

**Proposition 38: Local Schools and Early Education Investment and  
Bond Debt Reduction Act**

*August 2012*

SDCTA **opposes** Proposition 38. Proposition 38 would increase the state's personal income tax, making California the highest income taxed state in the country. Given the delicate nature of our state economy and the evidence of migration following tax increases in other states, compounding this problem with additional tax increases could have a negative effect on our attempt to attract businesses and create jobs. Rather than focus on reform efforts, such as pension reform, tax increases have been offered as a means to provide funding to services such as education.

- California's projected budget deficit for Fiscal Year (FY) 2013 is estimated to be \$15.7 billion.
- The FY 2013 budget was originally anticipated to total \$9.2 billion, but increased due to overly optimistic revenue projections included within the FY 2012 budget.
- Total Prop 98 funding has decreased between FY 2009 (\$49 billion) and FY 2012 (\$47 billion), but is projected to increase again in FY 2013 (\$52 billion).
- The state's personal income tax imposes rates ranging from 1.0% to 9.3% on the portions of a taxpayer's income in several income brackets, with the 9.3% rate applying to income in excess of \$48,029 for single filers and \$96,058 for joint filers.
- If approved by voters, Proposition 38 would increase the personal income tax rate for all taxpayers, except those within the lowest tax bracket. The resulting revenues would be dedicated to schools, early childhood education (ECE) programs, and debt service payments for education facilities through 2024. The tax can be extended through an affirmative vote of the electorate.
- The Legislative Analyst's Office LAO estimates the measure would generate between \$10 billion to \$11 billion for the first full fiscal year. For FY 2013, revenue estimates would total half that amount.
- Studies show that increases in the personal income tax rate affect the migration flows of taxpayers and income throughout the country.

**Proposition 38: Local Schools and Early Education Investment and  
Bond Debt Reduction Act**

*August 2012*

**Board Action:**

**OPPOSE**

**Title:** *Local Schools and Early Education Investment and Bond Debt Reduction Act*

**Election:** November 2012 General Election

**Description:** Increases personal income tax rates until fiscal year 2024 with revenues dedicated to K-12 education.

**Jurisdiction:** State

**Type:** Initiative Statute

**Vote:** Simple Majority

**Fiscal Impact:** Measure would generate \$10 billion to \$11 billion beginning in fiscal year 2014.

**Rationale:**

The chronic state budget deficits have lead elected leaders to rely on tax increases to balance the state's budget, as is the case with the Fiscal Year 2013 budget. Rather than focus on reform efforts, such as pension reform, tax increases have been offered as a means to provide funding to services such as education. Proposition 38 would increase the state's personal income tax, making California the highest income taxed state in the country. Given the delicate nature of our state economy and the evidence of migration following tax increases in other states, compounding this problem with additional tax increases could have a negative effect on our attempt to attract businesses and create jobs.

**Background:**

*California's Budget Deficit*

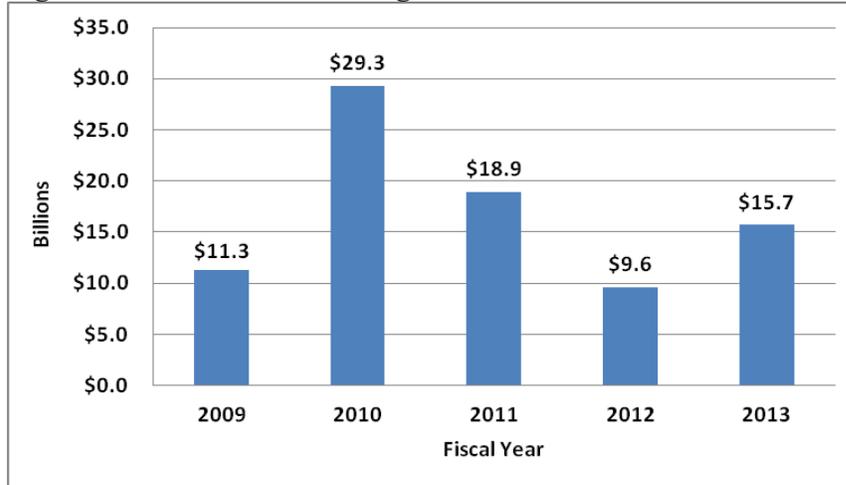
California's projected budget deficit for Fiscal Year (FY) 2013 is estimated to be \$15.7 billion. The FY 2013 budget was originally anticipated to total \$9.2 billion, but increased due to overly optimistic revenue projections included within the FY 2012 budget.<sup>1</sup> The FY 2012 budget agreement included increasing revenue projections by an additional \$4 billion. The California Department of Finance recently estimated that not only will the additional \$4 billion in revenues not materialize, but revenues will fall an additional \$1.2 billion short.

Figure 1 outlines the past budget deficits that were purported to be addressed during budget negotiations between the governor and legislature.

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<sup>1</sup> "Optimistic projections led to dramatic surge in California budget deficit". By Kevin Yamamura. *Sacramento Bee*. June 15, 2012.

**Figure 1: Past California Budget Deficits<sup>2</sup>**

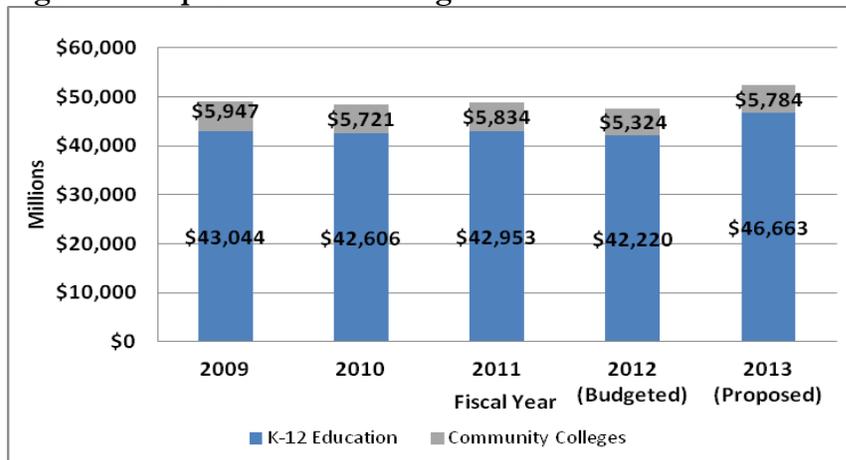


*Education Spending*

Proposition 98 (Prop 98), the “School Funding for Instructional Improvement and Accountability Initiative” establishes a minimum level of funding for public schools and community colleges (K-14). Funding is provided mainly through local property taxes and the General Fund. This funding level changes each year with the economy and changes in school attendance.<sup>3</sup>

Prop 98 funding is projected to increase by 10 percent, from \$47 billion in FY 2012 to \$52 billion in FY 2013. Figure 2 outlines Prop 98 funding between FY 2009 and the Governor’s proposed FY 2013 budget. Total Prop 98 funding has decreased between FY 2009 (\$49 billion) and FY 2012 (\$47 billion), but is projected to increase again in FY 2013 (\$52 billion).

**Figure 2: Proposition 98 Funding**



<sup>2</sup> California Legislative Analyst’s Office Budget Overview Reports. Fiscal Year 2009-2013.

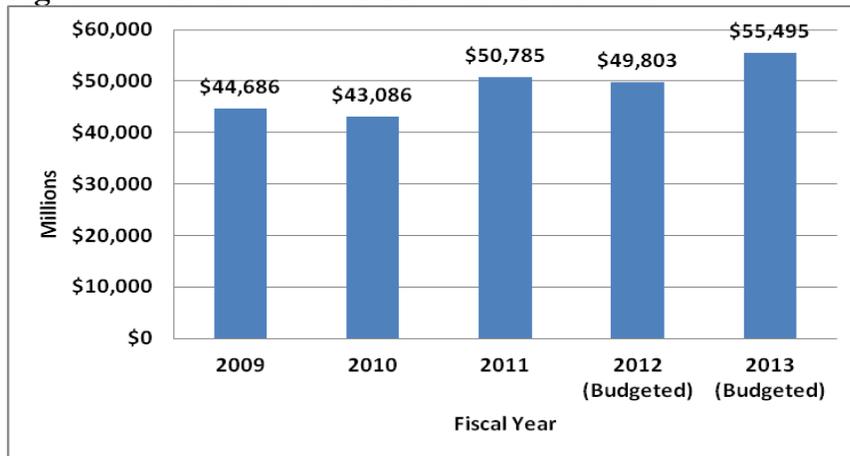
<sup>3</sup> Proposition 98 - the “School Funding for Instructional Improvement and Accountability Initiative”. SDCTA Backgrounder.

### *California Personal Income Tax*

The state’s personal income tax imposes rates ranging from 1.0 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. An additional 1.0 percent tax applies to income over \$1 million, with associated revenues dedicated to mental health services.<sup>4</sup>

Total personal income tax revenue has increased by 24 percent, from \$44 billion in FY 2009 to a projected \$55 billion in FY 2013. Figure 3 outlines personal income tax revenue each year between FY 2009 and FY 2013.

**Figure 3: California Personal Income Tax Revenue<sup>5</sup>**



### *Past SDCTA Positions*

The San Diego County Taxpayers Association (SDCTA) has consistently opposed proposals to increase the personal income tax rate in California. In 2009, SDCTA opposed Proposition 1A, which in part would have increased the tax rate for each bracket by a 0.25 percentage point. In 2006, SDCTA opposed Proposition 82 which would have increased tax rates by another 1.7 percentage points on those earning more than \$400,000 a year, with revenues dedicated to preschool education. In 1996, SDCTA opposed Proposition 217, which would have retroactively reinstated 10 percent and 11 percent tax rates, respectively, on taxpayers with taxable income over \$115,000 and \$230,000.

### **Proposal:**

Proposition 38, the Local Schools and Early Education Investment and Bond Debt Reduction Act, is an initiative that received at least 504,760 valid signatures to appear on the November 2012 ballot. If approved by voters, Proposition 38 would increase the personal income tax rate for all taxpayers, except those within the lowest tax bracket, with revenues dedicated to schools, early childhood education (ECE) programs, and debt service payments for education facilities through 2024. The tax can be extended through an affirmative vote of the electorate.

<sup>4</sup> Legislative Analyst’s Office Review of Initiative File No. 11-0088, Amendment #1S.

<sup>5</sup> FY 2009 – 2011 California Single Audit Reports and FY 2013 May Revised Budget.

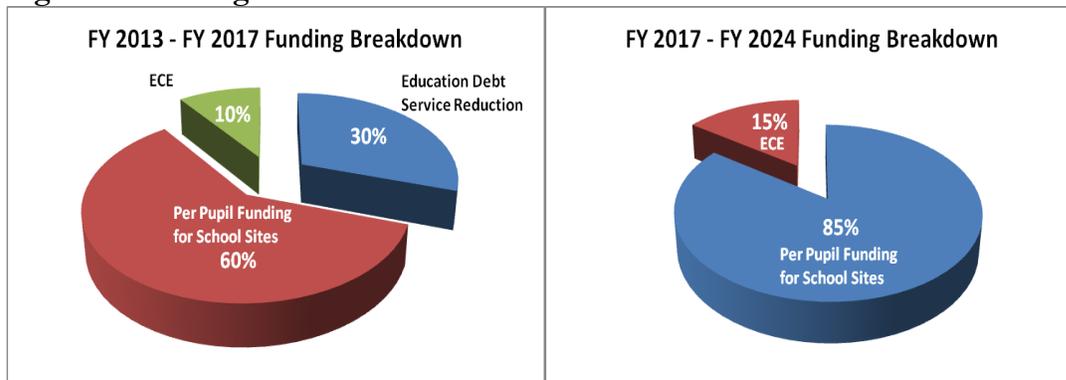
Figure 4 outlines the current (as of 2011 tax year) and proposed personal income tax marginal rates should voters adopt Proposition 38.

**Figure 4: Current and Proposed Personal Income Tax Marginal Rates<sup>6</sup>**

Single or Married/RDP <sup>7</sup> Filing Separately	Married or RDP Filing Jointly	Head of Household	Current Marginal Tax Rate	Proposed Additional Marginal Tax Rate	Total Tax Rate
\$0-\$7,316	\$0-\$14,632	\$0-\$14,642	1.0%	<b>0.0%</b>	<b>1.0%</b>
\$7,316-\$17,346	\$14,632-\$34,692	\$14,642-\$34,692	2.0%	<b>0.4%</b>	<b>2.4%</b>
\$17,346-\$27,377	\$34,692-\$54,754	\$34,692-\$44,721	4.0%	<b>0.7%</b>	<b>4.7%</b>
\$27,377-\$38,004	\$54,754-\$76,008	\$44,721-\$55,348	6.0%	<b>1.1%</b>	<b>7.1%</b>
\$38,004-\$48,029	\$76,008-\$96,058	\$55,348-\$65,376	8.0%	<b>1.4%</b>	<b>9.4%</b>
\$48,029-\$100,000	\$96,058-\$200,000	\$65,376-\$136,118	9.3%	<b>1.6%</b>	<b>10.9%</b>
\$100,000-\$250,000	\$200,000-\$500,000	\$136,118-\$340,294	9.3%	<b>1.8%</b>	<b>11.1%</b>
\$250,000-\$500,000	\$500,000-\$1,000,000	\$340,294-\$680,589	9.3%	<b>1.9%</b>	<b>11.2%</b>
\$500,000-\$1,000,000	\$1,000,000-\$2,000,000	\$680,589-\$1,361,178	9.3%	<b>2.0%</b>	<b>11.3%</b>
\$1,000,000-\$2,500,000	\$2,000,000-\$5,000,000	\$1,361,178-\$3,402,944	9.3%	<b>2.1%</b>	<b>11.4%</b>
Over \$2,500,000	Over \$5,000,000	Over \$3,402,944	9.3%	<b>2.2%</b>	<b>11.5%</b>

Revenues from the proposed measure would be deposited into a newly created California Education Trust Fund (CETF). If passed by voters, and until FY 2017, 60 percent of funds will be dedicated to K-12 education, 30 percent to “reduce state debt and prevent further harmful budget cuts that could undermine these new educational investments”, and 10 percent to ECE programs (Figure 5). Following FY 2017, revenues would be allocated toward schools and ECE programs (85 percent and 15 percent, respectively). Beginning in FY 2016, total CETF allocations 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 prevents these dollars from being used to supplant Prop 98 funding.

**Figure 5: Funding Breakdown**



<sup>6</sup> Legislative Analyst’s Office Review of Initiative File No. 11-0088, Amendment #1S.

<sup>7</sup> Registered Domestic Partnership

The funds would be appropriated by a newly created “Fiscal Oversight Board” consisting of the State Controller, State Auditor, State Treasurer, Attorney General and Director of Finance. Funds will be distributed to schools directly on a per-pupil basis, not through their respective school district.

Monies collected in excess of the growth rate limit would be required to be used to pay debt service costs for general obligation bonds issued for construction or rehabilitation of pre-kindergarten, K-12, or university school facilities. Figure 6 outlines the remaining general obligation bonds associated with education construction as of June 1, 2012. Based off a cursory review of the titles of the bonds, there is approximately \$40 billion in remaining bonds that have been issued and yet to be repaid.

**Figure 6: Outstanding Education Facility Related General Obligation Bonds<sup>8</sup>**

Authorized General Obligation Bonds	Amount Outstanding (thousands)
School Building and Earthquake Bond Act of 1974	\$18,640
Higher Education Facilities Bond Act of 1988	\$30,205
1988 School Facilities Bond Act	\$53,620
Higher Education Facilities Bond Act of 1990	\$65,865
School Facilities Bond Act of 1992	\$72,500
1990 School Facilities Bond Act	\$124,755
School Facilities Bond Act of 1990	\$200,325
1992 School Facilities Bond Act	\$341,360
Higher Education of Facilities Bond Act of 1992	\$405,225
School Facilities Bond Act of 1996	\$1,361,885
Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998	\$6,615,990
Kindergarten-University Public Education Facilities Bond Act of 2002	\$30,779,420
<b>Total</b>	<b>\$40,069,790</b>

**Fiscal Impact:**

If voters approve Proposition 38, the measure would take effect beginning January 1, 2013. For FY 2014, the first full year in effect, the Legislative Analyst’s Office (LAO) estimates the measure would generate between \$10 billion to \$11 billion. For FY 2013, revenue estimates would total half that amount. The LAO also predicts this amount would grow over time, “but be somewhat volatile due primarily to the volatility of income for upper-income filers.”

Based on the LAO’s revenue estimates, between \$8.5 billion to \$9.0 billion would be dedicated for schools, and \$1.5 billion to \$1.7 billion for ECE programs. These allocations

<sup>8</sup> California State Treasurer Report on Authorized and Outstanding General Obligation Bonds as of June 1, 2012.

would be excluded from Prop 98 calculations, so these monies would be in addition to the annual Prop 98 funding.

Depending upon the growth of personal income tax revenue compared with per capita personal income, some general fund relief would be experienced as additional revenues would be dedicated to paying debt service. For the FY 2013 budget, \$4.6 billion in general fund expenditures will be dedicated toward general obligation bond debt service. It is unclear how much is strictly dedicated to outstanding education facility bonds.

### **Policy Discussion:**

#### *Impact of Higher Personal Income Tax Rates*

A recent literature review conducted by the Center on Budget and Policy Priorities states, "...there is no compelling evidence to date of *real* responses to upper income taxpayers to changes in the tax rates...if the alternative to raising taxes is larger deficits, then modest tax increases on high-income households would likely be more beneficial for the economy over the long run."<sup>9</sup> Furthermore, the review states, "An important study by tax economists Joel Slemrod and Alan Auerbach found that such reductions in reported income largely reflect *timing and other tax avoidance strategies* that taxpayers adopt to minimize their taxable income, *not* changes in real work, savings, and investment behavior."<sup>10</sup> The argument for the decline in reported taxable income is that high-income earners change the timing of when they derive income as well as the utilization of other types of tax avoidance and evasion.

Following an increase in the "millionaire's tax" in New Jersey in 2004, the New Jersey Department of the Treasury completed a study reviewing how income taxes and other economic factors affect the migration flows of taxpayers and income throughout the country. The study concluded, "[A]verage marginal tax rates had a small but significant effect on migration decisions in the U.S. and in New Jersey. We estimate that higher New Jersey income taxes after 2003 was associated with a reduction of more than 20,000 taxpayers and a loss of annual income of at least \$2.5 billion."<sup>11</sup> The study goes on to further state that tax-induced migration would not come close to eclipsing immediate revenue gain from a tax increase, but losses would cumulate over time. The study used annual Internal Revenue Service data from 1992 to 2008.

#### *Tax Rates Across the US*

California currently has the second highest income tax rates among US states, with only Hawaii surpassing California with the highest rate at 11 percent. Most small businesses are S Corporations, partnerships or sole proprietorships, and pay their business taxes at the rates for individuals. Passage of Proposition 38 would move California to having the highest tax rate in the county at 11.5 percent.

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<sup>9</sup> "Recent Studies Find Raising Taxes on High-Income Households Would Not Harm the Economy." By Chye-Ching Huang. Center on Budget and Policy Priorities. April 24, 2012.

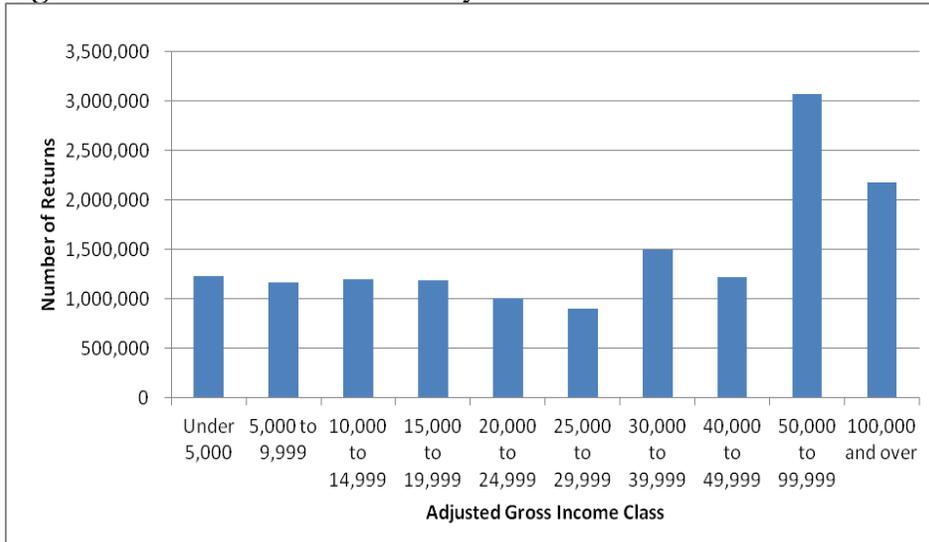
<sup>10</sup> Ibid.

<sup>11</sup> "The Effects of Marginal Tax Rates on Interstate Migration in the U.S." Roger Cohen, Andrew Lai, and Charles Steindel. New Jersey Department of the Treasury. October 2011.

*California Income Tax Data*

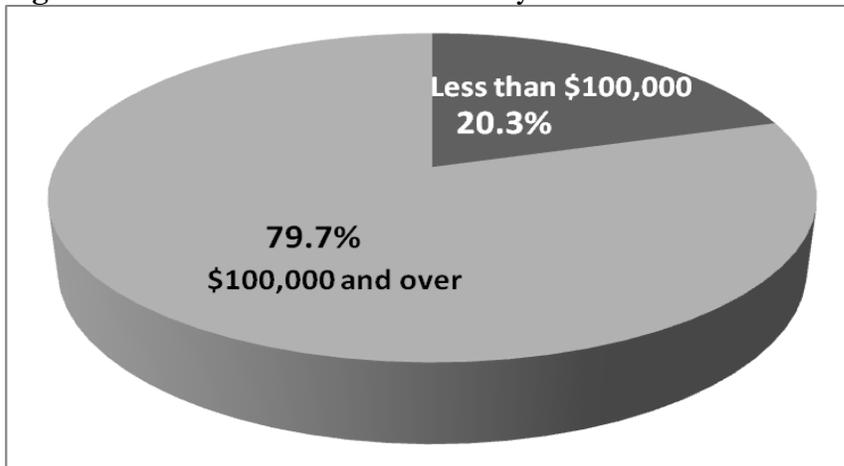
An evaluation of data from the California Franchise Tax Board shows that in the 2009 tax year (latest available), the number of tax returns for the income class above \$100,000 account for approximately 15 percent of total returns (See Figure 7).

**Figure 7: 2009 Tax Year Returns by Income Class<sup>12</sup>**



For the 2009 tax year, the total tax liability for all income classes amounted to approximately \$38.8 billion. Figure 8 outlines the make-up of this total liability by income class. In 2009, nearly 80 percent of the total tax liability came from those making over \$100,000 in adjusted gross income, despite more than five times as many returns being filed by those making less than \$100,000.

**Figure 8: Percent of Total Tax Liability – 2009 Tax Year<sup>13</sup>**



<sup>12</sup> State of California Franchise Tax Board 2010 Annual Report. Table B-2.

<sup>13</sup> Ibid.

If the theory holds true that an increase on marginal tax rates for high income earners will cause these individuals to migrate, California could experience a significant loss in tax revenue due to the over-reliance on those earning more than \$100,000 a year.

### **List of Proponents:**

- Molly Munger
- California State PTA

### **Proponent Arguments:**

- California ranks 47th out of 50 states in per-pupil education spending, and has the largest class sizes in the nation. Over the last three years we have cut public school budgets by more than \$20 billion and laid off over 40,000 educators, and more budget cuts are on the way.
- We believe our children deserve better. Every child should have an opportunity to learn to the best of their ability.
- Our Children, Our Future 2012 asks Californians to join together to invest in our children and our schools because we will all share in the benefits that better schools and a better-educated workforce will bring.
- New funding will be allocated to every local school on a per pupil basis, with funds directed to local school sites, not district headquarters. To help close the existing achievement and opportunity gaps, every local school will receive additional per pupil dollars based on the number of students who qualify for free lunches under the USDA's low- income eligibility guidelines. Every school and every child will benefit.
- Our Children, Our Future gives local communities control of the new education dollars. It requires school boards to adopt procedures for each school to ensure parent, teacher and community input on how the new funds will be spent.
- The initiative contains tough, effective accountability provisions that require oversight, audits and public disclosure. It requires an independent third party audit to make sure funds are only spent for authorized purposes. Anyone who knowingly violates the allocation or distribution provisions of the act will be guilty of a felony.

### **List of Opponents:**

- Governor Jerry Brown
- SEIU
- California Business Roundtable

### **Opponent Arguments:**

- Measure could prevent passage of Governor Brown's tax initiative to alleviate the budget deficit.
- California currently has the second highest income tax rates among US states.
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- Passage would move California to having the highest tax rate in the county at 11.5 percent.
- Passage of Proposition 38 would move California to having the highest tax rate in the county at 11.5 percent.