

**THE IMPACT OF THE STATE OF CALIFORNIA'S
PROPERTY TAX DIVERSIONS ON
ECONOMICALLY DISADVANTAGED STUDENTS**

A Policy Report Prepared for Educate Our State!

YOUTH AND EDUCATION LAW PROJECT
MILLS LEGAL CLINIC
STANFORD LAW SCHOOL

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In 2003, California enacted two measures that diverted property tax revenues to service state debts. First, the state cut the Vehicle License Fee (“VLF”).¹ Second, the legislature placed on the ballot, and the people enacted, an initiative (Proposition 57) that refinanced the State’s various debts into a single “Economic Recovery Bond.”² The measures were intended to provide financial relief to taxpayers and the State’s general fund. Rather than using State General Fund revenues to repay cities and counties for the loss of VLF revenues and funds “borrowed” to service the Economic Recovery Bond, the State diverted certain school-dedicated property tax revenues to pay off those obligations to cities and counties.

Educate Our State! has asked the Youth & Education Law Project of the Mills Legal Clinic at the Stanford Law School to examine the effects of those property tax diversions on California’s economically disadvantaged students. To address that issue, we analyzed the method by which the state diverts school-dedicated property tax revenues to service state debt and the fiscal effects of those diversions on school districts and schools. We conclude that the diversion of school-dedicated property taxes has tangibly affected the resources available to California school children. More important, because poor schools are more reliant on state funds and because the method for diverting tax funds falls more heavily on those districts and schools most reliant on state funds, poor children and their schools have been hurt the most.

I. How School-Dedicated Property Tax is Diverted to Service State Debt

A. The VLF Cut Is Backfilled By Diverting Money Away From Schools

Before the VLF cut, the VLF raised \$6.2 billion a year.³ Most of that money was distributed to cities and counties.⁴ The VLF cut (passed as SB 1096 (2004)) reduced the total raised to \$2 billion, a loss of \$4.2 billion a year.⁵ The cut most impacted cities (lost \$1.6 billion/year) and counties (lost \$2.6 billion/year).

¹ See Dave Downey, *Schwarzenegger repeals car tax*, SAN DIEGO UNION-TRIBUNE, Nov. 18 2003 (<http://www.utsandiego.com/news/2003/Nov/18/schwarzenegger-repeals-car-tax/>)

² See Alex Bluth, *Governor has a lot riding on bond package*, SACRAMENTO BEE, Feb. 15 2004 (<http://www.calstate.edu/pa/clips2004/february/16feb/riding.shtml>)

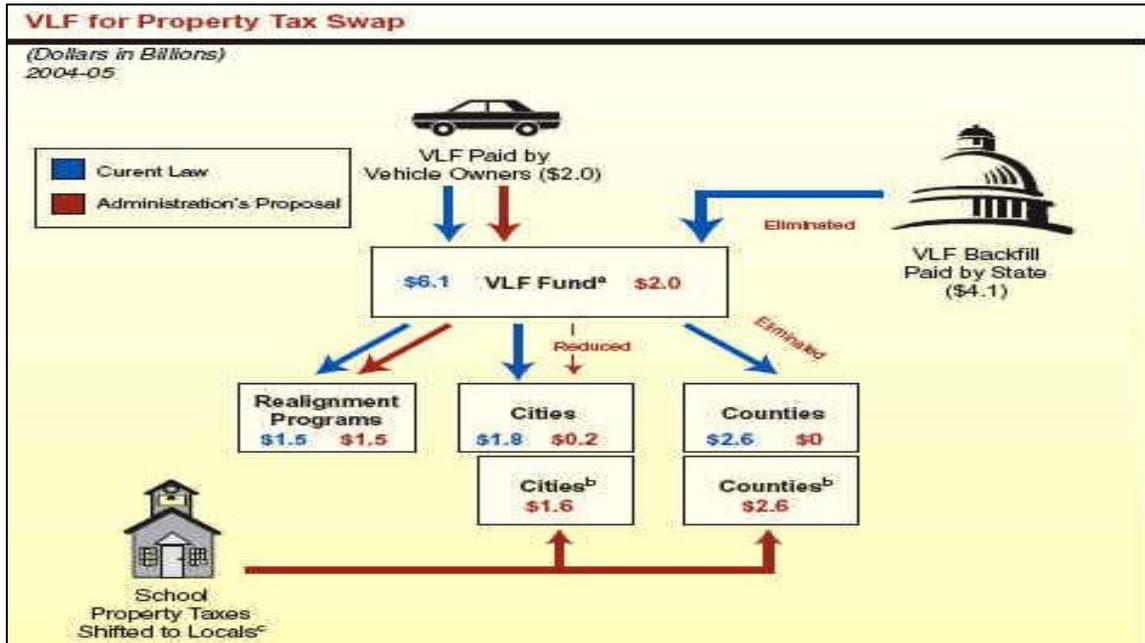
³ See LEGISLATIVE ANALYST’S OFFICE, ANALYSIS OF THE LOCAL GOVERNMENT PROPOSAL (May 2004) (http://www.lao.ca.gov/2004/local_gov/052404_loc_gov_proposal.htm)

⁴ *Id.*

⁵ *Id.*

Instead of either passing the lost revenue of the tax cut onto these local governments or backfilling the lost revenue with money from the State’s general fund, the state backfilled the lost revenues to cities and counties by diverting property taxes dedicated to schools.⁶ This policy is known as the “VLF Swap.” Figure 1 below illustrates the administration’s VLF money shuffle in 2004:

Figure 1: The VLF Swap (as enacted in 2004-05)⁷



⁶ Specifically, the VLF Swap authorized the State to create VLF Property Tax Compensation Funds in each county to compensate cities and county governments for their lost VLF revenue. The Funds were authorized to divert property tax revenues away from each county’s Educational Revenue Augmentation Fund (ERAF)* and redirect them to city and county government. In “non-basic aid districts” (i.e. districts with smaller property tax bases which rely on state funds in addition to local base property taxes), the VLF Swap also authorized the Fund to divert education-dedicated local base property taxes to cities and counties in the event that ERAF was inadequate to make cities and counties whole. Critically, the Funds were to determine the amounts to be diverted each year by adjusting the original lost VLF revenue by the annual increase in the gross taxable assessed property values within each city or each county. Because assessed property value is an imperfect proxy for projected VLF collections, the formula exposed schools to overpayments. See STAFF OF CAL. S. BUDGET AND FISCAL REV. COMM., ANALYSIS OF S.B. 1096 (July 27, 2004) (ftp://leginfo.public.ca.gov/pub/03-04/bill/sen/sb_1051-1100/sb_1096_cfa_20040729_111307_asm_floor.html)

*ERAFs were established in the early 1990s to adjust the restrictive Prop 13/AB 8 property tax allocation formula and grant more property tax revenue to K-14 schools. It did so by redirecting some of the amounts initially allocated under the Prop 13/AB 8 formula to cities and counties.

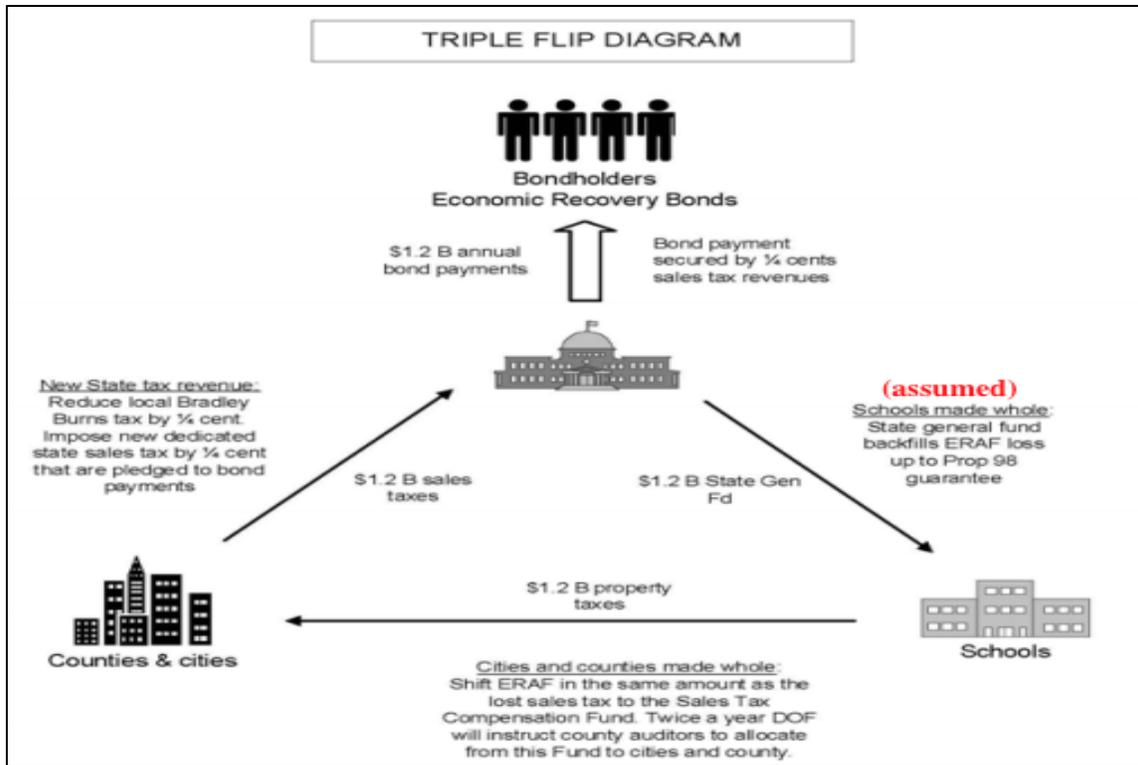
⁷ Graphic from LEGISLATIVE ANALYST’S OFFICE, ANALYSIS OF THE LOCAL GOVERNMENT PROPOSAL (May 2004) (http://www.lao.ca.gov/2004/local_gov/052404_loc_gov_proposal.htm)

B. The Recovery Bond Is Backfilled By Diverting Money Away From Schools

In December 2003, the legislature passed ABX5 9 to place Proposition 57 on the March 2004 ballot. The Proposition authorized the State to borrow up to \$15 billion through general obligation Economic Recovery Bonds (ERB) for the purpose of paying off the State’s accumulated debt. Prop 57 passed with 63% of the vote.

To service the \$1.2 billion annual payments to Prop 57 ERB bondholders, the State claimed city and county revenues generated from the 0.25% Bradley-Burns local sales tax and pledged the funds to bondholders.⁸ As with the VLF Swap, the \$1.2 billion lost by cities and counties was backfilled by diverting property tax revenue away from schools.⁹ The maneuver, known as the Triple Flip, is illustrated by Figure 2 below:

Figure 2: The Triple Flip¹⁰



⁸ See STAFF OF CAL. ASSEMBLY BUDGET COMM., ANALYSIS OF A.B. 9 X5 (Dec. 15, 2003) (http://www.leginfo.ca.gov/pub/03-04/bill/asm/ab_00010050/abx5_9_cfa_20031215_162609_asm_floor.html)

⁹ Specifically, Prop 57 set up Sales Tax Compensation Funds in each county. Twice a year, the California Department of Finance was directed to report the amount of lost sales tax, and the Funds were authorized to claim that amount from each county’s ERAF and base property taxes. See, e.g., OFFICE OF THE SANTA CLARA CONTROLLER-TREASURER, DEMYSTIFYING THE CALIFORNIA PROPERTY TAX APPORTIONMENT SYSTEM 43-46 (2006) (<http://www.csac.counties.org/publication/demystifying-california-property-tax-apportionment-system>)

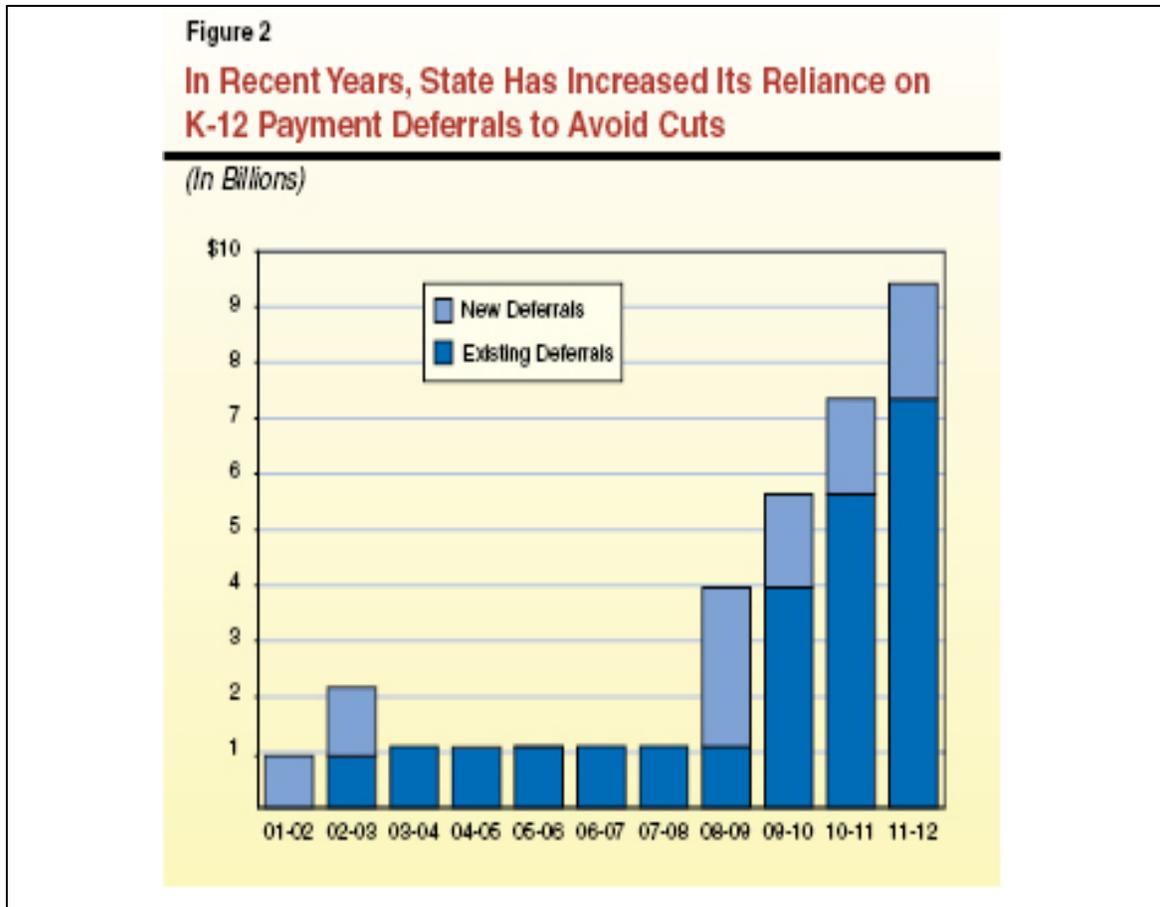
¹⁰ *Id.*

In their implementation of the VLF Swap and the Triple Flip, lawmakers assumed that existing minimum school funding mandates under Proposition 98 would require state general funds to replace the lost school-dedicated property tax and “make schools whole.”¹¹ The intent was to hold children harmless.

II. Schools and Children Have Not Been Held Harmless

Despite Proposition 98 and other minimum school funding mandates, the State has not refunded schools for their diverted revenues. Instead, the State has issued schools deferrals (essentially IOUs). All told, the Legislative Analyst’s Office estimates that the State has deferred nearly \$10 billion from schools (see Figure 3) since 2001.¹² Despite recent late payments, in January 2014 the Governor’s Office estimated that schools were still owed more than \$6.8 billion in outstanding deferrals.¹³

Figure 3: Accumulation of Deferrals¹⁴



¹¹ See *supra* n. 6, 8.

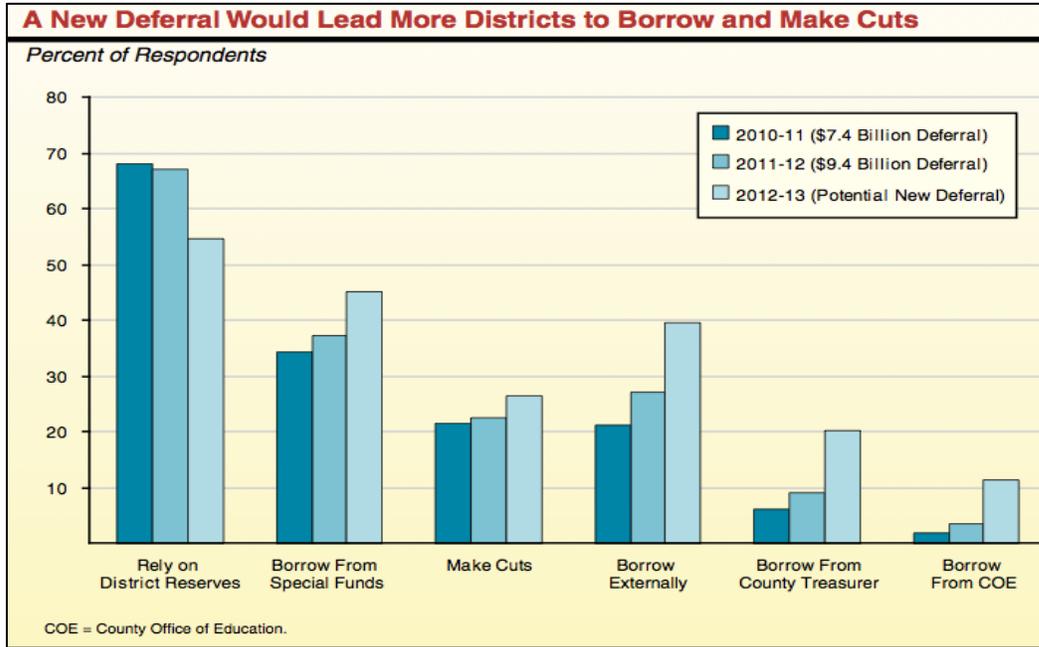
¹² LEGISLATIVE ANALYST’S OFFICE, TO DEFER OR NOT TO DEFER 3 (Jan. 2011) (http://www.lao.ca.gov/analysis/2011/education/k12_deferrals_012411.pdf)

¹³ OFFICE OF THE GOVERNOR, 2014-15 CAL. BUDGET SUMMARY 177 (Jan. 2014) (<http://www.ebudget.ca.gov/2014-15/pdf/BudgetSummary/FullBudgetSummary.pdf>)

¹⁴ See *supra* n. 12.

Repeated deferrals have strained school districts' limited reserve funds and forced districts to borrow money externally (at market interest rates on top of brokerage fees), or else cut educational programs (see Figure 4). For the 2012-2013 fiscal year, 40% of school districts planned to borrow externally and incur the associated transaction costs to compensate for state-imposed deferrals.¹⁵ At the same time, 26% of school districts planned to make cuts to their educational programs because borrowing was either too costly or unavailable.¹⁶

Figure 4: School Districts Borrow and Cut to Recover from Deferrals¹⁷



The cuts forced upon schools have had numerous direct impacts on educational quality. First, districts have had to decrease their teaching and learning support staff. Since 2008, districts were compelled to release more than 30,000 teachers (an 11% decrease), and nearly 4,000 student counselors and academic advisors (a 14% decrease).¹⁸

Second, class sizes have increased across grade levels: Grade 7-12 class sizes are up 6.7%, Grade 4-6 class sizes are up 3.3%, and children in Grades K-3 classrooms have increased a full 13%.¹⁹

¹⁵ LEGISLATIVE ANALYST'S OFFICE, YEAR-THREE SURVEY: UPDATE ON SCHOOL DISTRICT FINANCE 25 (May 2012) (<http://www.lao.ca.gov/reports/2012/edu/year-three-survey/year-three-survey-050212.pdf>)

¹⁶ *Id.*

¹⁷ *Id.* at 15

¹⁸ *Id.* at 8

¹⁹ See *supra* n. 15 at 9.

Third, children are spending fewer days in school. Deferrals have compelled many districts to reduce the number of instructional days they can offer each year. In 2008, 98% of California districts provided children at least 180 days of instruction. By 2011, just 61% of districts met the benchmark, while 17% of districts only offered instruction for the statutory minimum 175 days.²⁰

Fourth, students have suffered from cuts to educational, enrichment, and support programs. Deferrals have forced districts to shift funds away from these programs just to cover their basic fixed costs. These cuts, and the other impacts, are summarized below.

Figure 5: Deferrals Have Directly Impacted Education Quality

Education Staff Employed	Change from 2008	
<i>Teachers</i>	-11%	
<i>Counselors and Learning Support Staff</i>	-14%	
Class Sizes	Change from 2008	
<i>Grades K-3</i>	+13%	
<i>Grades 4-6</i>	+3.3%	
<i>Grades 7-12</i>	+6.7%	
Time in Classroom	Change from 2008	
<i>180 instructional days or more</i>	-37%	
<i>175 instructional days (legal minimum)</i>	+16%	
Selected Programs²¹	Program Cuts Since 2008-09	
	% of Districts Eliminating	% of Districts Cutting
<i>Community Based English Tutoring</i>	46% Eliminated	75% Cut
<i>Arts and Music</i>	43% Eliminated	77% Cut
<i>Math/English Professional Development</i>	43% Eliminated	75% Cut
<i>Professional Development</i>	41% Eliminated	76% Cut
<i>Targeted Instructional Improvements</i>	40% Eliminated	72% Cut
<i>Library Improvements</i>	37% Eliminated	75% Cut
<i>Supplemental Instruction</i>	36% Eliminated	72% Cut
<i>School Counseling</i>	35% Eliminated	68% Cut
<i>Gifted and Talented Education</i>	30% Eliminated	72% Cut
<i>Internship Program</i>	28% Eliminated	61% Cut
<i>Community Day Schools</i>	19% Eliminated	42% Cut
<i>Instructional Materials Fund</i>	18% Eliminated	63% Cut

In sum, because of deferrals, children are spending less time learning in schools that are also becoming more crowded, more understaffed, and more sparingly resourced.

²⁰ *Id.* at 26.

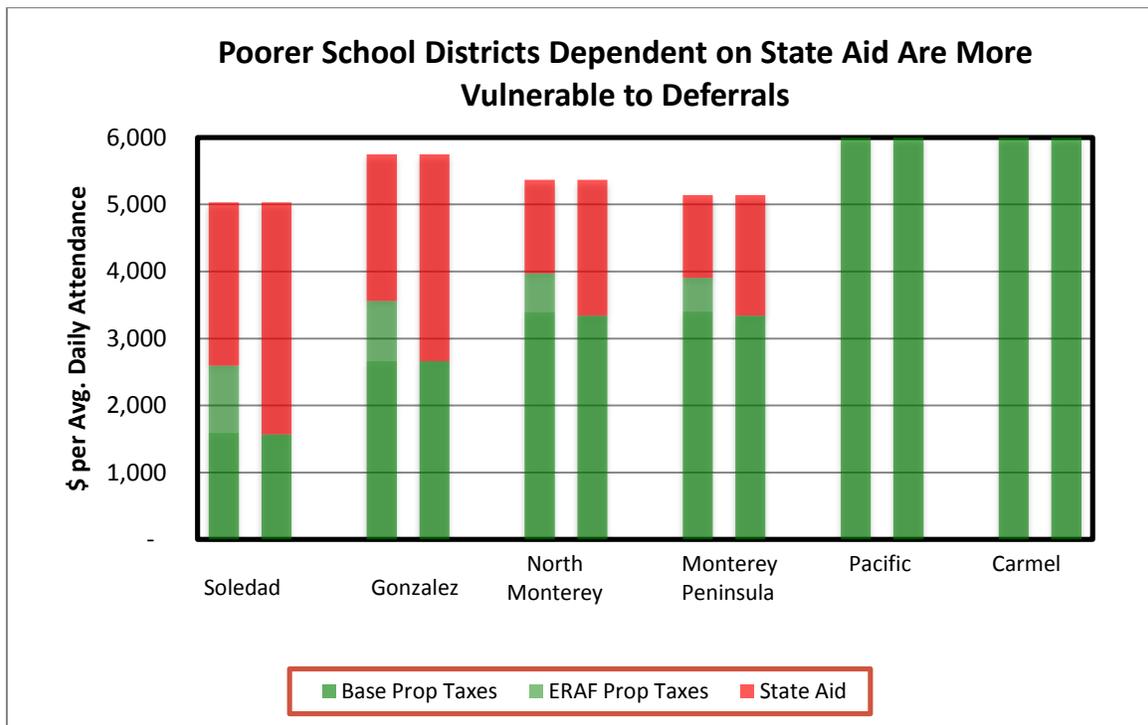
²¹ *Id.* at 23.

III. Harm Has Been Concentrated on Poorest Children in Vulnerable Communities

Two factors have concentrated the harms resulting from deferrals on poorer schools. First, poorer schools are more reliant on state funds, exposing them to the largest share of deferrals. This is because poor districts with low property tax bases collect money from Educational Revenue Augmentation Funds (“ERAF”) (derived from other local property taxes) and the State general fund to bolster their resources. When the State diverted ERAF to the VLF swap and Triple Flip backfills, the difference was made up with additional general funds—funds exposed to deferrals if the State so decided. By contrast, wealthy basic aid districts that rely on local property taxes alone are wholly insulated from deferrals because they collect no ERAF to begin with.

The effect is evident in the Figure 6 comparison of school districts in Monterey County. The wealthy Pacific Grove and Carmel districts, which collect no state aid, were not exposed to deferrals. By contrast, the poorer districts—Soledad and Gonzales—saw their share of state revenue increase, exposing them to a larger share of deferrals.

Figure 6: Poor Districts Dependent On State Aid Are Most Exposed to Deferrals²²

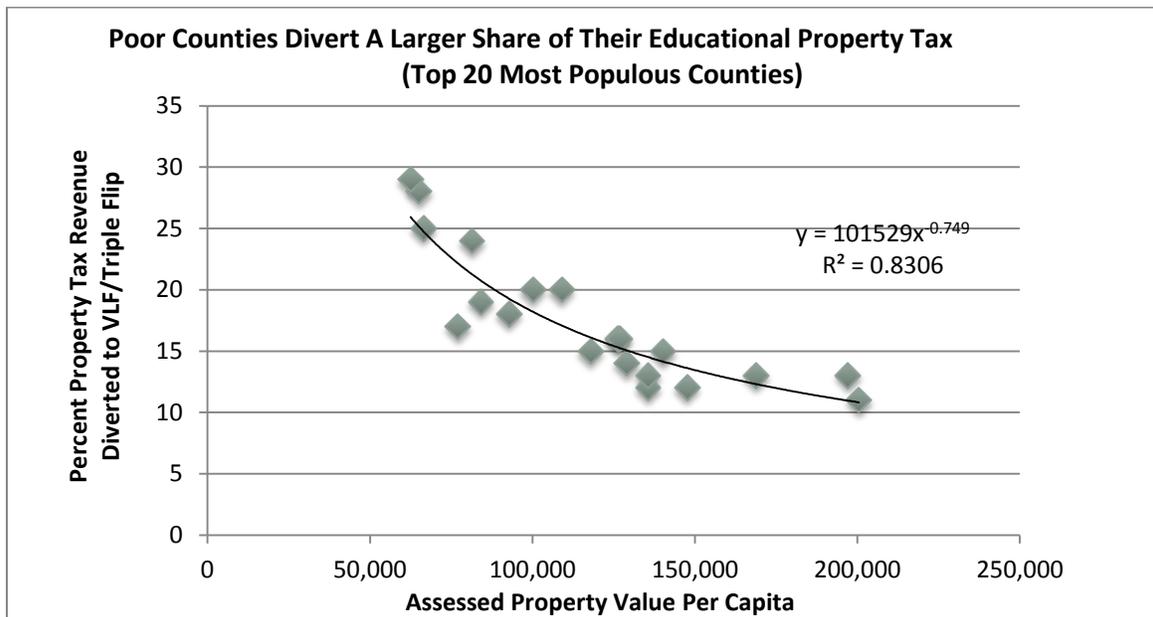


²² Data compiled from CALIFORNIA DEPARTMENT OF EDUCATION (<http://www.cde.ca.gov/ds/dd/>); ED-DATA, (<http://bit.ly/1kDjN4l>).

Second, the VLF swap replaced a percentage sales fee that raised larger sums from higher-end consumers, with a highly regressive Census apportioned per-capita assessment that harms high-population, low wealth counties. In California, Vehicle License Fees charge car-buyers a flat percentage fee of their vehicle purchase price. Wealthy persons purchasing expensive luxury cars thus pay more money in VLF than persons of moderate means purchasing less expensive cars. But when the VLF percentage was cut in 2004 and the State backfilled the lost revenue using educational dollars, it calculated the amount to be diverted from educational funds on a per-capita basis based on Census figures, not the actual purchase price of vehicles in that county.²³ In other words, money was taken from school districts based on how many people lived in the county, not how much money would have actually been raised from local vehicle purchases. This helped districts in low-population wealthy counties, which would have owed more backfill money if their obligation was calculated based on the price of vehicles sold locally. At the same time, it hurt districts in high-population poor counties because their obligations were calculated based on their high population, not their low-value vehicle purchases.

The result is that districts in low-wealth, high-population counties now divert more revenue to cities and counties relative to their total property tax value, while the schools in high-wealth low-population counties divert less revenue to counties relative to their total property tax value. Put another way, compared to the pre-2004 baseline, districts in poorer counties now have less property tax revenue than they did before.

Figure 7: The VLF Swap and Triple Flip Burden Poorer Counties More²⁴

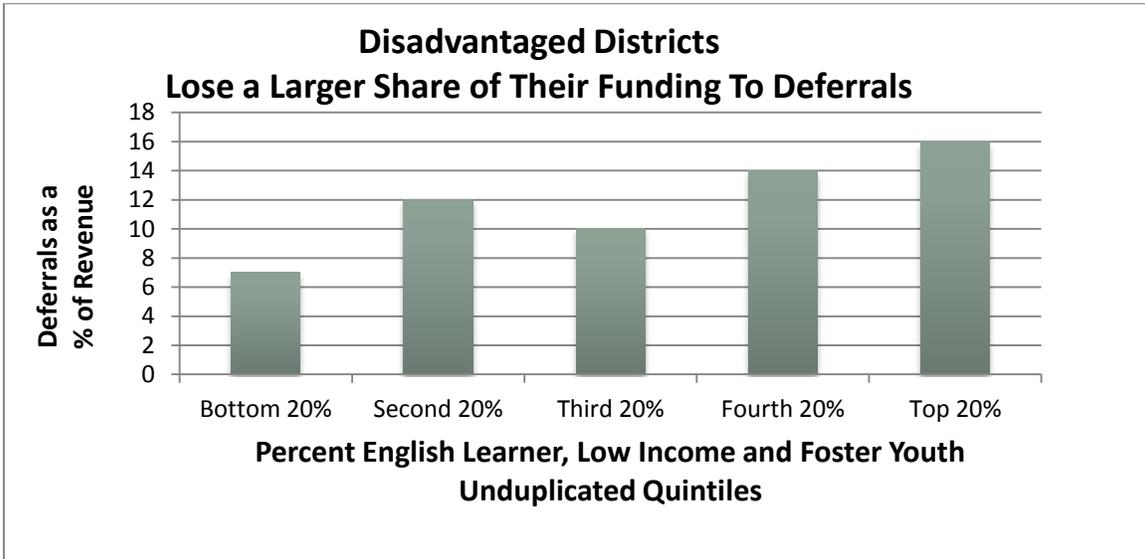


²³ It's unclear why the State used this formula. One possibility is that it serves as a simplifying mechanism, where population is used as a proxy for vehicle sale revenue.

²⁴ See *supra* n. 22.

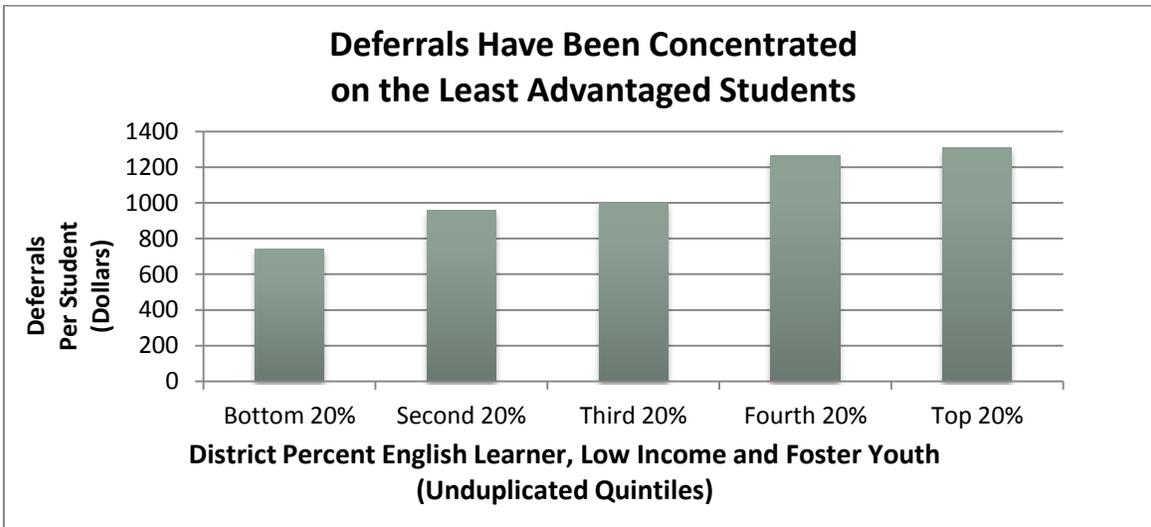
Consequently, when the State began deferring backfill to schools, it was the most disadvantaged school districts that lost the largest share of their funding. Figure 8 shows how the 20% of districts with the most English-learner, low-income, and foster children were deferred more than twice as much of their revenue (16%) as were the 20% of districts with the fewest of such children (7%).

Figure 8: Least Advantaged Districts Lose a Larger Share of Their Funding²⁵



Cumulatively, the effect on students is grim. Poor, minority, and foster children have absorbed nearly twice as many deferred dollars as their better-advantaged peers.

Figure 9: Deferrals Have Been Concentrated on the Least Advantaged Students²⁶



²⁵ See *supra* n. 22.

²⁶ See *supra* n. 22.

In fact, children in the 20% of districts with the most English-learner, low-income, and foster children absorbed 176% more deferrals (\$1,310.34 each) than their peers in the 20% of districts with the fewest of such children (\$742.72 each).

IV. Conclusion

The diversion of school-dedicated property taxes has tangibly affected the resources available to California school children. More important, because poor schools are more reliant on state funds and because the method for diverting tax funds falls more heavily on those districts and schools most reliant on state funds, poor children and their schools have been hurt the most.