DRAFT

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SUBJECT: **Unintended Consequences: AB1221 and Annexations**
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Urban growth frequently involves the annexation of an unincorporated land area into a city. The Cortese-Knox-Hertzberg Local Government Reorganization Act of 2000 requires a city and the county to agree to a property tax exchange agreement for an area to be annexed before the Local Agency Formation Commission (LAFCo) may approve the annexation.

AB1221 (Steinberg/Campbell) would change the mix of property tax and sales tax revenues for cities and counties. As such it has implications for these revenue sharing agreements. AB1221 would reduce the local sales tax by 0.5% per taxable dollar. In addition, the bill would establish new property tax apportionment rates based upon a base year circumstance of sales and use tax revenues cities and in unincorporated areas. The more sales and use tax revenues involved in the swap to property tax, the greater the additional property tax share the city or, in unincorporated areas, the county would receive.

Generally, unincorporated areas are rural and have lower sales tax revenues than incorporated areas. Consequently, in general, the revenue swaps under AB1221 is likely to be less substantial for unincorporated areas than in cities. This means in turn that the unincorporated tax rate areas will see less additional property tax apportionment for future growth of property tax revenue.

The intent of AB1221 is to encourage cities and counties to "make land use decisions based on the best interests of their communities and not simply based on what generates the most sales tax." This paper examines the effect of AB1221 on the fiscal impacts of development in annexation areas and concludes that in many areas, the bill as currently drafted would have precisely the opposite effect on land use decisions than its authors intend.

AB1221 and the Fiscalization of Land Use

A land use development project may contain a variety of uses including residential, commercial, industrial, etc. Local government service costs increase along with a land use development depending on the type and amount of development. Likewise local government revenues will increase along with the land use development depending – again – on the type and amount of development. The imbalance between new revenues and new service costs for differing types of development is at the heart of concerns over "the fiscalization of land use." The intention of AB1221 is to reduce the "over-incentive" for cities and counties to site retail sales generators and improve the incentive to site housing – especially affordable housing.

In my May 30 analysis of the effects of AB1221 on the city fiscal impacts of various types of development, I concluded:

1. AB1221 substantially reduces the surplus of revenues over costs for retail projects but leaves a comfortable net surplus.
2. AB1221 increases revenues for residential and non-retail commercial/industrial projects to

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varying degrees.

3. Even after AB1221 lower value residential projects, especially multifamily will show negative budget impacts in many cities.

AB1221 Property Tax Share Depends On Base Year Sales Tax Revenue

As I describe in previous analyses, AB1221 would swap half of the local Bradley Burns sales and use tax for greater shares of property tax to cities and counties. In the base year of the bill's implementation, the local Bradley Burns Sales and Use Tax rate for cities (and counties in unincorporated areas) would be reduced by 0.5% per taxable dollar. Each jurisdiction would receive property tax revenue equivalent to the reduction in local sales tax. Although it is not expressly provided in the bill, existing law and practice provides that property tax apportionment factors used to allocate the future growth of property tax revenue among local agencies would be increased to reflect this shift from ERAF to the city (or unincorporated county). In this way, the shifted revenues would grow over time.

Low Sales Tax Revenue Means Small Added Property Tax Share

As the May 30 analysis notes, in areas with comparatively very low sales tax revenues compared to the assessed value of the community, AB1221 would improve only the industrial scenario and worsen all other land use scenarios, *including residential*. The city garners half as much new sales tax revenue from purchases made in the city by the new residents. In areas with a small increase in property tax apportionment factor under AB1221, the additional property tax revenue is insufficient to make up for this loss. As a result, residential properties[1] result in a greater negative impact on the city budget than without AB1221. Meanwhile, even in these areas under AB1221, retail development would generate a reduced but still net positive budget impact on the city.

Notably, current standing annexation agreements among cities and counties call for the substantial portions of property tax revenue to be remitted to the county to mitigate county budget impacts of development. Given the reduction in sales tax revenues that an annexing city would garner under AB1221, an annexing city should get more property tax revenue than before AB1221. So these agreements would have to be revisited. But, because the loss of sales tax revenue from new development would exceed the revenue from the relatively small added property tax share in annexed areas, AB 1221 would result in cities and counties would left with <u>less net revenue among them</u> to cover the costs of city and county services to new development.

Most Unincorporated Areas Have Low Sales Tax Revenue[2]

Exhibit 1 shows the estimated additional AB8 apportionment share that county unincorporated areas would receive under the AB1221 swap. These estimates are based on the amount of unincorporated county sales tax revenue in each county as a percentage of unincorporated assessed valuation (net of exemptions and excluding assessed valuation subject to redevelopment tax increment). The exhibit excludes counties with no cities and the City/County of San Francisco. Due to data constraints, it also excludes counties with Revenue and Taxation Code Sec tion7200 city-county sales tax sharing agreements excluded.

[1] High value homes (not moderate or affordable) would be more likely to provide a net positive city fiscal impact.

[2] The essential comparative measure here is sales tax revenue (or half – per AB1221) as a percentage of unincorporated assessed valuation - net of exemptions and excluding assessed valuation subject to redevelopment tax increment.

The exhibit shows estimated AB8 factor changes ranging from 1.5% in Siskiyou County to 11.8% in the substantially more urbanized County of Sacramento. The next highest factor to Sacramento County is San Joaquin County with just 5.7%. The Los Angeles County estimate is just 3.3%, the median value among these counties.

Greater *Disincentives* to Housing Development

Exhibit 2A and Exhibit 2B show a project fiscal impact analysis for a hypothetical city annexation consisting of 5 acres. Property tax shares, service responsibilities and local tax rates vary among communities. Regardless, the overall effect of AB1221 is likely to be similar in nearly every county. That is, AB1221 worsens the fiscal impact on any city that may wish to annex and develop the area.

Of course, annexed areas involve a substantial portion of urban development. If AB1221 affects nearly all counties[3] in this way, then – as currently drafted – it will have a detrimental impact on a substantial portion of future housing development in California. The problem arises because, under the bill, future property tax revenue apportionments become highly dependent on past sales tax revenue patterns. AB1221 is more likely to improve the balance of municipal revenues and service costs in communities with substantial existing sales tax revenue compared to the assessed valuation of property. But in nearly all areas of the state, unincorporated areas will see only weak boosts in property tax share. AB1221 shifts away sales tax revenues from spending by new residents in these areas. For cities that would annex these areas, AB1221 actually means a greater disincentive to develop housing.

How Do We Fix This in AB1221?

The bill needs to increase the apportionment factors in all tax rate areas (including those for counties in unincorporated areas and those for cities in incorporated areas) by a minimum of 0.10 (e.g. from 0.25 to 0.35 etc.). It could accomplish this by

1. Shifting additional property tax revenues from ERAF in the base year sufficient to result in an apportionment factor change of at least 0.10; or
2. Requiring that AB8 apportionment factors be increased by at least 0.10 for every city and every county in unincorporated areas, regardless of the base year shift; or
3. Requiring additional property tax shift and apportionment factor adjustment for unincorporated tax rate areas upon annexation.

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Exhibits

1.0 Estimated Additional Property Tax Share Under AB1221 County Unincorporated Areas
2.0A Theoretical Comparison of Annual Costs and Revenues from a Development – Status Quo
2.0B Theoretical Comparison of Annual Costs and Revenues from a Development – After AB1221: 3.3% added PT share
2.0C Chart: Change in City Budget Impact of Annexation and Development under AB1221

[3] With the possible exception of Sacramento (due to its heavy existing urbanization and sales tax revenue in the unincorporated area) and San Francisco.

Theoretical Comparison of Annual Costs and Revenues from Different Development Proposals - Status Quo

	Hypothetical City Annexation			
	family Residential	Multi-family Residential	Industrial	Retail
Property Value [2]	8,125,000	14,250,000	2,500,000	7,500,000
Property Size (acres)	5	5	5	5
Retail Square footage per acre	-	-	-	10,000
Residential Units	25	95	n/a	n/a
Property Tax share of 1% [3]	11.0%	11.0%	11.0%	11.0%
Utility User Tax Rate [5]	2%	2%	2%	2%
CITY TAX REVENUE				
Property Tax Revenue	8,401	12,697	2,750	8,250
Sales Tax Revenue [4]	10,884	16,871	1,485	99,000
Utility User Tax [5]	3,968	6,031	6,388	4,106
Business License Tax [6]	-	665	2,250	1,063
Franchise Charges [7]	575	2,185	1,725	1,438
State Aid & other revenues [8]	4,697	16,542	69	206
TOTAL REVENUES	$ 28,524	$ 54,990	$ 14,666	$ 114,063
CITY EXPENDITURES				
Police Department	12,000	45,600	5,280	15,000
Fire Department	7,000	26,600	3,080	8,750
Public Works	3,375	12,825	2,970	8,438
Planning & Community Devl	900	3,420	792	2,250
Parks & Community Services	3,375	12,825	440	1,250
Library	1,875	7,125	-	-
General Government	3,425	13,015	1,518	4,313
TOTAL EXPENDITURES	$ 31,950	$ 121,410	$ 14,080	$ 40,000
NET	$ (3,426)	$ (66,420)	$ 586	$ 74,063
per unit	$ (137)	$ (699)		

NOTES

1. All revenue and expenditure estimates are based on a consensus of recent fiscal impact analyses, city budgets and reports to the state Controller.
2. Property values assume $325,000 per single family home, $150,000 per multi-family unit,
3. City property tax share is the average share of 1% property tax revenues paid in *non-redevelopment* areas. This rate differs from city to city depending on (among other things) the service responsibility of the city and the pre-Prop13 property tax rate.
4. Sales and use tax: retail project assumes 10,000 square feet of retail per acre with taxable sales of $240 per square foot, 75% of which is "new sales" (not moved intra-city). Tax rate to city is 1.025% of taxable sales (includes Bradley Burns and Prop 172). Residential project assumes 4% annual turnover (resale) of single family homes (2% for multi- family) times value
5. Some cities do not impose Utility User Taxes. Rates and applicability (e.g. electricity, gas,
6. Business License Tax estimated on DUE basis. Multifamily residential is assumed to be rental property. Assumes comparable rates similar to statewide average among these cities.
7. Franchise charge revenue at $23 per dwelling unit equivalent (DUE) and 1DUE/1000sf commercia
8. State subventions include per-capita based allocations such as MVLF, gas tax (residential only), HOPTR (residential), and Prop172 Public Safety Sales Tax. Also includes property
9. This city is a "full service city" including police, fire and library services.
10. Enterprise services such as water, sewer, and garbage are not included. These services are funded by user fees, such that costs equate to revenues.
11. Expenditure estimates are based on current statewide median values for full service urban cities corellated with a consensus of recent project fiscal impact analyses.

Theoretical Comparison of Annual Costs and Revenues from a Development - After AB1221: 3.3% added PT share

	Hypothetical City Annexation - With AB1221			
	family Residential	Multi-family Residential	Industrial	Retail
Property Value [2]	8,125,000	14,250,000	2,500,000	7,500,000
Property Size (acres)	5	5	5	5
Retail Square footage per acre	-	-	-	10,000
Residential Units	25	95	n/a	n/a
Property Tax share of 1% [3]	14.3%	14.3%	14.3%	14.3%
Utility User Tax Rate [5]	2%	2%	2%	2%
	-	-	-	-
CITY TAX REVENUE	-	-	-	-
Property Tax Revenue	10,922	16,506	3,575	10,725
Sales Tax Revenue [4]	5,442	8,435	743	49,500
Utility User Tax [5]	3,968	6,031	6,388	4,106
Business License Tax [6]	-	665	2,250	1,063
Franchise Charges [7]	575	2,185	1,725	1,438
State Aid & other revenues [8]	4,697	16,542	69	206
TOTAL REVENUES	$ 25,603	$ 50,364	$ 14,749	$ 67,038
CITY EXPENDITURES				
Police Department	12,000	45,600	5,280	15,000
Fire Department	7,000	26,600	3,080	8,750
Public Works	3,375	12,825	2,970	8,438
Planning & Community Devl	900	3,420	792	2,250
Parks & Community Services	3,375	12,825	440	1,250
Library	1,875	7,125	-	-
General Government	3,425	13,015	1,518	4,313
TOTAL EXPENDITURES	$ 31,950	$ 121,410	$ 14,080	$ 40,000
NET	$ (6,347)	$ (71,046)	$ 669	$ 27,038
per unit	$ (254)	$ (748)		
Change from status quo>>	- **$2,922**	- **$4,626**	+ **$83**	- **$47,025**

AB1221 <u>Worsens</u> City/County Fiscal Impact of Development in Annexed Areas