Toward Fiscal Authority and Stability: *Power and Risk in California City Revenues*

by Michael Coleman and Michael G. Colantuono

Something is seriously out of sync in California. Many of its cities' revenue sources aren't well aligned with their communities' changing service demands. Diminishing local control over their finances and the unprecedented dominance of the state in local affairs has left city officials frustrated as they work to respond to the growing needs of their communities. When legislators do seek to reform the current system of state-local finance, they encounter hundreds of distrustful local officials and technical complexities in a situation where almost any change helps some communities and harms others.

Understanding the City Revenue Big Picture: Three Things To Keep in Mind

How sustainable are California city revenues? How much authority do local governments have to redesign their finances to meet changing needs? To answer these questions, it's important to understand a few critical characteristics of California city revenues today and their ability to support local services in the future. More specifically, for each type of revenue, there are three characteristics to consider:

1. The degree of local control and discretion, including:
   - Control of the tax *base* (who pays); and
   - Control of the tax *rate* (how much they pay).

Michael Coleman is principal of Coleman Advisory Services and fiscal consultant to the League. He is the owner of CaliforniaCity Finance.com, an information resource on California local government finance. Michael G. Colantuono is a shareholder in the Los Angeles law firm of Colantuono, Levin & Rozell, APC. He serves as city attorney of Barstow and La Habra Heights and is first vice president of the League's City Attorneys Department.

2. The degree of economic risk, including:
   - Sustainability (the capacity of the revenue to grow comparably to growth in service demands); and
   - Volatility (the level of year-to-year fluctuation).
3. The degree of political risk, defined as the vulnerability of revenues to appropriation or reallocation by the state or federal government, including the courts.

Local Control and Discretion: Rate, Base and Use

Our analysis of the degree of flexibility that local governments have in the design of revenue measures looks at the amount of choice permitted in:

- Setting the rate(s) level;
- Determining who pays and on what basis (the *base* of the revenue measure); and
- Using the revenues.

For example, in adopting user fees, cities have wide latitude to determine who should pay (that is to say, which services and programs to subsidize and which to fund via service fees), but rate *levels* are limited by the rule that they must not do more than cover the cost of the service. State law imposes further limitations in some areas, such as developer impact fees, and the sharing of credit risk on residential tenants between landlords and municipal utilities. Generally, fees must be used to fund the services or programs for which they are charged.

Economic Risk

Two aspects of the long-term stability of government revenue portfolios are sustainability and volatility, which are largely functions of economic factors.

Sustainability

A tax is best suited to fund programs where the demand for services changes in proportion to the proceeds of the tax. A "sustainable" revenue source provides sufficient revenue to cover service costs, even as service demands change over time. Services to people match up well with taxes that increase (or decrease) as the population changes. Services to property generally relate well to the overall upward trend of property tax revenues over time. Services to businesses correspond with proceeds from taxes on commercial activity, such as the sales and use tax and the business license tax (see Figure 1).

An important aspect of sustainability concerns whether the revenue source can provide enough reliable growth to cover service costs over time. The sustainability of a revenue source depends not only on its rate and base, but also on how the revenues are allocated among government agencies.

Volatility

Some revenue sources are more susceptible to economic fluctuations than others. Volatility is a measure of the degree of annual fluctuation from the average

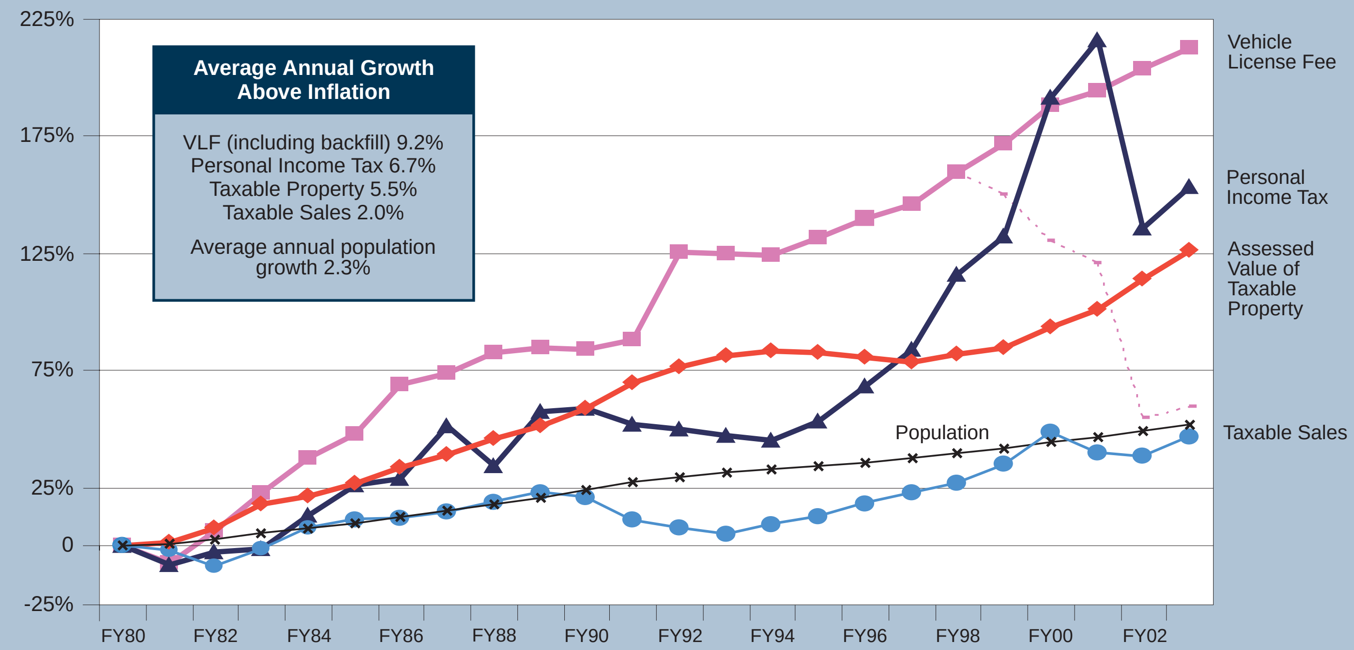
continued

Figure 1. How Sustainable Are Major City Revenues?
Other than raising rates, what factors influence city revenue collections?

City Revenue Source	Strongly Sensitive To:	Not Sensitive To:
Service Charges and User Fees	Service demand	Inflation (unless built into rate structure)
Sales & Use Tax (Bradley-Burns)	Taxable sales, inflation, commercial activity	Resident population
Property Tax	Real property values, sales	—
Vehicle License Fee	Resident population	Commercial activity
Utility User's Tax	Sales of utility services, population, commercial activity, utility rates, inflation	—
Business License Tax	Commercial activity, inflation[1]	Resident population
Transient Occupancy Tax	Hotel activity and rates, inflation	Resident population
Gas Tax	Resident population	Commercial activity
Local Assessments	Number of ratepayers	Inflation (unless built into rate structure)
Real Property Transfer Tax	Real estate sales, property values	—

1. Business License Taxes vary in design: Gross receipts-based taxes are sensitive to inflation; flat-rate taxes are not.

Figure 2. Growth in Major California Tax Bases Above/Below Inflation



Sources: Governor's Budget Summary, Board of Equalization, California Dept. of Finance

annual growth of a revenue source. Low volatility provides more predictability over time because the revenue maintains a more constant pattern of growth. But high volatility may be acceptable if:

- The source provides strong return in relation to service demand over time;

These problems are compounded by uncertainty in the state budget process.

- Sufficient reserves and use of one-time programming can be used to cushion the impacts of fluctuation; and
- The revenue budget contains a mix of other sources with different performance characteristics that mitigate the effects of fluctuations on the overall budget.

Figure 2 compares the volatility of city revenue sources.

Political Risk

Local revenue stability is also affected by the potential for the state or federal governments (or courts) to reduce the revenue, which we label "political risk."

Within the confines of the California Constitution, local home rule goes only as far as the state allows. Local government autonomy depends upon the delegation of authority through the state Constitution or statute. To the extent that this delegation of authority is accomplished by the state Constitution, the risk of state actions impacting local finances and powers is reduced (because the Constitution is more difficult to amend than ordinary state laws).

But incomplete constitutional protection is of limited value. In 1986, California voters amended the state Constitution to require that the proceeds from the Vehicle License Fee (VLF) be allocated to cities and counties. But the Legislature still determines the VLF rate, base and allocation among cities and counties. As this year's budget debate in Sacramento forcefully demonstrated, partial constitutional protection is not much protection at all.

Furthermore, certain bells cannot be unrung. Once a serious proposal is made to transfer a revenue stream on which local government has relied, the dependability of that revenue stream for long-range fiscal planning is significantly damaged for as long as the political memory of the debate remains. Orange County's solution to its bankruptcy included selling bonds — credit lent by the capital markets — backed by the county's share of VLF revenues. Those bonds found a market at a commercially reasonable price because Wall Street believed the revenue source was reliable and the bonds would be repaid. Should another California community seek to resolve a fiscal crisis on these terms following this year's VLF debate, those bonds may be more difficult to market and command a higher risk premium (and hence interest rate) as a result. Political risk means uncertainty, and in finance — whether public or private — uncertainty means at the very least higher costs and may mean complete frustration of important fiscal goals for a community.

California City Revenues: Local Authority and Risk

Figure 3 shows the major sources of revenue to California's cities and provides color-coded overall ratings for local authority/discretion, economic risk and political risk. Revenues are ordered from top to bottom, based on the total amount of revenue for each source collected by cities statewide. The figure is an indication of the complex combination of rules governing city revenues. It also allows some important observations.

California's current structure of local government finance is flawed. In many communities, it does not provide a sustainable base of revenue.

Local Authority and Political Risk

1. The rates and bases of the three largest sources of general-purpose revenues — the sales tax, property tax and VLF — are no longer under the control of the local agencies that rely upon them to fund essential services. As a result, these critical local revenues are subject to substantial political risk.
2. There is significantly more local authority with regard to other local taxes, such as the Utility User's Tax, (UUT), the Business License Tax and the Transient Occupancy (hotel) Tax. But these taxes require voter approval

continued

under Prop. 218 (Article XIII of the Constitution) and are subject to voter repeal or reduction under that same measure.

Economic Risk

1. Service charges and user fees, which are the largest single source of city revenue, track service demand closely and are generally not volatile. Assessments have similarly low risk. These sources, however, are subject to substantial legal constraints in their design (lawyers and engineers are often retained to help design these revenue sources) and are absolutely limited in the uses to which their proceeds can be put.

As this year's budget debate in Sacramento forcefully demonstrated, partial constitutional protection is not much protection at all.

2. The sales tax is somewhat volatile and does not match service demand as well as other resources. This is partly because the state-controlled tax base is not expanding commensurately with growth in population and inflation, and because non-taxed sales on the Internet and through catalogues are increasing. Social and economic change is undermining local government revenues because the complicated constraints imposed by the voter approval requirements of Props. 62 and 218 make it difficult for tax policies to change as rapidly as the economy.

3. A similar and troubling gap has developed between UUT ordinances and the dynamic realities of the telecommunications industry, creating distorting biases and unintended competitive advantages for "new" technologies at the expense of "old" services. The best example of this point is the cable television industry's current effort to secure state legislation to tax satellite-dish television providers commensurately with local utility taxes imposed on cable companies.

4. The property tax is generally more stable and dependable in its growth pattern and more closely matches municipal service costs. But while the property tax contributed 15 percent of city revenues in 1975, today it constitutes just 7 percent of California city revenues and no longer provides sufficient revenue to cover the full costs of property-related services.

5. Gas tax revenues are a state tax subvened to local governments and restricted by law to be spent on streets and roads. Local governments have no control of the rate or base of the gas tax and only limited discretion over how the funds are spent. Over time, fuel efficiency has risen in response to clean-air programs. But total vehicle miles traveled in the state have climbed enormously as housing is built ever farther from employment centers. These two trends have increased the need for road maintenance, while depressing the principal source of funding for that maintenance. Supplemental sales taxes adopted in many counties to fund road programs are slated to sunset over the course of the next few years. Due to the intervening adoption of Prop. 218 and judicial interpretations of Prop. 62, renewal of these taxes — many of which were adopted by simple electoral majorities — will require two-thirds voter approval, a daunting challenge. Given the importance of congestion relief to the California electorate and the substantial commercial support for transportation programs, legislation has been introduced to reduce this voter-approval requirement to 55 percent, but its future is uncertain.

6. Although they are quite politically vulnerable, VLF revenues are an economically stable resource. Because the VLF is allocated to cities in relation to population, it tracks favorably with the growth in local service demand related to residential development. Consequently, the increased political risk to city VLFs threatens to exacerbate California's persistent policy bias against the production of housing. Housing creates substantial service demand, but often provides inadequate city and county revenues to fund the services to meet that demand.

7. Depending on its structure, including which utilities are included in the tax base, the UUT can be quite volatile (especially as businesses tend to be large utility consumers and business activity rises and falls with the business cycle). But it tends to track closely with the degree of residential and commercial activity in the jurisdiction, which in turn relates well to municipal service demand. Despite the requirements of Props. 62 and 218 for voter approval of these taxes and the potential for their repeal or reduction by initiative, cities have more local authority and stability with the UUT than with other major sources of general revenue, including the property tax and sales tax.

Looking Ahead

In recent decades, local home rule in California has been substantially eroded, particularly in municipal fiscal affairs; our state has gone from a strong home rule state to the middle of the pack. Meanwhile, the state's economy and society are evolving, and finance officers are becoming increasingly concerned about the stability of city revenues. How will our mix of revenues weather economic ups and downs? Will these revenues grow in concert with increasing service demands? If our control of local revenues is more strictly limited, how can we influence our revenues to meet changing service demands?

California's current structure of local government finance is flawed. In many communities, it does not provide a

Figure 3. California City Revenues: Local Authority Discretion and Risk

Major categories of city revenues in decending order of value to cities statewide	Local Authority / Discretion[1]			Economic Risk		Political Risk
	Base (who pays)	Rate (amt paid)	Use (spending)	Volatility	Sustainability	Vulnerability
Service Charges and User Fees	yes	limited	limited	none[6]	very high[6]	none
Sales & Use Tax (Bradley-Burns)	no	limited	yes	medium	medium/varies	high
Property Tax	no	no[2]	yes	medium	high / varies	high
Vehicle License Fee	no	no[3]	yes	low	high(residential)	high
Utility User Tax	yes[4]	yes[4]	yes	medium	high	medium
Business License Tax	yes[4]	yes[4]	yes	high	high(commercial)	medium
Transient Occupancy (Hotel) Tax	yes[4]	yes[4]	yes	high	medium(visitors)	low
Gas Tax	no	no	limited	medium	high(residential)	medium
Local Assessments	limited[5]	limited[5]	limited	none[6]	very high	none
Franchises	yes	no	yes	high	high	low
Real Property Transfer Tax	no	no[7]	yes	medium	high(residential)	medium
Fines & Forfeitures	varies[8]	varies[8]	varies[8]	low	high	low

Color Ranking Legend

The colors are composite ratings of each category. The colors go from green to yellow to orange to red, with green being most desirable for city governance and red being least desirable for city governance.

Local Authority/Discretion	Economic Risk	Political Risk
Red – Little or none	Red – High	Red – High
Orange – Very little	Orange – Medium	Yellow – Medium
Yellow – Limited	Yellow – Some	Green – Low
Green – Good	Green – Low	

1. Source: Municipal Law Handbook,League of California Cities, [year]; City and County Statutorily Granted Tax Discretion, Manatt, Detwiler and Schaafsma,1995
2. With two-thirds voter approval, cities may increase rate to secure debt for acquisition of real property. Otherwise, local governments have no authority to alter the rate or allocation.
3. California Constitution, Article XI, section 15 requires VLF revenue to go to cities and counties, but state Legislature controls base, rate and allocation.
4. Voter approval required under California Constitution, Article XIIIC.
5. Ratepayer approval required. Base rate, use and approval procedures limited by statutes and/or by California Constitution, Article XIIID.
6. Service demands (expenses) rise and fall directly with revenues.
7. Charter cities may set any rate. For charter cities, this rating is "yes."
8. For base and rate control of state-imposed fines and forfeitures, this rating is "no." For base and rate control of locally imposed fines and forfeitures, this rating is "yes."

sustainable base of revenue. Over time, these cities will be forced to look for long-term tax increases, service cuts and land use decisions that may be inconsistent with their land use or other policy objectives.

These problems are compounded by uncertainty in the state budget process. Local governments face enormous difficulties in completing their budgets on time because city officials are constantly worried about state changes in local revenues, with state budgets that continue to run past the beginning of the new fiscal year.

The complexity of local finance baffles even its most dedicated students and practitioners, and confounds the taxpayers and service recipients who are expected to participate in our democratic process to affect tax policy. This complexity — and irrationality — has a significant distorting effect on our state's economy. Its rigidity promises to create an ever-growing gap between the reality of social and economic life in California and the carcass of a tax system created by past generations without any pretense of a rational strategy.

In recent years, many groups and individuals have studied problems of California state and local government finance. Numerous recommendations for reform have been made. These proposals must be examined and compared to determine whether they will improve local authority and discretion and foster fiscal stability. If we are to respond effectively to the changing needs and priorities of our communities, we must seek reforms that strengthen local authority and the stability and sustainability of local revenues.