LAO
70 YEARS OF SERVICE

January 27, 2012

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

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative (A.G. File No. 11-0088, Amendment #1S) that would increase personal income tax rates and dedicate revenues for K-12 education, early care and education programs, and debt service on education facilities.

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 for 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 few 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 several income brackets, with the 9.3 percent rate applying to income in excess of $48,029 for single filers and $96,058 for joint filers. The PIT revenue, which is deposited into the General Fund, totaled $49.5 billion in 2010-11. An additional 1 percent tax applies to income over $1 million, with associated revenues dedicated to mental health services.

Proposition 98 Funding. In 1988, voters approved Proposition 98. Including later amendments, Proposition 98 establishes a guaranteed minimum annual funding level—commonly called the minimum guarantee—for K-14 education (consisting of schools and community colleges). The minimum guarantee is funded through a combination of state General Fund revenues and local property tax revenues. In 2011-12, schools and community colleges received $48.7 billion in Proposition 98 funding. Of that amount, $43 billion was allocated to

K-12 local education agencies (LEAs)—school districts, county offices of education, and charter schools. The calculation of the minimum guarantee depends on a number of factors, including the year-to-year changes in General Fund revenues, student attendance, and California per capita personal income. With a two-thirds vote in any given year, the Legislature can suspend the Proposition 98 guarantee for one year and provide any level of K-14 funding it chooses.

Early Care and Education (ECE). In 2011-12, state and federal funds provided roughly $2.5 billion to offer a variety of child care and preschool programs for approximately 530,000, or about 15 percent, of California children ages five and younger. Standards and characteristics—including staff qualifications, curriculum, and adult-to-child ratios—vary across individual programs. In general, participation in these publically subsidized programs is reserved for families that display "need." Eligibility criteria include low family income, participation in the California Work Opportunities and Responsibility to Kids program or other work or training activities, and/or children with special needs. Because of funding limitations, waiting lists for subsidized programs are common in most counties. As of June 2010, about 125,000 eligible children under the age of five were waiting for a slot in one of the state's subsidized programs. Limited data are available on children's participation in non-subsidized programs.

Proposal

This measure increases rates on the vast majority of Californian personal income taxpayers and uses the funds for schools, ECE programs, and debt service payments for education facilities. We discuss these proposals in further detail below.

Increases PIT Rates Through 2024. As shown in Figure 1 (see next page), this measure increases PIT rates on all but the lowest income bracket, effective beginning in 2013 and ending in 2024. The additional marginal tax rates would be higher as taxable income increases. For income of PIT filers currently in the highest current tax bracket (9.3 percent marginal tax rate, excluding the mental health tax), additional marginal tax rates would rise as income increases. For example, as shown in Figure 1, an additional 1.8 percent marginal tax rate would be imposed on income of joint filers between $200,000 and $500,000 per year and an additional 2.2 percent marginal tax rate would be imposed on income of joint filers over $5 million per year. The income levels in the tax brackets shown in Figure 1 would be indexed for inflation. The current mental health tax would continue to be imposed.

Allocates Funds for Schools and ECE Programs. The revenues raised by the measure would be deposited into a newly created California Education Trust Fund (CETF). In 2013-14 and 2014-15, all revenues deposited into the CETF would be allocated for schools and ECE programs (85 percent for schools, 15 percent for ECE). Beginning in 2015-16, total CETF allocations to schools and ECE programs could not increase at a rate greater than the average growth in California personal income per capita in the previous five years. The measure also prohibits CETF monies from being used to replace state, local, or federal funding that was in place prior to November 1, 2012. All revenue collected by the measure and allocations made to schools are excluded from the calculation of the Proposition 98 minimum guarantee.

Figure 1

Current and Proposed Personal Income Tax Marginal Rates[a]

Annual Taxable Income at Top of Marginal Tax Bracket[b]				
Single or Married/RDP Filing Separately	Married or RDP Filing Jointly	Head of Household	Current Marginal Tax Rate[c]	Proposed Additional Marginal Tax Rate[d]
$7,316	$14,632	$14,642	1.0%	—
17,346	34,692	34,692	2.0	0.4%
27,377	54,754	44,721	4.0	0.7
38,004	76,008	55,348	6.0	1.1
48,029	96,058	65,376	8.0	1.4
100,000	200,000	136,118	9.3	1.6
250,000	500,000	340,294	9.3	1.8
500,000	1,000,000	680,589	9.3	1.9
1,000,000	2,000,000	1,361,178	9.3	2.0
2,500,000	5,000,000	3,402,944	9.3	2.1
Over 2,500,000	Over 5,000,000	Over 3,402,944	9.3	2.2

[a] Lists existing income amounts in each tax bracket as of tax year 2011. The taxable income amounts in each bracket will be adjusted for future tax years based on inflation.

[b] Amounts listed are the annual taxable income at the top of each marginal tax bracket. For example, a single filer with taxable income of $10,000 in 2011 could have a tax liability of $127 under current tax rates: the sum of $73 (which equals 1 percent of the filer's income up to $7,316) and $54 (2 percent of the filer's income over $7,316).

[c] Excludes the mental health tax rate of 1 percent for taxable income in excess of $1 million.

[d] The proposed additional tax rates would expire at the end of tax year 2024.

RDP = Registered domestic partners.

Excess Funds Used for Education Debt Service Payments. The measure requires any CETF monies collected in excess of the growth rate limit described above be used by the state to pay debt service costs for general obligation bonds issued for the construction or rehabilitation of pre-kindergarten, K-12, or university school facilities. These funds would offset the state's General Fund costs and would provide state General Fund savings.

Provides Three Grants to Schools. The measure requires 85 percent of CETF allocations be made to schools. These allocations are split into three different grants: educational program grants (70 percent of K-12 allocations); low-income per-pupil grants (18 percent); and training, technology, and teaching materials grants (12 percent). Educational program grants are distributed on a per-pupil basis depending on the grade of each student, with students in higher grades receiving more funding than students in the lower grades. Low-income per-pupil grants are allocated based on the number of low-income students (defined as the number of students eligible for free meals) enrolled in each school. These two grants can be spent on a broad range of activities, including instruction, school support staff (such as counselors and librarians), and parent engagement. Training, technology, and teaching materials grants are provided on a per-pupil basis and can be used for professional development activities, new technology, or teaching materials. The governing board of the LEA has sole authority over how to spend CETF funds.

Includes Several School-Site Spending Restrictions. Up to 2 percent of a school district's allocation can be used to cover the district's audit, budget, public meeting, and reporting requirements. The remaining funds allocated must be spent at the specific school where the associated student enrollment funding is generated. In the case of low-income per-pupil grants, for example, if 100 percent of low-income students in a school district are located in one particular school, all associated grant funds must be spent at that specific school. The measure also prohibits CETF funds from being used to provide salary or benefit increases for personnel, unless the increases are provided to other like employees that are funded with non-CETF monies.

Creates New School Reporting Requirements. The measure includes several reporting requirements for LEAs. Most notably, the measure requires all LEAs to create and publish an online budget for every school within the LEA's jurisdiction. The state Superintendent of Public Instruction must provide a uniform format for budgets to be reported and must make all budgets statewide available for the public. The LEA governing boards also must seek input from the public on how to spend CETF funds and explain how CETF expenditures will improve educational outcomes and how those improved outcomes will be measured. In addition, LEAs must provide a report on how CETF funds were spent at each school within the LEA's jurisdiction within 60 days after the close of the school year.

Expands ECE Programs. The measure dedicates 15 percent of CETF allocations to the state's ECE system for children ages five and younger. Of this amount, the first $300 million would be used to restore recent state budget reductions to existing child care programs. The majority of remaining funds would be used to expand the number of children from low-income families served in publicly funded child care and preschool programs. The measure also uses new revenues to establish a quality rating scale by which to assess the effectiveness of ECE programs; allocates supplemental funding to those programs achieving higher ratings on that scale; and establishes a new state database to collect and maintain information on ECE programs and participants.

Cannot Be Amended by the Legislature. If adopted by voters, this measure could only be amended by a future ballot measure approved by majority vote in a statewide election. The Legislature would be prohibited from making any modifications to the measure.

Fiscal Effect

Additional State Revenues. If approved, the measure's tax provisions would take effect January 1, 2013. In 2013-14 (reflecting a full-year fiscal effect), estimates of the additional state revenues that would be generated from the proposed PIT rate increases currently range from about $10 billion (based on the current Legislative Analyst's Office revenue forecast) to about $11 billion (based on the current Department of Finance revenue forecast). (In 2012-13, the partial-year effect would be additional revenues of about half this amount.) The total revenue generated would tend to grow over time, but be somewhat volatile due primarily to the volatility of income for upper-income filers. Most of the income reported by upper-income filers is related in some way to their capital investments, rather than wages and salary-type income, and can change significantly from one year to the next.

Uses of Funds. In the first full year of implementation, the measure would allocate $8.5 billion to $9 billion for schools and $1.5 billion to $1.7 billion for ECE programs. Given these revenues are excluded from the Proposition 98 calculations, the minimum guarantee would be unaffected by this measure. Accordingly, funding distributed to these educational entities under this measure would be in addition to their annual Proposition 98 funding.

In Many Years, Some Debt Service Relief. The measure is likely to provide General Fund relief on education bond debt service costs in many of the 12 years that the measure is operative. This is for two reasons. Because PIT revenues would increase as population growth increases, they likely would grow at a faster rate than *per capita* personal income. In addition, because PIT revenues are more sensitive to swings in the capital gains of upper-income earners, they tend to be considerably more volatile than the five-year average growth in per capita personal income, often exceeding that growth rate. When PIT revenues outpace the five-year rolling average of per capita personal income, the measure would provide General Fund savings. The exact amount of General Fund savings would depend in the difference in the associated PIT and per capita personal income growth rates, but state savings easily could be several hundred million dollars per year.

Interaction With Rest of State Budget. The vast majority of revenues raised by this measure would directly benefit schools and ECE programs, with no corresponding state General Fund savings. Given the state's fiscal situation, the state's General Fund budget still would need to be balanced in future years with actions such as further reductions in spending on other state programs or other increased taxes.

Summary of Fiscal Effect

- Increased state personal income tax revenues beginning in 2013 and ending in 2024. Estimates of the revenue increases vary from $10 billion to $11 billion per year initially, tending to increase over time. The revenues would be dedicated to K-12 education (85 percent of the funds) and early care and education programs (15 percent) and would supplement existing funding for these programs.
- In years with stronger growth in state personal income tax revenues, some of the revenues raised by this measure—several hundred million dollars per year—would be used to pay education debt service costs, resulting in state savings.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance