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Vexing Questions: Will the Proposed Local Government Budget Agreement Help or Hinder Efforts to Improve the Fiscal Relationship Between the State and Local Governments?

In mid-May, the Governor reached agreement with the League of California Cities, California State Association of Counties, California Special Districts' Association, and California Redevelopment Association on a proposal that would provide the state \$1.3 billion in savings in both 2004-05 and in 2005-06 by reducing local revenues.¹ The agreement would, beginning in 2006-07, prohibit the state from diverting certain local revenues in order to achieve state savings; prohibit the state from changing the allocation of local revenues; make changes to state practices regarding reimbursements for state-mandated costs; and make other changes to the fiscal relationship between the state and local governments. The agreement would place a constitutional amendment and accompanying statutory language on the November 2004 ballot. In return, local governments would drop support of an initiative that will also appear on the November ballot.

The local government agreement raises a number of important policy considerations that warrant careful scrutiny and consideration.² The fundamental question posed by the agreement is whether the state and local governments should bear shared or separate responsibility for the totality of public services provided to Californians. Local governments argue that state and local government finances should be separate and that the state should not have the authority to divert local revenues to achieve state savings or policy goals. Critics respond that the fiscal relationship between the state and local governments will make it more difficult to reform a system that virtually all agree suffers from major flaws and inequities.

This paper briefly reviews the history of the fiscal relationship between the state and local governments, identifies several important policy considerations raised by the local government agreement, and outlines the basic provisions of the agreement.

History

In 1978, voters approved Proposition 13, which reduced local property tax revenues by more than half by capping rates at one percent and rolling back property values to 1975-76 levels. Proposition 13 also gave the Legislature responsibility for allocating the remaining proceeds of the property tax; limited reassessment of property for tax purposes to when a property changes hands; capped annual increases in property value to no more than two percent; imposed a two-thirds requirement for the Legislature

¹ Appendix A describes the mechanism for achieving the savings, see *Temporary Property Tax Shift and Property Tax – Vehicle License Fee Swap.*

² In this context, the term "local government" refers to counties, cities, special districts, and redevelopment agencies.

to enact a state tax increase; and required any special-purpose local tax to be approved by a two-thirds vote of the electorate.

In the wake of Proposition 13, the state stepped in and assumed a larger share of responsibility for financing education. In what became known as the AB 8 bailout, the state shifted property taxes from schools to cities, counties, and special districts in order to cushion the blow to these jurisdictions from the loss of property tax revenues due to Proposition 13.

Subsequently, voter-approved initiatives have further defined and confined the fiscal relationships among the state, education, and local governments. Proposition 98 of 1988, for example, established a guaranteed funding level for K – 14 education from combined state and local sources. Proposition 218 of 1996 required local governments to seek voter approval for any tax increase, among other changes.

After the AB 8 bailout, the structure for allocating local property tax revenues remained relatively constant until the state budget crisis of the early 1990s. In 1992 and again in 1993, the state shifted property tax dollars from cities, counties, and special districts to K – 14 education in order to reduce the state's costs under the Proposition 98 guarantee. Proposition 172 of 1993 partially backfilled counties and cities for lost property tax revenues with the proceeds of a ½-cent sales tax rate.

After the property tax shifts of the early 1990s, cities and schools had approximately the same share of property tax revenues as they received prior to the passage of Proposition 13. Counties received a smaller share and other districts received a larger share of the property tax dollar.³

In 1998, the Legislature reduced the Vehicle License Fee (VLF) rate, which had been 2.0 percent since 1948.⁴ Since proceeds of the VLF went to counties and cities, the Legislature agreed to backfill these jurisdictions for lost revenues. The original measure phased in a reduction in the VLF rate using a series of triggers tied to state revenue levels. In 2001, legislation made the 0.65 percent rate permanent, but retained a trigger that increased the VLF rate in the event the state lacked sufficient revenues to backfill counties and cities. The rate was increased in 2003 using this trigger; however, Governor Schwarzenegger reversed the increase on his first day in office.

In January 2004, Governor Schwarzenegger proposed a permanent transfer of \$1.3 billion in property tax revenues from counties, cities, and special districts to schools in order to generate state savings by reducing state education spending.⁵ In April 2004, a coalition of local government groups submitted signatures to place an initiative on the November ballot that would "lock in" local control over revenue streams, make changes to the state mandate process, and rescind any actions taken as part of the 2004-05 budget to reduce certain local revenues, including the local property tax. The current agreement reflects negotiations between the Administration and local government organizations over the Governor's January proposal and the local governments' initiative.

³ The larger share going to other districts largely represents a shift of revenues from counties to redevelopment agencies.

⁴ The VLF rate was originally 1.75 percent. See Senate Local Government Committee, *Three Budget Topics* (January 22, 2003). ⁵ This measure uses the term "education spending" to refer to spending subject to the Proposition 98 school spending guarantee.

The Local Government Agreement Would Force the State to Bear the Full Brunt of Future Budget Balancing Efforts

The local government agreement would allow the state to achieve \$1.3 billion in savings in both 2004-05 and in 2005-06 and then constitutionally prohibit similar actions in the future.⁶ In the event of future budget crises, this provision would increase the likelihood of reductions in areas of the state budget that are not covered by constitutional or other protection, such as higher education, most social services and health care programs, mental health, housing, environmental and resource programs, and public safety.⁷ Proposition 98's school funding guarantee would continue to establish a funding guarantee for K – 14 education, although education advocates argue that the agreement's protection of local revenues would increase pressures to suspend the Proposition 98 guarantee in bad budget years.⁸ Some transportation funds, such as gas tax proceeds, are constitutionally protected; other funds can be and have been diverted in recent years to help bridge the state's budget gap.

The agreement could also increase the state's school spending obligations. The Legislative Analyst notes that growth in local property tax revenues has outstripped that of the VLF, after taking into account the reduction in the VLF rate. Thus, the proposed swap of VLF backfill for property taxes will potentially increase state costs for education over time. The added costs could equal \$200 million in 2006-07 and would increase thereafter.⁹

The Local Government Agreement Would Severely Limit Efforts to Address Adverse Fiscal Incentives

In recent years, constituencies ranging from homebuilders to housing advocates to environmentalists have faulted current revenue allocation practices for encouraging local governments to seek sales taxgenerating retail development over housing or other forms of commercial activity, such as manufacturing. The preference for sales tax generating development is often called the "fiscalization of land use." Legislation aimed at addressing this issue has garnered broad support, but has stalled in the Legislature due to opposition from localities that would be "losers" as a result of changes to the current system.

The local government agreement would lock in the current allocation of sales and property tax revenues absent subsequent statewide voter approval. By doing so, the agreement would make it much more difficult, if not impossible, to change a system that is widely considered dysfunctional. Specifically, the Legislature would be barred from statutorily changing the allocation of sales tax dollars from a point of sale to a population-based system. This provision would apply both to statewide efforts to reform the allocation of sales and property taxes, as well as to efforts within an individual region.

⁶ As noted previously, these savings would be achieved by shifting property taxes from some local governments to schools in order to reduce the state's school spending obligations and by ending the VLF backfill payments.

⁷ Some health and social service programs are subject to federal matching requirements. The state could, in many instances, make deep cuts before reaching the minimum federal spending level and in other instances, the state could make reductions that would result in a loss of federal funds. Some correctional expenditures would be required under the state's "Three Strikes" initiative, although reductions could be made.

⁸ Proposition 98 contains a provision that allows the Legislature to spend less than the minimum funding guarantee by a twothirds vote; the proposed local government agreement has no such suspension provision.

⁹ Legislative Analyst's Office, An Assessment: Governor's Local Government Proposal (May 24, 2004), p. 11.

The Local Government Agreement Does Not Protect State Allocations for Locally-Administered Services

While the agreement protects property tax, sales tax, and VLF revenues, and reimbursements for statemandated costs, it does **not** protect allocations for programs that are the shared responsibility of the state and county governments, including a number of health, mental health, and social service programs. By reducing the number of options available for achieving savings in the event of future budget crises, the state could, and would likely be forced to, reduce funding for child protective services, CalWORKs, courts, adoptions assistance, In-Home Supportive Services, Medi-Cal, and other county-administered services. There is no guarantee that counties would make up for reduced support and considerable evidence suggests that counties are reluctant to backfill for loss of state support in many of these programs.

The Local Government Agreement Contains No Plan for Paying for the Wider Budget Gap That Would Emerge in 2006-07

The agreement would significantly increase state costs beginning in 2006-07 by constitutionally requiring the state to repay various loans and other obligations, while at the same time requiring an increase in education spending to reflect the end of the \$1.3 billion in temporary state savings. Constitutional protection would make it difficult, if not impossible, for the state to delay repayment even if state resources are not available to pay the added costs. Other agreements between the Governor and various constituencies, such as higher education, do not contain similar protections.

The Legislative Analyst estimates that the policies outlined in the Governor's May Revision, including the local government agreement, would leave the state facing a shortfall of \$8 billion in 2006-07. The local government agreement would contribute to the structural deficit by constitutionally guaranteeing local governments a larger share of the property tax to make up for the ending of the VLF backfill. The 2006-07 shortfall would also include the \$1.2 billion repayment of amounts owed counties and cities for 2003-04 VLF backfill and the gap would be increased for five years beginning in 2006-07 when the state would be required to pay off \$1.6 billion in deferred reimbursements to local governments for mandated costs. While these costs are currently considered obligations of the state, the agreement would limit the state's options for addressing the shortfall.

The Local Government Agreement Would Complicate Efforts to Remedy Inequities in the Current Allocation System

The local government agreement would lock in each local government's share of the property tax dollar.¹⁰ Each city, county, and special district would be guaranteed a future share of the local property tax at least as large as their January 1, 2004 share. The current system for allocating local property tax dollars generally follows the relative allocation in effect in 1978. Put another way, the share of property taxes dedicated to non-school purposes is roughly the same today as it was in 1978.¹¹ During the past 26 years, significant changes have occurred and there has been no attempt to address changes in demographics, need, or other factors. The post-Proposition 13 bailout and subsequent actions have largely frozen in place longstanding disparities. For example, individual counties' share of the property tax dollar varies significantly. Los Angeles County, for example, receives 24 percent of

¹⁰ The agreement would not prevent addressing inequities by reducing schools' share of the local property tax, although that would result in added state costs.

¹¹ Schools received 52 percent of the local property tax dollar in 1977-78 and in 2002-03. Cities, counties, and other districts share the remaining revenues.

the local property tax, while Orange County receives just 10 percent.¹² Similar disparities exist among cities. The local government agreement would make it difficult to remedy these disparities in the future. The agreement could also discourage mergers among special districts aimed at achieving greater efficiencies or discourage the elimination of districts that have outlived their original purposes. For example, a mosquito abatement district that currently serves a largely agricultural area may no longer be needed if that area becomes urbanized. The district would, however, be constitutionally entitled to its current share of property tax revenues absent statewide voter action.

The Local Government Agreement Does Not Provide Voters' the Ability to Shift Priorities at the Local Level

The proposed agreement does not provide either local voters or the Legislature the ability to shift dollars between jurisdictions in response to local concerns. For example, statewide voter approval would be needed to reduce the share of the local property tax dollar going to a water district, which has the ability to levy fees to cover their cost of services, in order to increase the share going to a library or police protection district with little or no fee-generating ability. This could increase pressure on local jurisdictions to raise taxes to support local services or, alternatively, increase pressure on the state to provide supplemental funding such as the state aid provided to libraries in recent years.

The Legislative Analyst notes that, "the measure does not provide any increase in local resident authority over local taxes. For example, local residents would continue to have virtually no authority over the allocation of local property taxes."¹³

The Legislature Would Lose Flexibility to Set Tax Rates

The local government agreement would cap the VLF tax rate at 0.65 percent effective January 1, 2005. In general, state tax rates are specified in statute, not in the Constitution and the Legislature retains the ability to increase the rate by a two-thirds vote. The proposed cap would prevent future Legislatures from increasing the rate absent voter approval. This provision would also repeal the "trigger" included in the 1998 law that reduced the VLF rate that provided a rate increase if the state lacked resources to backfill lost revenues. Moreover, the proposed agreement would prevent an increase in the VLF rate as part of a revenue neutral measure or as part of a measure that actually reduced state taxes. For example, the Legislature would be prevented from cutting the sales tax by \$5 billion, while increasing the VLF by \$4 billion.

Conclusion

There is broad consensus that the current fiscal relationship between the state and local governments doesn't work. There is less agreement on how to fix it. The agreement between local governments and the Governor would lock in the status quo and, beginning in 2006-07, prevent the state from diverting local revenues to achieve state savings or policy goals absent subsequent voter approval. This would make it more difficult to reform the fiscal relationship between the state and local governments and limit the options available to the Legislature for closing future budget gaps.

Local governments argue persuasively for the need to protect local governments' revenue stream from diversion by state lawmakers. Many of the tensions between the state and local governments are

¹² California State Board of Equalization, *2002-03 Annual Report* (2004). Alpine County, with no incorporated cities, receives 68 percent of the local property tax dollar. However, Mariposa County, where no property taxes go to cities, receives just 26 percent of the local property tax and similarly situated Trinity County receives 29 percent of the local property tax.

¹³ Legislative Analyst's Office, An Assessment: Governor's Local Government Proposal (May 24, 2004), p. 9.

rooted in reductions in local revenues sources, such as the property tax cuts enacted by Proposition 13 and more recent reductions in the VLF. The current state budget crisis has made it difficult for the state to mitigate the impact of these reductions, while limits on the revenue-raising authority of both the state and local governments further complicate efforts to enact reform.

While there is much that is worthy in the current proposal, there is also room for improvement, such as:

- Allowing for a suspension of the protection of local revenues, similar to the suspension provisions of Proposition 98.¹⁴ Suspension could provide for a return to the minimum funding level, while avoiding a repayment obligation that might impose hardships on unprotected areas of the budget.
- Similarly, the agreement should allow for the delay of the repayment of VLF and mandate obligations in the event the state faces a deficit in 2006-07, as is forecast, or during the specified repayment plan.¹⁵ Alternatively, the proposal could provide for a multi-year repayment of the VLF obligation, as proposed by the Legislative Analyst.
- Guaranteeing local governments as a whole a specified funding level, while not locking in the share of each jurisdiction. While this would still limit the Legislature's ability to respond to future budget crises, it would not preclude efforts to reform land use incentives or correct inequities in local revenue allocations. The Legislative Analyst recommends that "the Legislature consider policies that offer local fiscal protection, but still allow the Legislature and local residents to modify revenue sources and allocations…we recommend the Legislature consider policies that protect local revenue streams in the aggregate, yet maintain authority to alter these taxes and the allocation of these revenues among local governments."¹⁶

Jean Ross prepared this Budget Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. Support for the CBP comes from foundation grants, publications, and individual contributions.

¹⁴ Suspension of the Proposition 98 guarantee requires a two-thirds vote of the Legislature in a single-purpose bill.

¹⁵ The agreement constitutionally obligates the state to repay \$1.2 billion in VLF backfill payments owed to local governments no later than August 2006, and to repay approximately \$1.3 billion owed as reimbursements for state-mandated costs in five equal installments beginning in 2006-07.

¹⁶ Legislative Analyst's Office, An Assessment: Governor's Local Government Proposal (May 24, 2004), p. 10.

Appendix A

VLF Tax Rate

The agreement: Caps the Vehicle License Fee rate at 0.65 percent in the state Constitution effective January 1, 2005.¹⁷

Current law : Establishes the rate in statute. The current rate is 0.65 percent of the depreciated value of a vehicle. The rate was 2 percent from 1948 through 1998. Current law includes a trigger that increases the VLF rate if the state lacks sufficient funds to reimburse local governments for revenues lost as a result of the rate reductions enacted in 1998 and thereafter.

VLF Allocation

The agreement: Allocates the remaining proceeds of the VLF to maintain funding for the Local Revenue Fund. This fund supports program responsibilities transferred to counties in the 1991 realignment of responsibility for certain health, social service, and mental health programs. Cities would receive the remainder of the VLF.

Current law: The constitution allocates the VLF to cities and counties.¹⁸ The formula for allocating the proceeds of the VLF among jurisdictions and between general-purpose county and city revenues and realignment is established by statute.

Mandates

The agreement: The agreement would specify that cities, counties, and special districts must be annually reimbursed for the cost of any mandated services. Unreimbursed mandates would be repealed. Amounts appropriated by the Legislature to reimburse local governments for the cost of mandated services would be excluded from the Governor's line item veto authority. The agreement would repeal the existing provisions for processing mandate claims and reinstate new expedited procedures.

The state would be required to reimburse local governments amounts owed for mandates determined to exist prior to January 1, 2005, approximately \$1.6 billion, in five annual payments beginning in the 2006-07 fiscal year. This provision would apply to reimbursements deferred as part of recent years' budget agreements.

Current law: The state Constitution specifies that the state cannot, in general, require ("mandate") local governments to perform a new or higher level of service without providing reimbursement.¹⁹ Current law contains a small number of exemptions. However, current law does not establish a timeline for determining whether a mandate has been imposed and the state may delay reimbursements while leaving a mandate in place. The last several budget agreements have deferred reimbursements for a number of mandates.

¹⁷ The following analysis largely draws on the Legislative Analyst's publication, *An Assessment: Governor's Local Government Proposal* (May 24, 2004).

¹⁸ Section 15, Article XI of the California Constitution.

¹⁹ Section 6, Article XIIIB of the California Constitution.

Property Tax Allocation

The agreement: This proposal would constitutionally "lock in" each local government's share of local property tax proceeds as of January 1, 2004. The Legislature could not reallocate property tax revenues among jurisdictions or transfer revenues to any special fund without statewide voter approval. The Legislature could increase local governments' share of property taxes by shifting property tax dollars away from schools and community colleges to cities, counties, redevelopment agencies, or special districts.

Current law: Proposition 13 of 1978 capped the local property tax rate and gave the Legislature the authority to allocate property tax revenues by statute.

Temporary Property Tax Shift and Property Tax - Vehicle License Fee Swap

The agreement: The proposal makes a series of complex transactions aimed at generating \$1.3 billion in state savings in both 2004-05 and in 2005-06. State savings would be generated by ending VLF backfill payments and by transferring property tax revenues to schools and reducing the state's school funding obligation by an equal amount.²⁰ Specifically, the agreement would reduce city revenues by \$350 million; county revenues by \$350 million; redevelopment agency property tax revenues by \$250 million; and independent special district property tax revenues by \$350 million in each of 2004-05 and 2005-06.

The agreement would eliminate the VLF backfill and provide each city and county with property taxes equal to the jurisdiction's prior backfill payment. Property taxes would be shifted from schools and community colleges to cities and counties and the state would backfill education for lost revenues.

Each county's loss would be specified in legislation and would be generally based on population. Three small counties (Lassen, Trinity, and Del Norte) would receive proportionately smaller reductions. The city loss would be allocated one-third based on current VLF revenues; one-third based on property tax revenues; and one-third based on sales tax revenues.

The independent special district loss would be split between enterprise special districts, those that have fee-generating authority, and those that do not. Enterprise special districts would shift 40 percent of their property tax revenues to schools up to a statewide maximum of \$225 million. Nonenterprise districts would shift up to 25 percent of their property tax revenues up to a statewide total of \$125 million. Police, fire, health care, and library districts would be exempt from the shift. If the methodology outlined above fails to generate \$350 million, the shifts would be increased proportionately.

The redevelopment agency loss would be \$250 million. Half of the loss would be allocated based on an agencies' share of gross tax increment revenues, with the remaining half based on tax increment net of revenues passed through to other jurisdictions. If an agency did not have sufficient resources to make the allocated shift, the agency's parent city or county would be responsible for the contribution. Agencies would be allowed to borrow from their housing set aside funds to make the shift. Finally, the life of redevelopment areas would be extended.

²⁰₂₀₂₀ This document uses schools to refer to education entities covered by the Proposition 98 school funding guarantee, including local school districts, county offices of education, and community colleges.

Current law: Under current law, the state reimburses cities and counties for revenues lost as a result of the VLF rate reductions enacted during the late 1990s.

VLF Backfill Loan Protection

In 2003-04, the state did not fully reimburse counties and cities for revenues lost due to the reduction in the VLF rate. The difference between full reimbursement and amounts actually received, approximately \$1.2 billion, is treated as a loan to be repaid on or before August 15, 2006. This agreement would constitutionally require the state to repay the VLF backfill loan no later than August 15, 2006.

Sales Rate and Allocation

The agreement would constitutionally require the state to restore the ¼-cent sales tax rate used to repay the deficit reduction bonds authorized by Proposition 57 to counties and cities once the bonds have been repaid. It would also prohibit the state from changing the formula used to allocate the proceeds of the local sales tax. It specifically would not, however, preclude the state from changing the allocation of the local sales tax in a manner needed to participate in a multistate agreement, such as the Streamlined Sales Tax Project, which is designed to establish a mechanism for collecting sales tax attributable to electronic and mail order sales.

Miscellaneous Provisions

The proposed agreement would also:

- Hold individual jurisdictions harmless from any impact due to the complex series of transactions described above. In particular, the agreement protects so-called "basic aid" school districts from the loss of funds.
- Provide protection for Orange County, which pledged certain revenue streams affected by the various provisions of this agreement as security for debt.
- Establish a statutory framework for determining and reimbursing schools for costs mandated by the state.
- Adjust, in statute, the percentage of state General Fund revenues allocated to schools under "test 1" of the Proposition 98 school funding guarantee.
- Ratify the changes to the VLF depreciation schedule made in 1991.
- Expand the ability of local governments to borrow against the future receipt of revenues.
- Repeal the so-called "poison pill" that invalidates the 1991 realignment under certain circumstances.