



League of California Cities

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TO: LEAGUE FISCAL REFORM TASK FORCE
FROM: MICHAEL COLEMAN
SUBJECT: A COMPARISON OF MAJOR CALIFORNIA TAX BASES
DATE: 12/10/1999
cc: Chris McKenzie, Dwight Stenbakken, David Jones

Several of the current major proposals for restructuring local government finance include some sort of a swap of revenue sources. The Speaker's Commission on Local Government Finance has proposed a swap of half of the Bradley Burns sales tax, compensating each city and county with additional property tax share. The Commission also considered (but did not adopt) a proposal to eliminate the VLF backfill to local government and replace it with a per-capita subvention based on growth of the state personal income tax.

The purposes of these restructuring proposals include: 1) establishing a fiscal system that will encourage balanced growth in a regional context.; and 2) strengthening the relationship between the type and level of public service demand and the type and growth of revenue needed to provide the services.

Different tax revenues exhibit different growth characteristics. Consequently, the volatility (the degree of ups and downs of a revenue source), and long-term growth potential of an agency's revenues would be changed by a shift in local revenue sources. These effects will vary locally depending on local economic activity. Nevertheless, we can draw some general sense of these changes by looking at the historical trends in these tax bases.

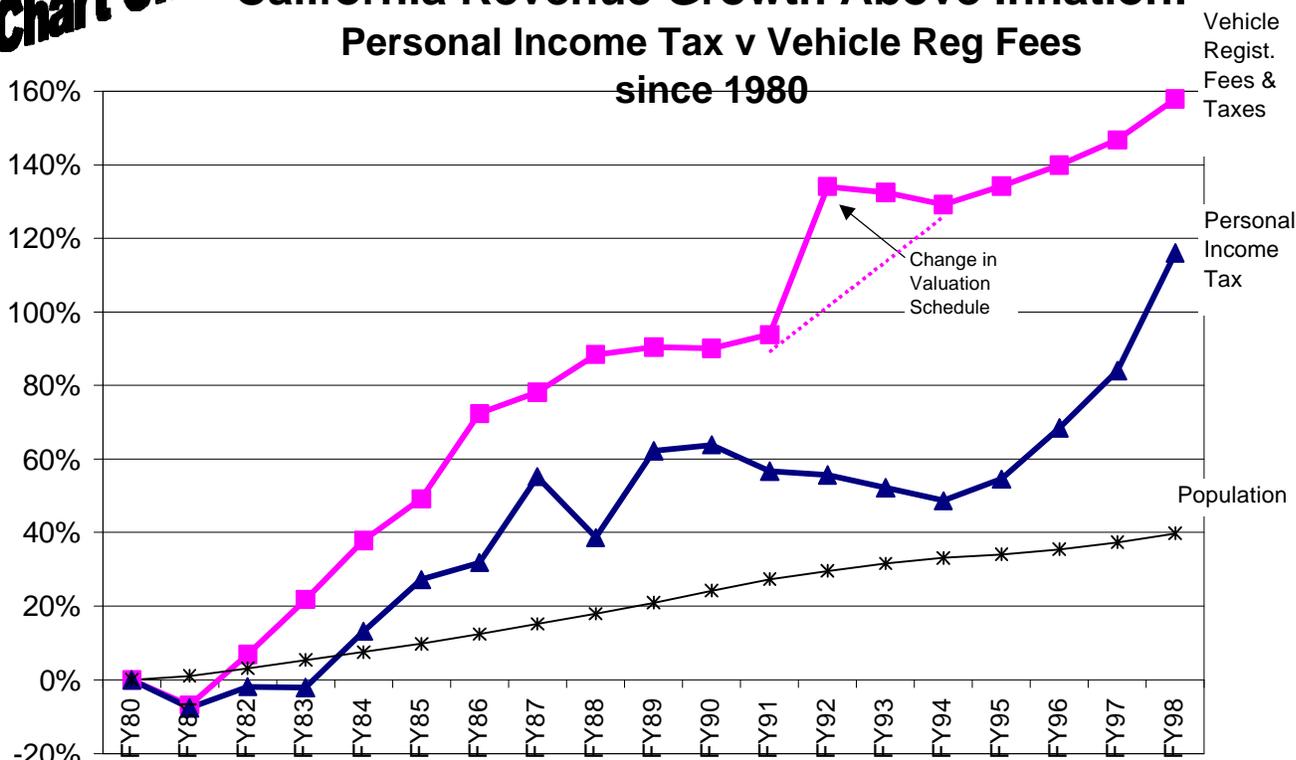
The Vehicle License Fee versus California Personal Income Tax

Chart One below compares the statewide change above/below in these two revenue sources since 1980. The change in statewide population is shown for comparison. The chart reveals the following:

- For several reasons, the state personal income tax is a more volatile revenue source. The personal income tax is highly responsive to changes in the economy. It has also been substantially affected by legislative changes including tax cuts, increases, exemptions and other alterations.
- The VLF has shown a more stable growth pattern. While the legislature also controls the Vehicle License fee and tax rates, it has manipulated these much less by comparison. Notably, unlike state personal income tax collections, VLF revenues were largely unaffected by the recession in the early 1990s - even taking into account the legislature's 1991 manipulation of the VLF valuation schedule.
- In recent years, the state personal income tax has been making dramatic leaps, year after year, due primarily to the healthy economy and booming stock market resulting in boosts in capital gains tax payments.
- Overall, however, the VLF has been a more strong and steady performer.

Chart One

California Revenue Growth Above Inflation: Personal Income Tax v Vehicle Reg Fees since 1980



SOURCE: Governor's Budget Summary, Dept of Finance, Coleman Advisory Services

Discussion: The VLF Backfill

The VLF tax cut law, signed by Governor Wilson in 1998, would reduce the VLF by 67.5% by January 2003 if all state budget revenue triggers (levels of revenue) are met. Under the law, the entire amount of this reduction to the local VLF, about \$3.5 billion in current dollars, must be backfilled by the state general fund. This backfill increases in accordance with the increases that would have occurred in VLF revenue without the cuts.

Current law would **not** eliminate the VLF entirely. However, should the VLF be eliminated, the state Department of Motor Vehicles would still have to collect vehicle valuation information on registrations in order to determine the growth of the VLF backfill. The presence of a local government subvention tied to a non-existent tax would seem to make the VLF backfill a ripe candidate for manipulation by the state. Hence the importance to cities and counties of protecting this revenue source with the voters.

Last week the Speaker's Commission came to a similar this conclusion and has recommended constitutional protection of the VLF backfill. The Commission determined that the source of revenue for the purpose of determining annual growth in the subvention (i.e., VLF/vehicle valuation versus personal income tax or growth in state general fund revenue) is less important than its protection from legislative tampering.

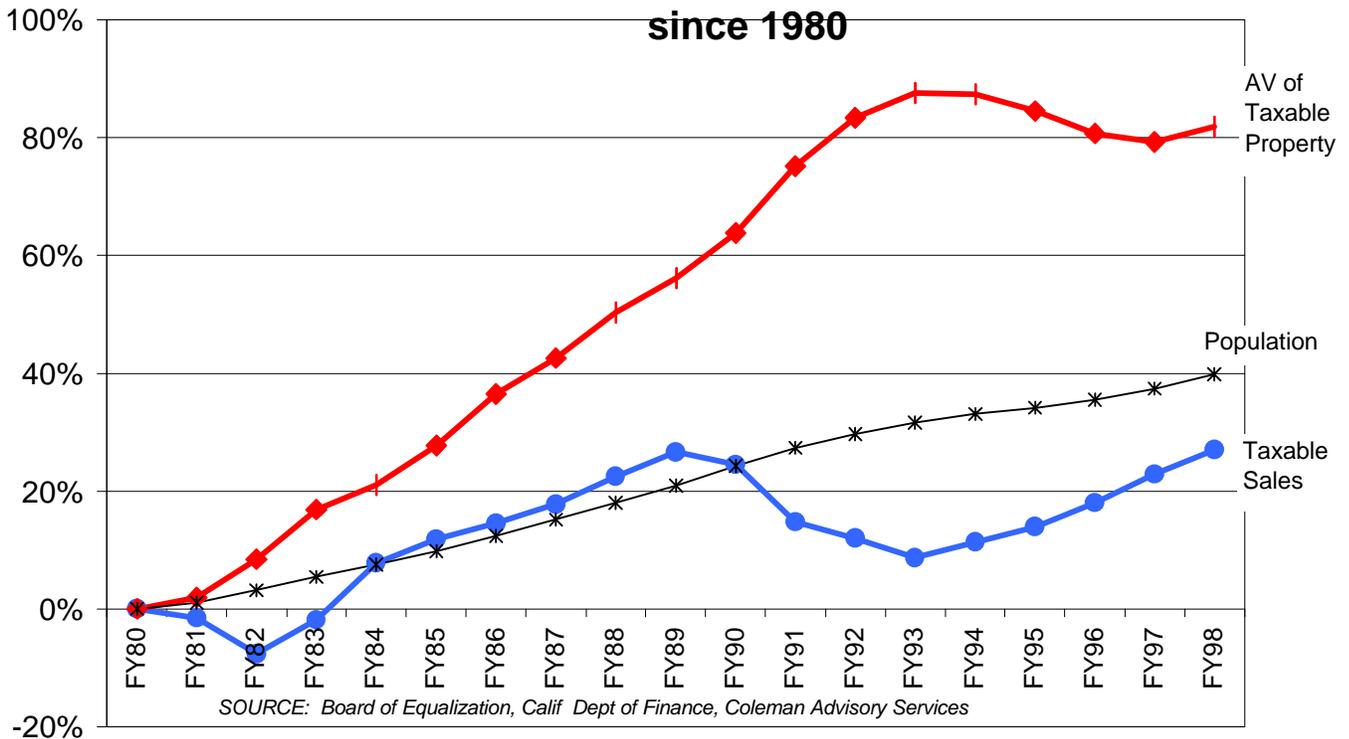
Sales Tax and Property Tax Revenue Growth

As individual cities and counties consider the 1/2-Bradley-Burns-for-property-tax-swap proposal of the Speakers' commission (see accompanying memo), they will of course look beyond the good government policy arguments to the long term financial impacts on their own budgets. The proposal attempts to eliminate any negative impacts initially, but the changed financial system will of course yield different results over the long term. These results will vary among local agencies depending on local economic conditions and the land use decisions. A central underlying question here concerns the character of property tax growth, of which cities would get more, versus sales tax growth, of which cities would get a smaller share.

Chart Two below compares the historic growth of these two tax bases in California. The chart compares the statewide change above/below in these two revenue sources since 1980. The change in statewide population is shown for comparison. The chart reveals the following:

- Property tax revenues show less volatility - a more steady growth than sales tax revenues.
- Recessionary impacts are felt fairly immediately in taxable sales. The effects on property tax revenue are delayed. The negative effects of the 1990s recession on property tax revenues lagged by as much as 3 years. Likewise, the recovery of property tax revenues has been delayed by comparison to taxable sales.
- Over the last twenty years statewide, the property tax has been a more robust performer than the sales tax. In fact, unlike property tax, income tax or the VLF, taxable sales have not kept pace with the combined effects of inflation and population growth over the last twenty years.

Chart Two California Revenue Growth Above Inflation: Property Tax vs Sales Tax Bases



Discussion: Property Tax v Sales Tax for Your Cities Future?

Barring legislative changes which must occur at the state and federal levels, the major economic will further depress the growth of sales tax revenue. These trends include the continuing shift to service economy and the boom of electronic commerce. The property tax base is unlikely to be negatively affected by these economic trends. For a city that has developed a strong sales tax base, this is an opportune time to trade for property tax base. Cities who do not have a strong sales tax base should ask themselves: "What reason is there to think that taxable sales have a brighter future in my community than my past?" Even so, economic changes which may boost sales activity will also bring boosts in taxable property values. And given history and current economic trends, the property tax base is likely to be more reliable.

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