CALIFORNIA PLANNING & DEVELOPMENT REPORT SPECIAL EDITION, JUNE 2003

Tax-Limiting Initiative Continues To Shape State

Reform Of Government Fiscal Tangle Remains Elusive

BY WILLIAM FULTON

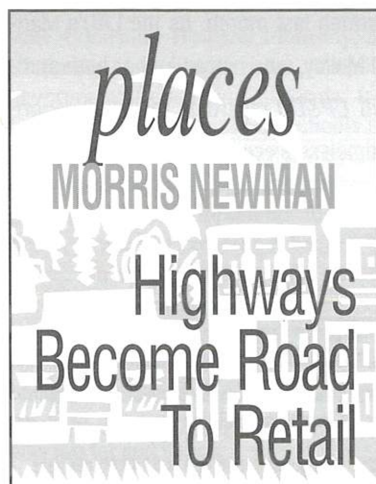
Once upon a time, growth was good. Not just because there was a philosophy that more people improved a community – or a state. But because there was a financial system based on the assumption that as communities grew, the value of their properties would grow commensurately. And so paying for the cost of new growth by taxing everybody – or, at least, all the property owners – was fair because in the end everybody would benefit.

That, of course, was the assumption under which California lived during the three go-go decades after World War II ended, when rapid suburbanization and relentless upward mobility went hand in hand. It came to a halt 25 years ago – on Tuesday, June 6, 1978, the day of the California gubernatorial primary – when the voters passed Proposition 13.

Proposition 13 immediately rolled back property assessments to 1975 levels and limited the property tax rate to 1% of assessed value. The initiative also permitted reassessment of property only when the property is sold; otherwise, property assessments may rise by only 2% per year.

The most immediate effect of Proposition 13 was to reduce property taxes for all California property owners by more than half. But for cities, counties, special districts – and even the state itself – the long-term effect was much more significant. It is not too much of an overstatement to suggest that the California planning and development landscape as we know it today was created by Proposition 13.

Proposition 13 did not invent most of the impulses at work in California's communities today, of course. Fiscal zoning and competition between municipalities for tax revenue is nothing new, nor is the vigorous political jockeying within any community over who pays — CONTINUED ON PAGE 12



People who want to understand the impact of Proposition 13 on California's cities may find their answer on Interstate 15. Starting in Riverside County, the southward drive toward San Diego is one of the most scenic in the state – a bucolic vista of rolling hills, forest and granite outcroppings that recalls the foothills of Colorado and Utah.

Then we enter Temecula.

The roadside erupts into a cacophony of candy-colored buildings and aggressive signs. Some retail centers are dressed up as quasi-Hispanic buildings with miniature towers and tile roofs, while others are little more than boxes. Things go upscale as we travel farther south in town, where we pass the Promenade mall, anchored by familiar names such as Sears, JC Penney, Robinsons-May and Macy's and featuring such popular merchants as Abercrombie & Fitch, Gap and Victoria's Secret. A little further south still is the Temecula Auto Mall, the first of several we shall see today. And in Temecula, as in many other cities, much of this cut-rate retail construction — CONTINUED ON PAGE 10

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editor's note

Twenty-five years ago this month, California voters fired the first shot in what has since become known as the American tax revolt: They passed Proposition 13, the sweeping initiative that cut property taxes in the state by more than half.

But did they know that they were dramatically reshaping the planning and development landscape of the state as well? For 17 of those 25 years, *California Planning & Development Report* has been reporting on trends in local planning and real estate development throughout the state. And most of the time, it seems like we have only been covering one story: fallout from the passage of Proposition 13. Development impact fees, wars over retail projects, the slowdown in construction of affordable housing, Mello-Roos bonds, the widespread use of assessment districts – all have a profound affect on urban development patterns in the state, and all are the direct result of the passage of Proposition 13. Even ballot-box zoning owes a lot to the tax cutters, in the sense that the Jarvis-Gann Initiative gave voice to residents' anger about how their communities were changing, and empowered them to "just say no" to things they don't like.

Because of the link between Proposition 13 and California's approach to planning and development, we decided to publish a special report to commemorate Proposition 13's 25th anniversary. To create this edition, we have ranged across almost two decades of our own files. We've consulted with an array of experts on what the impact has been. We've tried to recap the history, lay out the patterns, and speculate on what the future might bring. And we keep coming back to one inevitable conclusion: Proposition 13 was the seminal event in the shaping of the California that we at *CP&DR* cover today. It was, as journalist Peter Shrag says, the dividing line between suburban post-war California and the diverse, expensive, and complicated California we know today.

In our special edition, you will find a wealth of new material and fresh analysis. We also have reprinted six stories from past editions of *CP&DR* that capture the essence of Proposition 13's impact on planning and development. Towards the back of our special report, we have included the exact text of Proposition 13, as well as the Legislative Analyst's ballot pamphlet discussion of the initiative's fiscal effect.

Readers will also find a piece reprinted with the permission of the Howard Jarvis Taxpayers Association that addresses the fairness of Proposition 13. Finally, we offer two studies from the Legislative Analyst's Office (LAO). The first explains why some entities receive more property taxes than other entities. The second study examines how property taxes are allocated and offers a number of recommendations for change. The LAO reports were produced in 1996 and 2000, respectively, but because of the inertia behind our present system, they could have been written last month. As the LAO's Marianne O'Malley, who helped author both studies, told *CP&DR* regarding the 2000 report, "It's a timeless piece." ■

CP&DR
is published monthly by
Solimar Research Group Inc.
973 East Main Street
Ventura, CA 93001-3025
Telephone: 805/643-7700
Fax: 805/643-7782

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Subscription Price:
$249 per year
ISSN No. 0891-382X
Visit our website:
WWW.CP-DR.COM
You can e-mail us at:
INFO@CP-DR.COM

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California Planning & Development Report (ISSN No. 0891-382X) is published monthly by Solimar Research Group Inc., 973 East Main Street, Ventura, California, 93001-3025. The subscription rate is $249.00 per year. Periodicals postage paid at Ventura, California. Postmaster: Send change of addresses to California Planning & Development Report, 973 East Main Street, Ventura, California, 93001-3025. USPS 015-835

The 5 W's of Proposition 13

BY PAUL SHIGLEY

Proposition 13 was a reactionary measure in the most literal sense.

During the 1970s, California experienced its first rapid increase in home prices. At the same time, property assessment laws were revised to encourage higher and more consistent assessments. As a result, some California families lost their homes and farms because they could not pay the rapidly rising property taxes. Senior citizens with small retirement incomes were particularly hard hit.

State policymakers recognized a problem existed and they made several runs at a solution. But the answers were politically difficult and no consensus evolved, so the system and the practices of local government remained unchanged. At the same time, the State of California was both increasing its spending and creating a large surplus due to hikes in other taxes, especially the income tax.

From a distance of 25 years, it is easy to connect the dots from rising taxes, to political intransigence, to government spending and surpluses, to the "tax revolt" of 1978. This revolt manifested itself in Proposition 13, or the Jarvis-Gann Initiative. Howard Jarvis and Paul Gann were conservative, anti-tax crusaders who rose to prominence with their initiative, which promised a significant reduction in property taxes and a tight limit on annual increases.

When it became clear that voters were going to get to decide on the Jarvis-Gann Initiative, Gov. Jerry Brown and the Democratic-controlled Legislature approved a competing constitutional amendment. Their proposal authorized the Legislature to allow local governments to tax owner-occupied dwellings at a rate lower than applied to all other types of property. This became Proposition 8, and it appeared on the same June 6, 1978 ballot as Proposition 13.

During the campaign, most Republicans lined up to support Proposition 13. Democrats generally opposed Proposition 13 and backed the Proposition 8 alternative. Proposition 13 opponents, including the governor, warned of untenable reductions in public services if voters approved Jarvis-Gann.

In the ballot argument against Proposition 13, Los Angeles Mayor Tom Bradley, University of Southern California Dean and former state Controller Houston Flournoy, and California Common Cause Chairman Gary Sirbu wrote: "Proposition 13 invites economic and governmental chaos in California. It will drastically cut police and fire protection and bankrupt schools unless massive new tax burdens are imposed on California taxpayers. It will take decision-making away from the local level and weaken home rule."

Proposition 13 opponents further argued that the initiative was poorly drafted, a contention backed by the Legislative Analyst, who wrote, "In several instances the exact meaning of the language used in this measure is not clear."

The dire predictions and complaints of unclear intent, many of which came from public officials, appeared to play right into the hands of Proposition 13 backers, who said, in essence, why should we trust them now? Proposition 13 supporters said the government was too fat and happy.

On election day, it was not close. Proposition 13 received 64.8% of the vote, while Proposition 8 received only 47% approval. No matter one's worldview, California had changed.

In *Paradise Lost*, his book on the ills of contemporary California, *Sacramento Bee* columnist Peter Schrag points directly at Proposition 13: "The passage of Proposition 13 serves as a convenient way of dividing the post-World War II era in California between the postwar period of optimism, with its huge investment in public infrastructure and its strong commitment to the development of quality education systems and other public services, and a generation of declining confidence and shrinking public services," Schrag writes.

Ron Roach, spokesman for the California Taxpayers Association, which opposed Proposition 13 in 1978 but is now one of its staunchest defenders, sees a different importance in Proposition 13.

"A lot of people who think Proposition 13 is evil today don't remember what it was like before [Proposition 13]. You and I could lose our homes. It happened. Things just festered for years and years," Roach said.

Proposition 13 made six basic changes to the state constitution. The initiative:

- Capped the property tax rate at 1% of cash value at the time of acquisition
- Rolled back property values for assessment purposes to the 1975-76 level
- Prohibited reassessment of property except at time of resale
- Gave the state authority to allocate property tax revenues among local government entities
- Required a two-thirds vote of the Legislature to raise state taxes
- Required that "special taxes" (which were not defined) receive two-thirds voter approval.

As promised by proponents, Proposition 13 greatly reduced the ability of local governments to tax property. No longer could the county board of supervisors, city council, school board of trustees, and special district board of directors set new tax rates every year. No longer could the county assessor reassess every house on the street when one house sold. Moreover, property taxes immediately decreased by about 60% statewide.

"Proposition 13 was an earthquake back when it hit in the 70s because local government was so reliant on property taxes at the time," recalled Fairfield Finance Director Bob Leland, who was a consultant to the Assembly Revenue and Taxation Committee at the time.

An initial concern at the time of Proposition 13's passage was that it would encourage sprawl, said political pundit Bill Press, who headed the Governor's Office of Planning and Research from 1975 to 1979. The fear was that "local governments, strapped for cash and hungry for new sources of income, would throw planning out the window and allow helter-skelter development in return for high developer fees," Press said.

What followed in the weeks after the election may have been as important from a public policy standpoint as Proposition 13 itself: The state used $6 billion in surplus funds to bail out the local governments. The initial bail out was contained in SB 154. The one-year legislation provided block grants to cover revenue losses, and set a formula for distribution of property taxes.

In 1979, the Legislature approved AB 8, a complex measure that built on SB 154. The legislation re-established the formula for allocating property tax revenue, a formula that largely remains in place today. The formula essentially used the historic, relative share of property tax received by each taxing entity. However, AB 8 shifted about one-third of the school district's share of property taxes to other local government entities. The state itself then made up for the money lost by school districts. Also under AB — CONTINUED ON PAGE 9

Local Government Finance: A Complex Money Trail

BY PAUL SHIGLEY

Local government finance in California these days is very complicated. How complicated is it? It's so complicated that even the people who set the rules do not understand it.

Lobbyists and analysts say it is not unusual to encounter state lawmakers who have fundamental misconceptions about local government finance. But those misconceptions – such as not knowing which entities receive property tax revenues – are not surprising. After all, while state lawmakers have the authority to divvy up property tax revenues, the state itself does not receive any of that money. It does not help that countless newspaper stories have insisted that the state took property tax revenues for itself during the early 1990s, when, in fact, the state shifted the money from counties, cities and special districts to school districts.

"Nobody knows with any specificity where the property tax they pay goes," said Michael Coleman, a Davis-based fiscal consultant to the League of California Cities. "It was much easier to understand prior to Proposition. 13 because each taxing entity placed a tax on your bill."

Although experts such as Coleman are reluctant to blame Proposition 13 for all of the current system's ills, there is no doubt that a good portion of the system is a reaction to the 1978 initiative. Prior to Proposition 13, all local government entities relied heavily on property taxes. But when the initiative slashed property taxes and placed a tight cap on annual increases, city officials got creative. That creativity has increased as state assistance to local governments has decreased.

Jeffrey Chapman, then a University of Southern California professor and now at Arizona State University, summarized the situation well in a 1999 report for the Public Policy Institute of California (PPIC).

"Perhaps the most important insight that can be gained from the passage of Proposition 13 is that blunt initiatives lead to the development of other ways of getting things done," Chapman wrote. "These other ways are usually more complex, more expensive, and typically are not discussed in public forums in ways that are intelligible to the public and elected officials. The world is full of very bright and ingenious people who delight in ways of circumventing poorly drafted initiatives. The result is a finance system that is not easy for the public to understand."

Gene Albaugh, former administrator of Calavaras and Nevada counties and now a consultant to local governments, is even more to the point: "Everything you do anymore has a fee attached to it. Everything that used to be free – so to speak – has gone by the wayside."

Broad summary statements about how the system works are dangerous, in part because funding mechanisms are not the only things that have evolved. During the last 25 years, the responsibility for carrying out various programs has evolved, as have the programs themselves. This is especially true for counties, which, legally, are arms of the state government. Still, some generalities are necessary to grasp how the system works.

Chapman found that service charges and user fees, assessments and impact fees, and enterprise income (such as sewer, water and utilities charges) have come to make up about two-thirds of a city's revenue. Prior to Proposition 13, those revenue sources composed about half of a city's revenue stream. Counties have come up with new charges, too, but the biggest change there is the dramatic increase in funding from the state, which now provides about 40% of county revenues. Additionally, counties were hit much harder than cities when the state created the Educational Revenue Augmentation Fund (ERAF) concept during the early 1990s, giving school districts a larger slice of property tax revenues.

Local governments have also invented a number of new ways to fund capital facilities since 1978. Proposition 13 barred the use of general obligation bonds (voters dropped that prohibition in 1986), revenue bonds were seen as politically risky, and shrinking discretionary revenue made the pay-as-you-go approach infeasible, according to Chapman. Local governments turned to Certificates of Participation (COPs), which technically are issued by a nonprofit entity established by the legislative body. The local agency then "rents" the capital asset that the COPs funded. Unlike true bonds, COPs do not require voter approval and do not count against a debt ceiling. Another new capital financing options is Mello-Roos bonds, which provide a way for local government to charge the owners of new homes for roads, storm drains, parks and other infrastructure.

To generate new operating revenue, local governments turned to assessment districts (which Proposition 218 cracked down on), utility user taxes that ranged from 1% to 11% of electricity and natural gas bills, and various entrepreneurial activities. Because the increase in property tax revenue inside a redevelopment project area goes to the redevelopment agency, cities and counties began forming redevelopment agencies like mad. Since 1980, the number of redevelopment agencies has roughly doubled to 413 (of which 384 are active) and the number of project areas has increased by about 150% to 764, according to the state Controller's Office. And then there is the favorable nod cities and counties give to sales-tax generating retail development. The city or county where the sale occurs gets 1 cent for every dollar spent and can use that money however the City Council or Board of Supervisors desires.

Rick Cole, city manager for Azusa and former mayor of Pasadena, said the term "system" is a misnomer. "Almost none of the system was designed. It's a reaction to a reaction to a reaction," he said.

Cole contends that nobody understands the system and there are many negative consequences, such as the emphasis on retail businesses to the detriment of true economic and community growth. A city manager's job, Cole said, is a "nasty, brutish and short-sited scramble to survive," much like the Hobbesian state of nature.

"The problem is not Proposition 13, it's the lack of coherent response to Proposition 13," Cole said. "And that's ironic because the reason we got Proposition 13 was due to the lack of response [to rising property taxes] by the governor and the Legislature."

The irony does not end there. Another one of the primary reasons voters approved Proposition 13 was the lack of governmental accountability for property taxes. A homeowner's tax bill could contain levies imposed by the county, the city, a couple of school districts, and a variety of special districts. There was no single entity where a taxpayer could seek redress. But the direct and indirect fallout from Proposition 13 – remember, the initiative itself gave state lawmakers authority to allocate property tax receipts among local governments – has led to a complex system that lacks transparency and is, arguably, less accountable than the pre-1978 system.

Average citizens know they pay taxes, and they do not really care what level of government or agency is involved in providing a service, said Bob Leland, finance director for the City of Fairfield. When explaining things to average folks, Leland tries to impress upon them that the city receives only a small portion of the sales and property taxes that people pay. The state receives most of the sales tax, and property taxes get distributed among a number of local agencies, with schools getting the lion's share.

What frustrates local officials most might be the lack of control they have over revenues. Sales taxes, property taxes and vehicle license fees (VLF) compose 60% of Fairfield's general fund (which does not encompass utility enterprise funds), according to Leland. Yet a state formula determines what percentage of property taxes the city will receive, the state sets the VLF rate, and lawmakers are constantly toying with ideas regarding sales tax redistribution.

"We're on the sidelines watching while the state plays with our revenues," Leland said. When the state is facing a major budget deficit, as it is right now, local officials become even more frustrated. Tasks such as capital planning, labor negotiations and even adopting an annual budget are full of uncertainty.

Proposition 13 supporters, however, are skeptical of the complaints. Kris Vosburgh, executive director of the Howard Jarvis Taxpayers Association, rejected the notion that the initiative has decreased local control or that it has starved local government for revenue. Such arguments are put forward by people who want to raise taxes, including public employee unions, private companies that do work for the government, local government lobbying associations and municipal bond brokers, Vosburgh argued.

All Proposition 13 did was provide stability to taxpayers and give them a greater say over tax increases, Vosburgh said.

Indeed, depending on one's point of view, the post-Proposition 13 revenue-raising activities of state and local government are attempts either to *evade* Proposition 13, or *cope with* Proposition 13.

David Doerr, the chief consultant to the Assembly Revenue and Taxation Committee from 1963 to 1987, contends that cities and counties have cooked up all sorts of ways to replace property tax revenues. Utility user taxes, business license taxes, hotel bed taxes, real estate transfer taxes, parcel assessments – all have become commonplace since passage of Proposition 13, according to Doerr, now with the California Taxpayers Association. Court decisions, legislative interpretations and new laws have encouraged this proliferation.

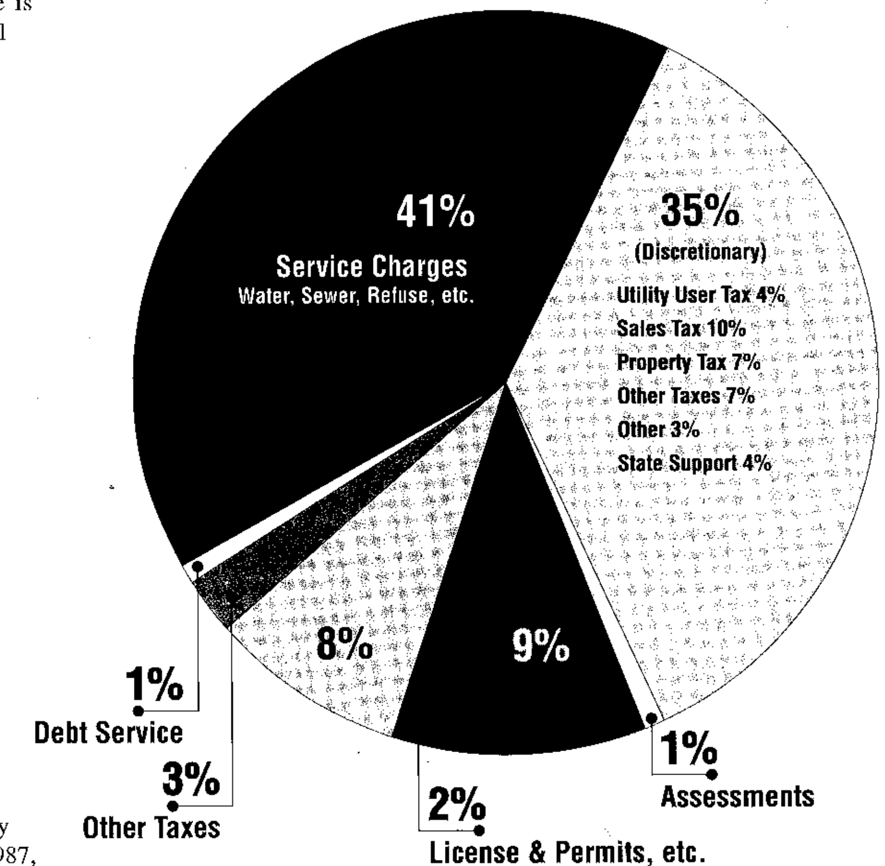
"Contrary to popular belief, counties and most cities have more non-property tax discretionary taxing authority under Proposition 218 than they had before passage of Proposition 13," Doerr wrote after voters approved Proposition 218, a follow-up to Proposition 13.

In one of the most comprehensive reviews ever of Proposition 13, the PPIC provided some support for Doerr's assertions. Michael Shires, John Ellwood and Mary Sprague, at the time all PPIC researchers, found that, in constant dollars, per capita public revenues and the per capita tax burden both declined by about 25% immediately after Proposition 13. By 1995, the government had recovered about half of the lost per capita, constant-dollar revenues, the PPIC report found.

Since the PPIC report was produced in 1998, government finance officials have only gotten more creative. Meanwhile, the link between taxes paid and services provided has become more tenuous.

Typical California City Revenues

Based on total cities statewide



Source: Coleman Advisory Services

"The system, at least today, does work – but at a cost," Jeffrey Chapman wrote in his report for PPIC. "The cost is that of confusion – public finance is a mystery to most citizens in California. In the long run, this constellation of confusion and mystery cannot exist without leading to undesirable governance consequences. The inhabitants of California need to have some understanding of how this finance system works." ■

Momentum Builds To Amend Proposition 13

BY PAUL SHIGLEY

While portions of Proposition 13, such as the 1% tax rate, appear to be politically untouchable, other aspects of Proposition 13 are under pressure in 2003.

The ideas that appear to have the most momentum are reducing the vote requirement on special taxes and bonds from two-thirds to 55%, and creating some sort of "split roll" with the intention of raising taxes on nonresidential properties. State lawmakers have introduced numerous bills regarding either the voter threshold or a split tax role.

Michael Coleman, a financial consultant to the League of California Cities, believes the most likely change will be lowering the voter threshold. Whether this is good public policy is another question, Coleman said. Revenues from special taxes come with limited discretion, and much of city spending is already restricted, he noted.

Under Proposition 13, only majority voter approval is required to hike a "general" tax (such as an annual parcel charge that goes to the general fund) while a "special" tax (such as a parcel charge specifically for library operations) requires two-thirds approval. Some people, including Assemblyman Lloyd Levine (D-Van Nuys) have suggested swapping the vote requirements. They question why a supermajority is required when voters know how the money is going to be spent.

Coleman calls this idea "too cute." Moreover, he said, it is one that local governments would fight because they want to maintain as much discretion as possible.

Supporters of the lower voter threshold are encouraged by voters' willingness in 2000 to cut the vote requirement on school bonds from two-thirds to 55%. Since the change, voters at the local level have approved school bonds at an unprecedented rate. However, amending Proposition 13 in this fashion takes a constitutional amendment, which requires a two-thirds vote in the Legislature. So far, no Republicans have publicly supported a lower voter threshold. Still, some advocates, including the well-funded Silicon Valley Manufacturing Group, have vowed to pursue an initiative if state lawmakers do not act.

The split role is not as straightforward. This issue is this: Because of corporate structures, many pieces of commercial and industrial property are never "resold," so the properties do not get reassessed at current value. The corporate entity that owns a particular parcel today might be entirely different from the legal entity that owned the parcel years ago. But if the ownership change occurred through a gradual transition in shareholders – which is common – then the parcel never qualified for reassessment. Typically, the property gets reassessed only if a majority of shares changes hands in one year.

Exactly how much money local governments "lose" because of this situation is unclear. Analysts have said a split role could deliver between $1 billion and $3.6 billion annually to cities, counties, schools and special districts, depending upon how the split role is devised.

Lawmakers have toyed with the split roll idea since the 1980s, but the concept might have more momentum in 2003 than ever before. One of the first questions that must be answered, though, is how much authority lawmakers have. The Legislative Counsel has advised lawmakers that they could redefine a "change of ownership" with a majority-vote bill. One long-time proposal is to say that a change of ownership has occurred if a majority of shares in a piece of property have changed hands, no matter the time period.

The California Taxpayers Association (Cal-Tax), a business-oriented group opposed to a split roll, contends that redefining a change of ownership in this way is an amendment of Proposition 13 because the reassessment would be based on an assessor's opinion, not on the "full cash value" as outlined in Proposition 13. Therefore, Cal-Tax contends, a voter-approval constitutional amendment would be required.

Jean Ross, executive director of the California Budget Project, an advocacy organization for poor and working-class people, believes a split roll is a good idea. But, she said, a constitutional amendment is the way to create it.

Ross takes this side because she believes trying to define changes in ownership is too messy. She and others advocate reassessing nonresidential property on a regular basis, whether or not there has been a sale. This approach would unquestionably be an amendment to Proposition 13, and, therefore, subject to voter approval.

Split roll advocates point out that the issue behind Proposition 13 was property taxes on homeowners. "Proposition 13 was never about commercial and industrial property," said Jonathan Zasloff, a law professor at UCLA and former advisor to Democratic Assemblyman Robert Hertzberg. "Politically, Proposition 13 was all about residential property."

Added Ross, "When people talk about how to fix Proposition. 13, this [the split roll] is what they talk about."

Still, Cal-Tax, the California Chamber of Commerce and other business organizations have blocked numerous past attempts to create a split roll. They contend the split roll would result in tens of thousands of lost jobs, higher consumer prices, and a loss of competitiveness for California businesses. And, according to a Cal-Tax fact sheet, allowing a change of stockowners to constitute a change in property ownership could result in reassessments multiple times in one year and associated administrative problems.

A different idea with at least some political traction is to reallocate property taxes among local government entities. The current formulas are based largely on how government functioned 25 years ago, and the allocations do not take into account new and evolving services and approaches to providing the services. Thus, a special district that does nothing except provide water often gets a small cut of property taxes. Yet a city that supplies water typically runs its water division solely on user fees and development impact fees.

On another front, Coleman suggested something that might strike people as even more radical: Allow voters to raise their property tax rates. "Proposition 13 treats property taxes different from any other tax in that it deprives voters from raising the taxes even if they want to," he said. The 1% tax rate is in the state constitution. "If voters thought about that, it might be something they want to empower themselves to do."

The staunchest supporters of Proposition 13 see no reason at all to tinker an initiative that they see as a necessary check on government's excess.

"All of this damage that Proposition 13 has supposedly done is just nonsense," said Kris Vosburgh, executive director of Howard Jarvis Taxpayers Association. "There is not one criticism of Proposition 13 that has substance."

The Jarvis group is publishing a new book, Legend of Proposition 13, that will detail the ills that the initiative has supposedly caused – ranging from the partial collapse of the Bay Bridge during the Loma Prieta earthquake to the Los Angeles County District Attorney's failure to convict O.J. Simpson. "It's all lies," Vosburgh said. ■

No Shortage Of Studies And Recommendations

BY PAUL SHIGLEY

The Constitution Revision Commission.

The Commission on Local Governance for the 21st Century.

The Speaker's Commission on State and Local Government Finance.

The State Municipal Advisory Reform Team.

The Commission on Building for the 21st Century.

All of these panels – and others – have conducted lengthy explorations of how California local governments are funded, the relationships among various levels of government, and the on-the-ground effects on urban development, and public facilities and services. All of the panels found a great deal of room for improvement. All of the panels made thoughtful recommendations in their final reports.

And, for the most part, those thick reports are gathering dust.

Then there are the numerous reports produced by think tanks, professors at public and private universities, consultants in the Legislature, special interest groups, and policy wonks. More thoughtful analyses. More problems identified. More recommendations for change. And, yes, more dust gathering.

Except for reports by ideologues, the themes are remarkably common: The financial incentives for local governments are fouled up. There is a lack of accountability at both the state and local level. California sees too much retail development and not enough new places to live for people who work in the retail developments. Infrastructure has not kept pace with population and economic growth.

Every year, the cry for reform gets a few decibels louder. Every year, hopeful analysts and lobbyists say the latest budget situation – whether surplus or deficit – offers the administration and Legislature an opportunity to overhaul things.

But the inertia behind the system is enough to keep the planets spinning.

"It's not like a whole bunch of blue ribbon commissions have not presented a whole bunch of very good and serious recommendations," said Rick Cole, city manager of Azusa and past mayor of Pasadena. Cole himself has offered plenty of observations and recommendations for altering the system, which he contends is not really "a system" at all.

"The house of cards gets higher and higher and higher, and it gets more divorced from the economic realities and democratic structures," Cole said.

Cole and others blame the failure to reform on a lack of leadership – a lack of political will.

"You need somebody who says this needs to be done," said Jonathan Zasloff, a UCLA law professor and former advisor to Democratic Assemblyman Robert Hertzberg. "If it is going to be anyone, it's a second term governor who is termed out."

In fact, Gov. Davis, faced with a huge budget deficit, has urged structural change. But that was about as far as he got. Neither his 2003-04 budget proposal nor the "May revise" contained significant amendments to the basic structure.

Besides a lack of leadership on the issue, two other obstacles stand out. One is the issue's zero sum nature. The second is the lack of interest among voters.

Unless politicians are willing to generate a significant amount of new revenues (read: raise taxes or impose new ones), any structural changes will create a new collection of winners and losers. Alter the allocation of the 1% local sales tax, and "winning" cities with thriving power centers and auto malls can suddenly become losers. Turning winners into losers is a painful choice for elected officials.

The lack of interest among voters makes that choice even more difficult. At some point, every attempt to overhaul the system meets resistance in the Legislature or the administration. But there is no built-in constituency to overcome that resistance. "Overhauling the government finance system" or "altering development incentives" are not issues that show up anywhere on the radar screen of public opinion.

Not that people do not care, or would not have concerns if the situation were explained to them. People would be shocked to know that the rate and allocation of most local revenues are controlled by state lawmakers, not by local elected officials responsible for providing services, said Michael Coleman, a financial consultant to the League of California Cities. Yet the system is so complex that even the rare citizen who wants to understand is apt to shrug shoulders and give up.

So the song, which began playing even before Proposition 13, remains the same. ■

Proposition 13 Never In Doubt In Courtroom

BY WILLIAM FULTON

Proposition 13 may have captured the public's imagination, but it belonged to an era of ballot initiatives that were not well drafted. The initiative's lack of clarity proved to be a lawyer's gold mine. During the first 15 years after Proposition 13 passed, the litigation seemed endless. But by the early '90s, the last major issues had been decided. Since then, the legal landscape surrounding Proposition 13 has been fairly stable

The initiative's passage in 1978 left two basic legal question. The first was predictable: given the inequities likely to emerge over time, was Proposition 13 constitutional? The second issue also was predictable, but the scope of the legal battles was extraordinary thanks in large part to the poor drafting of the initiative: Where were the loopholes in Proposition 13? It was not at all clear what revenue-raising activities were and were not covered by the provisions of Proposition 13. These questions were answered one by one – often in surprising and confusing fashion – in a series of court cases that dragged out well into the 1990s. The loophole question eventually led to several other ballot initiatives and in the end played an important role in shaping the motivations that California's local governments have in dealing with planning and development issues.

The constitutionality question was a straightforward one, even though it took almost 15 years to be resolved. Whether deliberately or accidentally, Proposition 13 divided property owners into many different classes – classes created in large part by the tenure of property ownership. To begin with, upon the passage of Proposition 13, all property assessments were rolled back three years, to 1975 levels. From then on, they were rolled forward with a permissible increase of no more than 2% per year. And, most important, reassessment was not permitted except when property was sold.

The stated purpose of these provisions was to protect elderly homeowners on fixed incomes whose property taxes had accelerated rapidly during the 1970s. Over time, Proposition 13 created huge inequities in the tax among owners of similar properties, providing a much lower tax burden to longtime property owners – not just elderly homeowners, but any owner of long tenure. And the faster property values increased – during the real estate boom of the late '80s, for example – the greater the disparities became. By 1990, therefore, it was not uncommon to find situations where a new homeowner was paying five times as much property tax as the longtime owner of a nearly identical house in the same neighborhood.

This was the basis for the direct constitutional challenge to Proposition 13 in *Nordlinger v. Hahn*, 505 U.S. 1 (1992), a case that was decided by the U.S. Supreme Court in 1992. In that case, Los Angeles property owner Stephanie Nordlinger argued that Proposition 13 violated the Equal Protection Clause of the U.S. Constitution by creating separate classes of taxpayers without a sufficient public policy rationale. At the very least, the plaintiffs argued, if the goal was to protect elderly homeowners, Proposition 13 was poorly targeted because it benefited all longtime property owners regardless of their circumstances.

The Supreme Court had invited the challenge to Proposition 13 in a case from West Virginia, *Allegheny Pittsburgh Coal Co. v. County Commission of Webster County*, 488 U.S. 336 (1989). In that case, the court struck down the practice of West Virginia local assessors who reassessed property only upon sale of the property, even though the state tax code did not call for such a practice.

In *Nordlinger*, however, the Supreme Court ruled that Proposition 13's reassessment-on-sale clause was constitutional because it was linked to what Justice Harry Blackmun called "plausible policy reasons" for differentiating the property owners. Blackmun found that Proposition 13 advanced at least two justifiable public policies. First, relying on the landmark zoning case of *Euclid v. Ambler*, 272 U.S. 365 (1926), Blackmun found that the state has "a legitimate interest in local neighborhood preservation, continuity, and stability" and therefore "can legitimately decide to structure its tax system to discourage rapid turnover." Second, Blackmun wrote, Proposition 13 furthers the state's goal of meeting longtime property owners "vested expectations" of a predictable level of property taxes.

Since *Nordlinger* was handed down, many of the inequities sanctioned by the case have only gotten greater, especially since the latest boom in real estate values began during the late 1990s.

The loopholes litigation is a far more complicated story that has had a greater direct impact on the planning and development of California's communities.

From the beginning, there were important legal questions about which revenue-raising activities Proposition 13 actually covered. The initiative itself placed strict limits on revenue that local governments could raise using a very specific tool – *ad valorem* property taxes, or property taxes levied against property owners based on the value of their property.

But by severely restricting property taxes, Proposition 13 altered the thinking of local government officials. Whereas previously they had been focused on increasing property tax rates and increasing assessments to cover a wide range of services, now they began to look for loopholes in Proposition 13 that could be used to raise revenue in different ways – often to replace lost general fund revenue. This trend, combined with the unclear language of Proposition 13, led to the seemingly endless litigation.

The loophole lawsuits covered several specific topics that appeared to be "moving targets" after the passage of Proposition 13, such as:

- The meaning of a "special tax" (as opposed to a general tax) under Proposition 13
- The circumstances under which a two-thirds vote was required to increase taxes
- The conditions required to determine when a new tax or revenue source was being used to replace lost general fund revenues.

The "special tax" was the most difficult question. Even as it capped "general" property taxes based on value, Proposition 13 permitted the imposition of "special" taxes with two-thirds voter approval. The initiative did state that a special tax did not include ad valorem property taxes, transaction taxes, or sales taxes on property transfers. But nowhere did Proposition 13 define what a special tax was.

That definition was a decision for the courts. And in 1982, four years after Proposition 13 passed, the California Supreme Court made that determination in *City and County of San Francisco v Farrell*, 32 Cal.3d 47. As a history of Proposition 13 prepared by the California Taxpayers Association recounts, the court sided with an interpretation by the state legislative counsel and "defined a special tax not by the type of tax it is but by how the money is spent. If spent for a 'special purpose,' it is a special tax."

The legislative counsel's ruling had already opened the door to parcel taxes, which were traditionally not permitted in California. The Farrell ruling encouraged cities and counties to pursue other non-traditional types of taxes. It also encouraged taxpayer groups to propose two propositions aimed directly at Farrell. The first was Proposition 36, which would have required a two-thirds vote for any local tax increase; that measure failed in 1984. The second was Proposition 62, which required a majority vote for general taxes and a two-thirds vote for special taxes. Proposition 62 passed in 1986.

Proposition 62's effects were confined to general law cities, however. Charter cities were exempt because, unlike Proposition 13, Proposition 62 was a statute and not a constitutional amendment. And in 1991 in *City of Woodlake v. Logan*, 230 Cal.App.3d 1058, an appellate court ruled that counties were not subject to the vote requirement.

Another important question was whether other locally imposed taxes were subject to a two-thirds vote (as opposed to a simple majority vote), even if the taxes were not tied to property value. The critical cases in this area dealt with county-level sales taxes. This taxing technique emerged in the 1980s for several reasons, including the passage of Proposition 13 and the stagnation of state revenue for transportation projects.

The first important challenge came in San Diego County, where local officials had won a sales tax increase for jail construction with 50.8% of the vote in 1988. In *Rider v. County of San Diego*, 1 Cal.4th 1 (1991), the California Supreme Court ruled that the jail tax was a special tax subject to the two-thirds requirement. San Diego County had set up a separate jail financing authority on which the supervisors held only two of seven seats, but the Supreme Court applied the two-thirds rule nevertheless. The court said that if an agency with sales-tax power is "essentially controlled" by cities or counties with property tax power, the courts may infer that the purpose of the agency is to circumvent Proposition 13.

Two years later, the Supreme Court ruled that another local sales tax was subject to a two-thirds vote, and, in the process, the court upheld the constitutionality of Proposition 62. Voters in Santa Clara County had approved a half-cent sales tax for transportation in 1992 with 54.1% of the vote. In response to the *Rider* decision, civic leaders had gone to great lengths to separate the revenue measure from the county government. Anti-tax activists sued, however, and in the lawsuit the county challenged the constitutionality of Proposition 62. However, the anti-tax activists won in *Santa Clara Valley Transportation Authority v. Guardino*, 11 Cal. 4th 220 (1995), thus kicking off a new era – one in which cities and counties had to win two-thirds voter approval for such tools as utility user taxes, which previously had been adopted only by elected officials.

Even as the battles over special taxes and sales taxes continued, local officials were pursuing other loopholes as well. In particular, cities and counties began using assessment districts to plug the revenue gap. Under laws first passed more than 90 years ago, benefit assessment districts, which place assessments on property owners, could be created without a vote. Over time, these assessment districts became more and more expansive in scope. This practice was sanctioned by the California Supreme Court in *Knox v. Orland*, 4 Cal.4th 132 (1992), a ruling that led directly to 1996's Proposition 218.

In the *Knox* case, the Supreme Court upheld a decision by the City of Orland to create an assessment district under the state's Lighting and Landscaping Act to assess every property owner in the city $24 to help fund operations of city parks. The Pacific Legal Foundation sued, pointing out that some properties were more than 20 miles from the nearest park and arguing that the benefit assessment mechanisms should not be used to pay for park operations. The California Supreme Court sided with Orland. "We cannot say the spirit of (Proposition 13) is violated where, as here, a city shifts its benefit assessments in order to equalize the benefits and burdens of park improvements and to end the windfall enjoyed by residential property owners outside the city who use, and whose property benefits from, such improvements," wrote Justice Marvin Baxter.

To overturn *Knox*, taxpayer advocates wrote Proposition 218, which subjects assessment districts to approval by a vote of property owners, and of registered voters. Proposition 218 also empowered voters to repeal taxes via initiative. Proposition 218 passed in November 1996 and – like the cases surrounding Proposition 62 – stimulated a whole new series of elections surrounding revenue measures in California.

And so the net result today is that, in most cases, Californians vote during local elections on revenue measures – not just conventional property taxes, but also on a wide range of other taxes and assessments that have come to replace the property tax lost under Proposition 13. And that has given the local governments more motivation to finance infrastructure by loading fees and assessments on new development, namely, on voters who have not turned up yet. ■

The 5 W's And The Offspring

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8, the state undertook partial or complete buyouts of many health and welfare programs previously funded by counties.

The system has evolved since 1979, with the biggest departure occurring during the early 1990s when the state shifted roughly one-quarter of property tax revenues back to schools. On the election front, two measures have built on Proposition 13. Voters in 1986 approved proposition 62, which attempted to close loopholes in Proposition 13. The measure, which does not apply to charter cities, requires majority voter approval of general taxes and two-thirds voter approval of special taxes. Ten years later, voters approved Proposition 218, which requires two-thirds approval of property owners for assessments. ■

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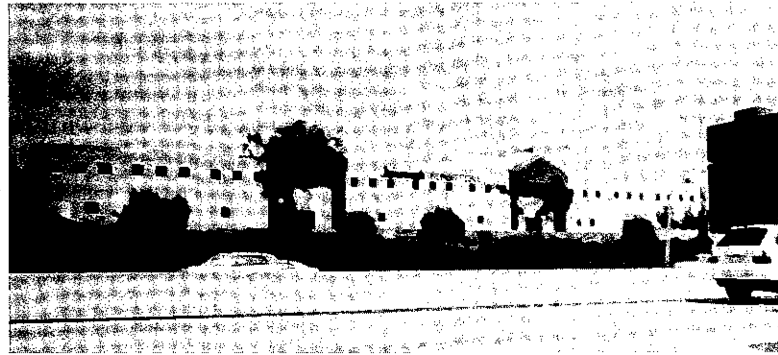
occurs within designated redevelopment project areas. Nearly all of it appears to have been built in the past five years. This is the landscape of Proposition 13.

The green hills resume for a few miles before we hit Escondido and the clutter resumes. A few blocks away from the freeway is another regional mall and another auto mall, the Escondido Auto Park. With 12 dealers, the mall claims to be more competitive than the auto park in neighboring Temecula. The regional mall, Westfield Shoppingtown North County, is anchored by- guess who?—Sears, JC Penney, Robinsons-May, Macy's and Nordstrom. A separate shopping center, Escondido Promenade (not to be confused with The Promenade at Temecula,) is anchored by Target and Mervyn's. The retail blight continues as we drive through Encinitas, where the featureless loading dock of a neighborhood shopping center boasts the names of merchants in tall red letters for the benefit of passing motorists.



A gigantic discount furniture store backs up to the freeway in Temecula.

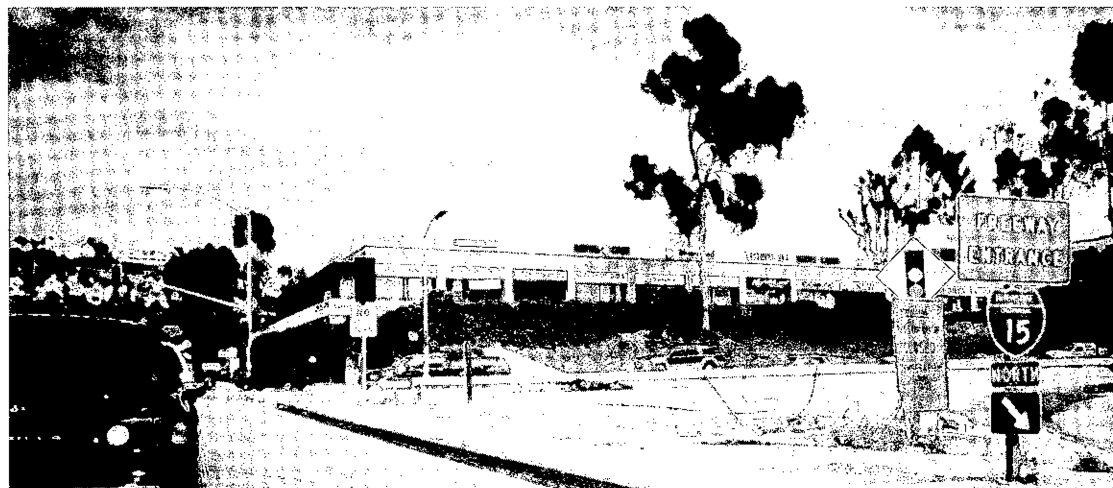
It is probably impossible to figure out exactly how much unsightly development stems directly from Proposition 13. Still, odd phenomena like repeating anchor stores and dueling auto malls suggest that local governments have been willing to devote far more land and resources to redundant and over-sized retail projects. These projects, in my view, have had a destructive effect on the visual quality of our freeways and open space. If they have added convenience and retail choice on one scale of value, these projects have also eroded our quality of life on another.

Disturbingly, the landscape of Proposition 13 is avoidable — if cities were willing to assert themselves and make developers stick to some basic rules about visual quality, and if cities did not believe they would be shunned by desirable retailers. Keep in mind that the degraded roadside is a *political* creation, not the inevitable cost of doing business.

This visual noise is not confined to Interstate 15, but is mushrooming wildly throughout California. The stretch of Interstate 10 in the eastern L.A. basin from Montclair through Ontario is worse than the Riverside-San Diego example, while roadside crud is rapidly spreading along Interstate 80 in Contra Costa County. Readers can probably nominate their own local horrors. Admittedly, some of this development is the inevitable cost of a growing population and the need of communities to attract business and jobs. Yet it is disturbing to reflect how much of this is a result of tax-starved cities that are encouraging, and in some cases subsidizing, development that they would otherwise shun if not forced to seek sales tax and tax increment revenue.

In cases where tasteless retail projects are built in redevelopment areas, the obvious irony is that one condition of blight – usually old, low-lying buildings – are replaced with a new blight of retail buildings that are far uglier and even anti-urban. But the new buildings come with more promising tax receipts. The only "beauty part" here is the money. In Temecula, for example, the mall and immediately surrounding retail contributes about $3 million in sales tax, while the auto mall provides another $2.5 million to a city with estimated annual sales tax revenues of $21.1 million in Fiscal Year 2002-2003. Both are located in a redevelopment area. In comparison, total annual revenues for Temecula in the same fiscal year are estimated at $39.7 million.

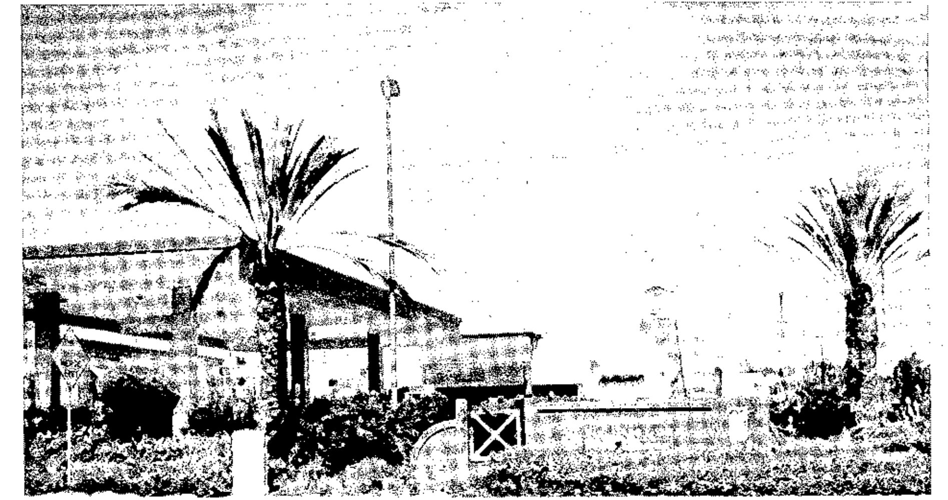
In fairness, it is too simple to demonize either Proposition 13 or the cities that turn themselves into camp followers of national retailers. Proposition 13 is only one of several factors that have led to the degradation of the California roadside, chief among which are the rapid growth in population and the continued urbanization/suburbanization of California, primarily along major



Retail greets motorists at nearly every exit on Interstate 15 in northern San Diego County.

arterials. Another culprit is the aggressive expansion of "national credit" retailers whose deep pockets and willingness to sign long-term leases have made them the darlings of retail developers. Some retail developers are no longer able to obtain financing without a certain proportion of national tenants to assure the lender that the project is viable.

Further, the shopping habits of Americans are changing from auto-oriented regional malls to even more auto-oriented power centers and discount centers, like Costco and Home Depot, which are surrounded by acres of surface parking. Stores with gobs of surface parking are considered more convenient and more conducive to car-mobility than, say, regional malls that required people to park in structures – even if the actual distance from the car to the merchant's front door is longer. Americans want to buy more, spend less for it, and get back into their cars more quickly.



Roadside "convenience"is inescapable on Interstate 15.

Another factor, and one that has not received enough attention for its impact on American life, is the peculiar land economics of retail development. Developers know that a retail building is only as good as its tenant and many retail tenants are only in buildings for five years, although some of the most desirable national credit tenants will sign leases for up to 20 years. Accordingly, a retail building is essentially a sort of temporary building whose improvements need not outlive its tenant.

Some retail developers have broken this mold and attempted to provide buildings of architectural interest and sound construction. Developer Rick Caruso's projects in Ventura and Los Angeles counties are cases in point, as are the new retail buildings on Pasadena's Lake Avenue. These are exceptions, however, and take place only in the most affluent areas with proven market conditions where developers feel assured that the extra investment in design will have a pay off.

The solutions to rampant retail blight are not obvious. The fundamental problems – the state's peculiar method of distributing sales tax and the perpetual under-funding of local government – are not solvable without a large-scale, grass-roots reaction that appears unlikely at this point.

Cities could enact strict height and signage requirements along freeways while protecting the most valuable view corridors. Cities could also encourage regional malls or major power centers to replace garish billboards with modest highway signs. Some affluent cities, such as Carmel, feel no need to compete for retail tax dollars, although tourism-oriented cities like Carmel may be able to compensate with sales tax and hotel tax revenues. Other cities could simply require considerable setbacks from the freeway, so that buildings do not become elongated billboards for national credit companies.

These actions can be undertaken without scaring away worthwhile retail tenants. Yet the idea of the next town over offering a better deal to retailers is enough to spoil any ideas of reform. Until tax competition becomes a thing of the past, we will be seeing more of the landscape of Proposition 13. ■

Motorists cannot miss opportunities to leave sales tax dollars in every city.

Proposition 13 Malls California Planning

Initiative Puts Property Tax Rate In Stone

By William Fulton

A citizen initiative placed on the ballot by taxpayer activists Howard Jarvis and Paul Gann, Proposition 13 contains three critical provisions that have become political bedrock in California during the past 25 years:

- Property may be reassessed only when it is sold
- The total property tax rate may not exceed 1%
- New property-based taxes may be imposed only by a vote, with a majority vote required for "general" taxes and a two-thirds vote required for "special" taxes.

The benefits of Proposition 13 are unquestionable, even if local government officials are rarely willing to admit it. By reducing property taxes and keeping them low, Proposition 13 slashed California's overall tax burden. Sales and income taxes are still high by national standards, but the low property tax means that overall California's tax burden falls somewhere in the middle nationally – rather than at the high end, as was the case prior to Proposition 13. This tax situation is especially important to property-intensive businesses, making California more competitive for businesses than it might otherwise be.

Proposition 13 also made real estate a better investment for most Californians. Every dollar not used for property taxes was another dollar available to pay the mortgage. Thus, the average homebuyer could qualify for a larger mortgage, which helped permit real estate prices to continue rising even after the passage of Proposition 13.

Perhaps most importantly, Proposition 13 eliminated the unpredictability of property taxes for millions of California homeowners. Traditionally, property owners had been vexed by two different types of unpredictability – the property assessment and the property tax rate. The assessment was in the hands of the county assessor, while the tax rate was in the hands of myriad local government agencies with the power to levy property tax. Keeping property taxes down required taxpayers to fight a war on several fronts at once. Proposition 13 ended that war.

"The lasting legacy for taxpayers," wrote Larry McCarthy of the California Taxpayers Association, "is the protection against surprise increases in assessed value. Taxpayers know what to expect in property taxes when they buy property and what they will owe 10 years down the road."

To understand why Proposition 13 passed and why it remains popular today, it is important to understand the problem that Proposition 13 was trying to address: a system of property assessment and taxation that was arcane and unpredictable at its best and scandalously corrupt at its worst.

In his book *Paradise Lost*, a chronicle of the Proposition 13 era, author Peter Shrag points out that until the 1960s, California, like most other states, was rife with shady assessment practices that led to jail time for more than a few local assessors. California's first attempt to deal with the property assessment problem came during the 1960s, when a new law was passed that

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for new growth, nor the slow-growth desire to "pull up the drawbridge," nor even the practice of requiring two-thirds voter approval for local school bonds.

All these things existed before 1978. But all were accelerated by the passage of Proposition 13. And just as important, Proposition 13 created an intensified, crisis-oriented atmosphere among local governments – a kind of a hothouse – within which all these trends have baked together to create California's peculiar approach to building and financing communities.

Part of Proposition 13's intent was to reduce the size of government by reducing the amount of tax revenue available. But it is not the impulse of government to cut its own size. Rather than do that, local government agencies throughout the state have gone into survival mode in two different ways. First, they have intensified their competition with one another for the revenue sources available. Second, they have been endlessly inventive in finding new sources of revenue that are not subject to Proposition 13's limitations.

And because local government revenue sources are so closely tied to land and real estate development, the "post-Proposition 13" culture quickly translated into tangible changes on the urban landscape, many of which were tied to new revenue-raising strategies.

The "auto mall" now common throughout the United States was invented in California – not by the auto industry or even by Cal Worthington, but by local governments trying to capture sales taxes. The plethora of outlet malls, entertainment retail centers, and regional malls is also partly the result of Proposition 13. So is the boomlet in the creation of new cities during the last 25 years because for the first time in history, a California community could incorporate by transferring money out of the county treasury rather than raising taxes. Many of California's sprawling regional development patterns are the result of Proposition 13 also. Well-located cities have been able to cherry-pick retail centers, high-end housing, and other tax "winners." Meanwhile, starter homes and other tax "losers" have been relegated to distant locations on the metropolitan fringe, often in unincorporated areas, where county leaders are desperate to generate any type of revenue they can get.

Similarly, California has become home to some of the most peculiar revenue-raising mechanisms in the history of American public finance. Parcel taxes, previously not permitted, are now common. Mello-Roos taxes, a municipal bonding mechanism that many on Wall Street still do not understand, were invented specifically to circumvent Proposition 13. Development impact fees are now a basic part of the California landscape, as is the "nexus consultant," whose job is to prove the relationship between the problem being created by the development and the fee that will solve the problem. The state has also seen creative use of many different types of assessment districts. The end result has been to shift most of the cost of new infrastructure from property taxpayers to developers and new homebuyers.

Most local government officials in California seem resigned to working within the basic tenets of Proposition 13: The 1% cap, the reassessment only upon sale and the two-thirds vote requirement. This acceptance has forced them to try to achieve traditional goals within the more rigorous framework that Proposition 13 imposes, and, in the process, they have begun to restore the faith of at least

some voters in at least some government activities.

Local school bonds backed by increased property taxes were originally banned under Proposition 13. By the mid-1980s, they were permitted by a two-thirds vote. Since the passage of Proposition 39 in November 2000, only a 55% vote is required to pass school bonds.

Even though the percentage of voters who are public school parents today is only half what it was in the 1960s (20% versus 40%), most school bonds are now winning. School districts have made the case that good school facilities help everyone in the community

The local school bond, however, represents a rare instance in the post-Proposition 13 world where local voters can engage in the traditional task of weighing costs and benefits. If there is one lingering problem that results from Proposition 13, it is that the process of raising government revenue has been severed from the process of spending it, which does nothing to restore faith in government. That is a problem nobody seems to be able to fix so long as a state constitutional amendment overrides local taxation power and gives allocation authority to Sacramento.

What is perhaps most surprising is that this basic model of California planning – the post-Proposition 13 model, we'll call it – has survived all the upheavals of the last 25 years. Slow-growth sentiment has chilled whenever the real estate market has tanked, but the sentiment did not vanish. Even when there was nary a construction loan to be found in the whole state, land developers kept pursuing specific plans and development agreements, and slow-growthers kept suing and forcing projects onto the ballot.

Similarly, just when the fiscal zoning fad should have been fading into the background, the harsh financial realities of the 1990s gave it new life. In 1992 and 1993, the state government reminded the locals of who's boss by shifting 25% of the property tax in the state – somewhere around $5 billion today – away from cities and counties to the schools. Unless they lie in a redevelopment project area, most housing and other development projects that do not generate sales tax have been a bad deal for cities and counties ever since Proposition 13 passed. Now these projects are a worse deal. And it is pretty clear that when the dust settles from the current state budget crisis, local governments will be more desperate than ever for new revenue – and will use land-use authority more aggressively than ever to pursue it.

In short, even during the 21st Century, we seem to be operating with more or less the same planning and fiscal architecture that we've had for close to two decades – an architecture that has led to unnecessary competition among cities, ghettoizing of land uses, and regional imbalances in our large metropolitan areas. This raises the question of whether California will ever revamp its crazy financial system and, in particular, whether an overhaul can be accomplished in conjunction with the many, mostly incremental, land-use reforms that work their way through the Legislature.

Even while the post-Proposition 13 fiscal system has changed over the last 25 years, the land-use planning system has remained largely mired in the 1970s. Most of California's major planning laws, including General Plan law and the California Environmental Quality Act, were either passed or underwent their last major amendment in the 1970s. Despite several attempts, wholesale land-use reform has never occurred in California. This has placed the state "behind the curve" compared with other states – New Jersey, Florida, Washington, Maryland – that have passed major reforms during the last 25 years.

Comprehensive land-use reform is

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required all property to be reassessed every three years at 25% of market value.

The irony, according to Shrag, was that even the crooked assessors had always been smart enough to assess residential property too low and business property too high. Such a skew was good politics because voters were far more likely to be homeowners than business owners. By standardizing assessment practices, however, the new law ended this favoritism and shifted the taxation burden away from businesses and toward residences. Little wonder that in San Francisco and elsewhere a popular bumper-sticker of the time said: "Bring back the crooked assessor."

When real estate prices skyrocketed during the 1970s, the tax burden on residential property only became more of a political target. Millions of middle-income homeowners saw their home values and their property assessments increase 30% per year or more. As a result, many property-tax bills doubled virtually overnight, quickly outstripping the ability of both working and retired homeowners to pay the taxes. It was the portrait of the retired widow forced to sell her house to pay the property tax bill that captured the public's imagination.

But the annual fight with the assessor was only half of the reason that property taxes were politically vulnerable because the assessed value of any individual's house is only part of the equation that yields the final property tax bill. Just as important, though harder to combat for the average taxpayer, was the property tax rate, which was set every year by local officials.

This was especially true in suburban areas – which is most of California – where the typical homeowner might be subject to a separate property tax from the county, the city, the elementary school district, the high school district, the community college district, the water district, the park district, the fire district, the cemetery district, the vector control district and more. Each government agency set its own rate, but no one was politically accountable for the bottom line. Typically, no single agency imposed a property-tax rate of more than one-half of 1%, but the cumulative total could easily add up to 2.5% or 3% on an assessment that, during the late 1970s, was rising dramatically every year. That's why the 1% cap on the property-tax rate was just as important as the reassessment provisions.

During the run-up to the June 1978 election, Proposition 13 was opposed by almost every element in the state's political and business establishment – not just public unions and government officials, but also the state Chamber of Commerce and the California Taxpayers Association. Most backed a competing ballot measure, Proposition 8, which would have permitted a split roll taxing owner-occupied residential property at a lower rate.

Nevertheless, 65% of the state's voters approved Proposition 13 at the June 1978 election. Throughout the country, Proposition 13 is widely viewed as the bellwether event in what became a widespread and enduring nationwide revolt against high taxes. Ronald Reagan quickly picked up on Proposition 13's themes in shaping his 1980 presidential campaign. Most other states now have some form of property tax restriction. And, as President George W. Bush has proven most recently, the rhetoric of limited taxes and limited government is now a staple of American politics. ■

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unlikely in the near future. But in the last year or so, some minor movement has occurred and more appears likely. The most important bill that passed last year was AB 857, which requires all state agencies to focus their planning on three "smart growth" goals: infill, compact development in new locations, and agriculture and open space preservation. Other bills are floating through the Legislature this year, including one sponsored by the author of AB 857, Assemblywoman Patricia Wiggins (D-Santa Rosa), that would require urban growth boundaries. At the same time, some bills would put more pressure on local governments to stimulate housing production, though these bills are not likely to pass this year.

The question is whether any of these bills will pass – or whether they will make any difference even if they do – without some revision of the fiscal tangle that has been created in the wake of Proposition 13. Endless proposals has been put forth during the last decade to redistribute or reallocate tax revenues, or to throw money back to all the local governments in a county and let them duke it out. The latest proposal is Sacramento Assemblyman Darrell Steinberg's AB 1221, which would swap sales tax and property tax between local state governments, so the locals get more property tax and less sales tax. The idea is that this will reduce the fiscalization of land use and make housing more attractive to cities.

But there is a trap here that California's communities – and its politicians – cannot seem to escape. Land-use reform will not do much good without fiscal reform. And fiscal reform has been stalled because the local governments do not trust the state, especially since the property tax shift of the early '90s. The current budget crisis is likely to erode that trust even further because more money will be shifted away from the locals to the state with no assurance it will be returned. It is pretty clear that the local governments don't want to have a conversation with the state on land-use reform – or anything else, for that matter – unless they can first get a constitutionally guaranteed set of revenue sources similar to Proposition 98 for schools.

If local governments do not get a Proposition 98-type assurance, then California is at a crossroad. Either the expenditure decisions will have to move up to the state level, where revenue is allocated, or the revenue allocation decisions will have to come down to the local level, where the expenditure decisions are currently made.

At first glance, this question may seem to be a long way from the question of planning and development, but the experience of the last 25 years suggests that it is not. Local land-use decisions will always be driven to some extent by revenue concerns. And it is clear that the more tangled local government finance has become over the last 25 years, the more difficult it has been for California's communities to engage in rational land-use planning. Neither of the two solutions described above may be ideal. On the one hand, a Sacramento-driven solution may strip local governments of much of their remaining power; on the other hand, the locals may not be able to work together well enough to allocate their own resources. But any solution that breaks the grip of the zero-sum culture on California's communities is better than the current state of affairs. ■

Local Government In A Zero-Sum Culture

BY WILLIAM FULTON

While Proposition 13 has become an icon of America's political culture, it has also become an important lesson in the politics of unintended consequences. Like most citizen initiatives, Proposition 13 was not finely crafted legislative surgery. It was a harsh blow with a blunt instrument. As such, it sent California government – and, by extension, California planning and development trends – spinning in unpredictable directions.

The immediate impact of Proposition 13 was pretty much as predicted. All local government agencies had less money, although the state bailout greatly softened Proposition 13's impact at city hall and in the classroom. But over time, the unintended consequences emerged, and they had a major effect on the distribution of political power and governmental resources.

For planning and development, Proposition 13 had two major impacts that were not foreseen at the time of its passage.

- It transferred a great deal of power from local governments to the state government in Sacramento.
- It led local governments on an endless quest for forms of revenue other than property tax – a quest that has benefited some local agencies (such as cities and redevelopment agencies) far more than others (such as counties and special districts dependent on property tax.)

It is difficult to imagine that either Howard Jarvis or Paul Gann intended to remove power from local governments and give it to the state. Yet that is what Proposition 13 did. In placing a cap on the overall tax rate, the initiative raised the question of who should allocate the property-tax revenues. Proposition 13 answered that question with a single sentence by delegating tax allocation responsibility to the state government.

Coincidentally, Proposition 13 passed only two years after the second of the two *Serrano v. Priest* court decisions, which required the state to "equalize" the operating budgets of school districts across the state. Prior to the *Serrano* cases, a school district with a large property tax base had more money per student than a school district with a small property tax base. After the court rulings, the state had to make up the difference.

The net effect of Proposition 13 and *Serrano* together was to convert the property tax into a de facto state revenue source. Under *Serrano*, the state was required to commingle its own funds with school property-tax revenue to reach a statewide equilibrium. Under Proposition 13, the state had the power to allocate property taxes among local agencies however it wished.

In 1979, when the state was flush with cash, it allocated most of the property taxes to cities and counties and made up the difference by increasing state outlays to schools. So perhaps it was inevitable that when the state ran into financial trouble during the early 1990s, the Legislature would reverse the trend. In the 1992-93 and 1993-94 budget years, the state shifted approximately 25% of the funds away from counties and cities and back to school districts to balance the state's own budget.

In this kind of environment, it is not surprising that local governments have become active lobbying groups in Sacramento. Under Proposition 13, one of their major revenue source depends far more on their lobbying ability in Sacramento than on their relationship with their own local residents and taxpayers.

By restricting property tax, Proposition 13 also changed the strategic importance of all revenue sources in local government. Sales tax became far more important – especially for cities – and development fees and property assessments emerged as critical revenue generators.

All these trends had an impact on urban development patterns. Proposition 13 essentially rewarded cities and counties for developing retail land uses, which generated sales tax, and punished them for developing land uses that generated only property tax – essentially, all low- and moderate-income housing. This is one of the main reasons for today's "fiscalized" urban landscape, with its plethora of shopping centers and auto malls, and its paucity of balanced housing developments.

While retail developments were subsidized because of their tax attractiveness, housing developments were essentially charged a premium in the form of development fees, which were required to pay for new infrastructure no longer obtainable through the increased property tax flows. Among other things, these trends have made local government budgets subject to far more volatility. Retail sales transactions and real estate development activity fluctuate wildly depending on market conditions, while property assessments are traditionally more stable.

Many of the revenue-raising measures that resulted from Proposition 13 created their own backlash. For example, after the 1992-93 property tax shift, counties and special districts turned to assessment districts as an important source of replacement revenue. These districts could be formed and assessments levied without a vote. This trend led directly to Proposition 218, the 1996 taxpayer initiative that required, in essence, two-thirds approval from property owners for assessments.

All across the board, local governments have taken advantage of complicated legal loopholes to gain an advantage in the "zero-sum culture." When Proposition 13 passed, for example, most experts assumed that declining property taxes spelled the end of redevelopment in California because redevelopment finance plans depended heavily in increased property-tax flows. But redevelopment enjoyed a scandalously successful renaissance during the 1980s because it was an important zero-sum tool: Clever cities could use it to capture property tax dollars that would otherwise have to be shared with counties, school districts and special districts. Widespread use and abuse of redevelopment as a zero-sum tool led directly to the redevelopment reforms of 1993.

Similarly, Proposition 13 sparked a renaissance in city incorporations because cityhood could also be used as a zero-sum tool. Incorporations had waned during the late '60s and '70s because of opposition from taxpayers, who correctly assumed creation of a new city also meant higher taxes. But with property tax increases outlawed by Proposition 13, political resistance to incorporations lessened. And cityhood proponents realized that incorporation was a good way to take property and sales tax revenue from a distant county treasury and return it to their community. Not surprisingly, this trend produced its own backlash: The "revenue neutrality" bill, passed in 1992 at the insistence of counties, which has stifled incorporations by requiring that new cities make counties financially whole. ■

insight WILLIAM FULTON

Sacramento Tax-Sharing Bill Forces Regionalism Issue, But Opposition Holds Firm

(Editor's Note: From CP&DR, March 2002.)

Perhaps no legislative proposal in recent memory has cut closer to the bone of California's state-local governance problems than AB 680, Assemblyman Darrell Steinberg's proposal to create a tax-sharing system for metropolitan Sacramento. And there's one simple reason for that: While tax-sharing has been discussed in legislative circles for close to 20 years, Steinberg's bill is the only one that has ever actually gotten very far.

Despite intense opposition from most Sacramento suburbs and the League of California Cities, Steinberg's bill has passed the Assembly – a remarkable achievement apparently due in part to the assemblyman's rising stature in the Legislature. The bill proposes altering the sales-tax distribution formula for metro Sacramento in exactly the way that good-government reformers often call for. It would allow all jurisdictions in the region to hang on to their current sales-tax base, but it would distribute future growth in a different way. A third would go to the jurisdiction where the retail transaction takes place. But another third would be distributed based on population and the final third would be distributed to jurisdictions that meet certain housing and planning goals.

It's hard to imagine that Steinberg's bill will survive the legislative session. Nevertheless, the mere fact that Steinberg's bill is still alive suggests that something is different in the Capitol these days. With more and more ex-local officials populating the Legislature, it may well be that the Capitol will begin to serve more frequently as a proxy for regional government, as it has in smaller states.

Part of the reason why this happens is that it's really hard to broker a productive regional conversation at the regional level. Regionalism is tricky in any metropolitan area with a dominant central city and a series of smaller suburbs.

It is virtually impossible for any central-city politician to promote regionalism without being accused of trying to cut a sweet deal for the central city. This is exactly what is happening to Steinberg, a former Sacramento city councilman.

He's not the first one to suffer this fate. It's exactly the same thing that happened to William Johnson, the mayor of Rochester, N.Y. In national circles, Johnson is regarded as an enlightened paragon of regionalism and "smart growth." Back in metropolitan Rochester, however, he is often accused of appropriating these agendas to channel wealth from the 'burbs back to the once-proud central city, whose population has dropped so much that Rochester is now about the same size as Fremont and Huntington Beach.

Given that political reality, many central-city politicians will tell you that if they want to promote regionalism they have to do it sideways, by whispering in the ear of suburban mayors and asking them to carry the torch instead. But this brings its own risk with it. For a suburban politician, it's almost impossible to promote regionalism without being accused of seeking to dilute central city (often meaning minority) political power. That's why so few metropolitan areas in the United States have merged their central city and central county. Indianapolis has a city-county "Unigov," and Louisville, Kentucky, will merge with its surrounding county next year – but those are rarities. Sacramento city and county have never done so despite repeated discussions.

The hue and cry from suburban Sacramento over the Steinberg bill sounds typical on the surface. Republican Assemblyman Dave Cox, who represents most of the eastern suburbs, complained that the bill allows the Legislature "to impose our will" and therefore "wipes out local control." William Kristoff, the mayor of West Sacramento, came out against the bill because, he said, "it creates winners and losers."

These comments are probably good politics in the 'burbs, where the appearance of local control is really important. But they conveniently ignore an undeniable reality: The Legislature has already imposed its will on local governments, and the system already creates winners and losers.

The state's tax distribution system is not a level playing field. It rewards jurisdictions for luring retail transactions inside their boundaries and, combined with Proposition 13, penalizes them for approving most housing development. This is not a deliberate state policy, but it is the net effect of all the tax laws currently in place.

Furthermore, the state has created a series of other "default" mechanisms that allow some cities to gain a financial advantage over others. For example, because there is no other method for adjacent jurisdictions to negotiate with each other over "impact mitigation" from development projects, the cities feeling "impacted" – especially by traffic – often sue under the California Environmental Quality Act. And they often settle out of court for road money. Thus, CEQA becomes a method of transferring funds from one jurisdiction to another – but, in most cases, only from jurisdictions accepting development to jurisdictions smart enough to hire good CEQA lawyers. A similar series of games can be played with redevelopment.

At least Steinberg's bill forces many people to acknowledge the fact that the state's tax distribution system and other state processes create a de facto regional planning system that already circumscribes local control. And the Sacramento debate has raised another important – and increasingly relevant – point about regionalism: It is rarely a central-city-versus-suburb debate anymore because suburbs themselves are so different.

Claiming that the Steinberg bill was, in fact, a central-city power grab, political columnist Dan Walters pointed out that the bill is unlikely to hurt the already-tax-rich suburb of Roseville, which would be held harmless – but it might hurt emerging close-in suburbs such as West Sacramento and Elk Grove, which hope to grow their sales tax base considerably in the future. Meanwhile, Mayor Kristoff of West Sacramento expressed support for a financial assessment on long commutes – a proposal that would probably help his city but harm a distant suburb, such as Rocklin.

Steinberg's bill will have a tough — CONTINUED ON PAGE 23

deals MORRIS NEWMAN

Lancaster Buys A Costco Store

(Editor's Note: From CP&DR, March 2002.)

Can this marriage be saved?

She – let's call her "L" – was a young, slightly naive city of 122,000 people in the high desert region of Los Angeles County. She loved her biggest retailer, Costco, very much. In their 13 years together, Costco had been a good provider, bringing about $470,000 annually to the city's general fund of $33 million. "L" vowed she would always be faithful to Costco, no matter the cost, no matter how much it hurt.

Now, Costco was one of those discount retailers with that bad-boy, big-box look that drives small-town city councils wild. He was not into architecture or decorating, to put it mildly. That's why prices were low, Costco would say gruffly. He just put the merchandise on the concrete floor, and people lined up to buy it. A lot of it.

At first, the marriage between Costco and Lancaster – oops, I mean "L" – appeared to be going well. "L" figured that if she and Costco stayed together, he could bring in something like $62 million during the next 30 years or so.

But Costco was restless. He wanted more. He thought his 131,154-square-foot house was too small, and he wanted a bigger one. About 148,000 square feet, plus a gas station, would do. It also turned out that Costco had a roaming eye – or so he said. If he didn't get his way, he would leave "L" for her sister, Palmdale, the other sizeable town in the Antelope Valley. Of course, he hinted that he didn't really want to go. But when a retailer gets its heart set on a gas pump island, well, something has to give.

"L" was frantic. She did not want to lose Costco for any reason, and was prepared to pay any price. If Costco wanted a bigger home, she would get him one: First she tried to condemn the neighboring merchant at Costco's old place. But the merchant, 99-cent Only Stores, sued the redevelopment agency, arguing that helping Costco was not a legitimate public reason to close another business.

> "Costco was sorry, to be sure, but 100 trees had to taste the chainsaw to make room for aisles of fertilizer spreaders, jumbo diapers and Britney Spears lunch boxes."

"L" looked at the old Sears lot, but it was too small for Costco, who apparently had very large feet (at least, he seemed to require a very big footprint.) Eventually, "L" would provide 14 acres of her own land, plus another five acres of Lancaster City Park, infuriating local picnickers.

Costco was sorry, to be sure, but 100 trees had to taste the chainsaw to make room for aisles of fertilizer spreaders, jumbo diapers and Britney Spears lunch boxes. The tearful city said she had to give up the parkland to preserve her "lifestyle." Apparently lolling in the shade at Lancaster City Park was not part of that lifestyle. Instead, she had her eye fixed on his rich streams of sales tax revenue and redevelopment tax increment. She hoped to reap $60.16 million in sales tax revenues, and another $2.2 million in tax increment, from the new Costco store and the old Costco store after it was reoccupied by another tenant during the life of the redevelopment project.

"L" wanted everybody to feel good, and she figured out a clever way to help, at only a moderate cost to herself. Here is how the deal works: Lancaster will sell nearly 14 acres to Costco for $3.275 million. When construction on the new store is done, the city will buy Costco's old building for $6.275 million, using the $3.275 million from Costco, plus $3 million of redevelopment money, which the city plans to recoup by selling the building to the owner of Costco's former shopping center. In addition, the redevelopment agency will pay the city $589,000 for the parkland-turned-discount-store-parking lot. Furthermore, the agency has agreed to pay $610,000 for 26 acres of former ranch-land on the other side of the town that can be used to enlarge another existing city park.

The city will essentially subsidize the construction of the new Costco store in the following way: The store's annual sales tax payments to the city are to be frozen at $470,000 annually, which is the sum that Costco generated at the old store. Costco can keep all the money above $470,000 that otherwise would have gone to sales tax, until those revenues have effectively reimbursed Costco for the full cost of building the new store, estimated to be between $8 million and $9 million; the city expects this process to take five to seven years.

Now, state law forbids redevelopment agencies from attempting to lure away another city's retailer with cash and other incentives. But don't worry. That is not happening here. Lancaster is paying money and giving away precious open space to prevent a retailer from going through with a threat to leave Lancaster for another city. See the difference? It's perfectly legal, even if it is no less objectionable.

True, Lancaster has replaced its lost parkland with newly acquired property in another part of town. That does not set things entire right. Open space is not a neutral condition whereof a loss on one side of town can be offset by a gain in another. Every part of the city needs open space, and Lancaster City Park is permanently diminished by this deal. It is a frightening precedent to begin thinking of parks as land banks for future redevelopment deals.

Deals like that of Lancaster and Costco put one form of desirable land use – redevelopment – into conflict with the equally desirable goal of open space preservation. Once again, the drive to "do the deal" wins out over a larger planning vision.

And was the deal even worth doing? Let me put forward the heretical notion that the parkland sacrifice was unnecessary. Costco would not have opened a store in the first place if Lancaster were not inherently a good trade area. If the city said no to Costco's latest demands, the store would threaten and fume, and go on doing business in Lancaster anyway – because it is profitable. As for going to Palmdale, don't think for a second that Costco will not open a store there the moment that market demographics justify it.

For the time being, honey, he's not going to leave you because he loves you – for your money. You would be surprised how many marriages are held together by that stuff. ■

Retailers Top List Of Favorite City Developments

Public Policy Institute Of California Study Finds Far Less Interest In Affordable Housing, Industry

(Editor's Note: From CP&DR, August 1999.)

BY WILLIAM FULTON

A new survey has documented what many planning and public policy experts have long suspected: California city managers prefer retail projects in their community over any other type of land use, and they least favor multi-family housing and heavy industrial projects.

The survey – part of a study of land use and sales tax issues by the Public Policy Institute of California – was released just as the California Legislature considers a bill that would require cities that lure large retailers across jurisdictional lines to share tax revenue with the "losing" jurisdiction. The bill, AB 178, carried by Assemblyman Tom Torlakson, D-Contra Costa County, was approved by the Senate Local Government Committee on July 14. A similar Torlakson bill failed to pass the same committee last year. The PPIC study also emerged at the same time that a committee appointed by the Board of Supervisors in Humboldt County concluded that big-box retailers will bring few new jobs and little new tax revenue to the county.

The city manager survey found that retail ranked significantly higher than office, mixed-use, and light industrial land uses, which also rated as city manager favorites. Surprisingly, the survey found little difference in city manager preferences for land uses inside and outside redevelopment project areas.

"To be fair, cities are not one-dimensional in their policy orientation, and they're still pretty interested in other types of development," said Paul Lewis, a PPIC researcher and co-author of the study, California Cities and the Local Sales Tax.

> **"Sales taxes are especially important because there are no legal constraints to growth in revenue and because the funds may be used for any purpose."**

The PPIC study also found that even though cities are heavily focused on sales tax, the hierarchy of sales-tax "winners" and "losers" in the state has not changed significantly in the last 25 years.

Furthermore, the study concluded, distributing sales tax on a population basis – either statewide or on a county-by-county basis – would not create significant change, as least on a macro scale. Approximately half the cities would be winners and half would be losers. Though individual cities would be heavily affected, there would be little difference, in the aggregate, between cities that win and cities that lose. Cities with a high Latino population would be winners – but so would extremely affluent cities, because they often have little retail base.

Sales-tax revenue has been considered especially important to cities ever since the passage of Proposition 13 in 1978. According to the report, cities received about 20% of their revenue from property tax and only 10% from sales tax prior to Proposition 13. Today, the two revenue sources are approximately equal at about 10% apiece. Cities receive most of their revenue from public service enterprises (approximately a third) and licenses, fees, and assessments (including development fees), which have grown from about 20% of revenue in the pre-Proposition 13 era to about 30% to 35% today.

Sales taxes are especially important, however, because there are no legal constraints to growth in revenue and because the funds may be used for any purpose.

In tracking city sales-tax revenue, Lewis and his co-researcher, Elisa Barbour, examined statistics in the 1991-93 period (a recession, especially for retailing) as well as historical trends from the early 1970s to the early 1990s. Among other things, they found that per-capita sales-tax revenue is generally higher in cities with declining household sizes, cities that have not had rapid population growth, and – significantly – cities located outside the Central Valley. These cities were more successful not only during the 1991-93 period, but also over the entire 20-year period.

In addition, PPIC found, cities active in redevelopment, those located near freeways, and those with a small African-American population were also successful in the sales-tax game – but these differences only showed up during the 1991-93 period, not over the 20-year period.

Significantly, however, researchers did find that central cities – defined as 36 older cities with established downtown areas – have lost considerable ground compared with suburbs. In 1971, central cities actually had greater sales-tax revenue per capita than suburbs did. Suburbs overtook central cities in the mid-'70s, and the gap has accelerated during the boom years of both the 1980s and the 1990s. Today, sales tax revenues in the central cities are about $90 per capita compared with about $110 in other cities.

The study also found an increasing gap in per-capita sales-tax revenues between the Bay Area and the Los Angeles region. Los Angeles had higher per-capita sales-tax revenue until the early 1980s but has been losing ground ever since. Today, the figures are approximately $125 per capita in the Bay Area and $95 per capita in Los Angeles.

The survey of city managers – to which about three-quarters of city managers in the state responded – measured not only land-use preferences but also factors reported by city managers that influence land use decisions. New sales-tax revenues came out as the most important factor, followed closely by city council support, eradication of blight (in redevelopment areas), infrastructure adequacy, and likelihood of job creation. With the exception of blight, these factors were not very different inside and outside redevelopment project areas. Meeting affordable housing needs, although higher in redevelopment areas, was among the least of city managers' concerns.

However, city managers in different regions of the state had different attitudes. City managers in all parts of the state listed sales-tax revenue as an important motivation. But Bay Area city managers, unlike their counterparts elsewhere, listed city council support, traffic problems, and neighborhood concerns as top factors. By contrast, Central Valley city managers were far more likely to list job creation as a factor influencing their land use decisions.

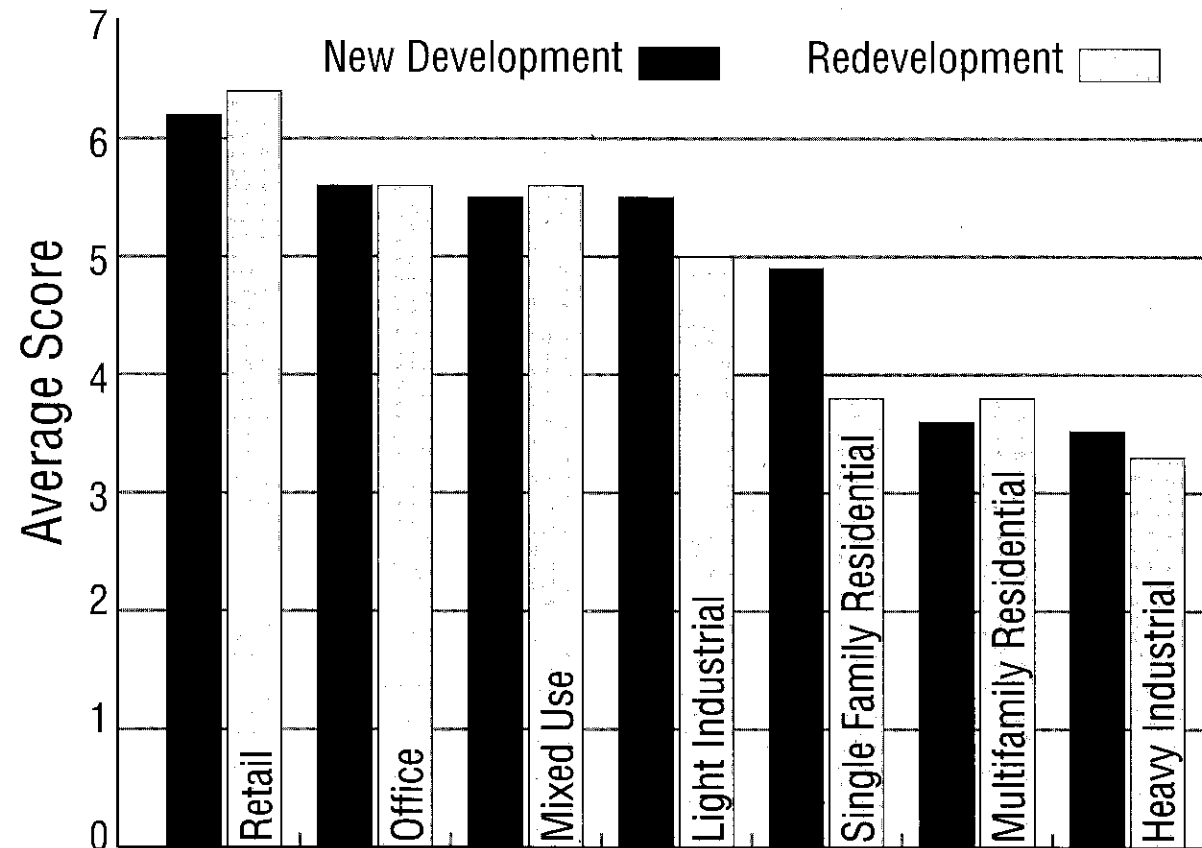
"If you're an isolated Central Valley city, you have to be concerned about jobs," Lewis said.

Though PPIC released the study at the same time the Senate Local Government Committee considered the Torlakson bill, it is hard to say whether the study affected the bill's success. AB 178, which was opposed by the California Motor Car Dealers Association among others, requires that if a city offers a subsidy to a big-box retailer or auto dealer to relocate within the same market area, the city must offer a sales-tax sharing contract to the city from which the retailer is relocating. The contract must be approved by a two-thirds vote of the city council or county board of supervisors in each jurisdiction. The legislation defines a big-box retailer as a store of at least 75,000 square feet.

Rex Hime, lobbyist for the California Business Properties Association, said opposition was muted by a number of changes from Torlakson's 1998 bill. Among other things, AB 178 limits the definition of a financial incentive so that some mitigation measures such as traffic improvements are not included and provides a specific definition of a "market area." As originally written, the bill defined "market area" as a 40-mile radius. At the July 14 hearing, the committee amended the bill to define the market area for big-box retailers as 25 miles, while retaining the market area for autos as 40 miles.

"It's a much different bill than it was before," Hime said.

The Humboldt County report was issued by a 10-member committee, including city managers and other prominent county citizens, appointed by the Board of Supervisors. The Ad Hoc Committee on Big Box Development concluded that because the county is isolated and its retail market is not growing very rapidly, any new big-box development would simply siphon jobs and sales from existing retailers. Supervisors created the committee in response to the pending question of whether to approve a Wal-Mart in Eureka. That question will be on the Eureka ballot August 24. The committee encouraged the county's cities to take advantage of the sales-tax sharing provisions in Proposition 11, passed by state voters last year. ■



Source: Public Policy Institute of California

Locals Grapple With Limits of Proposition 218

Major Effort Under Way To Secure Funding From Sacramento

(Editor's Note: From CP&DR, March 1997.)

BY WILLIAM FULTON

Four months after its passage, local governments and municipal bond experts are grappling with the fiscal constraints likely to be imposed as a result of the passage of Proposition 218 last November.

Among other things, localities are trying to sort the meaning of Proposition 218's provisions exempting certain "property-related" charges and fees from the two-thirds vote requirement. Meanwhile, bond experts are trying to determine whether the risk of municipal bond default will increase because of 218's provisions permitting repeal of taxes via initiative. The taxpayers advocates who drafted Proposition 218 have stated that they did not intend for the initiative to permit repeal of existing taxes which have been pledged to pay off outstanding bonds – and in fact are supporting legislation to make this point clear.

Meanwhile, the passage of Proposition 218 has stimulated new interest among lobbyists and legislators in Sacramento in stabilizing sources of local government funding. Democratic Assemblymen Mike Sweeney of Hayward and Tom Torlakson of Contra Costa County have formed a new Local Government Caucus in the Assembly, which already has 30 members. The caucus may soon lead the charge in restoring to local governments some of the property tax revenues lost in the state-imposed tax shifts of 1992 and 1993. "The issue of local government funding is on more radar screens in the Capitol than ever before," said Dwight Stenbakken, lobbyist for the League of California cities.

Proposition 218 was a constitutional amendment placed on the November 1996 ballot by the Howard Jarvis Taxpayers Association and other taxpayers groups. The wide-ranging initiative expanded voter-approval requirements to include assessment districts as well as actual taxes and also included a provision giving taxpayers the power to repeal local taxes, assessments, fees, and charges via initiative. The repeal-by-initiative provisions were included in order to place in the constitution the provisions of *Rossi v. Brown*, 9 Cal.4th 588 (1995).

The initiative also overturned two important court cases that expanded local government power to impose assessments and taxes without voter approval. In the Proposition 218 campaign, the taxpayer groups highlighted the fact that the initiative would overturn *Knox v. City of Orland*, 4 Cal.4th 132 (1994), a California Supreme Court ruling that affirmed an assessment district to pay for local parks even though some property owners in the district were 27 miles from the nearest park.

The initiative will also require voter approval for excise taxes that only affect new development projects. Such excise taxes were upheld by the Court of Appeal in *Centex Real Estate Corp. v. City of Vallejo*, 19 Cal.App.3d 1358 (1993).

For the taxpayer groups, Proposition 218 represented an attempt to eliminate the last remaining loopholes after Proposition 13 – especially assessment districts, which were widely used after the '92-'93 property tax shift because they did not require voter approval. Estimates of the likely fiscal impact on local governments vary widely but is likely to run into the billions of dollars. A recent survey by the California State Association of Counties estimated that the impact on 27 selected counties in the state would total $200 million.

Builders and developers fear that Proposition 218 will put more pressure on local governments to increase fees and charges on new development. The initiative specifically exempts "property-related fees" from any vote requirement. Infrastructure finance experts had expressed concern that this provision was too vague, which might lead to confusion about what it covers.

However, according to a recent "Statement of Drafters' Intent" issued by the Howard Jarvis Taxpayers Association, the provision should be "broadly construed to include levies imposed for services or regulatory activities which have a nexus to the beneficial use of the property including rent control fees." The statement specifically calls out sewer, water, and refuse collection as property-related fees not subject to a vote.

Jonathan Coupal, legal counsel for the Jarvis group, also said that he believes development fees will not go up much because they are currently constrained by state law – especially by the School Facilities Act and by AB 1600, which requires accountability on the use of development fees. The building industry has stepped up efforts to enforce AB 1600's provisions in the last year or so.

The Jarvis group has also been downplaying the potential significance of the initiative-by-repeal provisions of Proposition 218. Coupal emphasized that 218 simply "constitutionalized" existing initiative powers permitted by the Rossi decision. He noted that even though the Rossi ruling has been in effect for two years, no existing tax or revenue stream had been placed on the ballot by citizens anywhere in the state. He added that he does not expect a flood of such initiatives.

Coupal emphasized that the Jarvis group's official position is that the initiative powers cannot be used to eliminate an existing tax or revenue stream against which a local government entity has already bonded. In the Jarvis group's statement, he wrote that "these concerns are not well-founded." In particular, he pointed to the impairment clause of the federal constitution (U.S. Const., article I, . 10(1)) as a source of protection against the use of the initiative power to disrupt bond payments. The Jarvis group is one of a broad range of organizations supporting a proposed bill which would clarify that existing revenue streams would not be placed in danger.

Coupal did, however, hold out the possibility that citizens around the state might use the initiative power contained in Proposition 218 to block the sale of municipal bonds once they have been approved by a local government entity without a vote. He added that no such situations have arisen since the Rossi case, however. Regarding the whole repeal-by-initiative issue, he said: "I just don't think it's that big a thing."

The likely impact of Proposition 218 has added to pressure in Sacramento to restore some of the property-tax funding lost by local governments during the recession years of 1992 and 1993. Last year, the Legislature passed AB 2797, which would have allocated a greater percentage of new growth in property tax revenue to cities and counties, but Gov. Pete Wilson vetoed the bill, saying he wanted a more "comprehensive" solution. This year, lobbyists from local government and the building industry are again seeking to change the formula for increased tax revenues and possibly for existing tax revenues as well. The proposed shift in — CONTINUED ON PAGE 23

Sales-Tax Pie May Shrink Permanently

Cities Still Do Deals With Retailers, But Experts Say Markets Are Saturated

(Editor's Note: From CP&DR, October 1992.)

BY MORRIS NEWMAN

As sales-tax revenues continue to fall significantly in communities throughout the state, many real estate experts are beginning to suggest that retail markets in California have finally become saturated. Yet local governments – desperate for funds in the wake of the recent state budget cuts – are continuing to pursue subsidized deals with Wal-Mart, Price Club, Costco, and other big retailers.

The result may be that, for many cities, sales-tax revenues will continue to erode despite the presence of big new retail outlets. "The question is whether we are just rearranging income from one retailer to another, rather than creating an actual increase in sales-tax revenue," says Bart Doyle, general counsel to the Building Industry Association of Southern California.

Overall, the state Board of Equalization shows that revenue from taxable sales fell 4.4% last year. And, as with other economic indicators, the sales-tax figures show the sharpest drops in Southern California – with both Riverside and L.A. county shopping a revenue dropoff in excess of 6%. A larger drop is expected this year.

Some of the revenue loss is clearly due to the recession. Increasingly, however, analysts are suggesting that the fabled California retail market has at last reached its limit. In a recent report for the California Housing Round Table, Orange County retail consultant wrote that "the inventory of retail floor space is growing considerably faster than available consumer expenditure. As a result, consumer expenditure is being spread over more square feet of gross leasable area, resulting in suboptimal sales volumes per square foot."

Nevertheless, local officials throughout the state continue to subsidize major retailers and auto dealers, sometimes through land write-downs, sales-tax rebates, and other incentives. In the case of Price Club and Wal-Mart – the latter has become a major player in California in just the last year – it is not uncommon for California cities to offer $3 million in subsidies and incentives, usually through a redevelopment deal. Critics of redevelopment have long claimed that local governments are artificially creating too many retail outlets. Gobar says that so many Wal-Marts and Price Clubs "would not be developed in a pure market environment."

The need to generate revenue is understandable. Many of these cities are so-called "lows and nos," meaning they had low property taxes prior to Proposition 13 – or none at all – and therefore receive a small share of such taxes today. "They don't have the property taxes to fall back on," says Richard Norris, executive director of the Building Industry Association in the Antelope Valley. "They have been almost totally reliant on impact fees and sales-tax revenues to run their cities."

With construction down, impact fees have dropped precipitously, and the fight over sales-tax revenues is increasing. And the deals are continuing to be made. Palmdale recently doubled the size of its regional mall to 1.5 million square feet. And Oxnard just approved a 600,000-square-foot retail center anchored by a Wal-Mart. "We need revenue," City Councilman Manny Lopez said at the meeting where the project was approved. "We're at a situation where we can't even keep our restrooms open in the park." In an interview, Lopez acknowledged he wasn't sure whether the mall would be a success; he said he had merely taken "an educated guess" based on a consultant's projections.

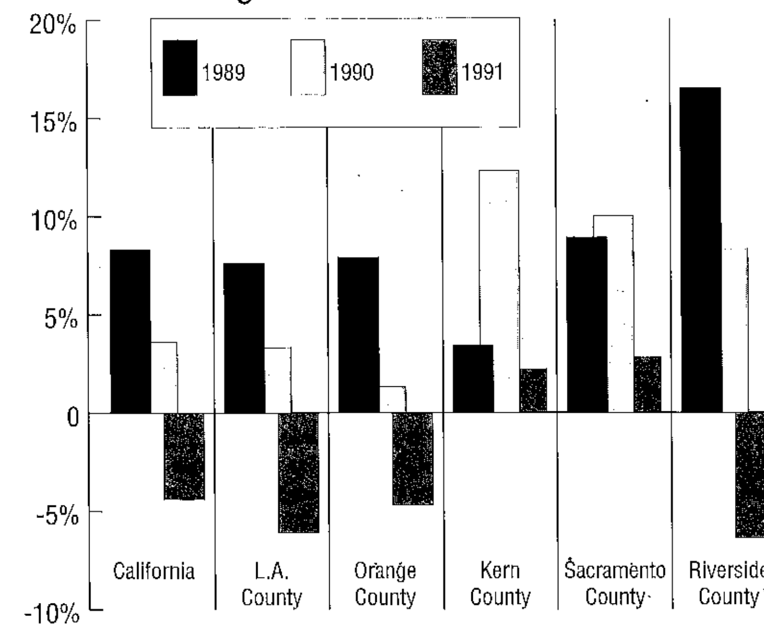
Yet it's not clear that bringing in a Wal-Mart or a Price Club into town results in a net increase in sales-tax revenue – either for the community which subsidizes it or for the surrounding region. Not only do big stores soak up the retail dollars that would otherwise flow to smaller, locally owned businesses, but they're so efficient at generating high-volume sales that they actually displace "Mom and Pop" stores on more than a one-for-one square-foot basis. Because a Circuit City can generate $650 per square foot in retail sales, every square foot can displace four square feet of little-guy space grossing $150 per foot.

At the same time, however, many cities seem to think they need the big retailers as a defensive move - to protect their sales-tax base against the inevitable decline of smaller retail stores when the bigger stores move into the region.

In Riverside County's Moreno Valley, where a Price Club opened in September, planner Mitch Slagerman acknowledges that sales tax is decreasing in the greater Riverside market area. But he still expects an increase in Moreno Valley's taxable sales: "In our community, taxable sales have traditionally been lower than in other communities because we didn't have the outlets." Also, Moreno Valley recently "won" a battle with Riverside over location of a regional mall.

At the Cerritos Auto Mall – long recognized as an economic development colossus – something similar is happening. The mall's sales — CONTINUED ON PAGE 23

Changes In Taxable Retail Sales



deals

MORRIS NEWMAN

Indio Chooses Sales Tax Over Tradition

(Editor's Note: From CP&DR, July 1992.)

The City of Indio faced an agonizing choice in the late 1980s: either lose the town's largest retail center or gut an African-American neighborhood that dated from the 1920s. The city's solution, still pending the resolution of a lawsuit, may result in some of the more interesting residential relocation strategies of recent years. Yet the question of what is more important – preserving an historic neighborhood or generating retail revenues at a time when cities are on the edge of insolvency – remains a wrenching issue.

Located about 25 miles east of Palm Springs, Indio is a desert agricultural and railroad town of 40,000 people. In contrast to such well-heeled neighbors as Indian Wells and Rancho Mirage, the city is one of the poor relations of the Coachella Valley, with a large working-class population. Also unlike some of its neighbors, Indio also has a minority population, including the longstanding African-American neighborhood of Noble's Ranch.

This same neighborhood is home of the Indio Fashion Mall, a 250,000-square-foot center anchored by Sears and Harris's. But retail development in surrounding communities has grown increasingly competitive, and both Sears and Harris's have reportedly threatened to leave the city if the mall is not expanded and more anchor stores are not brought in to boost foot traffic.

"The story of Noble's Ranch is part of the tradition of utopian communities in Southern California."

In 1987, the mall's owner, David E. Miller of Los Angeles, made a deal with the city to use redevelopment in order to expand the mall. Under the deal, the city would assemble a 23-acre site for the expansion of the mall, while Miller was to serve as a "bank" for the city – financing the land acquisition up front, with repayment coming later out of future tax increment. Meanwhile, the developer was to obtain construction financing for the mall expansion.

To date, J.C. Penney and Gottshalk's have signed commitments to serve as additional anchors, while the city has spent more than $2 million to acquire a little more than half the acreage – much of it from the adjacent Noble's Ranch residential neighborhood – and expects to spend at least that much to acquire the remaining land. Financing for the replacement housing is to come from the 20% tax-increment set-aside for housing required by the state's redevelopment law.

The city has big expectations from the mall expansion. According to the most recent numbers, which city officials say may be out of date, sales at the mall will grow from the current $33 million to $96 million annually. The job base will increase from 500 jobs to 1,150. Property tax will double from $185,000 to about $360,000 (although that number does not figure in the lost property taxes from Noble's Ranch housing to be demolished), and Indio's share of sales tax would increase from $330,000 a year to almost $1 million a year. In post-Proposition 13 California, those numbers seemed too good to pass up.

Of course, there is the matter of relocating the town's black neighborhood. The story of Noble's Ranch is part of the tradition of utopian communities in Southern California. John Noble, a prosperous black man from Oklahoma, purchased some acreage outside Indio city limits from a Native American tribe and created a home for his extended family and friends; several of their descendants still live in the area. According to Kevin Reed, a lawyer with the NAACP Legal Defense Fund, the city's decision in 1987 to condemn 23 acres of Noble's Ranch is only the latest in a series of indignities which Indio has inflicted on the neighborhood since it was annexed in the 1940s. Residents of Noble's Ranch, he says, "were always the last to get city services, such as street lights and sewers. They always had to sue. In fact, they never received city water."

In 1990, the NAACP Legal Defense Fund filed a class action on behalf of all of Noble's Ranch residents, protesting condemnation and relocation. The challenge cites Title 8 of the federal Fair Housing Act. "In essence, our challenge is based on two grounds: the act of redeveloping the neighborhood was a racially discriminatory act, and, intentionally or not, it has had a grossly disproportionate impact on a racially or ethnically distinct neighborhood," says NAACP's Reed.

To date, the city has relocated about half of the neighborhood's 200 households. Seventy-four houses remain, along with 20 residential units in a county-owned multi-family building. As part of an expected settlement – one that could come within a month – city officials say they plan to keep the Noble's Ranch residents together by buying groups of adjoining homes in a new subdivision. One group of five homes and another of seven are intended for specific extended families and/or social groups. If implemented, this solution would represent a unique effort to preserve social groups after displacement.

Meanwhile, not all is well at the mall. Earlier this year, Miller told the city he could not obtain financing and he was canceling the development agreement unilaterally. Arguing that Miller doesn't have the option to pull out of the agreement, the city sued. Miller is reportedly looking for a buyer, and the city is hoping he finds one, although it seems unlikely that any buyer will be interested in the mall until all lawsuits are settled and the expansion site is cleared. But with a settlement expected soon, that day appears close at hand.

As a postscript, it is worth examining the city's relocation proposal. The relocation of intact parts of a neighborhood is a humane and innovative way of softening this blow. But it does not prevent the larger injury to social institutions and collective memory of the neighborhood, which is made up of both people and physical landmarks. As ingenious as this solution is, group relocation should not become a rationale to make displacement politically acceptable. Indio might convince us, by arguing long and hard, that it had no other choice than to destroy Noble's Ranch.

We would argue that California cities should not be put in this position of having to choose between its tax base and its neighborhoods. A tax code that gives incentives to cities to destroy its neighborhoods in pursuit of big retailers should be rethought. And a redevelopment law that creates hardships for working-class people also needs intense re-examination. ■

insight WILLIAM FULTON

— CONTINUED FROM PAGE 16

time in the Senate, where the lobbying will be even more intense. The bill's chances were not helped when the Legislative Counsel issued an opinion in February that said the state constitution required the region's voters to approve the tax-sharing plan. Steinberg disagreed with the opinion, although he did not dismiss putting the issue on the ballot.

The Legislature is not a perfect proxy for regionalism because Assembly districts in California run to 400,000 people, which makes them much larger than the typical city. (Sacramento, by coincidence, is about 400,000 people, meaning Steinberg really is the city's assemblyman.) But the Capitol's role in this debate might grow, for the simple reason that local interests in the regionalism debate are getting more diverse and regionalism really has no other political forum to gravitate toward. Of course, regionalism would get a big push if California's governor were truly interested in it. It's hard to imagine the ever-cautious Gray Davis taking real interest in this bill. But the political equation might be altered by a Governor Richard Riordan. After all, he is simultaneously an elderly white Republican and the former mayor of a mostly minority central city – meaning he might be inoculated enough (or conflicted enough) to take on the issue. ■

Proposition 218 Ratchets Up Pressure On Local Officials

— CONTINUED FROM PAGE 20

funds is being put forth in AB 1 (Aguiar) and AB 95 (Sweeney) and would be locked into the constitution through ACA 4 (Aguiar), which would require voter approval.

Cities and counties lost some $4 billion – or about 25% of the property tax in the state – in the 1992-93 state budget cycles. Under Proposition 13, the allocation of local property tax revenues is determined not by local governments but by the legislature and the governor. But if property tax funds are shifted away from school districts to cities and counties – as happened in 1979 in response to Proposition 13 – the state must make up the difference to the school districts. Thus, by shifting property tax funds from cities and counties back to school districts, the state was able to save several billion dollars a year in its own expenditures.

This shift made it more difficult for local governments to fund such services as libraries and fire protection out of general property tax funds, causing them to look to different sources of funds, such as assessment districts. This trend, in turn, was one of the driving forces behind the taxpayer associations' desire to place Proposition 218 on the ballot. ■

Cities Fight Over Shrinking Sales Tax

— CONTINUED FROM PAGE 21

figures have actually climbed slightly, from $430 million in 1990 to $500 million in 1991. But within a 10-mile radius, auto malls have collapsed in Long Beach and Compton, while individual dealer sites have folded in Bellflower, Santa Fe Springs, Lakewood, and Downey.

"Eight years ago, the car dealerships in Cerritos were doing three times (the business) per dealership as the average dealership in the same county," Gobar said in an interview. "Cities said, 'Here's magic.' And they all get auto plazas. But there only so many consumers. When every city has an auto mall, sales revert to average sales volumes." Thus, the advantage any particular city has may be only temporary - and the sales-tax base that built up by aggressive cities may erode no matter what further actions they take. "There are limits to beggaring your neighbor," Gobar says. ■

Text And LAO Analysis of Proposition 13

(Editor's Note: On June 7, 1978, 64.8% of California voters approved Proposition 13. Below is the text of Proposition 13, as well as the Legislative Analyst's Office analysis of the initiative's fiscal effect.)

Proposed Addition of Article XIII A

Article XIII A

Section 1. (a) The maximum amount of any ad valorem tax on real property shall not exceed One percent (1%) of the full cash value of such property. The one percent (1%) tax to be collected by the counties and apportioned according to law to the districts within the counties.

(b) The limitation provided for in subdivision (a) shall not apply to ad valorem taxes or special assessments to pay the interest and redemption charges on any indebtedness approved by the voters prior to the time this section becomes effective.

Section 2. (a) The full cash value means the County Assessors valuation of real property as shown on the 1975-76 tax bill under "full cash value", or thereafter, the appraised value of real property when purchased, newly constructed, or a change in ownership has occured [sic] after the 1975 assessment. All real property not already assessed up to the 1975-76 tax levels may be reassessed to reflect that valuation.

(b) The fair market value base may reflect from year to year the inflationary rate not to exceed two percent (2%) for any given year or reduction as shown in the consumer price index or comparable data for the area under taxing jurisdiction.

Section 3. From and after the effective date of this article, any changes in State taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature, except that no new ad valorem taxes on real property, or sales or transaction taxes on the sales of real property may be imposed.

Section 4. Cities, Counties and special districts, by a two-thirds vote of the qualified electors of such district, may impose special taxes on such district, except ad valorem taxes on real property or a transaction tax or sales tax on the sale of real property within such City, County or special district.

Section 5. This article shall take effect for the tax year beginning on July 1 following the passage of this Amendment, except Section 3 which shall become effective upon the passage of this article.

Section 6. If any section, part, clause, or phrase hereof is for any reason held to be invalid or unconstitutional, the remaining sections shall not be affected but will remain in full force and effect.

Analysis by Legislative Analyst, Fiscal Effect

This measure would have the following direct impact on the state and local governments:

1. Local governments would lose about $7 billion in property tax revenues during the 1978-79 fiscal year. This is because the measure would reduce local property tax revenues (estimated at $12.4 billion under current law) by 57%, statewide. Some counties would lose more, and others would lose less.

2. The ability of local governments to sell general obligation bonds in the future would be severely restricted. These bonds are used to finance the construction of new schools, local government buildings, and a variety of other facilities such as parks and sewage treatment plants.

3. The reduction in local property taxes would reduce state costs for property tax relief payments by about $600 million in 1978-79.

The full fiscal impact of this initiative would depend on whether or not the $7 billion in local property tax revenue losses were replaced. Replacement revenues could come from two sources.

1. The initiative permits local governments to raise additional revenues by levying other unspecified taxes. Under existing law, most local governments would have to receive specific approval from the Legislature before levying new taxes. If the initiative is approved, new taxes would also have to be approved by two-thirds of the local voters. Thus the initiative would restrict the ability of local governments to impose new taxes in order to replace the property tax revenue losses.

2. Although there is nothing in the initiative or in current law that would require the state to replace any part of the property tax revenue losses, the state could agree to do so.

If these property tax revenue losses were substantially replaced, local governments could maintain the existing level of government services and employment. Part of these revenue losses could be covered temporarily by using the state surplus. Additional revenues to pay for these services would have to come from higher state or local taxes such as those imposed on personal income, sales and corporations. Depending upon which tax sources were used to replace local property tax losses, there could be a shift in who initially bears the tax burden. This is because most sales and personal income taxes are paid by nonbusiness taxpayers, whereas about 65% of property taxes are initially paid by business firms.

If the $7 billion in local property tax revenue losses were not substantially replaced, there would be major reductions in services now provided by local governments and in local government employment. We cannot predict which particular local services (such as schools, law enforcement, fire protection, health and welfare) would be affected because we do not know how the remaining property tax revenues would be distributed. Because state law requires local governments to pay for certain local programs at specified levels (for example, unemployment compensation benefits and most local welfare costs), the cuts could not be made in these area without further action by the Legislature.

The 2% limit on assessment increases would not allow property tax revenues to rise as rapidly as prices are expected to increase. This limit would tend to require additional cutbacks in local government services and employment in future years unless additional replacement revenues were available. By requiring that property be reassessed when sold, this initiative would, over time, cause homeowners to pay an increasing proportion of local property taxes because homes are sold more often than other types of property such as commercial and industrial.

If the state surplus is used to cover part of local revenue losses in 1978-79, it would not be available to maintain the level of government services in subsequent years.

In the long run, a major net reduction in property tax revenues and local spending could have significant economic effects on the level of personal income and employment in California. Such changes, in turn, eventually would produce unknown additional state and local fiscal effects. ■

Proposition 13 Supporters Answer Fairness Question

(Editor's Note: Proposition 13 is sometimes criticized as being unfair because its structure often results in the owners of similar houses on the same street paying widely disparate amounts of property tax. Because houses are reassessed only upon resale and because of the escalation of housing prices in California, a new homeowner can easily get a tax bill that is three, four or even more times larger than the tax bill received by the next door neighbor.

Courts have held that this discrepancy is not unconstitutional, and Proposition 13 supporters defend this tax structure. The following is taken from the Howard Jarvis Taxpayer Association's material on Proposition 13. It was written by Kris Vosburgh, HJTA executive director.)

What Do You Tell A New Neighbor About Proposition 13?

From time to time HJTA members write and ask what to tell a new neighbor who just doesn't understand Proposition 13.

Those who have owned their homes for a while, easily see the value of Proposition 13. Many of us remember that before Proposition 13 the average property tax rate in California was 3% of assessed value and there was no limit on annual increases.

In those days, if a house on your block sold for much more than you paid for your house, you shuddered in fear when you received your next property tax bill. Chances are, your new taxes would be based on what your new neighbor was willing to pay for his home. Things got so bad in the late 1970s that people were actually losing their homes because of uncontrolled tax increases.

Thanks to Howard Jarvis, Paul Gann and Proposition 13, the assessment rate is now only 1% for all California property, and annual tax increases are limited to no more than 2%. When property is sold it is then reassessed at market value, but the rate remains at 1% and the new owner is then protected by the 2% cap on annual increases.

However, to a new neighbor who is from out of state, or new to the housing market, Proposition 13 may still be a mystery.

Here are some questions commonly heard from newcomers to the neighborhood and some answers you may find helpful.

NEW NEIGHBOR What good is Proposition 13 to me, I'm not covered!

ANSWER Every owner of property in the state is covered. Proposition 13 is Article XIII A of the California Constitution..

NEW NEIGHBOR Then how come I'm paying more in property taxes than some of my neighbors who have similar houses?

ANSWER Under Proposition 13 you determine how much your property taxes will be. Your taxes are not based on your neighbors' [taxes], but are based on the price you voluntarily agreed to pay for your new home..

NEW NEIGHBOR We all get the same services, but I pay more. How can this be fair?

ANSWER In California, just like other states, services have never been related to the amount you pay in property taxes. If services were tied to what you paid, you might see four fire trucks assigned to a costly home while only one would protect a less expensive residence.

In fact, property taxes are not allocated for specific services. They go into the general fund along with other taxes and it is local public officials who determine how the money will be spent..

NEW NEIGHBOR Well, it still seems like I'm paying too much. Don't you agree?

ANSWER We all feel that way, but in fact, thanks to Proposition 13, the tax rate for all Californians is only a third of what it was. If you think things are bad now, multiply your tax bill by three and see what you get..

NEW NEIGHBOR That's easy for your to say, you're still paying less than I am.

ANSWER That may be true, but I've been paying for years. It's the neighbors that were here ahead of you that paid for all these local improvements you now enjoy..

NEW NEIGHBOR I still don't see what good Proposition 13 is to me.

ANSWER Well, besides your lower tax rate, it makes your taxes predictable. In a few years when new houses sell in the neighborhood for two or three times what you paid, you will be protected. Under Proposition 13 your property taxes can't go up more than 2% a year. You are going to find that very important when you get around to planning your retirement. If you ever find yourself on a fixed income, chances are, because of Proposition 13, you'll be able to keep your home. ■

Property Taxes: Why Some Governments Get More Than Others

(Editor's Note: The following is a 1996 Legislative Analyst's Office report.)

Summary

Some cities, counties, schools and other local governments receive more property taxes than others. The extent of this local government revenue variation is consider able, whether measured on the basis of dollars per resident or as a percent of property taxes collected in a community. Lately, this variation in property tax receipts has been the subject of legislative interest.

Why do some local governments receive more property tax revenues than others? Four factors account for most of this variation. Specifically, property tax revenues tend to be higher for those local governments where:

- Land is extensively developed.
- Few services are provided through special districts.
- Redevelopment is not used extensively.
- The government's property tax rate in the 1970s was relatively high.

This policy brief examines the variation in property tax receipts of local govern ments. It then reviews the four principal factors underlying this revenue variation, including "AB 8" (Chapter 282, Statutes of 1979)—the state law governing the distribu tion of property taxes. The policy brief concludes with a discussion of the concept of "equalizing" local property tax receipts.

Introduction

California property owners pay about $19 billion in property taxes each year. As a source of revenue, the property tax annually raises about as much as the state's income tax or the combined state and local sales tax. Unlike the income and sales taxes, however, property taxes are used exclusively for local purposes. All property taxes are allocated to local governments within the county in which the tax is collected. Specifically, property tax revenues are distributed to K-12 schools and community colleges, counties, cities, special districts, and redevelopment agencies as shown in Figure 1.

While Figure 1 shows how property taxes are distributed statewide, there is considerable variation among communities. Some local governments receive far more property taxes than others, regardless of whether the tax allocation is measured on the basis of dollars per resident, or as a percentage of total property taxes collected in the area. For this reason, there is currently considerable interest in the concept of "equalizing" local property tax receipts.

This policy brief examines the variation in property tax receipts by providing information on revenues to a variety of local governments. It then discusses the four principal factors underlying this property tax variation. The policy brief concludes with a discussion of the merits of reducing the variation in property tax receipts among local governments.

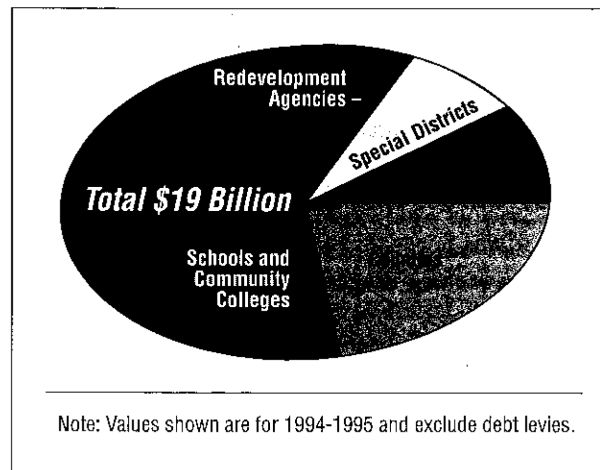
How Much Do Local Governments' Property Tax Receipts Vary?

While the property tax rate and assessment practices are uniform statewide, there is considerable variation in the distribution of property taxes among local govern ments. Specifically, (1) the amount of property taxes and (2) the share of property taxes a local government receives differ significantly throughout the state. Counties, for example, receive between 65 percent (Alpine) and 10 percent (Yolo) of the property taxes collected within the county lines. Measured in terms of property tax revenues per resident, Butte County receives about $45 per resident, while eight counties receive more than $200 per resident: Alpine ($1,068), Amador ($208), Colusa ($232), Inyo ($394), Mono ($537), Plumas ($212), San Francisco ($476), and Sierra ($563).

As Figure 2 shows, there is even greater variation in the amount of property taxes received by cities. While the average city receives about $75 per resident in property taxes, some receive more than $200 per resident and many receive less than $25 per resident. (Cities incorporated after 1978 commonly receive very low property tax revenues for reasons discussed later in this policy brief.)

School districts also report widely different amounts of property taxes per enrolled student, ranging from around $4,000 to less than $1,000. The state "tops off" school district property tax revenues with state funds, however, to bring most schools to a comparable spending level for general purposes. Finally, special districts and redevelopment agencies also receive widely varying amounts of property taxes. Data limitations, however, preclude us from summarizing this variation on a statewide basis.

1 Which Local Governments Receive Property Tax Revenues?



Note: Values shown are for 1994-1995 and exclude debt levies.

Source: Legislative Analyst's Office

Why Do Local Governments' Property Tax Receipts Vary?

Four factors account for most of this variation in local government property tax receipts. These factors are the:

- Number and Value of Homes and Businesses in the Area. Generally, high property values yield high property tax revenues.
- Extent to Which a Local Government Provides Municipal Ser vices. Local governments that provide a full range of municipal services – rather than relying upon special districts or other local entities – typically receive more property taxes than governments that provide fewer services.
- Extent to Which Land Is Included in a "Redevelopment" Area. Redevelopment activities may reduce property taxes to cities, counties, special districts, and schools in the area.

- State Laws Governing the Sharing of Property Taxes by Local Governments Serving a Community. Generally, the jurisdictions that had a relatively high property tax rate in the 1970s get a larger share of tax revenues today.

We discuss each factor separately below. This document also contains a detailed addendum on the state laws governing the sharing of property taxes.

2 How Much Property Taxes Do Local Governments Get?

Property Tax Receipts for Selected Local Governments

Cities	Property Taxes Per Resident	Counties	Property Taxes Per Resident	Counties	Property Taxes Per Resident
Industry	2,792	Sierra	563	Inyo	3,993
Beverly Hills	467	San Francisco[a]	476	Mono	3,454
Los Angeles	137	Inyo	394	Marin	3,428
Oakland	118	Colusa	232	San Mateo	3,194
Long Beach	105	San Luis Obispo	197	San Francisco	2,558
Vallejo	79	Los Angeles	136	San Diego	1,769
State Average	75	State Average	115	State Average	1,510
Santa Barbara	70	Alameda	102	Los Angeles	1,319
Stockton	64	Sacramento	94	Stanislaus	1,192
San Jose	60	Riverside	78	Fresno	913
Ahaheim	54	Orange	69	San Bernardino	862
Compton	21	Fresno	59	Merced	811
Bellflower	---	Butte	45	Kings	687

Note: All values shown are for 1994-1995 and exclude debt levies.
[a] San Francisco is a city and county.

Source: Legislative Analyst's Office

High Property Values Yield High Property Taxes

Market forces, government infrastructure investments, natural geography, and local land use choices have acted together to create a diverse array of California communities. Some of these communities are extensively developed and have many high-value homes and businesses. Others have few land developments, or few high-value developments. These differences in the extent and value of land developments affect the amount of property taxes a community receives.

Because property taxes are levied in proportion to the assessed value of property, communities with more land developments and higher-value land developments receive more property taxes than communities with fewer developments. (Assessed value is generally the market value of a property at the time of purchase adjusted annually by a maximum of 2 percent for inflation.)

This relationship between the extent of land development and a community's property tax revenues is common throughout the United States. Typically, local communities with more land developments require more public services, such as streets, water systems, and police and fire protection.

All Local Governments Are Not the Same

Not all California cities, counties, and special districts have the same responsibili ties. Some cities and counties provide a full array of government services, including fire protection, park and recreation programs, and water service. Other cities and counties rely upon special districts to provide some or all of these services. Statewide, for example, there are 557 special districts providing fire protection services and 293 special districts providing park and recreation services. Figure 3 highlights this variation in governmental responsibilities for three cities.

In addition to this variation in program responsibilities, county governments also vary in the extent to which their residents live in cities. In some counties, such as Los Angeles and Alameda, the vast majority of residents live in cities and receive some municipal services from their city government. Other counties have few or no cities—or function as both a city and a county. These counties have relatively more responsibilities.

How do these differences in responsibilities affect local government property tax receipts? If all other factors are the same, a local government providing more services generally requires more tax revenues to pay for these services. In the past, most local and state decision making regarding the allocation of the property tax has reflected this relationship. Thus, local governments with wider responsibilities typically receive more property taxes than governments with fewer responsibilities.

Use of Redevelopment Influences Property Tax Receipts

The use of redevelopment also influences the amount of property taxes local governments receive. This is because when a local government creates a "redevelop ment project area," most of the growth in property taxes from this area goes to the redevelopment agency, rather than other local jurisdictions, such as the schools, county, city, and special districts. Redevelopment agencies use these property tax revenues to finance improvements to revitalize the project area. After the redevelop ment work is complete (typically, 30 to 40 years later), the redevelopment agency's property tax revenues are reallocated to the other local governments in the area. To date, however, only a very small percentage of all redevelopment projects have been completed.

As shown in Figure 1, nearly 8 percent, or $1.4 billion, of property taxes is allocated to redevelopment agencies statewide. Some of these property tax revenues otherwise would have been allocated to other local governments in the community. The use of redevelopment varies extensively throughout the state. Some cities have placed most of their developed land in redevelopment project areas. Other communi ties do not have any redevelopment project areas.

State Determines How Property Taxes Are Shared

Finally, the amount of property taxes allocated to local jurisdictions is also a function of state property tax allocation laws, principally AB 8 (Chapter 282, Statutes of 1979). The responsibility for allocating the property tax was assigned to the state by Proposition 13 which stated that property taxes were to be allocated "according to law." Assembly Bill 8 allocated property taxes among the local governments within a county and provided fiscal relief to partially make up for property tax losses resulting from Proposition 13's tax limitation provisions.

The formulas contained in AB 8 — CONTINUED ON PAGE 28

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(for more detail see the addendum on page 10) were designed to allocate property taxes in proportion to the share of property taxes received by a local entity prior to Proposition 13. In general, each local government that provided services within a community was awarded a share of total property taxes collected within that community. Over time, as assessed values grow, the amount of property taxes received by a local government also grows. However, the share of property taxes does not change. For example, if a county, city, special district, and school district each receive 25 percent of property taxes collected within a community under AB 8, they will continue to receive 25 percent of taxes collected regardless of how much property taxes grow. These "AB 8 shares" were developed based on the historical share of property taxes received by local jurisdic tions prior to Proposition 13. Local jurisdictions that had received a large share of property taxes prior to 1978 received a relatively large share of property taxes under AB 8. Thus, the variation in property tax receipts in effect at the time was continued.

Since 1979, as discussed in more detail in the addendum, there have been just two significant changes to the original property tax shares contained in AB 8: legislation designed to aid cities that receive no, or very low, property taxes and the property tax shifts of 1992-93 and 1993-94. Despite these changes, however, the state property tax allocation system developed in 1979 in response to Proposition 13 continues to be the basis for the property tax allocation among local governments.

3 All Cities Do Not Provide the Same Services

Service	Los Angeles	Mission Viejo	Concord
Police	■	■	■
Fire	■	○	○
Emergency Medical	■	○	○
Sewers	■	○	▲
Parks and recreation	■	■	■
Libraires	■	■	○
Water	■	○	○

■ City Provides service or pays others to provide service
▲ City is partly responsible for providing or paying for service.
○ Service provided by a special district or county.

Source: Legislative Analyst's Office

Which Factor Is Most Important?

The four factors discussed above account for most of the variation in local government property tax receipts. Our review indicates that the relative importance of each factor differs on a community-by-community basis.

In some cases, the state's property tax allocation law – AB 8 – is the major factor determining the amount of property taxes a local entity receives. Specifically, two local governments that are very similar today may receive very dissimilar amounts of property taxes because AB 8 continues the tax sharing ratios of the 1970s.

In other cases, however, the amount of local development, the reliance upon special districts, or the use of redevelopment is more determinant than AB 8. School districts in Alpine County, for example, receive a lower share of the property taxes under AB 8 than do most other school districts in the state, and school districts in Stanislaus County receive a higher share. Nevertheless, school districts in Alpine County receive nearly twice as much property taxes per student than do schools in Stanislaus County. The difference is due to Alpine County's high property values relative to the number of students.

Similarly, cities in Riverside County and the county itself, tend to receive rela tively low amounts of property taxes per resident. These lower amounts of property taxes reflect, in part, Riverside communities' higher reliance upon redevelopment and special districts. Specifically, Riverside communities have placed large land areas under redevelopment, with the result that 19 percent of all property taxes in the county are allocated to redevelopment agencies. In addition, special districts provide some services to Riverside communities that elsewhere are provided by cities or counties.

Should the Legislature Equalize Property Taxes?

Over the years, various proposals for reducing the variation in local govern ment property tax receipts have been advanced. In considering these proposals, we recommend the Legislature first consider the causes for local government property tax revenue variation. In some cases, this variation appears to serve impor tant policy objectives. For example:

- Allocating more property taxes to extensively developed communities helps these communities pay for services to the land developments and to the people who live and work in them. The higher tax receipts also provide an incentive for commu nities to promote economic development.
- Providing more property taxes to local governments with more municipal program responsibilities helps the jurisdictions pay for these services.
- Allowing redevelopment agencies to keep most of the growth in property taxes in economically-distressed neighborhoods helps facilitate economic develop ment and the eradication of urban blight.

It is less clear, on the other hand, whether property tax variation caused by the AB 8 property tax sharing methodology continues to serve important policy objec tives. While this sharing methodology originally was designed to closely approximate Californian's preferences for local services, this methodology has not been updated for nearly 20 years. Since that time, California's population has grown by nearly 50 percent and the needs and preferences of local voters have surely changed. In some cases, local residents may prefer to have a special district's share of property tax revenues reduced and their city's share expanded—or the other way around.

In considering ways to update the AB 8 methodology, however, the Legislature faces major difficulties. Specifically, several thousand local governments – including over 1,000 school districts – receive a share of local property taxes. Updating the AB 8 methodology to reflect local preferences would require the Legislature to ascertain the needs and priorities of each California community and each local government. This is a task which, in our view, cannot be undertaken in a centralized manner.

For this reason, we believe that ultimately the control over allocating the property tax – or at least the nonschool portion of the property tax – should be decentralized. Decentralization would allow the debate regarding the appropriate distribution of local revenues to be carried out locally, rather than in Sacramento, and offers Californians the best chance of aligning tax revenues with local needs and preferences. ■

Reconsidering AB 8: Alternative Ways To Allocate Property Taxes

(Editor's Note: The following is a substantial excerpt from a 2000 Legislative Analyst's report.)

In Chapter 94, Statutes of 1999 (AB 676, Brewer), the Legislature declared the existing property tax allocation system to be "serious flawed" and stated its intent to revamp the system in order to: (1) increase taxpayer knowledge, (2) provide greater local control, and (3) correct the skewed land use incentives faced by local governments.

LAO Alternatives

This report highlights five alternatives to improve local finance:

- Alternative I: Set Uniform Rates. Each jurisdiction would be allocated a property tax share based on the services it provides.
- Alternative II: Local Control Over ERAF. Cities and/or counties would be given direct authority over the rate and allocation of a share of the property tax.
- Alternative III: Property Taxes for Municipal Services and Schools. The allocation of every property's tax bill would be identical – half to local municipal services and half to schools.
- Alternative IV: Re-Balance Tax Burden. Three local revenue sources would be changed significantly in order to provide a sales tax reduction and create local control over property tax rates.
- Alternative V: Making Government Make Sense. The responsibilities of the state and local governments would be realigned to create more efficient program coordination.

LAO Considerations

The following three considerations are important in improving the chances for local finance reform:

- No Perfect Solution Exists. By acknowledging the tradeoffs inherent in all reform proposals, the Legislature can determine which alternative best meets its priorities.
- Need for Focused Attention. The Legislature could create a joint committee charged with evaluating all reform proposals and recommending the best alternative within a specific time period.
- Set Aside Funds. In passing Chapter 94, the Legislature acknowledged the desirability of providing funding to facilitate reform.

Introduction

California's property owners pay over $20 billion of property taxes each year. These tax revenues – the third largest source of tax revenues in California – are then allocated among several thousand local governments, pursuant to a complex state statute. While significant legislation pertaining to the property tax allocation system has been enacted over the years, the allocation system is still commonly referred to as "AB 8," after the bill which first implemented the system, Chapter 282, Statutes of 1979 (L. Greene).

Over the years, the Legislature, local governments, the business community, and the public have become increasingly critical of the state's property tax allocation system because (1) it does not allocate revenues in a way that reflects modern needs and preferences of local communities and (2) it centralizes authority over local revenues in Sacramento.

To respond to these concerns, the Legislature enacted Chapter 94, Statutes of 1999 (AB 676, Brewer). Chapter 94 declares that California's system for allocating property taxes is "seriously flawed" and states legislative intent to revamp the property tax allocation system to:

- Increase taxpayer knowledge of the allocation of property taxes.
- Provide greater local control over property tax allocation.
- Give local governments greater fiscal incentives to approve land developments other than retail developments.

To assist the Legislature in this effort, Chapter 94 directs the Legislative Analyst's Office (LAO) to develop alternatives for restructuring the property tax allocation system, including one which provides for a minimum property tax share for each county. This report is written in fulfillment of Chapter 94's requirements.

This report begins with an examination of the problems in the current property tax allocation system and a discussion of the tensions and trade-offs inherent in reform proposals. The report then discusses five alternatives for revamping the "AB 8" system and outlines a process for enacting reform.

What Are The Problems With the Allocation System?

As noted above, Chapter 94 highlights three specific problems with California's system of property tax allocation. In addition, we have identified some other concerns [listed below] which are indirectly related to the current allocation system.

- Lack of Information Impedes Government Accountability
  - No entity-by-entity rates.
  - Outdated formulas reflect 1970s preferences.
  - Lack of accountability by officials.
- Lack of Local Control
  - No ability to raise or lower property tax shares.
  - System susceptible to state-controlled revenue shifts.
  - Inability to shift revenues among priorities.
- Skewed Development Incentives
  - Fiscal incentives encourage retail over other uses.
  - Fiscal incentives encourage proliferation and misuse of redevelopment.
- Other Related Issues
  - Assessment practices act as barrier to new businesses.
  - Reliance upon nondeductible taxes to finance government services.
  - Competition for resources results in inefficient intergovernmental program coordination.

Lack of Information Impedes Government Accountability

Prior to the passage of Proposition 13 by the California voters in 1978, each governmental entity (city, county, special district, and school district) would set a property tax rate annually. This rate would be combined with other local governments' tax rates to form a property owner's property tax bill. The taxpayer's total property tax owed would be determined by summing together the various rates and applying the total to the property's assessed value. Because the rates were connected to a specific government entity and set annually, taxpayers could see what percentage of their property taxes was going to each local government.

To implement Proposition 13, the Legislature enacted the AB 8 property tax allocation system. A single countywide rate of 1 percent replaced the numerous individual govern-

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ment tax rates. Although taxpayers gained the assurance that their rate could not increase from year-to-year, they lost the ability to see which entities receive revenues from their payments.

Complexity and Variation in Current Property Tax Allocations. Even if taxpayers today do further research regarding their property tax bill, they are likely to be confused when they find out that the allocation of revenues to any local government:

- Is based largely on the level of property taxes that it received in the mid-1970s, relative to other local governments in the same county.
- Generally can not be changed, except by state legislation.
- Varies significantly across taxpayers in the same county – and in comparison with taxpayers in other parts of the state.

Reduced Government Accountability. In addition to confusing taxpayers about how their tax dollars are distributed, the AB 8 system reduces government accountability. The link between the level of government allocating the tax (the state) and the entity that spends the tax revenues (cities, counties, special districts, and schools) has been severed. So, for example, if a taxpayer is not happy with the level of library services provided by an independent library district, it is difficult to hold the district accountable since the library district is not the agency responsible for determining the level of property tax revenues available for service delivery.

Lack of Local Control

The same forces that diminish taxpayers' ability to hold their governments accountable also reduce local governments' ability to control their own finances. Local governments lack the fiscal control to use the property tax for its traditional purpose: meeting the ever-changing municipal needs of a community. Local officials have no power to raise or lower their property tax share on an annual basis to reflect the changing needs of their communities.

As the property tax shifts of the early 1990s illustrated, the current state-controlled allocation of revenues leaves local governments vulnerable to changes in their base revenue levels. Even if these shifted funds (or "ERAF" funds, named after the fund into which the money was deposited, the Educational Revenue Augmentation Fund) were returned, local governments would remain susceptible to future revenue shifts. Without local control of property tax distribution, state redirections of local revenues remains a potential problem.

The state has left the distribution of property tax revenues among local entities largely unchanged since the 1970s. Counties receive a similar proportion of property tax revenues despite many changes to their program responsibilities. Water districts that received property taxes 25 years ago continue to do so, despite a general trend for these and other resource-related services to be funded by user charges rather than general taxes. Local citizens and their elected representatives lack effective fiscal authority to change the allocation of property taxes to reflect their community's current priorities. This problem is especially acute for cities and counties that provide many of their municipal services through independent special districts. If these special districts levied a property tax rate in the 1970s, they typically continue to receive a share of the property tax today.

Finally, if residents desire an enhanced level of a particular service, there is no local forum or mechanism to allow property taxes to be reallocated among local governments to finance this improvement. For example, Orange County currently receives a very low share of property taxes collected within its borders – typically only 4 percent to 7 percent. If Orange County residents and business owners wished to expand county services, they have no practical way to redirect the approximately 3 percent to 4 percent of property taxes currently allocated to water and sanitation districts to pay for this program enhancement. Instead, if residents wish to increase overall county services, they would need to finance this improvement through a mechanism such as an assessment or special tax. In this way, the overall level of government taxation and expenditures can be higher than it would be if communities had greater local control.

Skewed Development Incentives

Under California's system of local finance, communities receive increased tax revenues when property is developed. These taxes include: property tax, sales tax, and vehicle license fees (VLF). Typically, when a city (or a county in the unincorporated area) develops its general plan or receives a proposal for property development, it assesses the fiscal impact of the development on the community. Generally, most communities find that they receive the highest level of revenues from retail developments. This is because the state allocates one cent of the sales tax to the jurisdiction where the transaction occurs; this tax is called the Bradley-Burns sales tax and is allocated on a "situs" basis. In contrast, most communities receive only a small share of the property tax and, for residential developments, a modest per-capita allocation from the VLF. Accordingly, industrial, office, housing, and agricultural land uses generally yield much lower tax revenues than retail development.

Not surprisingly given these incentives, many cities and counties have oriented their land use planning and approval process disproportionately towards the development of retail establishments, a process referred to as the "fiscalization of land use." Some communities have even entered bidding wars with each other in order to attract a large sales tax generating establishment to their jurisdiction. Because the overall demand for retail services is not affected by this competition, local government's emphasis on retail development does not significantly increase the total amount of sales taxes collected by governments – or improve the state's overall economy.

The state has a clear interest in promoting land use decisions that lead to an appropriate mix of various land uses. However, the current fiscal structure fails to encourage this balance. The relatively small share of the property tax that cities are allocated, combined with the presence of a local sales tax allocated on a situs basis, disadvantages the approval of new nonretail developments.

Another consequence of the relatively low share of property taxes received from property within their jurisdiction is the proliferation of redevelopment projects. Without redevelopment, a city wishing to spend funds to upgrade a "blighted" area typically would receive less than 20 percent of the growth in assessed value resulting from any economic improvement in the area. However, by creating a redevelopment project for that same area, a city's redevelopment agency is eligible to receive all of the growth in assessed value (less statutorily required pass throughs)funds that would normally accrue to the county, special districts, school districts, and the city's general fund. This ability to reap higher-than-normal property tax revenues from within redevelopment project areas has led to some abuses and questionable declarations of areas as redevelopment projects.

Three Related Issues

While Chapter 94 focuses on limited information and accountability to taxpayers, lack of local control, and skewed development incentives as the major problems with the property tax allocation system, there are several other issues which are indirectly related to the allocation system and which constrict California's ability to have a healthy state-local government relationship. Accordingly, when considering alternatives for reforming the AB 8 system, the Legislature may wish to consider solutions that address the following issues as well.

Acquisition Assessment As Barrier to Entry to Market Place

Proposition 13 instituted major changes to the method by which property is assessed. Before Proposition 13, property was revalued annually to reflect its market value. Proposition 13 instead requires property be assessed only at the time of acquisition and then increased annually at a maximum of 2 percent. Thus, assuming that property values are on the rise, a property owner who has owned property for a long time will pay significantly less in property taxes than a new property owner of an equivalent property.

For residential property, this acquisition value-based system has some policy merit. Specifically, it (1) encourages stable communities and (2) ensures no sharp increases in taxes from year to year (of particular concern for senior citizen homeowners on fixed incomes). At the same time, however, new homeowners – both first-time home buyers and those relocating – bear a disproportionate share of the residential property tax burden. It is only after a number of years of home ownership that the financial benefits of the acquisition assessment system accrue to homeowners.

The same benefits of the acquisition value system exist in terms of commercial and industrial property; however, the disadvantages of this policy for businesses in a competitive economy are somewhat troubling. The system can present an economic barrier to entry for new businesses. If a competitor has been in the same location for a number of years, a new business faces higher operating costs. This can discourage the formation of new businesses and reduce competition.

Reliance Upon Nondeductible Revenues

California's state and local governments rely on a sales tax levied at a rate higher than in most other states. California households are not able to deduct these taxes against their federal personal income tax liability. Replacing a portion of the revenues collected under California's sales tax with revenues raised from a deductible tax (property tax, income tax, VLF) would result in a net increase in after-tax income for California residents.

Inefficient Program Coordination

California's residents receive government services from a wide variety of federal, state, and local agencies. Although many services may appear to be provided by a single agency, typically more than one agency is involved in paying for the service, determining how much of the service is provided, and controlling the details of program delivery.

Viewed as a whole, California's existing "system" of government does not work together well to achieve the public's goals. Rather, the different levels of government often have no common mission and work at cross purposes to one another. Governments compete among themselves for resources and to shift program costs to other governments. The public, in turn, finds that they cannot hold any particular agency responsible for the quality of governmental services.

Several years ago, in outlining a proposal for state-local reorganization, "Making Government Make Sense" (in The 1993-94 Budget: Perspectives and Issues), we concluded that California's existing system of government was dysfunctional. While the Legislature has improved upon this system somewhat in recent years, many problems of inefficient program coordination, counter-productive fiscal incentives, and reduced accountability remain. These problems span a wide variety of areas, including the provision of many social service and criminal justice programs, land use development, and the administration of the property tax collection system.

Why Is it So Difficult to Improve the Allocation System?

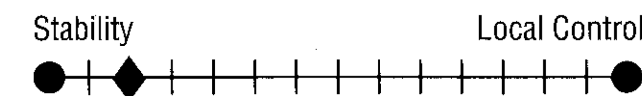
The problems with the state's property tax allocation system articulated in Chapter 94 are not new or unknown. These problems have been recognized and discussed by countless local government commissions, committees, and working groups for the last 20 years. Despite the large degree of consensus on the problems, enacting reform has proven elusive because it requires making difficult tradeoffs across multiple worthy policy objectives. That is, in most cases, making progress towards one desirable reform objective requires taking a step away from another.

Our review of previous reform efforts highlights four key areas of policy tension inherent in local finance and property tax allocation system reform proposals:

- Property Tax Rate: Taxpayer Stability versus Local Control.
- Property Tax Allocation: Local versus State Control.
- Focus of Government: Special Purpose Agencies versus General Purpose Governments.
- Local Finance: Reform versus Fiscal Stability.

In developing its proposal to revamp property tax allocation, the Legislature will confront these policy tensions—and will need to strike a balance that meets its policy preferences. Below, we begin our discussion of each policy tension with a graphic showing how the current local finance system is balanced between the competing policy objectives (indicated by a " ♦ ").

Property Tax Rate: Taxpayer Stability versus Local Control



The property tax is the only tax in which the maximum rate is set in the State's Constitution (at 1 percent of assessed value). Decreases in the property tax rate are authorized under state statute, but are difficult to implement. Increases over the base property tax rate may be authorized only for capital purposes and require approval by two-thirds of the local voters. [Editor's note: The two-thirds requirement for local school bonds has been reduced to 55%.] Combined, these constitutional and statutory provisions provide a very high degree of stability to the taxpayer, but limit local control over the tax rate.

For these reasons, in our chart above, we place an "" representing the current local finance system—much closer to the goal of property tax rate stability than local control. In developing a reform proposal, the Legislature will need to consider the extent to which it wishes to maintain this level of property tax rate stability for all property owners – versus giving communities greater control to increase and decrease their property tax rates.

Property Tax Allocation: Local versus State Control

Currently, as discussed earlier in this report, the state controls the allocation of local property taxes. (Thus, — CONTINUED ON PAGE 32

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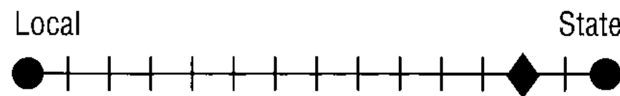
the graph shows the " ♦ " next to "State.") State control of the property tax, however, is a relatively recent development in the state's history. Between 1910 and 1978, local governments had exclusive control over the allocation of the property tax; before 1910, this authority was shared between state and local governments.



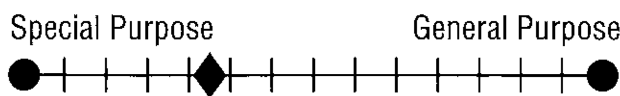
Proposals to reform the property tax allocation system inevitably confront policy tensions between advocates for state and local control. On the one hand, keeping the state in control of property tax allocation allows the state to use the tax in a manner which reflects statewide concerns, such as funding for: education, state-county partnership programs, and newly developing or low-wealth communities. Transferring power over property tax allocation to local communities, on the other hand, would increase the likelihood that the tax revenues are used in a manner consistent with local preferences.

Because California has thousands of local governments, many with overlapping jurisdictions, reorienting the property tax allocation system to give local control requires major change. In general, we find that there are two ways to provide local control:

• Create a local forum for deciding how property tax revenues collected in a community should be allocated among local governments. The California Constitution Revision Commission, for example, suggested that each county enact a voter-approved charter defining, among other things, how property taxes are to be allocated. Alternatively, the Legislature could allocate a large share of the property tax to a single general purpose government, such as a city, and require the city to allocate the property taxes to other local governments providing services to city residents. By giving this responsibility to a local general purpose government, the allocation of the property tax could be determined annually, in a manner consistent with local priorities.

• Modify the current 1 percent property tax rate so that each local government sets its own rate. This would allow each government to raise or lower its property tax rate, possibly subject to voter approval or tax increase limitations. This option, of course, would require modification to Proposition 13.

Focus of Government: Special Purpose Agencies Versus General Purpose Governments



California allows special purpose governments and agencies to play a major role in providing governmental services, including fire, water, redevelopment, and parks and recreation. Local governments in other states typically have more of these services controlled by a single general purpose government, such as a city or county. Currently, it is not uncommon for a single home or business in California to be served by a dozen special purpose entities, with many of them receiving a share of property tax.

California's property tax allocation system also contains provisions which strengthen the fiscal position of some special purpose agencies. Specifically, state laws permit virtually any city to create a redevelopment agency capable of redirecting property taxes away from general purpose governments. In addition, as we discussed earlier, state laws controlling the allocation of property taxes may have worked to limit the extent that some special purpose governments (such as water and sanitation districts) are shifted from property tax to user-fee financing.

Because California's system of local government grants significant legal authority to special districts and maintains their share of the property tax, the graphic above shows California's system of local government leaning moderately in favor of special purpose governments.

Local Finance: Reform Versus Fiscal Stability

The last of the four policy tensions pertains to fiscal stability. Given the thousands of units of local government, any change to the allocation system for property taxes – or to local finance in general – will cause some fiscal disruption to the state or local governments (thereby reducing California's current level of fiscal stability, at least in the short-term). In confronting this trade-off, many previous reform committees have chosen to favor fiscal stability more than reform. In fact, some previous reform efforts have sought to make improvements under the constraint of complete fiscal neutrality: no individual government would gain or lose current revenues under the proposal and no taxpayer would pay more. While the goal of maintaining a government's and taxpayer's fiscal condition is worthy, we note that there is tension between the goals of improving the system and maintaining the status quo.

In enacting Chapter 94, the Legislature recognized this tension and specified that it "intends to consider allocating an unspecified amount in additional revenues available to cities, counties, and special districts" to mitigate any fiscal disruption. We think this statement by the Legislature was an important recognition of the tension between reform and fiscal stability. While there are various options for the Legislature to consider to minimize the economic disruption (such as phasing in changes, making them optional, or providing increased taxing authority), it is important to note that the goals of local finance improvement and short-term fiscal stability are at odds.

What Are The Alternatives?

In this next section, we describe five alternatives for revamping the property tax allocation system in a manner consistent with the goals stated in Chapter 94. In reviewing these alternatives, we note that they do not represent the only choices for the Legislature, but a look at the spectrum of options available. In addition, in many cases, elements of these alternatives can be modified to alter the emphasis given to any of the competing policy objectives discussed above, or to address other policy objectives of the Legislature.

Alternative I: Set Uniform Rates

Chapter 94 requires the LAO to consider the option of "establishing a minimum percentage of the property tax to be allocated to each California county." This concept of assigning local governments a minimum share of the property tax has been discussed over the years. The Legislature took a step in this direction in passing Chapter 1211, Statutes of 1987 (SB 709, Lockyer), guaranteeing a minimum share of property taxes to certain cities that did not levy a property tax rate (or levied only a very low rate) prior to Proposition 13. The Legislature also has considered bills to increase certain counties' shares of property taxes.

One difficulty associated with these "minimum percentage" proposals is that there is no common set of governmental responsibilities. Some cities, for instance, provide a wide array of services: police, fire, and parks and recreation. Other cities provide public protection and land use planning, but rely on the county or special districts to provide other services to their residents. Similarly, in some counties most people live within the boundaries of full-service cities. Other counties, by serving unincorporated areas, provide municipal services to a large number of their residents. As a result, assigning the same property tax share to all cities and counties disadvantages those local agencies with more service responsibilities. We note, for example, that an analysis performed for the League of California Cities found that, after correcting for their typically lower service obligations, cities with low shares of the property tax often receive a higher share of the property tax than many other cities.

If the Legislature wishes to revamp the property tax allocation to improve uniformity in the distribution of property taxes, the Legislature should acknowledge the differences in local government service obligations. Accordingly, this first alternative outlines a process by which the Legislature could assign shares of the property tax which reflect the number of services provided by the local government.

How It Would Work

Based on a statewide study of local government costs to provide services, the Legislature could enact a statute assigning specific shares of the property tax for each service. For example, the statute might assign K-14 finance a 50% share of the property tax; county-wide services a 25% share; fire and police/sheriff 10% shares each; and library, parks and recreation, and other services a share of the remaining 5%.

Any individual government's share of the property tax, in turn, would reflect the number of services it provides. For example, a city that provides a full array of municipal services might receive 25% of the property taxes collected within its borders (10% each for police and fire, and 5% for other services). Conversely, a city that relies more extensively on special districts might receive a 10% share (for police services). Similarly, a county might receive 45% to 50% of the property tax collected from properties in its unincorporated area, but only 25% of the property tax in areas included within a city's boundaries.

The Legislature would have many options in implementing this alternative. For example, the Legislature could specify that the scheduled shares apply only:

• To the growth in property taxes, leaving the existing $20 billion "base" of property taxes allocated as it has in the past.

• To governments where it would increase their share of property taxes.

• To governments where the current per- capita amount of property taxes is lower than average.

Alternatively, the Legislature could develop a statewide uniform schedule, applicable to only a specific county or counties on a trial basis.

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Alternative II: Local Control Over ERAF

This next alternative focuses more directly on Chapter 94's goal of increasing local control over the property tax. Specifically, Alternative II gives local governments direct authority and responsibility over part of the property tax rate and its allocation.

How It Would Work

Currently, about 18 cents of every property tax dollar paid is allocated to the fund created as part of the early 1990s property tax shift, ERAF. Money from ERAF is allocated to K-14 schools in each county. Under this alternative, the state would reduce the overall property tax rate from 1 percent of assessed value to 0.9 percent. Cities, counties, and special districts would not sustain any property tax revenue losses as a result of this change. The only effect of the tax reduction would be to decrease revenues allocated to ERAF. The state would be obligated to offset school losses with increased General Fund dollars. After reducing the property tax rate from 1 percent of assessed value to 0.9 percent, the Legislature would instruct cities and/or counties that it is their decision whether to (1) increase city or county property taxes up to the maximum 1 percent rate and/or (2) pass on the tax cut as property tax relief to property owners in their communities.

What Vote Would Be Needed to Increase the Tax Rate? Provided the maximum property tax rate did not exceed 1 percent, Proposition 218 (Article XIII C, Section 2 [b]) appears to give this tax adjusting authority to city councils and boards of supervisors, without requiring a vote of the local electorate. Should local residents object to their representatives' decisions, local residents could elect different local officials, or overturn the property tax change using the initiative powers set forth in Proposition 218 (Article XIII C, Section 3). Cities and counties also could choose to place these taxation matters before their local electorate.

Which Level of Government Would Have Power Over the Tax Rate? The Legislature would need to designate the extent to which cities and/or counties would have authority over the rate. Absent a constitutional change, we do not believe that special purpose agencies, such as schools or special districts, would have authority to modify the rate.

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Alternative III: Property Taxes For Municipal Services and Schools

The third alternative significantly revamps and simplifies the property tax allocation system to meet Chapter 94's goals. Specifically, this alternative links the property tax exclusively to two purposes: (1) municipal services and (2) school finance. Each of these purposes would receive half of the property tax revenues collected from any property.

How It Would Work

Under this option, the allocation of every property's tax bill would be identical—half to local municipal services and half to schools. For the half allocated to schools, the funds would be deposited into a countywide fund. From this fund, schools throughout the county would receive an allocation. As with current law, the state's General Fund would supplement these funds and schools would be held harmless. For the remaining half of the property tax, the funds would be allocated to the city in which the property is located. For unincorporated areas, the county would receive the funds to carry out its role as the property's municipal service provider. Funds provided to a county for this purpose could not be redirected to pay for general countywide services, such as county jails, public health, and welfare.

City or county (in the case of unincor- — CONTINUED ON PAGE 34

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porated areas) representatives would be responsible for providing (or contracting for) a defined set of municipal services for their residents, such as police, fire, parks, libraries, etc. Cities or counties could elect to allocate a portion of their property taxes to special districts and/or redevelopment agencies. Because this alternative provides such a large share of the property tax to municipal service providers, counties would need a replacement revenue source to pay for countywide services. This alternative shifts most city Bradley-Burns sales tax and some city VLF revenues to counties for this purpose. Counties would receive sales tax revenues from sales taking place anywhere within their borders, not just from sales occurring in unincorporated areas.

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Alternative IV: Re-Balance Tax Burden

Under this alternative, a number of revenue sources are changed significantly to: reduce the state's reliance upon nondeductible taxes, provide a more balanced set of local government fiscal incentives regarding land use, give communities local control over the property tax rate and allocation, and reduce the barriers to entry for new businesses under an acquisition-based assessment system. While these goals could be achieved in a number of ways, one approach is outlined below. As summarized [below], the alternative makes changes to the sales tax, the property tax, and the VLF in achieving its goals.

- Reduce Sales Taxes by 1.25 Percent ($5 Billion)
  - Reduction split between state (0.75 percent) and local (0.50 percent) rates.
  - Under current law, state's loss of revenue would be largely offset by reduced state spending from future vehicle license fee (VLF) reductions not going into effect.
- Increase City and County Property Tax Revenues ($1.3 Billion)
  - In exchange for the receipt of these new revenues, local governments would forego the revenues from the existing VLF backfill.
- Increase Local Control Over Property Tax Rate
  - Each local entity would be authorized to raise or lower its own property tax rate.
  - Taxpayer protections would include the requirement of a local charter and a 2 percent maximum annual increase.
- Assess Nonresidential Property at Market Value ($2 Billion)
  - Business personal property and state assessed property (like public utilities) are already assessed in this manner.

How It Would Work

Sales Tax Changes. This alternative reduces the sales tax by $5 billion (1.25%) in order to (1) reduce a tax which California households can not deduct against their federal income tax liabilities and (2) reduce local governments' incentives to favor retail developments. Because of differential rates across counties, this tax cut would reduce the sales tax rate in Los Angeles County from 8.25% to 7%, and in Butte County from 7.25% to 6%.

This composite sales tax reduction of 1.25% would come from cutting the:

- State's sales tax rate by three-quarters of a cent.
- Local Bradley-Burns sales tax rate by one half cent.

In addition, in order to further correct local government's strong incentives to approve retail developments over housing, half of local governments' remaining Bradley-Burns sales taxes would be allocated on the basis of population, not by where the sale occurs.

These sales tax cuts would have an indirect effect on future VLF rate reductions. As part of the 1998 budget agreement, the VLF was cut permanently by 25%, with additional VLF reductions beginning in 2001 if specific revenue levels are reached. (In addition, the Legislature enacted legislation increasing the VLF reduction to a cumulative 35% for calendar year 2000 only.) [Editors note: These VLF reductions continued through the 2002-03 fiscal year.] To offset the city and county revenue losses associated with these VLF reductions, the state provides cities and counties the same amount of revenues they would have received under prior law; these state General Fund subventions are called the VLF "backfill." Under the VLF legislation, any additional tax reductions that the Legislature enacts reduces, on a dollar-for-dollar basis, the amount of tax relief provided through future VLF reductions. Under this alternative then, the state's sales tax cut would replace the scheduled future reductions to the VLF over the base 25% reduction. This option, therefore, reduces a nondeductible tax (sales) instead of a deductible one (VLF).

Increase Property Tax Shares. In order to provide more "neutral" land use incentives to local governments, this alternative shifts about $1.3 billion of property taxes from schools to cities and counties. This redirection of property taxes would increase state General Fund costs for education. To offset these increased state education costs and hold itself harmless, the state would eliminate the $1.3 billion General Fund VLF backfill associated with the existing 25% VLF reduction currently allocated to cities and counties. (Taxpayers, however, would continue to receive the 25% reduction.) Thus, as a result of this revenue swap, local governments would continue to receive $1.3 billion in revenues. However, cities and counties would now receive a revenue source which enhances land-use incentives for balanced development (the property tax), as opposed to a state-controlled subvention (VLF backfill).

Increase Local Control. In order to increase taxpayer understanding of their property tax bill and facilitate local allocation decisions, this alternative would split the current 1% base property tax rate into a series of individual local government by local government rates. Each local government's rate would be shown on the property owner's tax bill. The total of these rates for any property would sum to 1% initially.

The Constitution would be amended to specify that this maximum aggregate rate of 1% applies in all parts of the state – unless it is superceded by a voter-approved local government charter which specifies a process by which the local government's property tax rate may be increased or decreased. (For example, one city's local charter could specify that property tax rate changes are permitted upon a two-thirds vote of the electorate, while another city's charter could require a majority vote of the governing board.) The Constitution would specify, however, that no local government would be permitted to raise its rate by more than 2% per year – for instance, from 0.50% to 0.51%. (There could be exceptions to this limit in cases where a local government was absorbing program responsibilities formerly provided by another government, such as a special district.) Thus, communities would gain a mechanism for increasing and decreasing the level of property taxes allocated to any jurisdiction. At the same time, homeowners would continue to be protected from large year-to-year changes in their property tax bills.

Reduce Barrier to Entry for New Businesses. Finally, in order to address the problem associated with higher property taxes paid by new businesses, this alternative calls for assessing all nonresidential property at its current market value. Business personal property and state assessed property (like public utilities) are already assessed in this manner. This change in assessment practices would likely generate about $2 billion in additional property taxes in the first year. Revenues in subsequent years would vary with economic conditions.

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Alternative V: Making Government Make Sense

This fifth alternative addresses the goals of Chapter 94 and the problem of inefficient intergovernmental program coordination, discussed earlier in this report. Specifically, this alternative, "Making Government Make Sense" (MGMS) (1993-94 Budget: Perspectives and Issues), provides for significant fiscal changes and a realignment of the duties of state and local government. This alternative illustrates how the issues of local finance, governance, and program reform may be addressed together.

How It Would Work

A series of guiding principles underlie the MGMS proposal and direct its reforms. Specifically:

- Maximize the separation between state and local duties.
- Whenever possible, transfer program responsibilities to the level of government closest to the people.
- Focus state responsibility on programs where uniformity is needed – or where statewide benefits are to be achieved.
- Ensure that program funding responsibility and program policy control reside at the same level of government.
- Rely on financial incentives to promote intergovernmental coordination.
- Match state goals for economic development with fiscal incentives facing local communities.

The MGMS alternative relies upon these principles as it examines each governmental program and assigns principal responsibility for the program to the state – or a single local government entity. For most purposes, this alternative eliminates the differences between city and county program responsibilities. Thus, a city is responsible for providing all local services to city residents and a county is responsible for providing all services to residents of the unincorporated area. Special districts and redevelopment agencies are not assigned duties by the state, but may be delegated responsibilities by cities or counties.

Alternative V also significantly modifies the state-local financing system to reflect the changes in program responsibility and the statement of principles. Specifically, this alternative shifts a very large share of property taxes from schools to cities and counties to offset (1) the net fiscal effect of the program shifts and (2) a transfer of all of the local Bradley-Burns sales tax to the state. In order to equalize opportunities for community success, each community's allocation of property taxes would be redetermined by the state. This allocation of property taxes would consider local needs for municipal and community-based services. After this initial allocation by the state, local governments would be authorized to raise or lower their property tax rates by majority vote of the local electorate.

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Comparing the Alternatives

Each of the five alternatives described above would improve upon the current system of property tax allocation. Each alternative addresses at least one of the three major problems with the current property tax allocation system described by Chapter 94 limited accountability to taxpayers, a lack of local control, and skewed development incentives. In [the chart] we rate these alternatives on their ability to solve these problems, as well as the larger state-local issues of barriers to new businesses, tax deductibility, and intergovernmental program coordination. We have assigned from zero to three checkmarks to each alternative for its ability to solve these problems (with three checkmarks being the best score).

For instance, Alternative III is given three checkmarks for its ability to address skewed development incentives (since it dramatically increases property tax shares for cities — CONTINUED ON PAGE 36

Addressing Tax Allocation Problems: Comparison of Alternatives

Problem	Set Uniform Shares	Local Control Over ERAF	Property Taxes for Municipal Services and Schools	Re-Balance Tax Burden	Making Government Make Sense
Limited accountability to taxpayers	❑	❑	■	■	■
Lack of local control	❍	▲	❑	■	■
Skewed development incentives	❍	❑	■	■	■
Barrier to new businessess	❍	❍	❍	▲	❍
Reliance on nondeductible taxes	❍	❍	❍		❍
Inefficient intergovernmental interim coordination	❍	❍	❍	❍	■

❍ Does not address problem ❑ Some Improvement ▲ Moderate Improvement ■ Significant Improvement

Source: Legislative Analyst's Office

— CONTINUED FROM PAGE 35

and reduces the situs allocated sales taxes). However, this alternative receives only one checkmark for its ability to enhance local control (although some fiscal flexibility is provided, there is no authority to modify the property tax rate).

An examination of Figure 4 reveals an increasing number of checkmarks as one moves from Alternative I to Alternative V. This is not a coincidence – in order to make significant progress in addressing the stated problems, the alternatives make increasingly dramatic changes to the status quo. For instance, while we believe Alternatives IV and V offer the most progress to a long-term solution to the state-local fiscal relationship, these alternatives come with a cost. In order to implement these alternatives, both statutory and constitutional changes would be needed that would reduce – at least in the short-term – fiscal stability. For example, Alternative IV and Alternative V would require changes to the constitutional provisions governing the maximum property tax rate and voter approval requirements.

Moving Forward to a Solution

In enacting Chapter 94, the Legislature declared its intent to revamp the state's system of property tax allocation. Given the policy tradeoffs inherent in the five alternatives and the failures to implement past reform proposals, is there hope for local finance and property tax allocation reform in the near term? We believe there is reason for optimism if the following considerations are kept in mind.

No Perfect Solution Exists

None of the five alternatives is the perfect solution to California's property tax allocation problems. Nor will the Legislature find a perfect solution by waiting to take action. In fact, the longer the current system remains unchanged, the worse the problems become. Local governments adjust to the counter-productive fiscal incentives inherent in the current finance system, and residents turn increasingly to the state to address local concerns. By acknowledging the shortcomings and tradeoffs inherent in all local reform proposals, the Legislature can make an informed determination as to which alternative best meets its priorities.

Need for Focused Attention

If the Legislature considers each reform proposal individually, each proposal likely would be rejected because entities negatively affected by it will mount strong opposition, emphasizing the proposal's imperfections. However, the Legislature could increase the likelihood of enacting reform by (1) creating a joint committee, charged with evaluating all reform proposals and (2) requiring the committee to recommend the best alternative within a specific time period. This focused attention, given to all reform proposals by a single body, would facilitate the process of appraising the strengths and limitations of reform options. This process also would increase the likelihood of compromise, innovation, and ultimately enacting an agreeable solution.

In addition to the alternatives described in this report, the committee could consider proposals from the Speaker's Commission on State/Local Government Finance, the Commission on Local Governance in the 21st Century, the Controller, and local government associations. Ideally, the administration would participate in these deliberations given the interest in local government fiscal reform it expressed a year ago.

Set Aside Funds

Given its long-standing concern about improving local finance, the Legislature should consider setting aside a realistic level of one-time and ongoing resources to implement its final reform product. As discussed earlier, many previous reform efforts have failed due in large part to their attempts to be fiscally neutral. Chapter 94, in contrast, acknowledges the desirability of providing resources to facilitate reform. Setting aside funds could ease the transition to a new system. One-time funds could reduce the fiscal impact on local governments during the initial implementation period. Ongoing resources may be needed to implement the long-term structural changes.

The magnitude of dollars needed for this purpose is difficult to determine before the Legislature has developed a local reform proposal reflecting its priorities. Given the billions of tax dollars potentially subject to reallocation and the thousands of local governments involved, however, resources in the range of hundreds of millions of dollars may be necessary to minimize the fiscal disruption associated with local finance reform.

Developing a set-aside of this magnitude would compete with other legislative priorities but need not be solely reliant on new state resources. Rather, the Legislature could consider redirecting some of the local subventions that have been created in recent years (partly in response to the impaired fiscal capacity of local governments). If the Legislature's reform proposal improved local fiscal capacity and accountability, the need for these subventions may be reduced. For example, the Legislature could consider redirecting into a local reform set-aside funds currently budgeted for some of the following programs: the Citizen's Option for Public Safety (COPS) program, property tax administration loan program, booking fees reimbursements, redevelopment subventions, and criminal justice grants administered by the Office of Criminal Justice Planning. Combined, the Governor's budget currently includes over $300 million for these purposes.

> **"The longer the current system remains unchanged, the worse the problems become."**

Conclusion

This report outlines five alternatives which would make progress towards the goals articulated in Chapter 94 and local government finance in general. None of these alternatives is perfect; each requires difficult tradeoffs across multiple, worthy policy objectives. In developing a local government reform proposal, the Legislature will confront the tensions between taxpayer stability and local preferences, local and state control, general purpose and special purpose governments, and reform and fiscal stability. Notwithstanding these tensions, the current year offers a good opportunity for the Legislature to consider making improvements in the property tax allocation and local finance systems. ■