December 22, 2003

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative (File No. SA2003RF0057) entitled the "Improving Classroom Education Act." Below, we: (1) describe the major provisions of the proposed initiative and (2) analyze its fiscal effects.

Proposal

This initiative includes major constitutional and statutory provisions that would generate additional government revenues and expenditures.

Revenue Provisions

The initiative includes provisions that would generate additional property tax revenue and designate the additional revenue for a variety of purposes.

Property Tax Provisions. Under the California Constitution, the tax rate on real and personal property currently is limited to 1 percent of its assessed value, plus an additional rate for the payment of principal and interest on certain voter-approved debt. This initiative would amend the State Constitution to allow for an increase in the tax rate for property used in certain income-generating activities, such as commercial, industrial, and residential rental property. (Owner-occupied residential property would not be affected by the measure.) Specifically the measure:

- Increases the property tax rate for *commercial* and *industrial* property from 1 percent of assessed value to 1.55 percent of assessed value.
- Increases the property tax rate for certain income-producing *residential* property from 1 percent of assessed value to a maximum of 1.55 percent of

assessed value—with higher tax rates levied on properties with higher assessed values.

- Provides a partial exemption from the tax for personal property. The mechanism for the personal exemption would be determined by implementing legislation.

Revenue generated by the higher tax rates would not be considered as "proceeds of taxes" under the state's appropriation limit, and thus would not be subject to it. The revenue also would not be considered when calculating the Proposition 98 minimum funding guarantee for K-14 education.

Uses of Additional Property Tax Revenue. The initiative requires that the revenues generated from the higher property tax rates be transferred to the state and used as follows:

- ***Backfill General Fund Losses.*** A portion of the additional revenue raised from the property tax increase would backfill losses to the General Fund resulting from declines in personal income tax and corporation tax revenues. These revenue declines would occur as a result of larger tax deductions associated with the increased property tax payments by businesses and individuals.
- ***Compensate Local Governments for Revenue Losses.*** Ten percent of the remaining additional revenues would be used to compensate local governments for revenue losses due to the partial property tax exemption for personal property provided for in the measure.
- ***Fund Preschool and K-12 Education Programs.*** The remainder of the additional revenues would be placed in a new special fund—the "Improving Classroom Education Fund" (ICEF)—and reserved for specific education activities (as discussed below). The monies in this fund would be "continuously appropriated"—that is, appropriated automatically each year without the need for further legislative action.

Education Expenditure Provisions

K-12 Education. Of the monies in the ICEF, the initiative would distribute two-thirds to school districts using an equal per-pupil amount based on their K-12 enrollment. School districts could use the funds for one or more of the following purposes: (1) reduce class size in grades K-12; (2) purchase textbooks, instructional materials, supplies, and equipment; (3) train teachers; and (4) increase teacher compensation. None of the monies designated for K-12 education could be used for administrative costs.

Preschool. The remaining one-third of monies in the ICEF would support voluntary preschool. The initiative requires that funds be distributed to school districts using an equal per-pupil amount based on their preschool enrollments. Districts could use the preschool funds to: (1) purchase preschool textbooks, instructional materials, supplies, and equipment; (2) train preschool teachers; (3) compensate preschool teachers; (4) renovate, rent, or lease preschool facilities; and (5) buy school furniture. During a specified transition period, districts also could use the ICEF funds to recruit and certify staff as well as provide facilities. None of the monies designated for preschool could be used for administrative costs other than clerical functions.

By July 1, 2011, the initiative requires that every elementary and unified school district offer free, voluntary preschool to all children one year before they enroll in kindergarten. (A school district could operate its own preschool program or work jointly with other school districts.) Under this initiative, preschool programs must consist of: (1) a minimum of 180 instructional minutes per day for 175 days each year, (2) a curriculum aligned to the state's academic standards for elementary education, and (3) classes of no more than 20 children taught by a teacher(s) holding a teaching credential or permit issued by the Commission on Teacher Credentialing.

No funds provided by this measure for K-12 education or preschool may be used to supplant federal, state, or local funds. Thus, the estimated $700 million school districts currently receive for state preschool and federal Head Start would need to be maintained.

Fiscal Effects of the Initiative

Effects on State and Local Revenues

The measure would affect state and local revenues in several ways.

Net Increases in Local Property Tax Revenues. The increase in local property tax rates on certain types of income-producing *real* property under the measure would generate additional property tax revenues of around $7 billion annually beginning in 2005-06, and increasing amounts thereafter. About $1 billion would be needed to backfill reductions in local personal property tax revenues and state income tax revenues, as noted above. Thus, the net revenues available for educational purposes would be around $6 billion annually.

Indirect Effects on Revenues. The owners of real property used for business-related activities would face increased costs due to the higher property taxes imposed by the measure, and they potentially could have reduced after-tax incomes. The reduction in after-tax incomes could result in state and local revenue reductions to the extent it reduces business activity, due to such factors as less investment, fewer business expansions, and reduced operations. Many businesses would act to avoid absorbing these costs, such as by "passing them along" to consumers through higher product prices or to employees by cutting back on hours or wages. These actions too, however, could reduce overall economic activity and thus revenues. The net adverse effect of these factors on revenues is unknown.

Effects on Expenditures

The measure would provide around $6 billion annually for K-12 education and preschool.

Impact on K-12 Funding. The K-12 education system would receive an additional $4 billion annually. This funding would provide around $650 per pupil (just under a 10 percent increase in total per-pupil funding).

Impact on Preschool Funding. The measure would provide around $2 billion annually for universal preschool. The per-pupil funding level provided would depend on the participation rate in universal preschool and on school districts' ability to continue to access federal Head Start funds. We assume that not all four-year olds would participate in a state-subsidized preschool program because some parents might (1) choose to keep their children at home or (2) send their children to private preschools. If, for example, 70 percent of four-year olds (365,000 pupils) participated, then total preschool resources ($2 billion in new revenues and $700 million in existing resources) would provide school districts almost $7,500 per pupil. This per-pupil rate is over double the current state preschool rate of $3,143 per pupil.

Impact on Proposition 98 Minimum Guarantee. The initiative stipulates that revenues derived from the new tax do not count as proceeds of taxes in the Proposition 98 calculation for K-14 education. Since the portion of the new tax revenues used for the General Fund backfill would not count as General Fund revenues in the Proposition 98 minimum guarantee calculation, the minimum guarantee may be affected by this measure. Depending on the other Proposition 98 factors (per capita personal income, General Fund revenues per capita, and outstanding maintenance factor) in 2005-06, the measure may result in a reduction in the minimum guarantee in the low hundreds of millions of dollars in the early years of the initiative.

State and Local Administrative Costs. The state would incur additional costs associated with: (1) assessing state properties, (2) providing technical assistance to local governments, (3) collecting property tax revenues from counties, and (4) allocating funds to school districts. In addition, local governments and school districts would experience administrative costs. For example, school districts would need to complete an annual audit indicating how ICEF monies were spent. Counties also would experience additional costs for property assessment activities. We estimate that total state and local administrative costs could be in the tens of millions of dollars annually in the near term, with lesser costs thereafter. The initiative does not identify a funding source to cover these administrative costs.

Summary of Fiscal Effects

The measure would have the following major fiscal effect:

- Additional net property tax revenues of approximately $6 billion annually, beginning in 2005-06. These revenues would be used for state-funded universal preschool and specified K-12 education purposes.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Donna Arduin
Director of Finance