2011 Initiative Analysis: Protection of Local School Revenues Act of 2014 (Amendment #2-S)

lao.ca.gov/ballot/2013/130707.aspx

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Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative related to property tax allocation (A.G. File No. 13-0047 Amendment #2-S).

Background

Proposition 98 "Minimum Guarantee" for Schools and Community Colleges. State budgeting for schools and community colleges is governed largely by Proposition 98, passed by voters in 1988. The measure, modified by Proposition 111 in 1990, establishes a minimum funding requirement for schools and community colleges, commonly referred to as the minimum guarantee. Both state General Fund and local property tax revenue apply toward meeting the minimum guarantee. The Proposition 98 minimum guarantee is determined by one of three tests set forth in the State Constitution (known as Test 1, Test 2, and Test 3). These tests are based on several inputs, including changes in K-12 average daily attendance, local property tax revenues, per capita personal income, and per capita General Fund revenue. Though the calculation of the minimum guarantee is formula-driven, a supermajority of the Legislature can vote to suspend the formulas and provide less funding than the formulas require.

Supplemental Appropriation Required in Test 3 Years. When the minimum guarantee is determined by Test 3, the state is typically required to make a supplemental payment in addition to the amounts determined by the Proposition 98 formulas. This is because of a statutory provision related to Proposition 98 that requires K-14 funding per student to grow at least as fast as per capita General Fund spending on non-Proposition 98 programs in Test 3 years. Test 3 has been operative in 7 of the 25 years since Proposition 98 was approved by voters. A supplemental appropriation was required in each year, although it was suspended once (in 1993-94).

The Role of Property Taxes in Education and Local Government Funding. Because the Proposition 98 minimum guarantee is met using state General Fund and local property tax revenues, the state has a substantial fiscal interest in the distribution of property tax revenue among local governments—schools, community colleges, cities, counties, and special districts. The county auditor is responsible for allocating revenue generated from the 1 percent rate to local governments pursuant to state law. All property tax revenue remains within the county in which it is collected to be used exclusively by local governments.

Property Tax Revenues Contribute Toward Meeting Specified Per-Pupil Funding Amounts. School and community college districts receive a certain level of general purpose per-pupil funding, as specified in the annual budget act. School districts receive this funding from a combination of local property tax revenues and state General Fund revenues, while community college districts receive funding from local property taxes, student fees, and state General Fund revenues. If a school or community college district's local property tax revenue (and student fee revenue in the case of community colleges) is insufficient to fund the authorized per-pupil rates, the state provides General Fund revenues to meet the statutory requirements. Conversely, if a district's non-state resources alone exceed the per-pupil rates, the district does not receive general purpose state aid. This latter type of district is commonly referred to as a "basic aid" district.

Property Tax Revenue Shifted to Schools in Early 1990s. In 1992-93 and 1993-94, in response to serious budgetary shortfalls, the state permanently redirected almost one-fifth of total statewide property tax revenue from cities, counties, and special districts to school and community college districts. Under the changes in property tax allocation laws, the redirected property tax revenue is deposited into a countywide fund for schools, the Educational Revenue Augmentation Fund (ERAF). The property tax revenue from ERAF is distributed to nonbasic aid schools and community colleges, reducing the state's General Fund obligations.

In 2004, Some Property Tax Revenue Shifted Away From Schools. In 2004, state voters approved Proposition 57, a deficit-financing bond to address the state's budget shortfall. The state enacted a three-step approach—commonly referred to as the triple flip—that provides a dedicated funding source to repay the deficit bonds:

- Beginning in 2004-05, one-quarter cent of the local sales tax effectively was redirected to the state to repay the deficit-financing bond.
- During the time these bonds are outstanding, city and county revenue losses from their reduced sales taxes are replaced on a dollar-for-dollar basis with property taxes shifted from ERAF.
- School and community college district property tax losses from the redirection of ERAF to cities and counties, in turn, are offset by increased state General Fund.

The VLF Swap Also Resulted in Some Property Tax Revenues Being Shifted Away From Schools. The vehicle license fee (VLF)—a tax on vehicle ownership—provides revenue to local governments. In 1999, the state began reducing the VLF rate and backfilling city and county revenue losses from this tax reduction with state aid from the General Fund. The 2004-05 budget package permanently replaced the state VLF backfill by redirecting to cities and counties some property tax revenue from ERAF and, if necessary, nonbasic aid school and community college districts —a transaction known as the "VLF swap." In 2004-05, cities and counties did not experience a change in overall revenue due to the VLF swap, as the amount of property tax shifted to them was equal to the VLF backfill amount. In subsequent years, state law specifies that each local government's VLF swap payment grows based on the annual change in its assessed valuation. As assessed valuation typically grows more quickly than VLF revenue, the vast majority of cities and counties benefit fiscally from the VLF swap. Annual statewide VLF swap payments now are roughly $2 billion (around 50 percent) greater than the VLF revenues lost by cities and counties. Similar to the triple flip, school and community college districts' property tax revenue losses are made up with increased state General Fund.

Minimum Guarantee "Rebenched" to Ensure Property Tax Shifts Do Not Affect Schools and Community Colleges. *Because the amount of local property tax revenues can sometimes affect the Proposition 98 calculation, s*hifting the allocation of property taxes can unintentionally increase or decrease the state's overall funding requirement to schools and community colleges. To ensure that these property tax shifts have no effect on the total amount of funding schools and colleges receive, the minimum guarantee is rebenched any year in which the state adopts policy changes that affect the amount of property taxes that schools or colleges receive. (Technically, the state's General Fund Proposition 98 obligation is rebenched/adjusted to account for the shift in the amount of property tax revenues going to schools and colleges.)

Some County Offices of Education (COE) Receive Comparatively More Property Taxes. Similar to school districts, state law dictates that each COE receive a specified level of funding from a combination of local property taxes and state aid. A few COEs—Placer, San Mateo, and Santa Clara—receive property taxes in excess of their specified funding level. The county-auditor controller deposits these excess property taxes into a county account called the Supplemental Revenue Augmentation Fund (SRAF). Revenue deposited in the SRAF are distributed to trial courts within the county, offsetting state costs.

Proposal

Eliminates the VLF Swap. Effective July 1, 2015, the measure ends the shift of property taxes from ERAF and school and community college districts to cities and counties under the VLF swap.

Establishes a New VLF Backfill Mechanism. Beginning in 2015-16, the measure requires the State Controller to transfer monthly from the state General Fund to a new VLF Backfill Fund the amount of funding necessary to fully reimburse city and county VLF revenue losses due to the reduction in the VLF rate from 2 percent to 0.65 percent. The State Controller would distribute to each city and county a portion of these backfill funds roughly equal to the decrease in VLF revenue to the city or county resulting from the VLF rate reduction.

Prohibits Shifts of Property Tax Revenues Away From Schools. The measure prohibits the Legislature from reallocating, transferring, or otherwise reducing the amount of property taxes allocated to educational entities—school districts, community college districts, ERAF, and COEs.

Requires COE's Excess Property Tax Revenue to Be Spent on Child Care. The measure eliminates the requirement that a COE's excess property tax revenue restricted funds be deposited into SRAF. Instead, the measure would require county auditor-controllers to deposit these funds into a countywide account—known as the Child Development Fund—to be used to fund child care and development services within the county.

Fiscal Effect

City and County Revenues. By eliminating the VLF swap, the measure decreases annual city and county property tax revenues by about $7 billion, beginning in 2015-16. About $4.5 billion of this revenue loss, however, would be offset by increased state aid. On net, therefore, the measure decreases annual city and county revenue by around $2.5 billion in 2015-16. In future years, city and county revenue reductions likely would grow because the state aid provided to cities and counties likely would grow more slowly than city and county property tax revenue losses.

School and Community College Funding. The effect of the measure on school and community college districts would depend on whether the 2015-16 minimum guarantee is determined by Test 3 and the state provides a supplemental appropriation. If this does not occur—probably the most likely scenario—the measure would have no effect on the minimum guarantee and the increase in school property tax revenues would be fully offset by a reduction in state General Fund support for schools and community colleges. In this case, the measure would reduce state education costs by about $7 billion per year, beginning in 2015-16, but would not affect total school and community college district resources.

Conversely, if the 2015-16 minimum guarantee is determined by Test 3 and the state provides a supplemental appropriation, total school and community college funding would increase. This is because the shift in property taxes required by this measure would free up additional General Fund revenues that the state could use for various purposes and the supplemental appropriation would ensure that school and community college funding per student grows at least as fast as per capita General Fund spending on non-Proposition 98 programs. The increase in school and community colleges from the supplemental payment could range from the low hundreds of millions to several billion dollars. This supplemental payment would, in turn, increase school and community college funding in future years.

State Costs. The measure increases state costs to aid cities and counties by about $4.5 billion annually, beginning in 2015-16. This increased state cost would be offset by a reduction in state aid for school and community college districts. The net fiscal effect for the state would depend on whether a Test 3 supplemental appropriation was provided. If the Test 3 supplemental appropriation was not provided, the $4.5 billion in increased state aid to cities and counties would be more than offset by reduced state education costs of $7 billion, resulting in annual savings of about $2.5 billion. In future years, state savings probably would grow because the cost to provide aid to cities and counties likely would grow more slowly than the offsetting reductions in state aid for school and community college districts. Conversely, if a Test 3 supplemental appropriation were provided, some or all of these net state savings would be offset. In some circumstances, the state cost to provide a Test 3 supplemental appropriation could be greater than $2.5 billion, resulting in a net increase in state costs of several hundred million dollars or more annually.

Summary of Fiscal Effect

- Net decrease in city and county revenue of about $2.5 billion per year, beginning in 2015-16.
- Uncertain impact on annual state costs ranging from savings of a few billion dollars to costs of a few billion dollars, beginning in 2015-16.
- Possible increase in school and community college funding.

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