

LEGISLATIVE ANALYST'S OFFICE

Superior Court Invalidates Proposition 98 Funding Shifts

In a decision with a potentially significant General Fund fiscal effect, a state superior court recently ruled invalid certain Proposition 98 funding shifts, which are a key feature of the 1992-93 and 1993-94 state budget agreements.

A major element of the state's response to budget crises over the period 1991-92 through 1993-94 involved budget accounting shifts of K-14 education funding from one fiscal year to another. The purpose of these funding shifts was to maintain actual cash spending per pupil in public schools at the level provided in the 1991-92 Budget Act while maintaining the amount of state funding for K-14 education that counts as Proposition 98 spending at the minimum required level. Spending above the minimum level increases the "base" funding required in future years. The total amount involved is \$3.1 billion, including \$1.3 billion in "recaptures" and \$1.8 billion in "prepayment loans."

The constitutionality of these funding shifts was challenged in *California Teachers' Association et al. v. Gould*. The plaintiffs argued that cash allocated for spending by schools

Types of Funding Shifts

RECAPTURE

The state deems funds originally appropriated in one fiscal year as a loan, to be repaid by schools from appropriations in the subsequent fiscal year. The state has implemented recaptures when there has been a mid-year reduction in the estimate of the minimum amount of state school support required under Proposition 98.

PREPAYMENT

The state loans cash to school districts and community colleges that will be repaid out of their future Proposition 98 funding. These loans have occurred when the amount required to meet a per-pupil spending goal exceeded the minimum amount required to be spent under Proposition 98.

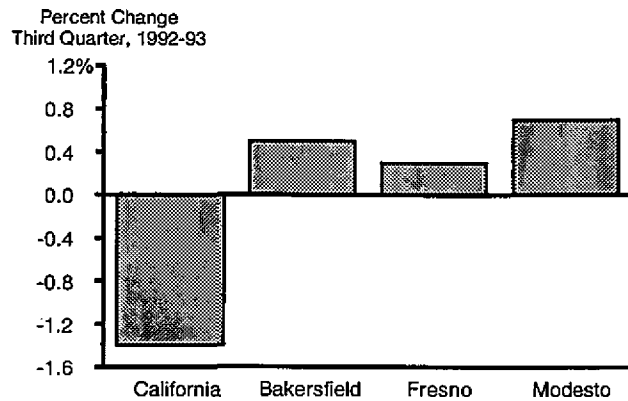


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ECONOMIC UPDATE

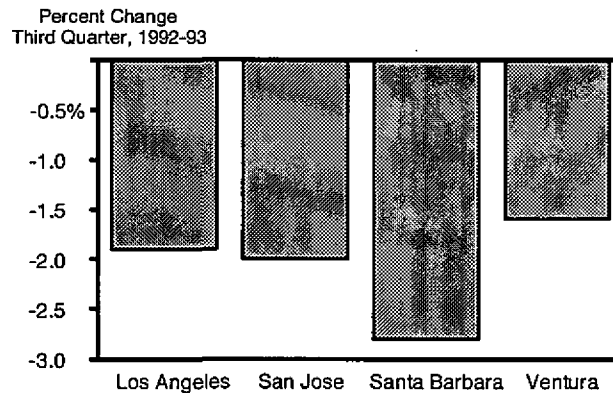
Some Metropolitan Areas Have Gained Employment in 1993

- While nearly all of the state's 17 largest Metropolitan Statistical Areas (MSAs) have lost jobs during the past year, three have grown slightly.
- The three MSAs in the chart are all in the San Joaquin Valley, whose revival is primarily based on recovery of the agricultural sector from the state's long drought.



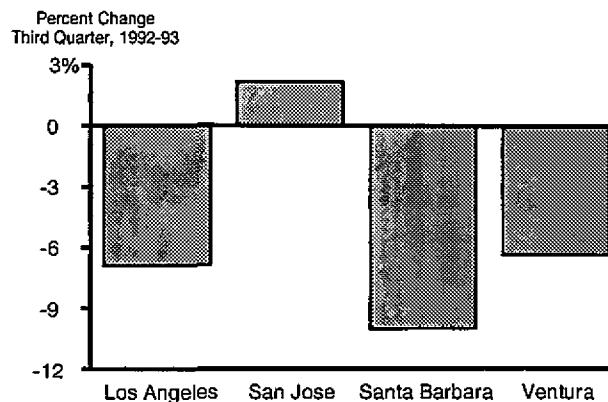
Other Metropolitan Areas Have Continued to Experience Declines

- The four MSAs in the chart have all dropped in nonfarm jobs by more than the 1.4 percent statewide decline during the past year.
- The most common characteristic of these regions is relatively high direct or indirect dependence on defense contract employment.



Single-Family Home Prices Tend to Follow Employment Declines

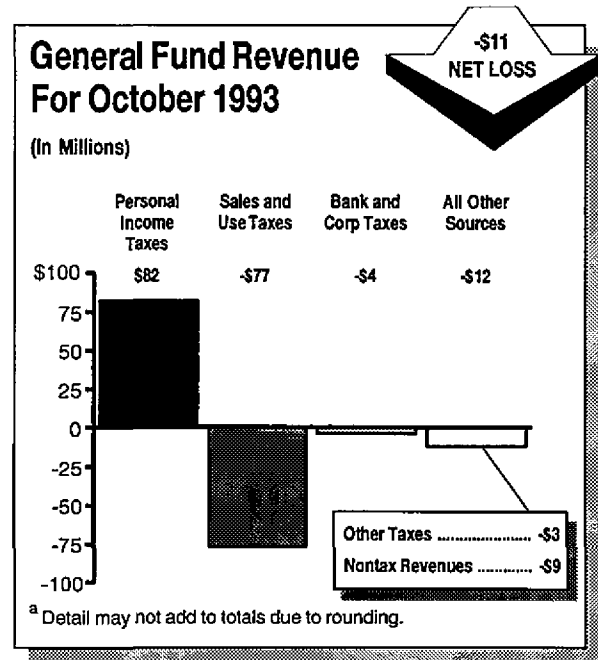
- Home prices have continued to fall in most areas of the state, with the greatest declines associated with large job losses.
- An exception is San Jose, where both home prices and housing permits have risen. The success of the commercial electronics and computer sectors in this area may be generating a turn-around in expectations.



Sales Tax Revenues Dip

General Fund revenues in October were \$11 million below the Department of Finance's forecast of \$2.1 billion. For the year to date, revenues are \$203 million above the budget estimate.

The most important revenue development was a \$77 million, or 11 percent, permanent loss in sales tax revenue. Receipts data indicate that this loss reflects a weakness in this fall's taxable sales relative to the department's forecast. Offsetting this loss was an \$82 million gain in personal income tax revenues. The majority of this gain, however, is attributed to continued processing delays of tax refunds at the Franchise Tax Board, and should be offset in the coming months.



Supreme Court to Hear Tax Cases

The United States Supreme Court decided to hear two cases which challenge California's method of taxing multinational corporations. If the Court rules against California, the state potentially would be required to pay up to \$1.7 billion in tax refund and interest payments to dozens of multinational corporations as early as 1994-95.

The Supreme Court agreed to review lawsuits from Barclays Bank PLC and Colgate-Palmolive Corporation that challenge the state's use of the "worldwide unitary" method of taxation. Under this method, the state taxes a portion of the total world-wide income of multinational companies and their affiliates. The state uses a formula to estimate the portion of the companies' income which can be attributed to business activity in California. Officials with the Franchise Tax Board, California's income tax agency, expect the Supreme Court to rule on these cases no later than June of 1994.

Since 1988, the state has given these companies the option of being taxed on income directly attributable to business activities in California. Companies could choose this method of taxation, known as "water's-edge," if they paid "election" fees and followed various accounting rules. This past summer, the Legislature passed Senate Bill 671, which eliminated the water's-edge fee and relaxed these accounting rules, thus making the water's-edge method of taxation financially feasible for more multinational firms.

FUNDING SHIFTS

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must count as Proposition 98 spending on the state's books in the year in which the funds were allocated. The case was recently decided at the superior court level. While neither a written record of the decision nor a hearing transcript is yet available, the decision as expressed orally by the presiding judge appears to hold that:

- Schools are not required to repay recaptured funds totaling \$1.3 billion (\$1.1 billion originally appropriated in 1991-92 and \$190 million originally appropriated in 1992-93). However, the state is not required to count these allocations as Proposition 98 spending in the original year appropriated.
- Schools and community colleges are not required to repay prepayment loans of \$973 million in 1992-93 and \$787 million in 1993-94. The state must count these loans as Proposition 98 spending in 1992-93 and 1993-94.

Impact on General Fund Deficit

Until the decision is available in written form and any appeals are decided, its fiscal implications are not clear. What does appear certain is that the decision, if upheld on appeal,

would make the state's General Fund condition at least \$1.8 billion worse than it would otherwise be. This is because as a result of the decision, \$1.8 billion in prepayment loans would likely be treated as expenditures on the state's books, and there would not be any repayment to the state.

Impact on Future Proposition 98 Funding Requirements

It is not yet clear how the judge's decision would affect the state's fiscal obligation under Proposition 98 for 1993-94 and subsequent years. It appears that the decision could require the state to count a significant additional amount of funds as Proposition 98 spending in 1993-94, thereby increasing future-year obligations under Proposition 98. (There is a "poison-pill" provision in the loan legislation that would mitigate this effect. However, the provision takes effect only upon a finding by an appeals court.) At a minimum, it appears that future-year obligations could be increased by an amount in the order of magnitude of the 1993-94 prepayment loan (\$787 million). Depending on the details of the written decision, it is possible that the Proposition 98 effect could be significantly greater. When a written decision becomes available, we will provide an updated analysis.

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