Municipal finance in California -- who would design such a system? As one peels back the many layers of the local government finance system and lays bare its many elements, it seems hopelessly complicated, internally inconsistent, and even nonsensical. The historic underpinnings of each element help us to see why things are done this way. But the fact is that this is not a system that was designed in an integrated, comprehensive way. Rather, it reflects the complexity of the populace it serves and their conflicting goals and interests. It is a product of an evolving society with changing needs, technologies, challenges and opinions. It is a compendium over time of tweaks, changes and “reforms.”

What is Reform?

There have been numerous efforts to reform various aspects of the California’s state and local governance and finance structure. Each of these has begun as an attempt to address a problem but with diverse participants that view the problem from different, often conflicting, perspectives.

Reform efforts have been aimed at a wide variety of issues related to local government finance and governance including:

- Urban sprawl, restore vitality to center cities and older suburbs.
- Transit and pedestrian systems.
- Affordable housing.
- Declining main street business areas versus malls and big box retail
- Open space and natural resources and amenities.
- Agricultural land preservation
- Shifts of local revenue by the state
- Unfunded mandates on local government
- Inequities among communities
- Antiquated revenue structures out of sync with social, technical and economic changes.
- The decline of discretionary local revenue.
• Too many local agencies, especially special districts – need for consolidation.
• Fragmentation and inequity in local property tax shares.
• Declining public infrastructure: roads, water systems, sewer systems, drainage, flood control, parks, etc.
• Unsustainable costs of excessive public pensions.
• Supermajority vote requirements.

Local Government Finance and Governance: Reform Efforts

Any proposal to change some aspect of the system might be considered “reform” by its supporters. But there have been a number of concerted efforts to examine some widely acknowledged problems with state and local governance and finance in California and to propose reforms. These have come from a variety of institutions, each with differing and particular leanings, objectives and approaches. Some have come from policy think tanks such as the non-partisan Legislative Analyst’s Office, the Little Hoover Commission or the Public Policy Institute of California. Some have come from stakeholder groups such as the League of California Cities or the California State Association of Counties. Some have been the product of blue ribbon commissions established by the Legislature such as the Constitutional Revision Commission (1996) or the Speaker’s Commission on State and Local Government Finance (1999). Some have come from non-profit groups established for the purpose of studying and enacting reform such as California Forward.

Reform has meant different things to each of these groups and often to the participants as well. Although it touched on issues of local finance, the 1997-2000 Commission on Local Governance for the 21st Century established by then Assembly Speaker Robert Hertzberg, for instance, was focused on examining the laws governing city, county and special district boundary changes. The Commission on the 21st Century Economy (2008-2009), whose members were appointed by the Governor and legislative leaders, was charged with examining the state system of taxation. In so doing some discussion of the local taxation system was necessary – but the concern of the commission was focused on the stability and fairness of state revenues.

Given their diverse origins, different emphases, and the unavoidable biases of participants, reform efforts often have not entailed a thoughtful review of the local government landscape and its flaws. Consequently, the proposals of these groups often do not address many of the local issues, and may even complicate them.
Challenges to Reform

Everyone’s quick answer as to why so many reform proposals have done so little is “political obstacles.” Indeed the task of local government fiscal reform involves hundreds of varied interests, each impacted uniquely. Major interest groups in any discussion of change are frequently internally divided.

Cities, counties and special districts vary, not only in size, populations and underlying economies, but in the character, needs and desires of their residents and in their service responsibilities – all of which are reflected in different financial situations and dependencies. Most reform measures, therefore, would result in both “winners” and “losers.”

Mindful of this inherent reality, many proposals have suggested that the State provide funding to mitigate the financial losses of any losers at the local level. The result is that such proposals may ensure that no individual local agency is negatively impacted by a change, but it would also mean an ongoing commitment of additional money to local government by the State. Also, by eliminating the “losers” under any reform, the proposal is likely to contradict the intents, and actual effects, of reform itself -- at least in part. Most major local finance reform 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), the assembly speaker’s Commission on State & Local Finance (2000), the 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.
Complicating matters, the fiscal impacts are frequently poorly understood or in dispute. When uncertain, interest groups tend to oppose reform proposals, particularly in the current climate of local distrust of the state legislature and the specter of continuing raids on local revenues.

But sometimes ideas fail for legitimate 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 an adequate, thorough analysis of the implementation and impacts of the concept, particularly as it would extend over time, is rare. It should come as no surprise, then, that the legislative process uncovers difficult, even fatal problems in the reform proposal.

Common Flaws in Reform Efforts

Many of the reform efforts of blue ribbon commissions, think tanks and others, have produced disappointing products and had little success. The reasons for this are telling for future reformists:

- **Poor problem definition.** Blue ribbon commissions have typically featured a series of hearings by interested parties. But they often have failed to carefully and accurately define the problem which they are addressing. In the worst case, they plunge into solutions without understanding and clearly defining the problem. Some have had trouble reconciling very different views and agendas among members. The better efforts have had expert staff and have taken the time to build a consensus around a common and accurate understanding of the problem before launching into talks of “reform.”

- **Solutions not analyzed as to the effect on the problem.** Even if the problem is well defined, the solutions are not always as obvious as some people think they are. Some reformists leap to a favored solution – perhaps one that seems to address their favorite part of the problem – and then seek justification to support that solution. But these conceptual solutions are usually not analyzed to determine if they would really work; success is often just assumed.

The local revenue system is complicated and the implementation and effects of, for example, a revenue swap or reallocation proposal are always much more complex than the concept suggests. Analytical evaluation of these proposals has been very limited. For example, questions like 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 and reducing the “fiscalization of land use,” etc.) are not objectively analyzed. Consequently both proponents and opponents of these reform 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. For example, it seems evident that changing allocation of the local sales tax based solely on where the sale takes place would reduce undue competition for commercial development - and many such approaches have been considered. But in each case, the analysis has consisted 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 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, an analysis of the effects of revenue swap proposals such as AB1221 (2003) that would have exchanged ½ cent sales tax for property tax, or a similar proposal to reduce local reliance on VLF and sales tax in exchange for a greater share of the property tax, shows that the swaps would have 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. But the proponents of these proposals never conducted an analysis looking at the changed city revenue/cost impacts of development scenarios under their reforms.

The State-Local Relationship
Since Proposition 13: A Rough Road
Defining the Problem: Local Government Finance and Governance

Improvement requires a sufficient and accurate understanding of the problem. There are four primary areas of California’s local governance and finance system that need reform. These four problem areas emerge among the most well considered themes among the studies and reform efforts that have examined California local government governance and finance.

1. State actions threaten local revenues, imperil critical local public services

Major changes to local finance have usually been the product of ulterior motives, in the last 35 years particularly those of the state Legislature and Governor to remedy the state’s fiscal woes. The disappearance of may state subventions during the 1980s, the ERAF property tax shifts that began in the early 1990s, the realignment of state health and welfare programs to counties, the sales tax triple flip (2004), the property tax – VLF swap (2004), the gas tax swap (2009) … were all born out of efforts to solve state budget shortfalls. But when the prime objective is solving a state budget problem rather than improving local finance, the “reform” may have negative consequences for local public services.

The legislature’s cuts of local revenues have run directly contrary to the common core goals of local government fiscal reform. In particular, shifts of local city, county and special district revenues have:

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

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Over the last decade in particular, local governments have responded aggressively, seeking and obtaining voter approval for constitutional protection of local revenues and strengthening of prohibitions against unfunded mandates.

2. **The current design of many local revenue sources is out-of-step with technological and social changes.**

   The sustainability of some local revenues is threatened as social and technical changes result in reductions in the tax base. Tax structures designed many decades ago for different social, technical and economic situations fall out of sync with today’s world, and efforts to modernize the law to keep up run into voter-imposed tax approval procedures and other limits.

   The second largest source of discretionary tax revenue for cities and counties is the sales tax. Sales tax revenue is also the second largest source of revenue to the state general fund, providing over 30 percent of those discretionary monies. But, unlike most states, California taxes only the sale of tangible goods, not services. Since the growth in the California economy over the last half century has been primarily in the service sector, taxable sales in California have not kept up with the combined growth in inflation and population.

   Other aspects of the state and local tax system have not kept up with social and technical changes. Most utility user taxes on telecommunications were crafted at a time of wired land lines and billing based on time and distance. With wireless technology, flat rate bundled services, and prepaid phone cards, many utility user taxes are antiquated and have needed new wording to keep the taxes applicable to the new technologies and practices. Because of the Proposition 218 tax rules, these updates typically require voter approval even if rates are not increased.

   State and federal Motor Vehicle Fuel Taxes (also known as Highway User Taxes) are based on an amount per gallon with no adjustment for inflation. Consequently, even as the use of streets and roads increases, revenues from these taxes fall behind the consumer price index and decline with better gasoline efficiency.

   The internet has affected the taxability of some sales transactions. It has also re-made economic sectors, such that tax and fee rules adopted in the past are largely outmoded. When on-line travel companies, for example, collect the *full* hotel tax rate (“transient occupancy tax”) on the rate paid for a booking, they...
only pass on the portion related to the *wholesale* rate to the local hotel (who then pays the city or county), and retain the difference as a processing charge. This adds up over time to significant reductions in local TOT.

3. **The decline of local revenue authority to fund core tax supported services, especially police, fire, libraries, parks, planning, streets and roads.**
   - Voters can’t increase property tax above 1% (except GO bonded debt with 2/3)
   - Two-thirds supermajority for special taxes

California’s unique initiative process has produced strict limitations on local government’s ability to raise revenues. A collection of voter approved statewide measures, most amending the state constitution, including Proposition 13 (1978), Proposition 62 (1986), Proposition 218 (1996) and Proposition 26 (2010) have:
   - Removed the ability of locally elected officials to increase taxes without voter approval.
   - Removed the ability of local agencies to increase the ad valorem property tax rate, even with voter approval.
   - Established new limits and procedures on the imposition of property related assessments, property related fees, and regulatory fees.

At the same time, assistance from the state and federal governments has declined and discretionary subventions from the state and federal governments have disappeared. The remaining state and federal assistance comes with spending restrictions and often with additional program mandates.

4. **Lack of local control of local property tax allocation**
   - Fragmented property tax $ and governance among overlapping agencies
   - Allocations out of step with current needs & priorities

The loss of local control over the property tax has resulted in allocations that are fragmented, inconsistent and outdated. Property tax shares are based mostly on the decisions and needs of cities, counties and special districts 35 years ago and do not necessarily reflect the modern needs and priorities of communities. The authority to adjust local property tax shares rests with a state Legislature that is ill suited to determine the relative needs for limited tax resources in specific communities (and is not vested with that authority traditionally). Moreover, in some areas, portions of the limited property tax subsidize commodity-based special district enterprises (water, solid waste collection, etc.) that should, in most cases, be fully funded by user fees.
5. The disconnect between service costs and ongoing revenues with certain types of land uses impairs balanced planning.

California municipalities have very little control over the two largest sources of general fund revenues: property tax and sales tax. The state, not local governments, controls the tax rate, tax base, and allocation of revenues. The state constitution prohibits an increase in the property tax rate above 1% - except with two-third voter approval for general obligation bonds. Reluctant to increase tax and fee rates, local policy makers search for other ways to fund growing service costs.

Some localities have found that a way to increase municipal revenues is to pursue land use development that generates a net gain of municipal revenues versus increased service costs. This phenomenon, which is not unique to California, has been labeled the “fiscalization of land use.” It is a valid and responsible practice to analyze and consider the effect of a land use development proposal on public service needs together with the revenue impacts of the proposal. Land use planners should examine how governments will provide and finance urban development. But the current structure of municipal revenues and service responsibilities tends to incentivize certain land use types and discourage others.

In particular, land uses that generate substantial increases in taxable sales usually generate a substantial surplus of additional revenues compared to added service costs, thus providing a strong incentive to municipalities to sway land use decision-making over other land uses. In contrast, lower cost housing development often does not provide adequate additional municipal revenues to support the added service costs it brings.

Due to reduced state and federal assistance and voter imposed tax and fee raising limitations over the last 30 years, California municipalities have become increasingly reliant on sales tax revenue for discretionary funding and have often sought to increase those revenues through land use decision making.  ii

6. The costs of some local government pensions and other post employment benefit levels are unsustainable.

Governor Schwarzenegger and the legislature made major changes in state employee pension benefits in 2010. They lowered pension benefit levels that would apply to future hires, but all state employees, regardless of when they started their jobs, will be required to contribute more towards their pension plans in the future. Local agencies throughout the state are negotiating similar changes with their employees.
The changes are urgently warranted. Over the last 20 years, public pension and retiree health benefit costs, especially for corrections, police and fire employees, have become so generous as to be financially unsustainable. California faces huge retirement liabilities and rising retirement costs at both the state and local levels. Most state and local governments also face substantial OPEB liabilities -- with no plan to address them.

The problem of public pensions and other post employment benefits may be the largest fiscal problem facing state and local governments. But in many ways, there are fewer barriers to public pension and OPEB reform than the other fiscal problems in California local government finance. There are no constitutional barriers, no voter approval requirements in most jurisdictions, and few conflicts with other objectives. Moreover, there is wide and growing public awareness of the problem and sentiment in favor of reform.

**Principles of Local Government Fiscal Reform**

Assuming we understand the problems, in what direction should our proposed improvements to the system take us? It’s one thing to identify something that isn’t working. The next step is to orient our thinking toward what would be better. The following four principles help to ground and guide proposed solutions:

- seek greater fiscal stability and local choice
- better match local government revenues with local public service costs
- improve transparency and simplicity to residents, taxpayers and customers
- avoid harmful effects on individual agencies and groups

1. **Enhancing Fiscal Stability and Local Choice.** The efficient and effective delivery of public services requires reasonable durability and stability of fiscal resources. It also requires flexibility for local policy makers to make choices, including the reallocation of resources to meet changing needs. Improvements to the local fiscal system should:

   - Increase “local control,” the ability of local governments to respond effectively and efficiently to municipal service priorities and needs of their residents, homeowners, businesses and civic institutions.
• Stabilize and protect local government revenues and prevent mandated responsibilities from capricious actions by the state.
• Improve the efficiency, effectiveness and responsiveness of local government by consolidating finances, roles and responsibilities and increasing the ability of cities and counties to decide the allocation of municipal revenues, and how and what municipal services are provided.
• Provide sufficient fiscal resources to underfunded local governments.
• Enable and encourage intergovernmental cooperation, consolidation and improvement.
• Establish a local fiscal system that is sustainable, and that can respond to evolving economic conditions and local public service needs.

2. **Matching Local Government Revenues with Local Public Service Costs.** When the demand for local public services expands due to development and population growth, local fiscal resources need to grow in tandem. Improvements to the fiscal system should:

• Provide a responsive palate of revenues that grows concomitantly with service demand so as to minimize the need for restructuring or tax increases except to enhance service levels.
• Provide sensible incentives for the development of desired land uses that may not generate high revenues, such as affordable housing or open spaces.
• Avoid incentives that encourage cities and counties to overemphasize certain land uses, such as retail development, at the cost of well-balanced communities.
• Consider tax deductibility, so that the structure of taxes causes the federal government to shoulder a greater share of public service costs and provide tax relief and/or service improvements.

3. **Improving Transparency and Simplicity to Residents, Taxpayers and Customers.** The local fiscal system is extremely complicated. Unnecessary complexity wastes resources and creates distrust among residents and stakeholders. Improvements to the fiscal system should:

• Enhance the transparency of where taxes, fees and other funds are allocated and spent, making the system more understandable, accessible and less complicated.
• Minimize administrative bureaucracy and costs while providing sufficient systems to assure accountability and measure performance in order to maximize the efficiency and effectiveness of public service delivery.
4. **Avoiding Harmful Effects on Individual Agencies and Groups.** In almost any fundamental change to the local fiscal system there will be some agencies and individuals that will be better off and some that will be worse off than they would have been. This is the “winners and losers” challenge of reform. Improvements to the fiscal system should endeavor to minimize or mitigate the impact of changes on institutions and individuals.

California communities and the public agencies that serve them are diverse in service needs, in philosophy, and in the structure of their finances. Changes to the system should allow for local flexibility and choice and avoid one size fits all solutions.

**Some Prescriptions for Reform**

Based on the diagnoses above, here are some possible remedies that might actually work. Much of this medicine is bad-tasting. It will displease some people. It may seem politically impossible. But if any of these were easy they’d have been done by now.

1. **De-fragment local property taxes and governance.**

**Illness:** The property tax is too fragmented among too many local governments and no one at the local level has sufficient authority to reallocate these shares to more efficiently reflect the needs of contemporary communities. This is the largest area of fiscal waste, misallocation and inequity in California local government.

**Remedy:** Define local governments’ responsibilities and grant local governments the authority to control certain local revenues at levels sufficient to meet those responsibilities. Property tax revenue should be allocated among cities, counties and schools only. Consolidate all property tax shares attributable to city functions within each city to the city along with the responsibility for those functions and the choice to contract back to special purpose agencies. Consolidate all property tax shares attributable to county functions to each county along with the responsibility for those functions and the choice to contract back to special purpose agencies. Special Districts could continue as service providers under contract to general purpose agencies (cities and counties). Consolidate all school property tax shares within each county and allocate to districts by ADA.
2. **Allocate sales and use tax pools on population.**

**Illness:** Too much of the sales and use tax is allocated on a situs basis contributing to competition among municipalities for certain land uses and sometimes skewing land use decisions.

**Remedies:** Use tax revenues that are currently pooled and then allocated at the statewide and regional level in proportion to situs taxable sales, should instead be allocated in proportion to population. This allocate more revenues on the basis of where people reside (with their commensurate service demands) and more closely match revenue allocations with the costs of services. Analyses show that it is important to allocate most sales tax according to the situs rule in order to balance new revenues with the new costs of commercial development, but by allocating use tax pools on population, fiscal incentives for affordable residential development are improved.

3. **Broaden the sales tax base to cover services commonly taxed in other states.**

**Illness:** California sales tax revenues are not keeping up with population and inflation growth. California has comparatively high sales tax rate and narrow base (services are exempt) resulting in a volatile, declining resource.

**Remedy:** Broaden the sales tax base to include some services.

4. **Close Sales and Use Tax and Property Tax loopholes / eliminate unwarranted exemptions.**

**Illness:** Exemptions for sales tax and property taxes are tax expenditures, programs in which the state and local governments forgo revenue for a public purpose. Many of these tax expenditures persist for years and years without any evaluation of their value or effectiveness, costing governments and taxpayers millions.

**Remedy:** Tax expenditures should be routinely sunset and periodically reviewed. These programs should be eliminated if they are infective or unwarranted.
5. **Allow voters the choice to increase ad valorem property taxes.**

**Illness:** The ad valorem property tax is the only tax for which California voters are constitutionally denied the right to vote an increase.

**Remedy:** Change California Constitution Article XIII to allow cities, counties and schools to submit proposals before their voters to increase local property taxes for general purposes (majority approval) or specific purposes (55% approval). The maximum composite rate and amount of increase could be limited in statute. The ad valorem property tax is the only tax for which voters are denied the right to vote in California.

6. **Reduce the vote threshold for the increase or extension of a special tax or parcel tax for city, county or schools to 55%.**

**Illness:** The two-thirds vote requirement for special taxes is unreasonable and denies voters local choice. Some higher vote threshold discourages earmarked taxes and budget fragmentation.

**Remedy:** Change California Constitution Article XIII to allow cities, counties and schools to submit proposals.

7. **Reassess all commercial property at market value.**

**Illness:** Commercial property transfers often do not trigger Proposition 13 re-benching of assessed valuation to market value. As a result, residential property has shouldered a greater and greater portion of the property taxes paid.

**Remedy:** Require periodic reassessment of commercial property to full market value regardless of change of ownership.

**Conclusion**

In order to govern effectively, to provide the most efficient public services, 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. Consequently, the necessary
foundation of fiscal reform must be the restoration of local revenue stability: the protection of local revenues from capricious actions of the State. 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 have contradicted the goals of local fiscal reform. These actions have cut local revenue, local services, and created distrust. But more importantly, state policy makers, mindful only of their budget problem and not of the local fiscal system effects, have further distorted the balance of local revenues and local service costs and have worsened the “fiscalization” of land use.

Over the last decade, the voters have approved several constitutional measures preventing the state from taking, shifting, borrowing or delaying local revenues. Nevertheless, the state’s fiscal situation is still dire and ideas to redirect local revenues – whether legal or not - are still emerging in the capital.

But the reform of local governance and finance must focus not just on reallocation of local revenue by the State, but also 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 choice and 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.

NOTES

i For more discussion of various reform proposals, links to the reports and critiques, see the California Local Government Finance Almanac at www.CaliforniaCityFinance.com

ii The term “fiscalization of land use” was first used to describe the skewing of land use decisions by fiscal impact considerations by Dean J. Misczynski (1986) in the article “The fiscalization of land use.” In J. J. Kirlin & D. R. Winkler (Eds.), California policy choices (Vol. 3, pp. 73-105).