March 4, 2004

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 9005, we reviewed the proposed initiative relating to local government finance, the "California Home Rule Amendment" (File No. SA2004RF0006).

MAJOR PROVISIONS OF THE INITIATIVE

This measure amends the California Constitution and state statutes to:

- Change how revenues from three major taxes are allocated among cities, counties, and K-14 districts.
- Reduce the state's authority over local government finance.
- Expand the situations under which the state must reimburse local agencies for mandated costs.

Provisions Reallocating Local Revenues

Under existing law, cities, counties, and K-14 school districts receive revenues from the property tax, but only cities and counties receive sales taxes and vehicle license fees (VLF).

Vehicle License Fees. The Constitution requires the state to allocate to cities and counties VLF paid by California vehicle owners. The Constitution, however, does not specify a VLF rate or allocation methodology. Under current law, Californians are charged annual VLFs at an effective rate of .65 percent of vehicle value. The state supplements these vehicle owner payments so that cities and counties receive VLF as if the rate were imposed at 2 percent of vehicle value. This state supplement is referred to as the "VLF backfill." Under current law, about three-quarters of VLF revenues (including backfill revenues) are allocated to cities and counties for general-purpose use and are referred to as "base VLF." The remaining one-quarter of VLF is referred to as "realignment VLF" and is allocated to counties to support certain health and social service programs.

Sales Taxes. Cities and counties currently have authority to impose sales and use taxes for general purposes at the rate of one-cent per dollar of taxable sales. Beginning in mid-2004, city and county authority to impose sales and use taxes will be reduced by one-quarter cent until certain state deficit-related bonds (authorized by Proposition 57 on the March 2004 ballot) are repaid, from 9 to 14 years from now.

Revenue Shifts From Cities and Counties to Schools. This measure shifts the allocation of base VLF (and any related VLF backfill revenues) from cities and counties to newly created countywide funds for the support of K-14 education—the School Assistance Fund for Education (SAFE). The measure also reduces permanently, by one-half cent, city and county authority to impose sales and use taxes. The measure would create a replacement sales tax for deposit to SAFE: a one-quarter cent SAFE sales tax would be established in the near term and another one-quarter cent SAFE sale tax would be established after the state's deficit-related bonds are repaid.

Revenue Shifts From K-14 Districts to Cities and Counties. Beginning in 2005-06, to offset city and county ongoing tax losses associated with (1) these VLF and sales tax swaps and (2) any statutory change to property tax shares enacted between January 1, 2004, and the measure's effective date, the initiative directs county auditors to permanently reallocate to each city and county a share of the property tax—collected within the local agency's borders—that otherwise would be allocated to K-14 districts. Auditors would implement this tax share change over a two-year period. If K-14 district property taxes are not sufficient to fully offset a local agency's losses, the measure specifies that it shall receive funding to mitigate its losses from the county SAFE. The measure is not clear whether revenues allocated from SAFE would be provided on an ongoing basis or how SAFE funding would be allocated if demands on the account surpass its revenues. Finally, within three years, county auditors would increase a city or county's property tax share if the local agency demonstrated that it would have received additional sales taxes from properties under development at the time this measure passed.

Provisions Relating to State Authority Over Local Finance

Existing law and the Constitution give the state broad authority over major local tax revenues, including the property tax, sales tax, and the VLF. For example, the Legislature may enact a law that changes (1) the allocation of property taxes among local recipient agencies (K-14 districts, cities, counties, and special districts) and (2) the rate and allocation methodology for the sales tax and VLF. The state also has some authority to modify or eliminate other local taxes, such as the business license tax, utility user tax, and transient occupancy tax.

This measure prohibits the Legislature from enacting any measure that:

- Reduces, reallocates, suspends, or delays a city or county's share of the property tax or requires a city or county to remit property taxes to a state-created fund or another local government without the consent of the local agency.
- Restricts the authority of any local government to impose a sales and use tax, or changes the method of distributing sales and use tax revenues.
- Appropriates, reallocates, suspends, or delays revenues from taxes imposed by local governments, including but not limited to the business license tax, transient occupancy tax, and utility users tax.

Provisions Relating to Mandated Local Programs

The Constitution requires the state to reimburse local agencies (cities, counties, special districts, and K-14 districts) for the cost of implementing a state mandated "new program" or "higher level of service," unless the mandate pertains to a crime or infraction or other conditions apply. This measure expands the circumstances under which the state must provide reimbursement to local agencies. While the range of state actions that would require reimbursement under this measure is not clear, it would include state laws or other requirements that transferred from the state to a local agency an increased share of costs for a jointly financed program.

Under existing law, local agencies must implement a state mandate during times when the state's reimbursement is delayed. With certain exceptions, this measure authorizes local agencies to suspend performance of mandates created on or after January 1, 2005 if the state does not provide timely reimbursement.

FISCAL EFFECT

This measure makes major changes in state and local finance. It shifts tax revenues among cities, counties, and K-14 districts; reduces the state's authority over local finance; and modifies the state mandate reimbursement process. The fiscal effect of this measure on state and local governments would depend, in part, on future revenue performance of the affected taxes and the interpretation and implementation of several key provisions in the measure. We summarize the likely major fiscal effects of this measure below.

Local Government

Tax Revenue Shifts

The measure reallocates local tax revenues by shifting (when fully implemented):

- About $7 billion of city and county VLF (about $4.7 billion) and sales taxes (about $2.5 billion) to K-14 schools, generally replacing these lost city and county revenues with increased property taxes.
- About $7 billion of K-14 property taxes to cities and counties, generally replacing these lost education revenues with funding from the sales tax and VLF.

Fiscal Effect of Tax Shifts Uncertain

The past revenue performance of the VLF, sales tax, and property tax has varied substantially. Thus, it is not clear whether local governments as a group would realize increased or decreased future revenues due to the measure's swap of VLF and sales tax revenues for increased property taxes. Given the great variation in the economic characteristics of specific cities and counties, however, it is likely that some local governments would receive higher overall revenues from the existing local government tax base (which includes substantial VLF and sales tax revenues) than from a tax base with increased reliance upon the property tax, while others would receive lower overall revenues. In addition, the interpretation of several provisions of the measure relating to SAFE revenues, sales tax rates, redevelopment, and property tax allocation could affect local government revenues. Depending on the date this measure is placed before the state's voters, for example, the sales tax rate provisions in the measure could result in an unreimbursed reduction to local government sales tax revenues in 2004-05 of up to several hundreds of millions of dollars.

Higher City and County Revenues Due to Recalculation Provision

Under the terms of this measure, every city and county would qualify for an increased share of property taxes within three years if it demonstrated that developments underway in 2004 would have yielded sales taxes. Given the number of property developments underway at any time in California, many cities and counties would qualify for such an increase in their property tax shares. Conversely, the measure does not provide a comparable *downward* adjustment for cities and counties experiencing declines in sales tax activity over the three-year period. Because of this "one-way" recalculation provision, we estimate that the level of property taxes that cities and counties receive from K-14 districts may be hundreds of millions of dollars higher than the amount of sales taxes and VLF cities and counties shift to schools.

Most K-14 Districts Unlikely to Experience Fiscal Changes

In terms of K-14 districts overall, this measure's provisions do not appear to affect the required level of state-local support required under the Constitution by Proposition 98. Thus, most K-14 districts probably would not experience a direct fiscal effect from this measure. In the case of "excess tax" K-14 districts (those receiving little or no state support for general program operations because they receive high levels of property taxes), these districts likely would experience reduced property tax revenues over time because the measure shifts part of their tax share to cities and counties in the tax swap. While the measure initially offsets these excess tax district property tax losses through allocations from SAFE, these allocations are phased out over ten years.

Higher and More Stable Revenues From Limits on State Authority

The Constitution grants the Legislature significant authority over local taxes. Over the years, the Legislature has used this authority to alter the balance of resources between local and state programs, reduce overall taxation in California, and reallocate resources among local governments. During the last 15 years, the Legislature enacted many laws that would not have been permissible under this measure. For example, during this period, the Legislature enacted laws that:

- Annually transfer over $5 billion of property taxes from cities, counties, and special districts to K-14 districts. The increased school property taxes, in turn, reduce the state's K-14 spending obligations by a commensurate amount.
- Delay city and county receipt, in 2003-04, of about $1 billion of VLF replacement revenues.
- Alter the allocation of property taxes and VLFs among some cities and counties.

In addition to these *past* state actions, the *Governor's 2004-05 Budget* proposes to permanently shift $1.1 billion of property taxes from cities and counties to K-14 districts.

Given the frequency, magnitude, and nature of these past and proposed state actions affecting local finance, restricting the Legislature's authority to enact such measures in the future would have potentially major fiscal effects on these local governments. Specifically, the state could not enact measures that reduce city and county revenues from local taxes. As a result, this measure would result in city and county revenues being more stable—and higher—than otherwise would be the case. The magnitude of the fiscal effect on city and county revenues is unknown and would depend on future actions by the Legislature. Given past actions by the state, however, the level of future city and county revenues affected by this measure could be in the billions of dollars annually.

State Government

Limits on State Authority. In general, the measure's provisions limiting the state's authority over local tax sources would have fiscal effects that mirror those on local finances. Specifically, because the Legislature could not now enact some measures that were previously allowed, this measure could result in lower resources being available for state programs than otherwise would be the case. This reduction, in turn, would affect state spending and/or taxes. For example, because the state could no longer use some local government property taxes as part of the state's budget solution, the state would need to take *alternative* actions to resolve the state's budget difficulties—such as increasing state taxes or decreasing spending on other state programs. While the magnitude of the fiscal effect on the state would depend on future actions by the state, the total fiscal effect of this reduced authority could be in the billions of dollars annually.

State School Spending. Because the measure specifies that any school SAFE revenues would be considered "local revenues" for purposes of calculating state school funding obligations, a trade of K-14 property taxes for an equivalent amount of sales taxes and VLF may not change overall state spending for K-14 districts. Because the measure shifts *additional* K-14 district property taxes to cities and counties within three years (as compensation for future developments), however, the measure likely would increase state education costs, possibly by hundreds of millions of dollars annually. Under current law, excess property taxes are not counted to meet the Proposition 98 minimum guarantee. This measure transfers some K-14 district excess property taxes to cities and counties to implement the tax shift. All revenue that cities and counties shift to SAFE (in exchange for property taxes) are counted towards the Proposition 98 minimum funding guarantee, provided the revenues are used for education purposes. The fiscal effect of this excess property tax shift—which indirectly replaces a non-Proposition 98 revenue (excess taxes) with a Proposition 98 revenue (SAFE)—appears to reduce the level of state resources needed to meet the funding guarantee by up to hundreds of millions of dollars annually.

Increased Reimbursement Costs. Because the measure expands the circumstances under which the state is required to reimburse local agencies, the measure may increase future state costs or alter future state actions regarding local or shared state-local programs. While it is not possible to determine the cost to reimburse local agencies for potential future state actions, our review of state measures enacted in the past suggests that, over time, increased state reimbursement costs could exceed a hundred million dollars annually. In the case of state education spending, any increase in reimbursement to K-14 school districts probably would be offset by decreases in other forms of state education support.

Summary

The initiative would have the following major fiscal effects, the magnitude of which would depend on future actions by the state and local governments and interpretation of the measure's provisions by the courts.

- Annual shift of about $7 billion in VLF and sales taxes from cities and counties to K-14 districts; offset by a roughly comparable shift of property taxes from K-14 districts to cities and counties.
- Higher and more stable local government revenues than otherwise would have been the case, potentially several billion dollars annually. Conversely, significant changes to state finance, potentially including higher state taxes or lower spending on state programs than otherwise would have been the case. The state fiscal effect would be commensurate with the measure's impact on local governments.

Sincerely,

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Legislative Analyst

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Director of Finance