February 17, 2005

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. SA2005RF0025) entitled the "The High Quality Classroom Act."

Proposal

This initiative includes major constitutional and statutory provisions that would result in 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 State 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 amends the State Constitution to allow for an increase in the tax rate on commercial real property (except for commercial residential real property and property used in commercial agricultural production). Specifically, the measure:

- Increases the property tax rate on specified commercial real property from 1 percent of assessed value to 1.5 percent of assessed value.
- Provides tax relief to owners of personal property (primarily businesses).

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 commercial property owners.
- ***Compensate Local Governments for Revenue Losses Related to Personal Property.*** Ten percent of the remaining additional revenues would be used to compensate local governments for revenue losses due to the relief provided to owners of personal property. (This amount would allow for about a 25 percent reduction in personal property tax bills.)
- ***K-12 Education Programs.*** The remainder of the additional revenues would be placed in a new special fund—the "High Quality Classroom Fund" (HQEF)—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. The initiative would distribute all of the monies in the HQEF 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.

No funds provided by this measure for K-12 education could be used to supplant federal, state, or local funds.

Fiscal Effects

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 commercial real property under the measure would generate additional property tax revenues of around $5 billion annually beginning in 2006-07, and increasing amounts thereafter. About $800 million 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 in excess of $4 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 have the following expenditure impacts.

Impact on K-12 Funding. The K-12 education system would receive over $4 billion annually. This funding would provide around $660 per pupil (just under a 7 percent increase in total per pupil funding).

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 2006-07, the measure could 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, school districts, and local governments would incur some additional costs to implement the measure's provisions.

Summary of Fiscal Effects

The measure would have the following major fiscal effect:

- Additional property tax revenues of around $5 billion annually, beginning in 2006-07. These revenues would be used for specified K-12 education purposes (over $4 billion) and to backfill state revenue losses and provide targeted property tax relief ($800 million).

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance