Statement to Little Hoover Commission

January 22, 2004

Scott H. Peters, Councilmember, City of San Diego[i]

Cities provide the most basic public safety and quality of life services for most Californians. Our organic public health and welfare responsibilities are to provide police and fire protection, clean drinking water, and trash and sewage disposal. It also falls to cities to provide the most basic quality of life amenities, like parks, libraries and useable roads.

Throughout California, however, the ability of cities to provide these most basic services is under serious threat. Before 1978 it was inconceivable that a California city could not maintain its streets, equip its libraries or build and maintain attractive parks. Everyone knows that Proposition 13 limited property tax revenues, but few citizens are aware that it also shifted power over the allocation of those revenues from local governments to Sacramento. The separation of local responsibility for services from authority over the revenue needed to fund them has led to an unfair and unwise local tax policy.

Since the State Steals Local Money
to Meet its State Obligations,
Local Government Funding is Insecure.

It is apparent that state leaders no longer respect the difference between state and local tax revenues. In the past ten years, the state legislature and governor have approved laws that divert, use or delay the payment of local tax revenues to local governments.

ERAF. In the early 1990s, the state instructed county auditors to shift the allocation of property tax revenues from local governments to "educational revenue augmentation funds" ("ERAFs") to support schools. Although the property tax revenue technically was spent locally, the state in effect shifted a portion of its own constitutional obligation for school funding onto cities, counties and special districts, leaving those entities with that much less money to do their own jobs. The League of California Cities estimates that more than $30 billion of local property taxes have been drained from cities, counties and special districts—costing cities alone $800 million in FY 2003-04 and $6.9 billion the last 12 years. San Diego has certainly lost enough revenue to pave every street and fix every sidewalk in the City, with enough left over to build several parks and libraries and properly pay and equip our police and fire forces.

Delayed Reimbursements. In recent years the state also has shifted costs for state-sponsored programs and delayed constitutionally required reimbursements to local governments for state mandated programs and services. In the last two fiscal years, the state has "deferred" over $1 billion in constitutionally required reimbursements to local governments for mandated services and programs. For example, the State mandates the City assume full liability for cancer-related medical costs for police officers and firefighters. The State has committed to pay 50% of these costs but has only appropriated

$2,000. The resulting cost burden of $600,000 for FY 04 is then paid with local taxes that should be used for important local services.

Vehicle License Fees. One of the funds dedicated to local governments is a percentage of the value of all vehicles in the state. When Governor Wilson reduced vehicle license fees, the state provided a backfill, with the presumption that the fee would be restored to its original level in times of fiscal crisis. The restoration of the VLF led to the recall of Governor Davis, and Governor Schwarzenegger repealed the increase. In December, his executive order appropriated $2.625 billion for backfill funding to cities and counties as an emergency measure. However, any permanent backfill would be subject to the approval of the legislature.

VLF is San Diego's fourth largest revenue source, after property, sales and visitor taxes. In FY 04, the City expected $72 million from that source out of a discretionary general fund of $743.0 million. If VLF were not backfilled by the state, the City could expect to lose up to approximately $50 million in Fiscal Year 2004 and has lost over $12 million to date this year.

Potential Redress. Cities, counties and local districts have found deaf ears and blind eyes in the legislature when attempting to gain local revenue security. In the California tradition, they are left to the ballot box.

The California Commission on Tax Policy in the New Economy recommended a constitutional amendment for protection for local revenues. Local governments have also circulated a ballot proposal. The League of California Cities, the California State Association of Counties and the California Special District Association are sponsoring the Local Taxpayers and Public Safety Protection Act, which generally would require a vote of the people when the state seeks to raid funds dedicated to local governments. The League expects the measure to be on the ballot in November 2004.

State Funding of Local Government is Irrational.

The amount of property taxes returned to cities by the state varies without reason. The state's allocation formula apparently attempted to soften the blow of Prop 13 by freezing 1978 property tax distribution levels.[ii] The result is wide disparity from city to city in California, favoring those that happened to be the big spenders in the late 1970s.

Following is the average share of the 1% property tax levy for the largest California cities:[iii]

Los Angeles	25.8%
San Diego	16.9%
San Jose	12.6%
Long Beach	21.9%
Fresno	24.4%[iv]

Sacramento	25.4%
Oakland	26.7%
Santa Ana	19.0%
Anaheim	10.7%
Riverside	11.1%
Stockton	17.4%
Bakersfield	19.0%
Glendale	12.2%
Huntington Beach	15.8%
Fremont	14.0%
San Bernardino	16.5%
Modesto	9.7%
Oxnard	17.6%
Garden Grove	12.1%
Chula Vista	13.6%

There is no principled reason why homeowners and business owners in Los Angeles get back a quarter from their property tax dollar for local investments that support those property values while similarly situated people in Anaheim get a dime.

Potential Remedy.

Although there are political obstacles inherent in doing so (or in doing anything), the amounts could be equalized.

State Funding Methods for Local Government Undercut Good Local Decision Making.

The 1955 Bradley-Burns Uniform Local Sales and Use Tax Law allocates to cities and counties one percent of every retail purchase that takes place within their jurisdictional boundaries. It has therefore become important for city budgets to make sure that sales of goods take place within those city boundaries. As a result, cities are often in competition with each other for automobile malls and "big-box" retail stores, sometimes offering major tax concessions to move a proposed store just a few blocks across the city line. For small cities in particular, one Wal-Mart or Mile of Cars can make the budget.

Conversely, there is little financial incentive for cities to support land uses that may be important for the regional and state economy, such as manufacturing or housing, but don't generate sales taxes. As shown above, the state gives a relatively small amount of property tax revenues to cities. A rational funding plan might reward cities for increasing property values by assigning them a meaningful share of property tax revenues.[v] That would encourage more balanced local planning and development, including basic quality of life infrastructure that makes California a decent, if expensive, place to live: parks, libraries, street and sidewalk repair. Not incidentally and not coincidentally, those are the investments that increase property values and property tax receipts.

On the other hand, why is it good policy to fund local governments with money generated in ways that are unrelated to the function of local government? For instance, why does it make sense for cities to rely on VLF generated from automobile sales, or even from the sales of goods? It seems better policy to fund local governments with property taxes generated as a result of good decision making by those same localities.

Potential Remedy.

There have been a number of suggestions to swap property tax from the state in exchange for sales taxes or vehicle fees unrelated to local government performance. The California Commission on Tax Policy in the New Economy summarized these ideas as follows:

> Property/sales tax swaps are one way to restructure local government finance in an attempt to correct some of these problems. Different swap mechanisms have been proposed over the years; the tax-swap proposal debated in the 2003 Legislature was a bi-partisan measure introduced by Assembly Members Steinberg and Campbell, AB 1221.[vi] The general idea with this swap proposal was to reduce the one percent locally levied sales tax rate to ½ percent and replace it with an equal amount of property tax. Some observers think that a property-sales tax swap should only be done in conjunction with a revision of current property tax allocation formulas (AB 8).

Against this Backdrop, Additional Local Funding Is Unlikely

State officials testifying before the California Commission on Tax Policy in the New Economy during 2002 and 2003 often suggested that local governments should raise additional revenues locally (as though property taxes don't belong to local governments).

The inability to count on constant tax revenues from the state makes it virtually impossible to raise money locally. The bar is already high. Proposition 218 requires a 2/3 majority to pass any local special tax, although a general tax that does not designate expenditures can be passed with a majority vote. Additionally, local general-obligation bonds other than school bonds require a two-thirds majority to pass.[vii] Moreover, and generally, what rational elected official would propose a property tax increase without constitutional protection for existing revenues?

Potential Remedy

Before considering asking local governments to raise taxes, it would be absolutely vital to provide constitutional protection for minimum local funding levels. The Commission on Tax Policy in the New Economy also discussed the following options:

1. Lowering the vote threshold on local special taxes would make it easier for local government to raise local revenues and increase local authority.

2. Lower the vote threshold for voter-approved local bond measures for purposes other than education bond measures, which are now at 55 percent.

Flip the two-thirds approval now required for “special purpose” local tax revenue measures and apply it to “general-purpose” revenue measures. The simple-majority approval now required for general-purpose revenue measures would then be applied to special purpose tax revenue measures. The vote threshold should be lower for special purpose revenue measures because voters and taxpayers by definition have more control over special purpose revenue measures.

Conclusion

Our state government’s relationship with local government is characterized by indifference to local needs, incentives and obligations. The current funding levels are unfair to local government, some more than others. Current funding methods distort incentives for sound land use decisions. There is little incentive or ability for local governments to raise additional revenues in this environment.

Attachments

Western Cities Article

San Diego Union Tribune Article

[i] The content of much of this statement is taken from the League of California Cities, www.cacities.org, and from correspondence from Chris McKenzie, its Executive Director, and from materials prepared by Dr. Martha Jones for the California Commission on Tax Policy in the New Economy. I am also grateful to Lisa Irvine of the City of San Diego Financial Management Department, who provided budget data for the City of San Diego.

[ii] In 1978, Senate Bill 154 (SB 154) provided a temporary policy for allocating the 1% property tax, and providing "bailout" block grants to local governments to partially offset the revenue loss resulting from Prop. 13. In 1979, Assembly Bill 8 (AB 8) provided a long-term policy for property tax allocation and fiscal relief to local governments, largely based on the methods established by SB 154.

[iii] Average property tax shares computed by taking total property tax revenue including in-lieu subventions as a % of assessed value net of redevelopment tax increment assessed valuation. CaliforniaCityFinance.Com 12/23/2003

[iv] Fresno, Bakersfield and Garden Grove do not fund or provide library services. Instead, a countywide special district provides these services and receives a portion of the property tax that would otherwise go to the city. All other cities listed here are full service cities.

[v] A substantial property tax allocation to cities does take place in the context of redevelopment law, covering areas meeting statutory tests as "blighted." For instance, downtown San Diego has seen the investment of billions of dollars in commercial and residential projects as a result of the city's ability to capture the property tax increment that results. Amendments to redevelopment laws have stiffened the tests for blight, however, and the tool is not widely applicable.

[vi] AB1221 was placed on the inactive file.

[vii] School bonds pass with a 55 percent majority.

The San Diego Union-Tribune.

The road to fiscal reform in California

By Scott Peters
September 18, 2002

California is the envy of states and countries around the world.

In business and in pop trends, it is said that "as goes California so goes the nation." Perhaps there is less envy of California's public finance structure. Our prosperity is threatened by a state and local tax structure that is too vulnerable to boom and bust cycles, too unfair and inefficient in allocating revenues, and too inflexible to support our increasingly mobile and dynamic information economy.

Today, the California Commission on Tax Policy in the New Economy, of which I am a member, will meet in the San Diego City Council Chambers to hear testimony about how to reform the state's tax structure. The commission was formed through an act of the Legislature, SB 1933, to recommend strategies to bring California's tax structure from the last century into the next, with an economy still dependent on tourism, agriculture and manufacturing, but increasingly based on information, communications and services.

Our commission arose out of the debate over Internet taxation, but our assignment is much broader: "to evaluate our entire system of tax policies and collection mechanisms in light of this new economy," including sales and use taxes, telecommunications taxes, income and property taxes. We will generate a final advisory report by the end of next year.

San Diego's "new economy" flourished in the 1990s with increased reliance on biotechnology, electronics, telecommunications and software. That diversification saved us from some of the harsher impacts of recession in the last decade.

San Diego is a more expensive place to do business than many other high-tech centers. Fortunately, San Diego offers a quality of life that exceeds that of our competitor cities, and maintaining our economic prosperity depends on maintaining our quality of life.

That means we have to keep and improve the very infrastructure that kept the "old economy" moving – roads and transit, housing, water and sewer lines, schools and public safety. That's why my particular tax policy concern is the effect our tax system has on public infrastructure.

Before 1978 it was inconceivable that a California city could not maintain its streets, equip its libraries or build and maintain attractive parks. Everyone knows that Proposition 13 limited property tax revenues, but few citizens are aware that it also shifted power over those revenues from local governments to Sacramento. The separation of local responsibility for services from authority over the revenue needed to fund them has led to an unfair and unwise local tax policy.

The state's allocation formula attempted to soften the blow of Proposition 13 by freezing 1978 distribution levels. This unfairly rewarded high tax cities and penalized conservative cities. Now, San Diego receives 17 cents on the property tax dollar while Los Angeles receives 26 cents. What is the policy justification for that?

Then, in 1991, Sacramento began keeping money that had gone to local governments in order to balance the state budget. The $311 million shifted from the city of San Diego since then would be enough to pave every street and fix every sidewalk in the city, with enough left over to build several parks and libraries and properly pay and equip our police and fire forces.

The incentives for local government action are also wrong. Since cities cannot rely on property tax revenue, they look to increase sales tax revenue. That sends cities scrambling to build Walmarts and Home Depots we don't really need instead of the housing we desperately do need. Under the current system, housing costs more for a city than the property tax the city can get back from Sacramento by approving it.

We are thankful that Gov. Gray Davis and the Legislature have created the commission to begin to address these inequities and inefficiencies and have attempted to backfill some of the lost local revenues. This year the governor kept his promise to not balance the state budget on the backs of localities. In this impossible budget year, this was a bold first step in fixing the relationship between the State and local governments.

The creation of this broken tax structure is the fault of no political party, proposition or single political action. It is the result of emergency actions, legislation and a series of ballot measures, all well-meaning but all with unintended and unfortunate consequences.

Mending the tax structure will take a concerted effort by both political parties and a willingness to try creative strategies. The California Commission on Tax Policy in the New Economy is a great start, and I am hopeful that we will play an important role in keeping California prosperous and beautiful in this new century.

Peters is a member of the California Commission on Tax Policy in the New Economy and a member of the San Diego City Council.

July 2003

The California Commission on Tax Policy in the New Economy

by Scott Peters

Scott Peters is a council member for the City of San Diego and was appointed by the governor to the California Commission on Tax Policy in the New Economy. Peters also serves on the California Coastal Commission and chairs the City of San Diego's Land Use and Housing Committee.

California is the envy of states and countries around the world. Regarding business and popular trends, it's generally said, "As California goes, so goes the nation." California's public finance structure, however, is less enviable. Its prosperity is threatened by a state and local tax structure that is too vulnerable to boom and bust cycles, too unfair and inefficient in allocating revenues, and too inflexible to support an increasingly mobile and dynamic information economy.

The California Commission on Tax Policy in the New Economy, of which I am a member, has been meeting in cities throughout California for the last year and a half to look at ways of reforming and updating our state's tax structure. The commission was formed by an act of the Legislature to recommend strategies for bringing California's tax structure into the 21st century. The commission assumes an economy still dependent on tourism, agriculture and manufacturing, but increasingly based on information technology, communications and services. The commission arose out of the debate over Internet taxation, but our assignment is much broader: "To evaluate our entire system of tax policies and collection mechanisms in light of this new economy," including sales and use taxes, telecommunications taxes, and income and property taxes.

The bipartisan commission includes elected officials, tax policy experts and industry representatives, as well as ex-officio members from relevant state bodies, such as the Board of Equalization and Franchise Tax Board. We have heard presentations from a variety of groups and academics that will help us generate the final advisory report that is due to the governor and the Legislature in December 2003. Virtually every idea is on the table, including regular reassessment of commercial property values, assessment of sales taxes on certain services, and a tax on remote sales of goods made over the Internet.

The commission has also created an interim report that explores principles of taxation and presents potential changes in tax policy. The report, along with presentations to the commission made by a variety of people, can be viewed on the commission's website at http://www.canewe conomy.ca.gov/. The commission welcomes public input.

A Dysfunctional Fiscal Relationship

My particular interest on the commission is the dysfunctional fiscal relationship between the state and local governments. Before 1978, it was inconceivable that a California city could not maintain its streets, equip its libraries or build and maintain attractive parks. Everyone knows that Proposition 13 limited property tax revenues, but few citizens are aware that it also shifted the power over those revenues from local governments to the state. The separation of local responsibility for services from authority over the revenue needed to fund them has led to an unfair and unwise local tax policy. The state's allocation formula attempted to soften the blow of

Prop. 13 by freezing 1978 distribution levels, but this unfairly rewarded “high tax” cities and penalized conservative cities.

Then, in 1991, the state began shifting local government money away from cities and counties to balance its budget. The $311 million shifted from the City of San Diego since then would be enough to pave every street and fix every sidewalk in the city, with enough left over to build several parks and libraries and properly pay and equip our police and firefighting forces.

No Easy Fixes

This unbalanced and unfair state-local relationship is not an easy one to fix. The money that was taken from the cities is now funding worthy programs — like education and healthcare — and it will be difficult to simply take it back. State fiscal policy has also been constrained by ballot initiatives that have reduced flexibility by earmarking revenues, not to mention that California is a net loser in money paid to and received from the federal government.

Governor Davis has signaled a willingness to try to fix some of these structural problems, so the current fiscal crisis may act as a catalyst for real change. Mending the tax structure will take a concerted effort by both political parties and a willingness to try creative strategies. The California Commission on Tax Policy in the New Economy is addressing these difficult problems, and I am hopeful that our recommendations will play an important role in keeping California prosperous and beautiful in this new century. To learn more about the commission, visit http://www.caneweconomy.ca.gov/ .