

Little Hoover Commission
Public Hearing: "Roadmap for Reform"
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It's a pleasure to be with you to discuss the challenging topic of reform of California's state and local government fiscal system. You've asked me to discuss challenges faced by other reform efforts. Clearly many of the obstacles to reform have to do with the policymaking process, conflicting interests of various individuals, and the inability of the need and desire for reform to overcome these concerns. I'll give you a few thoughts along those lines, but as a specialist in municipal finance, I will emphasize the need for better information and analysis, better understanding and consensus about revenue reform, and the dangers of unintended consequences. Please understand that my remarks today express my personal opinion, and are not necessarily those of my primary client, the League of California Cities.

Common Core Goals of California Local Fiscal Reform Proposals

Of course, efforts to improve our system of local governance and finance are old as the California republic itself. But in the last dozen years, there have been (by my count) more than two dozen different blue-ribbon commissions, academic studies, interest group task forces or position papers, in addition to numerous legislative hearings and proposals to consider these proposals and generate others. I find the following common goals in most of these efforts to improve California municipal governance and finance:

1. Enhance fiscal stability
 - a. Political: Constitutional protect local revenues from state legislative action
 - b. Economic: Improve the stability and diversity of local revenues
 - c. Structural: Improve the revenue base such that overall revenue growth keeps up with service demand and costs.
2. Improve local control, accountability and choice
 - a. Promote local discretion over revenues
 - b. Reform unfunded mandates
3. Align revenue allocations with service cost impacts
 - a. Land use development incentives should be in concert with state and local public policy objectives
4. Avoid harmful effects

This is a big fish and it seems to be swimming upstream. Over the last two decades, the most significant state legislative ventures into local government finance have been born out of state budget concerns. The legislature's cuts of local revenues have run directly contrary to the common core goals of local government fiscal reform. In particular, continuing shifts of city, county and special district property tax and cuts and threats to city and county vehicle license fee revenues have:

- o Reduced general purpose revenues, increased earmarked revenues.
- o Increased pressure for local tax increases with disparate results.
- o Increased the dependence of local government budgets on more volatile, less sustainable revenue sources.
- o Worsened the disincentive to develop moderate and low cost housing. Increased the incentive to compete with other jurisdictions for sales-tax generating commercial development.
- o Eroded intergovernmental trust and cooperation.

Political Obstacles to Local Fiscal Reform

Everyone's quick answer as to why so many reform proposals have gone such a short distance is to look to political obstacles. Indeed the task of local government fiscal reform involves hundreds of varied interests, each impacted uniquely. Major interest groups in this discussion are frequently internally divided. Most proposals would result in "winners and losers" over time.¹ Complicating matters, the fiscal impacts are frequently poorly understood or in dispute. When divided or uncertain, these interest groups tend to oppose or not to support reform proposals particularly in the current climate of local distrust of the state legislature and the specter of continuing raids on local revenues.

Sometimes Ideas Fail for Legitimate Reasons

Many proposals have met their demise in the political process for sound public policy reasons. After all, most of the ills in the current system that we now seek to cure are the result of usually unforeseen effects of some previous reform. Nearly every proposal from a blue-ribbon commission, academic study, or interest group is presented in concept. But you will rarely find an adequate, thorough analysis of the implementation and impacts of the concept. Assuming the concept isn't actually inherently flawed (and in view of some of these proposals I think that's a major assumption), perhaps it is reasonable for the more critical detail and analysis involved in making the law and the policy be completed where the laws are actually made: in the legislature. Then it should come as no surprise to anyone that the legislative process uncovers difficult, even fatal problems in the implementation and impacts of these proposals.

The Fiscal Implications of Most Proposals Are Not Well Understood

Even legislative efforts to consider reform proposals have lacked the essential fiscal analysis. The local revenue system is complicated and the implementation and effects of a revenue swap or reallocation proposal is always much more varied than the concept suggests. Analytical evaluation of these proposals has been very limited. Proponents and opponents may examine the budgetary impacts on individual local agencies and the state. But none have adequately evaluated: how the revenue swaps would be implemented given the existing system, and how well (if at all) the revenue swaps would achieve their goal (e.g. balancing fiscal incentives, reducing the "fiscalization of land use," etc.). Consequently both proponents and opponents of these proposals usually do not really understand the fiscal effects of their ideas, and most importantly, if the intended policy goals would really be met at all.

The most serious examples of this are with proposals which aim to address the "fiscalization of land use," to balance service costs with revenues through swapping or reallocating revenue sources. It seems evident that reducing the situs allocation of the local sales tax would reduce undue competition for taxable sales generating commercial development. There are many approaches. But in each case, the analysis consists of estimating how much money would be swapped or reallocated from each agency's annual budget, and perhaps a projection of budget impacts into the future. Apparently everyone assumes that making the reallocation will fix the problem or at least improve the situation. But rarely do those who propose these

¹ Ensuring that no individual local agency is negatively impacted would 1) cost the state an ongoing commitment of additional money to local government, and 2) probably contradict the effects and intents of the reform in some areas. Most major proposals have included constitutional protection of local revenues and a call for additional on-going state funding to local governments to mitigate the negative impacts of change. Examples include the Constitutional Revision Commission (1996), the California Governance Consensus Project (1999), Speaker Villaraigosa's Commission on State & Local Finance (2000), Commission on Governance for the 21st Century (2000), and the Legislative Analyst Office (2000). But proposals including additional on-going local government aid or constitutional protection of local revenues could not succeed in the Legislature even in years of state budget surplus.

reforms ever actually examine how the change would affect fiscal incentives related to land use development, the essential issue in the debate about the “fiscalization of land use.”

For example, I have conducted analyses of the effects of revenue swap proposals such as the AB1221 (Steinberg) ½ cent sales tax for property tax proposal, Bob Hertzberg’s VLF and sales tax for property tax swap on the balance of revenues and costs from new development. As currently designed, the swaps would actually WORSEN the disincentive for low and moderate residential development in some areas, and potentially increase the competition for taxable sales tax generators in others. I do not reject the basic concept of these sorts of swaps and reallocations. These problems might be reparable, but not without better vetting and some fundamental changes.

Some Concluding Thoughts

I’ve come to believe that the necessary foundation of fiscal reform must be the restoration of local revenue stability. That is, local officials need confidence that fiscal reform is not just another way to take their locally adopted revenues, leaving local officials to face their residents with service cuts or increased taxes.

Second, I believe the reform of local governance must focus not just on reallocation by the state of local revenue, but on removing the quarter-century old barriers to local choice. That is, reform should reduce the fragmentation of local governance and finance, reduce special purpose earmarking and providing greater flexibility for local elected policymakers to reallocate resources to reflect the changing needs and priorities of their constituents. Too many proposals have sought only to engineer a master solution from the Capitol instead of enhancing choice and flexibility at the local level.

Third, despite numerous studies and recommendations of reform groups over the last dozen years, the continuing actions of the state legislature and governor to shift local revenues (ERAF), defer mandate funding, and cut local taxes without reimbursement (the VLF backfill gap in FY 03-04) have contradicted the goals of local fiscal reform. This is not only because of the loss of local revenue, the local service impacts, the local tax impacts or the antipathy and distrust these actions cause. In selecting these particular local revenues, state policy makers have further distorted the balance of local revenues and local service costs and have worsened the “fiscalization of land use.”

Finally, as I continue to learn something new everyday, I am mindful of unintended consequences and saddened by both proponents and opponents of local government fiscal reform proposals whose fervor is based on misinformation or a lack of essential analysis. I’m hopeful that the greater trust and confidence that should come with constitutional protection of local revenues will improve our ability to study, listen, and understand before we advocate.

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For more resources on California local government fiscal reform see www.californiacityfinance.com/#REFORM