March 4, 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. SA2005RF0059).

Background Information

Real and personal property is subject to a local property tax administered in large part 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, 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 changes ownership.

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, and special districts based on 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

Revenue Provisions

The measure changes the assessment of most nonresidential real property. For this property the annual assessment would be based on the fair market value of the property rather than on the acquisition price of the property. Thus, each year, beginning with 2006-07, affected nonresidential property would be reassessed by the county assessor according to the market value. In addition, the measure exempts from property taxation the first $500,000 of value of personal property owned.

Expenditure Provisions

The measure provides that revenues raised from the increased property tax would be spent according to the following schedule:

- 50 percent of the revenues would go to school districts in the county of collection, with at least 10 percent of the amount so allocated spent on instructional materials. These would be counted as Proposition 98 funds and would be a supplement to the existing minimum funding guarantee.
- 20 percent would go to senior citizens' property tax relief programs.
- 15 percent would go to transportation projects in the county of collection.
- 15 percent would go to enhance local public safety in the county of collection.

Fiscal Effects of the Initiative

Effects on State and Local Revenues

The measure would affect state and local revenues in various ways:

Net Increase in Local Property Tax Revenues. Reassessing at fair market value most nonresidential real property would generate additional property tax revenues of around $3.5 billion annually beginning in 2006-07. These revenue increases 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. (This revenue reduction would likely reduce the Proposition 98 minimum guarantee by roughly half that amount.)

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. Any declines in after-tax incomes could result in state and local revenue reductions to the extent they reduce business activity, due to such factors as lower investment or reduced operations. These reductions would be partially offset by the effects of the increased exemption for personal property, which could increase certain types of capital investment or other spending. The net effect of these factors on revenues is unknown.

Fiscal Effects on Local Governments and School Districts

The measure would provide around $2.8 billion annually in net additional local property tax revenues. These revenues would be distributed as follows:

- ***K-12 Education***—$1.4 billion annually, of which $140 million would be targeted for instructional materials.
- ***Senior Citizens' Property Tax Relief***—$560 million annually.
- ***Transportation Projects***—Over $400 million annually.
- ***Local Public Safety***—Over $400 million 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 on state and local governments:

- Increase in net local property tax revenues of approximately $2.8 billion annually, half of which would be spent on education purposes and the other half on senior citizens' property tax relief, transportation projects, and local public safety.

- Reduced state income tax revenues of approximately $150 million annually as a result of increased property tax deductions.

Sincerely,

____

Elizabeth G. Hill
Legislative Analyst

____

Tom Campbell
Director of Finance