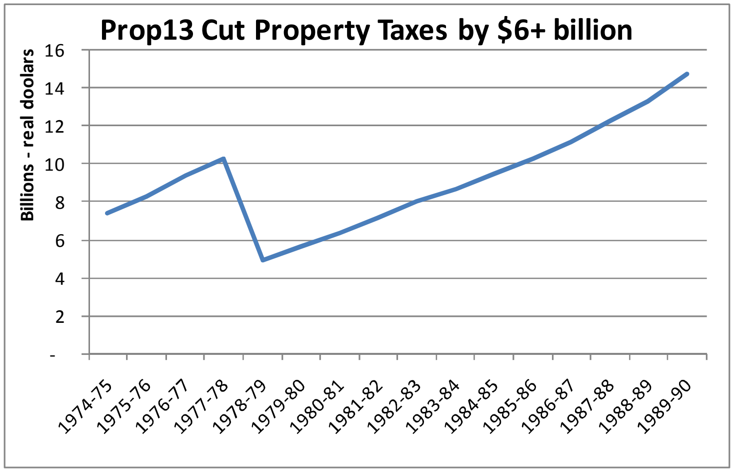
# The State-City Fiscal Relationship Since Proposition 13: Is the AB8 Bailout still Alive?

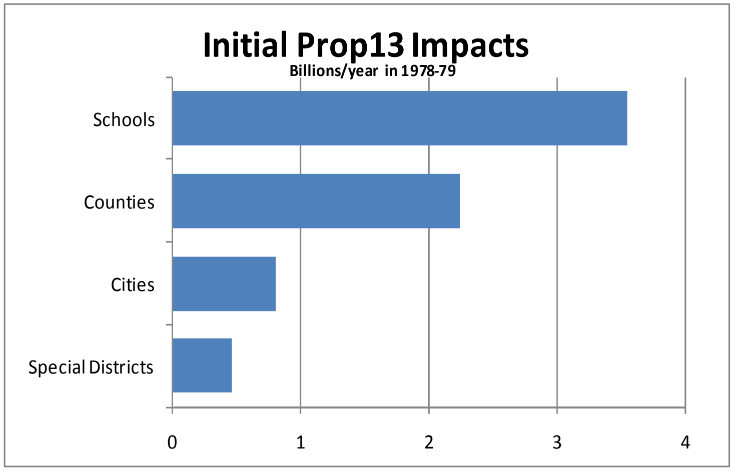
The dance of governance and finances between the state and local governments is as old as the inception of the California Republic. But most observers begin with Proposition 13 to tell the story – and with good reason.

## Local Government Impacts of Proposition 13

By 1978, as frustration with property tax assessments peaking and the Proposition 13 campaign raging, the state general fund faced an unprecedented surplus of some $5 billion – roughly 40% of revenues. It was clear from campaign rhetoric that the presence of this surplus convinced many voters that state and local government had sufficient funds as a whole and could sustain a revenue reduction. In other words, the voters intended that the state allocate this surplus to mend the effects of Proposition 13 on local governments.

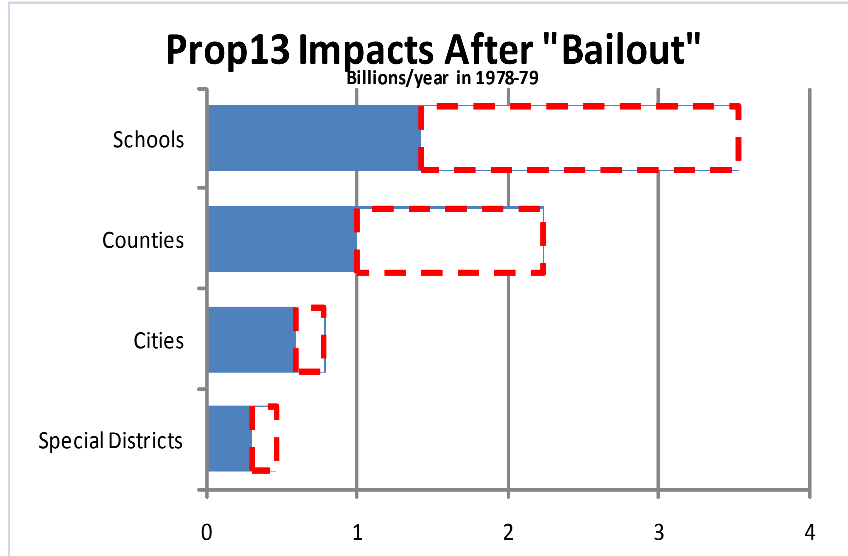



Proposition 13 cut local property tax collections by some $6.1 billion in 1978-79 (a 53 percent reduction), capped their growth, and shifted the authority for allocation of these local revenues to the state legislature.




The brunt of the initial impact was on schools and counties, since those agencies together accounted for over 80% of property tax levies.

The Legislature responded in 1978 by passing SB154 which provided block grants to localities. Cities were slated for $250 million, but the actual allocation came to about $220 million after special adjustments for general fund reserves, and for non-full service cities (specifically those not providing fire or library services). The following year, the legislature adopted AB8 which allocated a portion of the SB154 block grant on a permanent basis and set the allocation of




property tax growth relative to each agency's proportional tax share within defined tax rate areas. Cities received 82.91% of the SB154 amount, about $183 million or about 22% of the initial Proposition 13 impact.

Unlike cities and special districts, the bailout to counties involved not just a shift in revenues, but assumption of financial responsibility of certain county medical and SSI/SSP costs, AFDC grants and other public health services.

**The State Personal Income Tax Windfall.** The state's ability to sustain a bailout was buoyed by Proposition 13 itself which created a $1 billion personal income tax windfall for the state (and a $1.6 billion personal income tax windfall for the federal treasury). This windfall occurred because of the reduction in local taxes that could be deducted on income tax returns. To legislators in 1978 and 1979 pondering if and how to assist local governments financially, the legitimate course of these windfall revenues was back to local government.

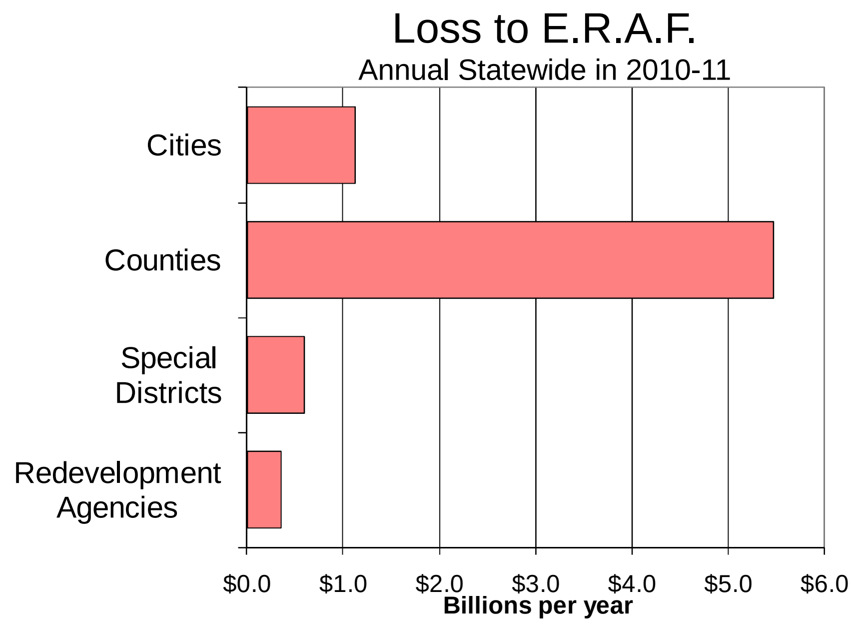
**The "Deflator."** Initially state legislators did not have confidence that the state would be able to continue to maintain the bail-out in future years. Consequently, AB8 included provisions known as the "deflator" which would allow the state to roll back the bailout in times of fiscal distress. But state fiscal experts came to believe that the bailout was sustainable indefinitely. The deflator was never employed and was eventually repealed.

**Post Prop13 State Fiscal Retrenchment.** Despite the repeal of the AB8 deflator the state did retract a number of forms of state assistance to cities in the 1980s and since. Subventions initially enacted to reimburse locals for exemptions in state law from local property tax were repealed. In 1981-84, hundreds of millions of Vehicle License Fee revenues, which since the 1930s had been slated for cities and counties as successor revenues to local property taxes on motor vehicles, were taken by the Legislature.

**The City response.** Cities responded to the loss of property tax revenue and state assistance by seeking new and higher forms of taxation, by increasing fees to more fully cover the costs of fee supported services, by consolidating and other forms of cost saving redesign of services, and by cutting services – especially non-public safety services. Taxpayers in turn responded by placing more and more restrictions on revenue raising authority into the state constitution.

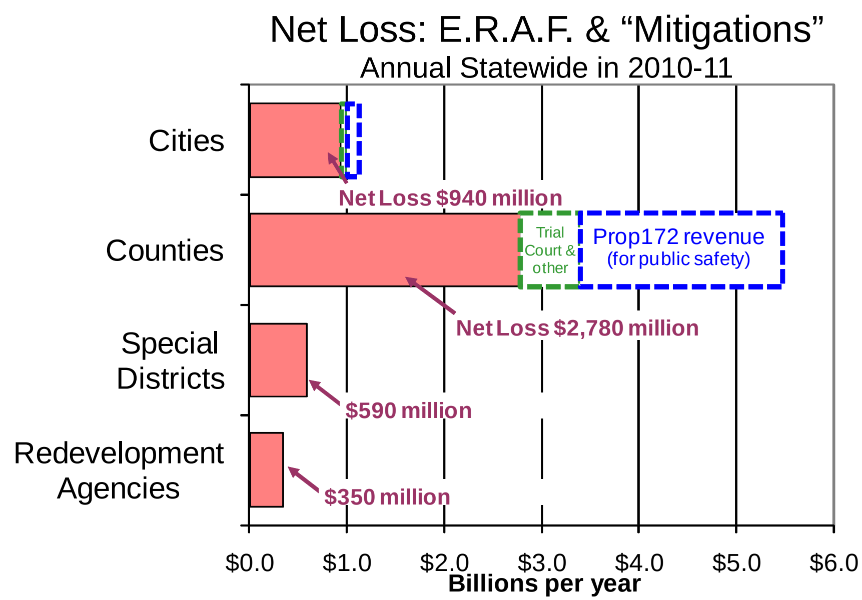
## Fast Forward: ERAF – Reversing the Bailout

In the face of serious financial difficulties, the Legislature, in 1992, shifted city, county and special district property tax revenues to local schools. Although nearly 15 years had passed since Proposition 13, and the deflator had been eliminated, the rationale and formulas for the Educational Revenue Augmentation Fund (ERAF) shifts were the reversal of the post-Proposition 13 state bailouts.




The state has provided some funding to local governments that it considers mitigation of ERAF. However, all of these funds are earmarked for particular purposes and most go to counties. [1]

Reacting to ongoing threats to local revenues of state actions, the voters of California in 2004 voted with an unprecedented 84% yes vote to protect municipal revenues (property tax, local sales tax, etc.) from taking by the state.




[1] State allocations to cities that have been considered "mitigation for ERAF" include Proposition 172 sales tax revenues and the COPS/Juvenile Justice program, most of which go to counties.

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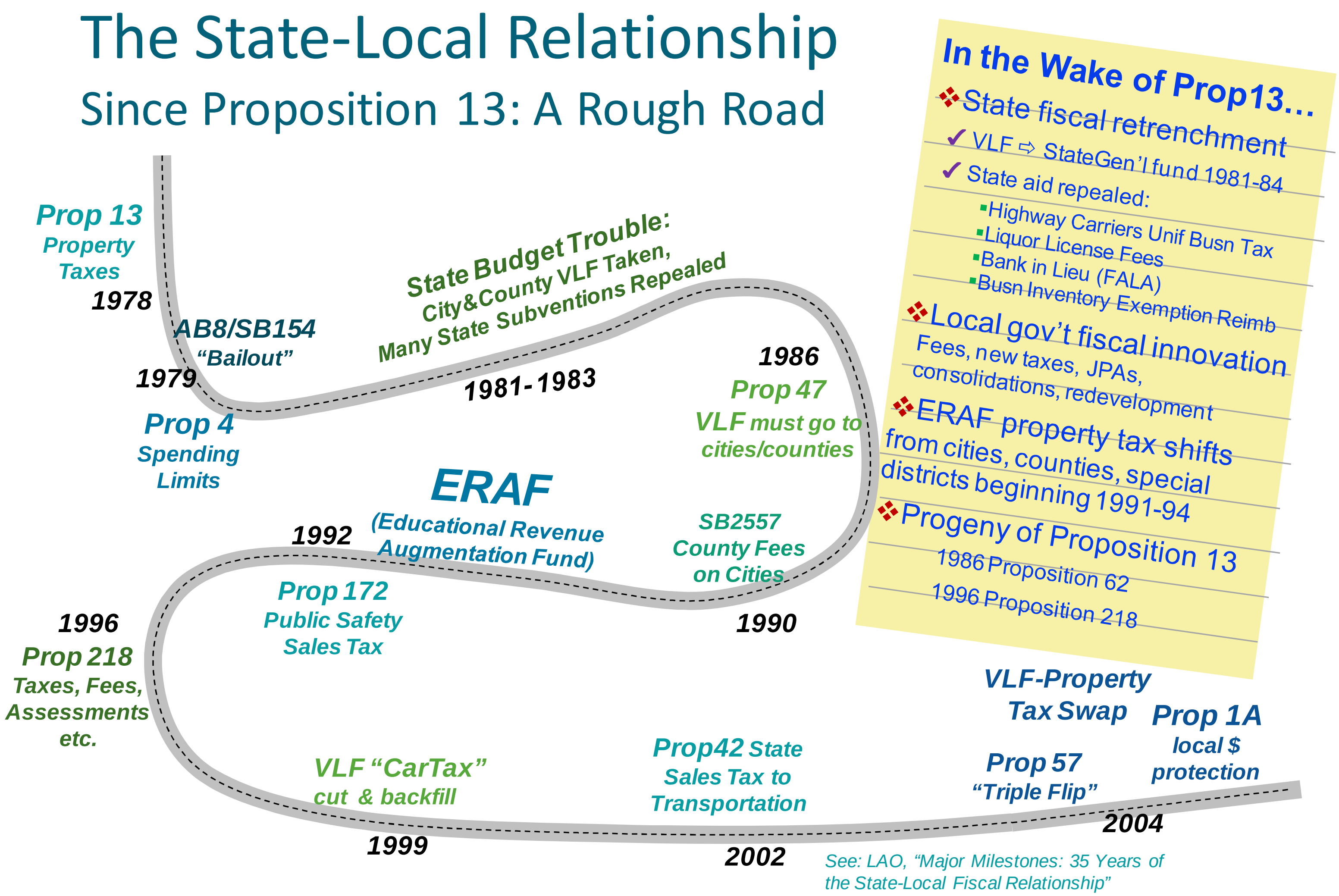


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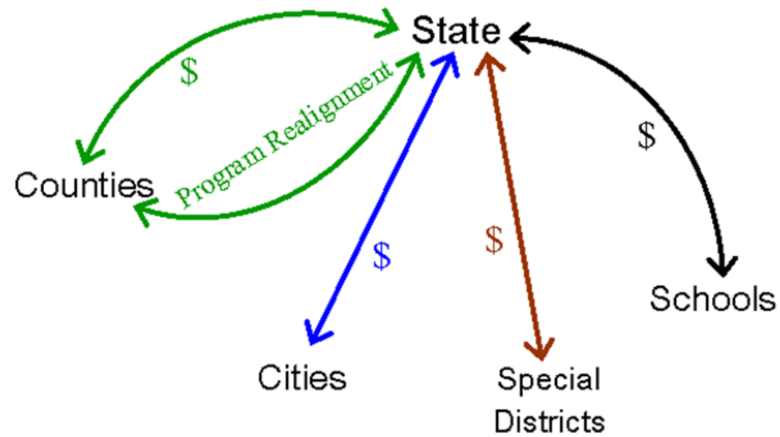
## Realignment/Devolution Primarily Concerns Counties

While California history is peppered with a seemingly constant discussion of state-county service realignment and financing shifts, the core responsibilities of California cities have not changed. Aside from conflicts over unfunded mandates, the state-city interchange has had more to do with shifts of revenues than service responsibility.[2]




An inventory of all the gives and takes between the state cities since Proposition 13 reveals that, even taking into account new revenues provided by the state to cities at various times, state takeways - primarily the ERAF property tax shifts and the loss of various state subventions - have essentially wiped out the financial boost provided by SB154/AB8.[3]

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[2] For an excellent explanation of the California state-local fiscal history see Elisa Barbour, "**State-Local Fiscal Conflicts in California: From Proposition 13 to Proposition 1A**" Public Policy Institute of California. December 2007. http://www.ppic.org/main/publication.asp?i=785

[3] An inventory of all the gives and takes between the state and local governments is a difficult and contentious exercise – although easier for cities than for counties. The graphic is a bit simplified since the major revenue shifts from cities, counties and special districts to the state have been of property tax via schools.

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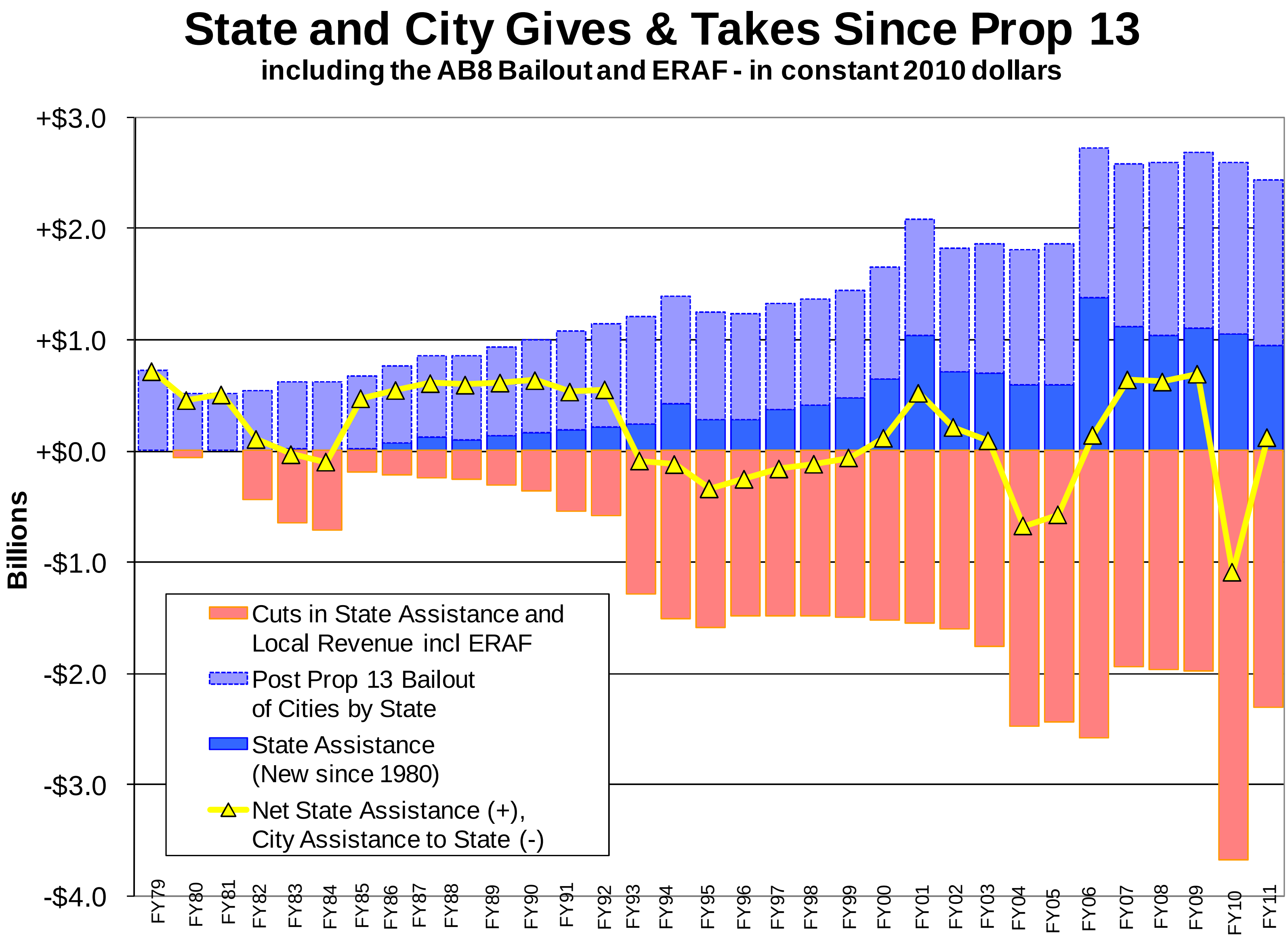


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