LAO
70 YEARS OF SERVICE

January 13, 2012

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Dawn McFarland
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative concerning taxation and funding for education and county programs (A.G. File No. 11-0091, Amdt. #1S).

Background

State's Fiscal Situation. California's General Fund, the state's core account that supports a variety of programs (such as public schools, higher education, health, social services, and prisons), has experienced chronic shortfalls in recent years. During this period, policymakers have taken actions to reduce expenditures in a variety of public programs and temporarily raised certain taxes between 2009 and 2011. State General Fund shortfalls of several billion dollars per year are expected to continue over at least the next five years under current tax and expenditure policies.

Personal Income Tax. The state's personal income tax (PIT) imposes rates ranging from 1 percent to 9.3 percent on the portions of a taxpayer's income in each of six income brackets, with the 9.3 percent rate applying to income in excess of $48,029 for single filers or $96,058 for joint filers. The PIT revenue totaled $49.5 billion in 2010-11, which was deposited into the General Fund. There is an additional 1 percent on income over $1 million that is dedicated to mental health services. As this results in higher tax rates on those with more income, the 1 percent of tax filers with the most income now pay around 40 percent of state income taxes.

Proposal

Income Tax Surcharge to Fund Public Services. Starting with tax year 2012, the measure raises the PIT an additional 3 percent on the portion of a taxpayer's income between $1 million and $2 million and 5 percent on any income above $2 million. As with the current mental health surcharge, the brackets would be the same for single, joint, and head-of-household returns and would not be indexed for inflation.

The incremental revenue raised from the two new brackets would be deposited monthly into the new California Funding Restoration Trust Fund (CFRTF) and continuously appropriated to:

- Public school districts, county education offices, state special schools, and direct-funded charter schools to be distributed on an equal per-pupil basis based on fall enrollment numbers (36 percent of total revenue).
- The University of California system (8 percent).
- The California State University system (8 percent).
- Community college districts, to be distributed on an equal per-student basis based on full time equivalent student enrollment (8 percent).
- County programs for seniors, children, the disabled, and public health (25 percent).
- County public safety programs (10 percent).
- County road and bridge maintenance (4.9 percent).
- State administrative costs (up to 0.1 percent).

Funding for all county programs would be distributed proportionate to each county's population.

Restrictions on Uses of Funds. The measure forbids K-12 and higher education entities from using these funds for "administrative costs" or capital outlay and defines administrative costs as the pay or expenses of managers or supervisors not assigned to a specific school or campus. The Legislature, the Governor, and other state officials would be prohibited from directing local school districts how to spend funds appropriated to them under this initiative.

Oversight by Controller. The State Controller is responsible for administering the new funds and distributing them to the designated recipients and is also charged with auditing the recipients to ensure that funds are being spent properly. Misappropriating any of these funds would be a felony.

Amendment Provision. The measure allows the Legislature to amend its provisions with a 55 percent vote of both houses if the amendment is necessary to further the purposes of the measure. The measure also briefly describes three types of amendments that would further its purposes.

Fiscal Effects

Proposed New Revenues Likely to Be Volatile. Most of the income reported by California's upper-income filers is related in some way to their capital investments, rather than wages and salary-type income. While upper-income filers' wage and salary income is volatile to some extent (due to the cyclical nature of bonuses, among other things), their capital income is *highly* volatile from one year to the next. For example, the current mental health tax on income over $1 million generated about $734 million in 2009-10 but has raised as much as $1.6 billion in previous years. Given this volatility, estimates of the revenues to be raised by this initiative will change between now and the November 2012 election.

This volatility makes it difficult to forecast this measure's state tax revenue gains from high-income taxpayers. As a result, the estimates from our two offices of this measure's annual revenue increases vary. For purposes of this analysis, we assume the measure would be approved by voters in November 2012 and take effect during the state's 2012-13 fiscal year. In 2012-13, the Legislative Analyst's Office (LAO) currently forecasts this measure would generate about $6 billion of new revenues, and the Department of Finance (DOF) currently forecasts the measure would generate about $9.5 billion of new revenues. (Under existing state accounting methods, revenues from the proposed taxes for all 12 months of tax year 2012, plus six months of tax year 2013, would be booked in 2012-13, and this likely would produce a somewhat higher level of receipts during the first fiscal year.) In 2013-14, the LAO currently forecasts this measure would generate about $4 billion of new revenues, and DOF forecasts the measure would generate about $6 billion of new revenues. In later fiscal years, these amounts would tend to grow.

Funding of Education and Certain County Services. The revenues generated by this measure would be distributed to school districts, community college districts, public universities, other local governments, and state administrative agencies as described above. Proposition 98's minimum guarantee of state and local funding for school and community college districts (funded from state General Fund and local property tax moneys) would be unaffected by this measure. Accordingly, funding distributed to these educational entities from the CFRTF would be in addition to their annual Proposition 98 funding.

The amount of state General Fund support provided each year to schools and community colleges through Proposition 98, as well as General Fund resources for other state-funded programs, would depend on future actions of the Legislature and the Governor. This measure would prohibit its increased tax revenues from being transferred to or otherwise used by the General Fund. Accordingly, the state's General Fund budget still would need to be balanced in future years with actions such as further reductions in spending or other increased taxes.

Other Impacts. The measure's significant increases in the marginal tax rates for high-income Californians would have some impact on taxpayers' future investment, employment, and location decisions. In the near term, these effects might not be significant. For example, New Jersey raised its top income tax rate by 2.6 percentage points on income over $500,000 in 2004, and the evidence to date suggest that this tax increase caused only a very small outmigration of people. Over the longer run, as individuals and businesses adjust to the higher rates, the impacts could be greater.

Summary of Fiscal Effect

The measure would have the following major fiscal effects:

- Increased state personal income tax revenues dedicated to public universities, school districts, community college districts, and other local public services. Estimates of the revenue increases vary—for 2012-13, from $6 billion to $9.5 billion and for 2013-14, from $4 billion to $6 billion. These revenues would tend to grow in later years.

Sincerely,

____

Mac Taylor
Legislative Analyst

____

Ana J. Matosantos
Director of Finance