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December 16, 2009

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional and statutory initiative (A.G. File No. 09-0078), which affects local property tax rates on nonresidential property.

BACKGROUND

Local Property Tax

The State Constitution establishes a 1 percent maximum base property tax rate on real and personal property. Counties collect these tax revenues and allocate them to local governments (cities, counties, special districts, redevelopment agencies, schools, and community colleges) according to law.

Real property includes land, buildings, and other things affixed to the land. Personal property includes boats, airplanes, business fixtures, and other property not affixed to real property.

State and Local Tax Exemptions, Deductions, and Credits

State law creates several exemptions, deductions, and credits related to property taxes that reduce the amount of taxes owed, as described below.

Homeowner's Property Tax Exemption. The Constitution grants a $7,000 property tax exemption on the assessed value of owner–occupied dwellings. The state is required to reimburse local governments for the resulting reduction in local property tax revenues. This exemption reduces the typical homeowner's taxes by about $75 annually. The state provided about $450 million from the state's General Fund to reimburse local governments for this exemption in 2008-09.

Property Tax Deduction. Businesses may deduct payment of local property taxes as a business expense in their computation of taxable income under the state's corporate tax (CT) and personal income tax (PIT). The Franchise Tax Board estimates that business property tax deductions totaled approximately $500 million in 2008-09.

Renter's Tax Credit. Low-income renters may claim a non-refundable credit that reduces their state PIT liability. In 2008-09, the credit provided up to $120 in tax relief per household at a total cost to the state of about $100 million.

Proposition 98

Adopted by the voters in 1988 and amended in 1990, Proposition 98 establishes a set of formulas that are used to annually calculate a minimum funding level for K-12 schools and the community colleges. In 2008-09, K-12 schools and community colleges received a total of $49 billion in Proposition 98 funding. This funding level is met using state General Fund dollars and local property tax revenues.

PROPOSAL

This measure amends the Constitution to (1) increase the property tax rate for nonresidential real property and (2) use the new tax revenues to supplement funding for school districts, community colleges, and the California State University (CSU). We discuss these changes below.

Tax Changes

Property Tax Rate. The measure increases the property tax rate from 1 percent to 1.55 percent of assessed value for all nonresidential real property, except property used for commercial agricultural production. This tax rate increase would begin in the 2011-12 fiscal year. Residential property such as single-family or multifamily dwelling units would not be affected by this tax rate change.

Exemptions. The measure also (1) exempts from taxation the first $1 million of value of business personal property and (2) doubles the homeowner's property tax exemption (to $14,000) and the renter's tax credit (to a maximum of $240).

Distribution of New Property Tax Revenues

Under the measure, counties would transfer to the state the property tax revenues attributable to the higher property tax rate. The State Controller, in turn, would take the following actions:

- Transfer to each county funds to compensate local governments for property tax revenue losses due to the personal property exemption and the doubling of the homeowner's tax exemption.
- Transfer to the state General Fund funds to offset the state's PIT and CT revenue losses due to the deductions for higher business property taxes and increased renter's tax credit.
- Deposit all remaining funds in a new education fund, the "Public School Investment and Accountability Fund" (PSIAF).

Education Expenditures

Allocation. The measure requires the Controller to distribute 78 percent of PSIAF revenues to school districts and the remainder, in equal shares, to the community colleges and CSU. Each school and community college district's allocation of PSIAF would be based on the district's proportionate share of statewide enrollment.

Use of Funds. Schools and colleges could use PSIAF monies for a variety of educational purposes, including purchasing instructional materials and compensating nonmanagement staff. Educational agencies could not use these revenues, however, to pay administrative costs. Every year, school districts and colleges would file an annual audit showing how they spent PSIAF revenues.

Other Requirements. Finally, the measure specifies that the state shall not (1) count PSIAF revenues or the increased property taxes for purposes of calculating the state's minimum funding requirement under Proposition 98 or (2) use these funds to supplant federal, state, or local funding.

FISCAL EFFECTS

Effect on Tax Revenues

Net Increases in Property Taxes. In 2008-09, California property owners paid about $45 billion in property taxes. Approximately $10 billion of this amount was associated with nonresidential real property as defined in the measure. Thus, increasing the nonresidential property tax rate to 1.55 percent of assessed value would increase property tax revenues by about $5.5 billion. From this amount, the State Controller would transfer in the range of $1.5 billion to the state General Fund and counties to offset revenue reductions associated with the increased exemptions and credits that are contained in the measure and backfill revenue losses to the PIT and CT. Thus, the net increase in tax revenues for educational programs under the measure would be in the range of about $4 billion annually.

Indirect Effects on Revenues. Owners of nonresidential real property would face increased costs due to the higher property tax rates imposed by the measure, which would reduce 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. Some 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 compared to what they otherwise would be. These actions also could reduce overall economic activity. Conversely, the effects of spending increases discussed below would have positive indirect effects on state revenues. The net effect of these factors on revenues is unknown.

Effect on Expenditures

Increased Education Spending. The measure would provide around $4 billion annually for K-14 districts and the CSU. The increase would equate to about a 7 percent increase from current Proposition 98 funding levels for K-12 districts and community colleges. For CSU, the new funding would translate into an increase of about 20 percent in state funding.

Decreased Proposition 98 Minimum Guarantee. Because the measure would reduce state General Fund revenues from the PIT and CT and specifically excludes revenues raised by this measure from the Proposition 98 calculation (including the dollars which would backfill General Fund losses), the state's minimum school spending level under Proposition 98 would be affected by this measure. Depending on the other factors included in the Proposition 98 calculation, this measure could reduce the minimum guarantee by up to several hundreds of millions of dollars during the early years of the measure's implementation.

Increased State and Local Administrative Costs. State and local educational agencies would experience increased administrative costs to complete the required annual audits. These costs probably would be in the low millions of dollars annually.

Summary of Fiscal Effects

The measure would have the following major fiscal effect:

- Increased net state revenues of about $4 billion annually, due to higher taxes on nonresidential real property. These revenues would be spent by K-12 school districts, community colleges, and CSU.

Sincerely,

Mac Taylor
Legislative Analyst

Michael C. Genest
Director of Finance