the Due Process Clause of the 14th Amendment of the federal constitution already bars states from engaging in unreasonable retroactive taxation.²⁸ In many cases good tax policy requires that new taxes apply to at least some transactions that happened before the tax was adopted. New taxes are often effective prior to enactment date in order to prevent arbitrage or other evasive transactions before the tax can go into effect. Other retroactive measures may simply fix a mistake or close off an unintended tax shelter that taxpayers have been exploiting, as in the leading Supreme Court cases. In other cases, going back to sometime before enactment of the tax may ensure a more accurate measure of the tax base. For example, the federal Tax Cuts and Jobs Act did just that.²⁹ Having a tax change be retroactive to the start of the year is also a way to start raising revenue immediately should that be desired. All of these practices are longstanding and common and flow from the states' inherent power to control their own revenue systems.

Prop 42's retroactivity bar could also further complicate health care financing legislation. Provider fee statutes are sometimes written so that they apply to periods that begin before enactment, with collection following once federal approval arrives. A post-2025 statute with this structure could thus be threatened by Prop 42, Sec. 2(a)(1). The existing hospital fee framework predates 2026 and thus has a grandfather defense shielding it from these threats,³⁰ but this defense does not protect future bills that may reach backward, and so drafters will face new constraints and risks if Prop 42 passes.

Conclusion

California's public finance rules are already exceptionally baroque. This irrational opacity is particularly harmful considering that California's underlying tax bases have not

²⁸ United States v. Carlton, 512 U.S. 26 (1994).

²⁹ 26 USC 965(a)(1).

³⁰ Sec. 2(b).

been substantially reformed for a century and the state has many urgent needs. Both Propositions 41 and 42 add even more complexity to this rickety system, which, by itself, should be avoided. As it is, the complicated and vague new rules that would be imposed by Propositions 41 and 42 are likely to make it much harder to finance all manner of public goods going forward.