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February 24, 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 constitutional initiative relating to property taxation in the state (File No. SA2005RF0034).

Background Information

Real and personal property is subject to a local property tax administered by the counties. The California Constitution limits the property tax rate on real and personal property to 1 percent of assessed value (plus a rate necessary to pay debt service on voter-approved debt).

- Assessed value for personal property (such as business equipment) and state assessed real property is determined annually by county assessors, and is based on the current market value of the property irrespective of its acquisition date.
- Assessed value of real property is determined by the acquisition cost of the property, plus an adjustment of up to a 2 percent increase each year to account for inflation. Except for this inflation adjustment, the assessed value of real property changes only when the property is sold or transferred.

As a result of the acquisition-based system for real property, properties that change hands less frequently will generally have lower assessed value and have lower taxes than properties that change ownership more frequently.

Local property tax revenues are distributed to school districts, community colleges, cities, counties, redevelopment agencies, and special districts based on constitutional and statutory provisions. Local property tax revenues allocated to school districts and community colleges count toward the Proposition 98 minimum funding guarantee.

Increases in local property tax revenues reduce the General Fund obligations to meet the Proposition 98 minimum guarantee.

Provisions of the Initiative

The measure changes the assessment procedures for certain types of commercial property. For commercial property—except for residential commercial property and property used in commercial agricultural production—the annual assessment would be based on the fair market value of the property, rather than on the acquisition price of the property. Thus, every year, affected commercial property would be reassessed by each county assessor according to the market value. In addition, the measure would exempt from property taxation the first $500,000 of value of personal property.

Fiscal Effects of the Initiative

Effects on State and Local Revenues

The measure would affect state and local revenues in the following manner:

Net Increase in Local Property Tax Revenues. The increase in local property tax resulting from reassessing at fair market value certain commercial *real* property under the measure would generate additional property tax revenues of around $3.5 billion annually beginning in 2006-07, and increasing amounts thereafter. These revenues would be partially offset by the tax exemption granted to owners of *personal* property. The personal property exemption would reduce annual property tax revenues by approximately $700 million, resulting in net annual revenues of about $2.8 billion.

Decreased Income Tax Revenues. Businesses filing under the corporation tax (CT) and the personal income tax (PIT) may deduct local property taxes as a business expense in computing taxable income. To the extent local property taxes increase, income tax revenues would decline due to the decrease in taxable income. The reduction in CT and PIT revenues resulting from these increased business deductions would be approximately $150 million 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, which could potentially reduce after-tax incomes. These reductions would be partially offset by the effects of the exemption for personal property, which could increase certain types of capital investment. Any decline in after-tax incomes could result in state and local revenue reductions to the extent it reduces business activity, due to such factors as lower investment, fewer business expansions, and reduced operations. Some businesses would act to avoid absorbing these costs, such as by (1) pushing them forward to consumers through higher product prices or (2) decreasing employee compensation. These actions could also reduce overall economic activity and thus revenues. The net effect of these factors on revenues is unknown.

Fiscal Effects on Local Governments and Schools

The measure would provide around $2.8 billion annually in additional local property tax revenues. Based on current law, these revenues would be distributed as follows:

- ***Cities, Counties, Redevelopment Agencies, and Special Districts.*** Local governments would receive roughly $1.7 billion (about 60 percent) of the new revenues. These revenues could be used at the discretion of the local governments.
- ***School Districts and Community Colleges.*** School districts and community colleges would receive about $1.1 billion of additional funds as general purpose funds for school district revenue limits and community college apportionments. Under current law, revenue limits and community college apportionments for most districts are comprised of a combination of state General Fund and local property tax revenues. In general, the increase in property taxes resulting from this could reduce General Fund expenditures on schools by roughly the same amount. However, a small number of school districts and community colleges meet their budget requirements based solely on property tax revenues and receive no state General Fund appropriations. The state would not be able to reduce their General Fund support, and thus these districts would directly benefit from property tax increases in the tens of millions of dollars annually.

Fiscal Effect on the State

The additional local property tax revenues do not change the overall funding obligation of the Proposition 98 minimum guarantee for school districts and community colleges. The revenues do provide additional resources to meet that minimum guarantee, reducing the costs to the state by roughly the same amount. As a result, the state could reduce General Fund appropriations to meet the minimum guarantee for schools by about $1.1 billion annually.

The Proposition 98 minimum guarantee is a complicated set of formulas. One of the inputs into the formula is General Fund revenues. Since the measure would reduce CT and PIT revenues by roughly $150 million, the Proposition 98 guarantee could decrease by the high tens of million of dollars annually.

State and Local Administrative Costs

The state would incur additional costs associated with providing technical assistance to local governments and allocating funds to school districts. In addition, county governments would experience additional administrative costs associated with 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.

Summary

This measure would have the following major fiscal effects:

- Annual increase in net local property tax revenues of approximately $2.8 billion resulting from assessment of certain commercial real property at fair market value. This would provide additional revenues to local governments ($1.7 billion) and schools ($1.1 billion). The school revenues would reduce state education spending by a commensurate amount.
- Annual decline in state income tax revenues of approximately $150 million from increased property tax deductions.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance