TO: Dwight Stenbakken, League of California Cities
FROM: Michael Coleman
SUBJECT: AB1221: Fiscal and Policy Implications for Cities
DATE: 3/17/2003 UPDATED 11 APRIL 2003[1]
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In March 2000, the Speaker's Commission of State and Local Governments Finance presented it's final report. The Commission was assembled by then Assembly Speaker Antonio Villaraigosa and included representatives from business, labor, taxpayer groups, and local government including the California State Association of Counties and the League of California Cities. Among its many recommendations was a trade of city and county sales and use tax for greater property tax, property tax return to cities, counties and special districts, and constitutional protection of local revenues. AB1221 (Steinberg) mirrors sales tax for property tax portion of that proposal.

I. How the Sales & Use Tax / Property Tax swap in AB1221 (Steinberg) Would Work.

Under AB1221, each city and each county would swap a portion of the locally levied sales tax for an equal dollar amount of the property tax. The situs-allocated local sales and use tax rate would be reduced by 0.5% from 1% to 0.5%[2]. An equal amount of property tax would be shifted from each county ERAF fund to each city and each county. The state sales and use tax rate would increase by 0.5% from 5.0% to and 5.5%. Essentially, this revenue would be sent to local schools to cover the reduction in ERAF.

The property tax allocation for each city and county would work as follows:

1. The 1% property tax is currently levied countywide and allocated to agencies within the county by statute. Under this proposal the county and each city would be allocated the amount of property tax it received in the prior year, augmented with the amount of the sales tax that it lost. This action would have the effect of increasing each city and county's share of the property tax since the relative shares of the property tax among the jurisdictions receiving the tax would change. The city or county share would go up and the ERAF share would go down.

2. Each year thereafter, the city and the county would receive the amount they received in the prior year (the adjustment for the sales tax swap is now in the base property tax) plus a share of the property tax that is attributable to the growth in assessed value within their jurisdiction. This share would be based on the new, increased base amount of the agency relative to that of other taxing agencies in their jurisdiction. In other words, the swapped amount would grow with the growth in property tax collections.

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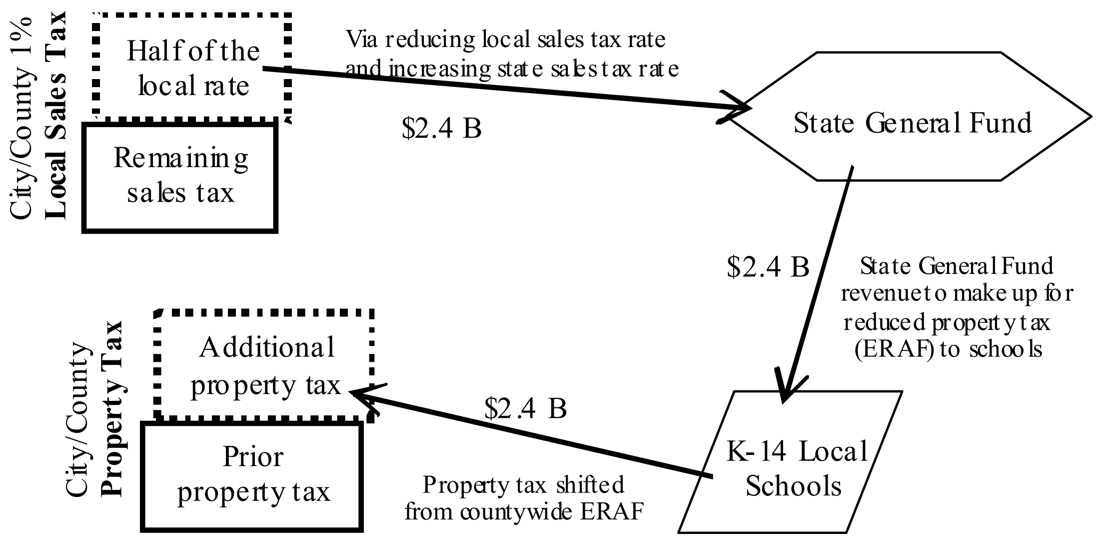
[1] This analysis was updated to reflect the current version of the bill.

[2] Some cities have adopted local sales tax rates below 1%, in which the difference remains with the county. For example, cities in San Mateo County get 0.95% on taxable sales within their jurisdiction, with 0.05% going to the county general fund. Under AB1221, the local rate would be reduced by 0.5%, leaving the cities in San Mateo County with a local rate of 0.45%. There would be no effect on the 0.5% county rate or annual revenue from transactions in cities.

3. The property tax would be shifted from each county ERAF. The reduction in property tax going to school districts (ERAF) would be replaced by state general fund dollars.



Figures 1 and 2 show an example of how sales tax and property tax revenues for a typical city would change.

Figure 1

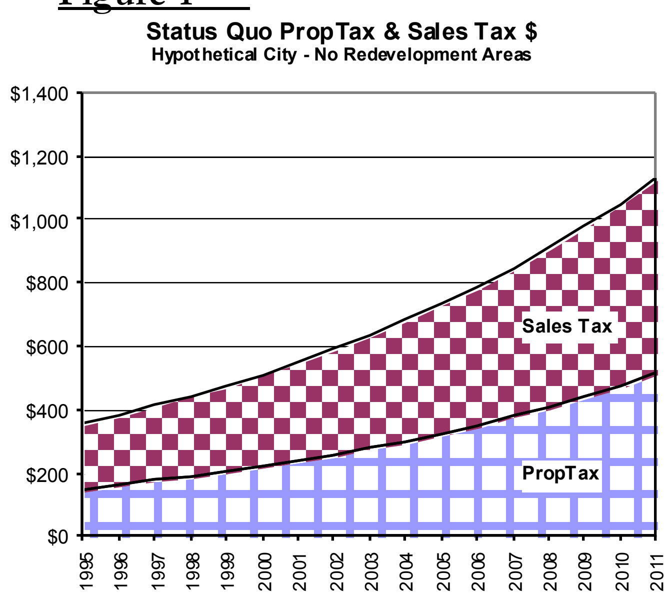
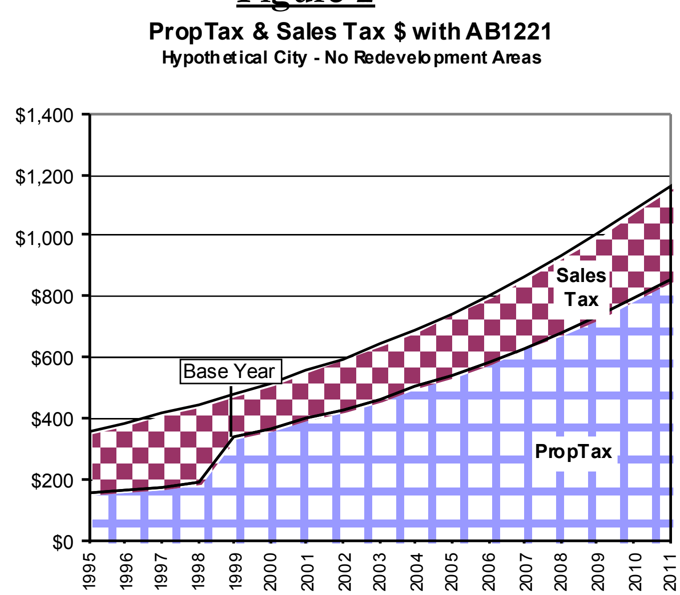


Figure 2



II. Estimated Individual City Impacts. How Would The Proposal Affect The Finances Of Individual Cities?

The fiscal impacts of AB1221 depend entirely on how the California property tax base and sales tax base will grow in the future. More specifically, the impact on an individual city or county depends on the future growth of these revenues within that individual jurisdiction, which depends in turn on the unique character and future direction of the local economy.

Reasonably accurate estimates of a city's future growth in these revenues cannot be determined based on the last five years, the last ten years, the five years before that, etc. What happened in the past is in the past, and we cannot expect any particular previous five or ten year period to match the next.

To reasonably estimate the budgetary impacts of AB1221 on any particular, one must consider:

1) Local long-term economic trends in the context of statewide trends,
2) Future land use and economic plans for the city,
3) The existence and plan for completion of redevelopment project areas, and
4) A range of possibilities.

This analysis provides my broad-based conclusions based on models of the effect of the swap proposal on a variety of cities and an in-depth analysis of the mechanics of the implementation of AB1221. The detailed tables in the attached exhibits provide the specific numeric assumptions and outcomes of the analyses.

The fiscal impact of the swap depends on the city's relative future growth of property tax revenue versus sales tax revenue.

Cities with future property tax revenue growth to surpass future sales tax growth will gain from the swap. For those forecasting stronger growth in city sales tax revenue than in city property tax revenue, the impact of the swap is negative. By "growth" I mean growth rates (%), NOT necessarily dollar amounts. That is a city with low property taxes, but large sales taxes would be better off if the property tax growth rate exceeds the growth rate of sales tax revenues.

The fiscal impact of AB1221 does not depend on the current amount of sales tax or property tax revenue a city receives. It simply effects the amount of funds involved in dollar for dollar base year swap. In this base year, the swap changes the composition of city revenues, but not the total amount. The fiscal impact concerns how this new mix of revenues grows over time versus how it would have grown otherwise.

Historical patterns and economic trends suggest that California local governments on the whole will be better off with more property tax and less sales tax. Figure 3 shows the sales and use tax base compared with the property tax base since 1980, adjusted for inflation. But the critical comparison here is how these tax bases have grown over that time. Figure 4 shows the cumulative growth above/below inflation of taxable sales compared with the cumulative growth in the taxable assessed value of real property. The figure also shows the growth in California population over that time. The figure reveals that 1) the property tax base is less volatile on a year to year basis, and 2) the property tax base has a much stronger growth trend over the last 20 years.

Figure 3

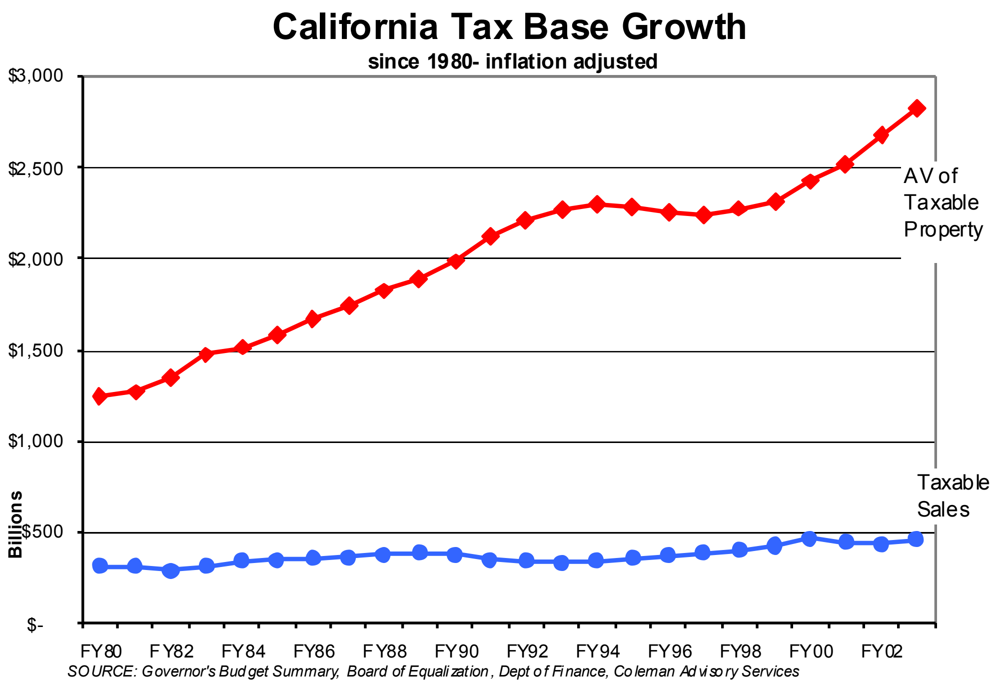
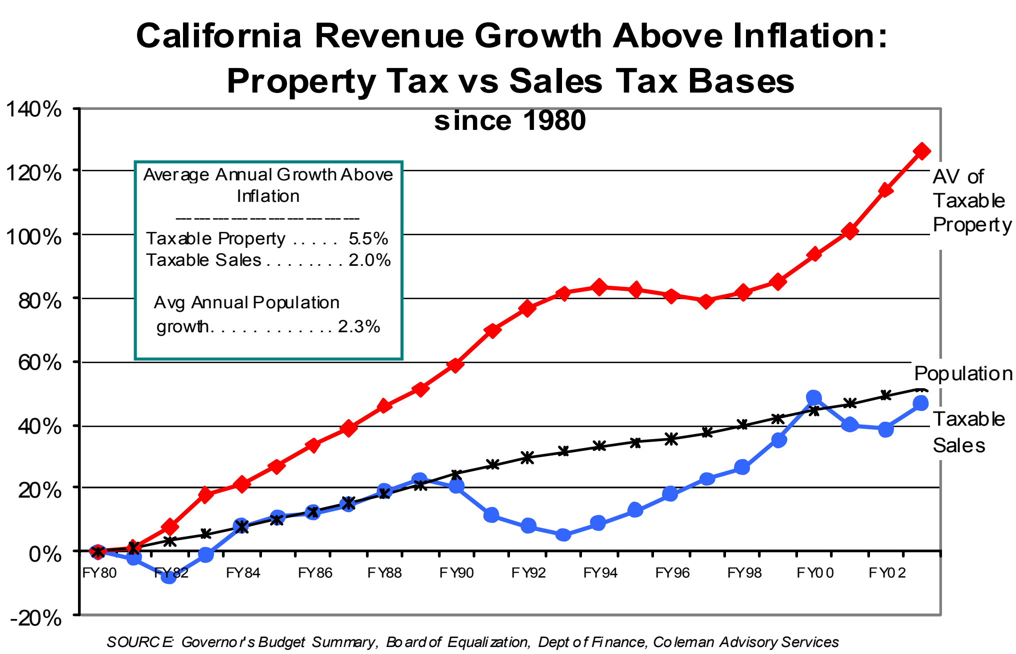


Figure 4



These trends are statewide and local economic conditions vary. However, in a 2000 survey of city revenue growth projections conducted for an analysis of a sales tax for property tax swap proposal from the Speakers Commission on State and Local Finance, four out of five cities estimated their city's future property tax revenue growth to match or surpass future sales tax growth. These cities showed net gain or break even results from the swap.

Exhibit One (attached) shows FY1999-2000 revenues for California cities determines the volume of dollars that would be swapped in each jurisdiction under AB1221 if implemented in FY1999-2000. The exhibit then provides a range of possible future year fiscal impacts for each jurisdiction. The negative impact assumes sales and use tax revenue growth of 5% with a 5% decline in property tax. The positive scenario assumes 5% property tax revenue growth and a 5% sales & use tax decline.

The primary factors that contribute to a city having higher sales tax than property tax revenue growth are 1) a large proportion of the city in redevelopment, and 2) future land use development that is dominated by a high mount of taxable sales generators.

A. Cities with substantial redevelopment programs are less likely to benefit from the swap.

Cities with substantial redevelopment programs are less likely to benefit from the swap while redevelopment project areas are in place because redevelopment dampens city property tax revenue growth.

Redevelopment is largely financed by property tax increment that accrues within a project area. Redevelopment has the effect of limiting the growth of property tax revenues to the taxing agencies that serve the redevelopment area. Thus, the larger a redevelopment project area, the more significant its drag on a local agency's property tax revenue. Figures 5 and 6 show how the presence of a redevelopment project area affects the impact of AB1221. In this extreme example, all property tax growth is going to the redevelopment agency leaving the city with zero property tax growth status quo.

Figure 5

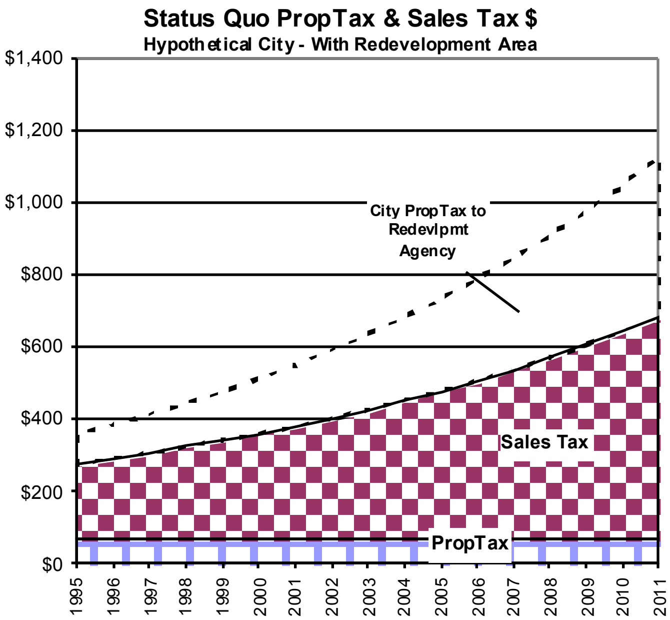
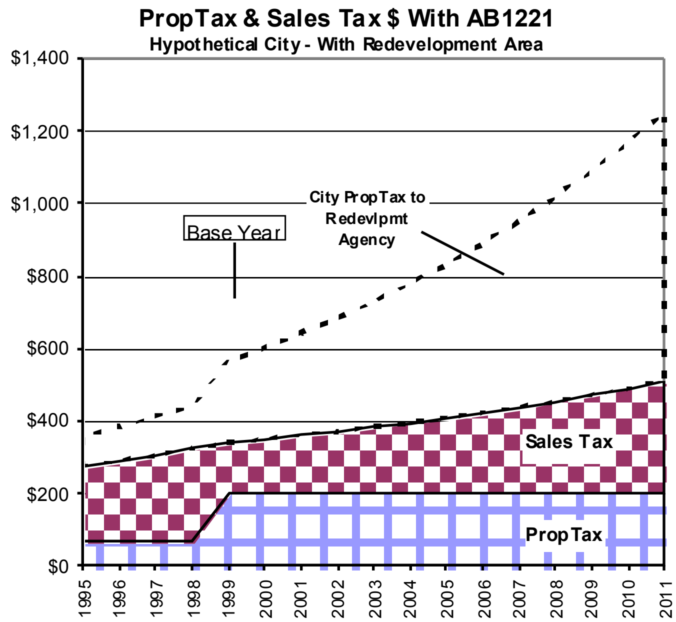


Figure 6



An addendum to this report contains a more thorough discussion of the interactions of AB1221 and redevelopment for city budgets.

C. However, with AB1221, cities with redevelopment areas will be better off financially when project areas area completed and closed.

Once a project area closes, the city would garner more property tax share under AB1221 than without it. That's because AB1221 would have the affect of increasing the city's apportionment of the redevelopment tax increment when the project area closes. Figures 7 and 8 below compare a city closing its redevelopment project under status quo and under the AB1221 swap.

Figure 7

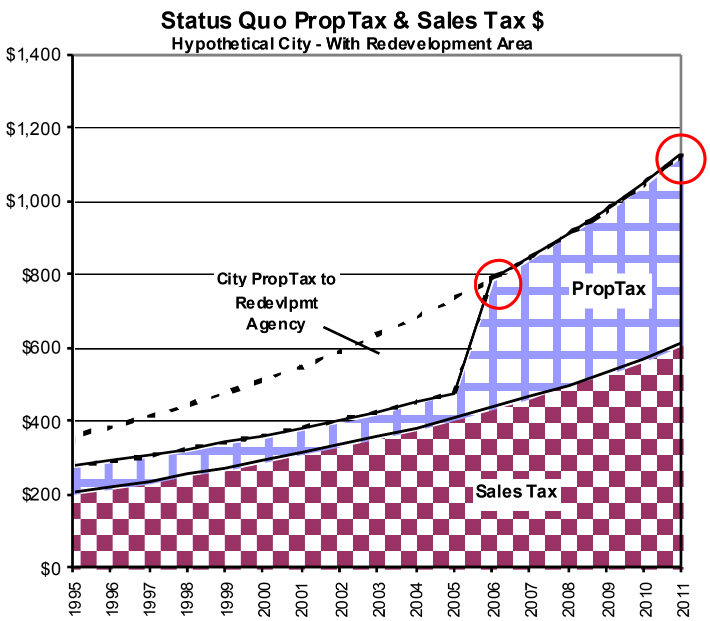
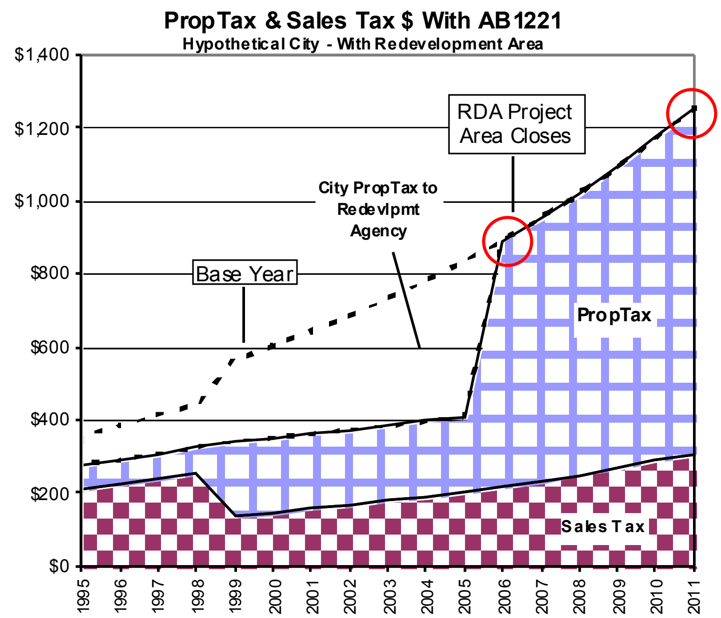


Figure 8



D. Cities whose future land use development is dominated by new sales tax generators are likely to be worse off under the swap proposal.

The Speaker's Commission on State and local finance intended by a similar sales tax for property tax proposal in 1999-2000 to "facilitate balanced, state, regional and local conservation and development policies." A sales tax for property tax swap such as AB1221 will have the accompanying effect of reducing the revenue gain potential to cities with potential and plans for substantial development of their taxable sales base.

a. However, retail land uses would still provide more city tax revenue than the added city service costs they create.

In cities with plans for substantial commercial development (including taxable sales generators such as regional retail), the city would receive less net revenue (new revenue minus new service costs) than under the current system. However, even under AB1221, new city revenues from the land use development would still more than pay for the added city service costs. Fiscal analyses of projects that are dominated by sales tax generators show substantial net revenue to the city. My analysis of these models indicates that under a sales tax for property tax swap (as in AB1221), these projects would still produce substantially more new city revenue than new city costs.

b. In some cities that expect substantial taxable sales growth from new development, the lost sales tax revenue under the swap would be offset by net gains in existing areas of the city.

The negative effects on these cities may be mitigated by net positive revenue effects in existing development. That is, stronger property tax revenue growth versus sales tax growth within exiting development may still exceed net revenue losses due to the swap in new development.

E. For cities that are already especially dependent upon sales tax revenue, AB1221 will improve revenue diversity and economic stability.

These cities are particularly vulnerable to the volatility and economic sluggishness in the brick and mortar retail sector. Moreover, cities with comparatively high sales tax per capita revenues may have less potential for developing new taxable sales generators than other growing communities. For these cities, the future of sales tax growth is much more dubious than their historical experience.

For cities that are highly sales tax dependent, the swap has the additional benefit of providing more diversity to the city's revenue base. With a better balance between property tax and sales tax revenues, the two highest sources of general fund revenue, these communities are less vulnerable to economic fluctuations and the long term economic stability of their overall revenue base is improved.

Regarding political risk, both the property tax and sales tax are equally vulnerable to future intervention by the state.

F. Cities with mixed residential/commercial growth futures will be better off under AB1221 unless they expect to attract new regional-draw sales tax generators.

Many cities are forecasting substantial growth in the coming decade. For most of these communities, a sales tax for property tax swap provides the city with a substantial net gain in revenues over the current system. AB1221 would reduce the net gain from taxable sales generators because the additional property tax share can't make up for the reduced sales tax revenue. But revenues from residential, office and industrial development will improve. Consequently, AB1221 would help cities that are building housing to cover the additional service costs of the development. However, my analyses of the project fiscal evaluations indicates that in many cases, this future residential development still might not provide sufficient local government revenues to cover the additional service demands it creates.

G. In the long run, most built-out cities may be better off under AB1221.

Many cities predict no significant land use development of any kind in the foreseeable future. Surprisingly perhaps, the effect of AB1221 on a "built-out" city may be positive. In most cities, even growing ones, new construction is actually a lesser component of property tax AV/revenue growth than is resale/market increases in existing areas. A city with very little new construction still often sees property tax growth of 5% to 10%. To the extent that the lack of new construction also covers the commercial sector of these cities, sales tax growth may be more adversely impacted by no new construction than property tax growth. In the 2000 fiscal impact analysis of the Speaker's Commission swap proposal, "built-out" cities generally predicted steadier, stronger growth in property tax revenue than sales tax revenue.

E. AB1221 would reduce financial distortions at the root of the "fiscalization of land use" problem . . . somewhat.

AB1221 would improve the balance of service costs and revenues related to land use. Although situs sales tax revenue would be reduced, situs property tax would increase over broader categories of land use activity. In most cases, retail land uses would still provide more city tax revenue than the added city service costs they create.

AB1221 would increase municipal revenues from residential, office and industrial land uses. In many cases these land uses do not generate sufficient city or county revenues to pay for municipal service demands they create. In addition, AB1221 reduces (but would not eliminate) the substantial surplus municipal revenue that taxable sales generating land uses contribute in excess of municipal service costs. However, while the proposals are a step in the "right direction," the basic dynamics of the fiscalization problem will remain: 1) residential and mixed use development still won't pay its way in some areas without additional fees/taxes or municipal service cuts, and 2) sales tax generating land uses will still provide substantially more revenue than costs to cities and counties.

V. POLICY CONSIDERATIONS

A. The Economic Stability of City Finances Would Be Improved By A Sales-Tax-For-Property-Tax-Swap, But The Political Stability Of City Finance Requires Constitutional Protection and Mandate Reform.

Two important factors affect the stability of local government finances: 1) economic vulnerability and 2) political vulnerability from other governmental units and the voters. My analysis of suggests that, AB1221 would improve the economic stability of most cities' finances.

But the most significant factor in the instability of city finance in California is the lack of local control over revenue allocations and rates. A restructuring of city finance will be of little effectiveness to our constituents if the state continues to beset cities with mandates, revenue earmarking, and the taking of local revenues. Current state subventions to local government should have their use restrictions lifted in favor of discretionary revenue for local government. Cities must have constitutional protection and mandate reform.

B. County Property Tax Changes From AB1221 Must Be Localized to Unincorporated Areas.

For counties, the local sales tax is collected from unincorporated areas.[3] Likewise, the change to county property tax shares under AB1221 should be localized to county – not city - tax rate areas. In the case of any future annexation or incorporation, the county and the new or annexing city need the full effect of the swap will be needed for tax sharing to cover the costs of services. If, on the other hand, county property tax shares are increased countywide in swap for a portion of the local sales tax, unincorporated areas will not be sending adequate revenues to cover county and municipal services. Among other adverse policy effects, this will seriously hamper future annexations and incorporations. AB1221 may need to be amended to clarify this aspect.

C. Other Legislative and Judicial Acts May Change the Fiscal Effects of AB1221.

The state and local budget impacts of AB1221 depend upon the growth of sales and use tax revenue relative to the growth of property tax revenue. Future changes in the economy or law that reduce the value and growth of the property tax impair the benefit of a greater share for cities and counties. Changes that improve the value and growth of local property tax revenue would make AB1221 more attractive to individual agencies. If value and growth of the sales and use tax is likely to improve because of legal/structural change, then it is more likely that cities and counties will be better off financially if they do not swap away sales tax.

The local fiscal impact will depend on the net effect of many different possible future changes. The likelihood of each of these is entirely speculative at this point. They include:

1. **The "Pool case" in Orange County (County of Orange v. Orange County Assessment Appeals Board) challenging property tax reassessment procedures.** This case challenges the long-standing and widely used interpretation and practice of property reassessment. Under Proposition 8, which followed Proposition 13, taxpayers may receive reduced assessments if the market value of their properties falls below inflation adjusted acquisition cost. County Assessors throughout the state routinely increase the assessed valuation of properties that benefit from Prop 8 reductions as much as necessary until the assessed valuation reaches the lesser of the current market value or the owner's purchase price, adjusted for inflation by 2%-per-year from purchase. Mr. Pool, an Orange County attorney, alleges that his Prop 8 appealed reduction was essentially permanent and that no assessed valuation could increase more than 2% per year.

   If the ruling is affirmed on appeal, hundreds of millions of dollars of property tax might be lost to California's cities, counties, special districts and schools. Moreover, stripped of the ability to "recapture" from Prop 8 reductions, the property tax will not grow as strongly as it has over the last twenty years.

[3] With the exception of some cities that have adopted sales tax rates less than 1%

2. **Changes in the property tax reassessment procedures for commercial properties.** The assessed value for taxation of commercial property tends to lag behind market value substantially more than residential property, and this gap is growing. As a result, residential property is shouldering a larger and larger share of the property tax paid. There have been a number of proposals to close loopholes in the state's tax system which allow this. These proposals are gaining more serious attention currently than in many years. A requirement that commercial property be reassessed at least every five years would increase property tax revenues by hundreds of millions of dollars and would improve local property tax revenue growth, depending on the amount of commercial property affected in a jurisdiction.

3. **Changes related to the collection of sales and use taxes on remote sales** (catalog, internet, etc.) would improve sales tax collections by tens to hundreds of millions of dollars. If these reforms succeed, the lag effect on sales and use tax revenue collections of increasing remote sales activity would be mitigated.

4. **Extension of the sales tax to certain services.** In the context of the current state budget problem, legislators are considering more seriously the broadening of the sales and use tax base to some categories of services that are currently not taxed. Over the last several decades, the socio-economic shift toward a more service-based economy has been a major cause of statewide sales and use tax collections lagging behind combined inflation and population growth. Reforms to broaden the sales and use tax to services would improve the long term health and growth potential of the sales and use tax, although local jurisdiction effects would vary.

5. **Increase of the state sales and use tax rate.** The Governor has proposed increasing the state sales and use tax rate by 1 cent as a budget remedy. Whether temporary or permanent, an increase in the total sales tax will have some (probably very minor) negative effect on taxable sales. This will in turn negatively effect local sales and use tax revenue receipts.

D. How Does AB1221 Meet the Goals of Reform?

AB1221 is an attempt to reform one aspect of the local finance system. Policy makers may wish to consider how well the proposal meets the overall needs and goals of reform.

1. Fiscal Reform Task Force of the League of California Cities. In 1999-2000, the League's Fiscal Reform Task Force identified the following goals of state & local finance reform.

- Promote local discretion over revenues.
- Match local government revenue with responsibility and accountability to the local electorate.
- Provide constitutional protection and stability for revenues of all cities and promote California's long-term economic growth.
- Avoid harmful effects on individual local governmental units and state government service delivery obligations and programs.

- Enforce the prohibition against unfunded mandates.

2. Others

a. Speaker's Commission on State and Local Finance (2000). The Speaker's Commission begins its recommendations with the following "guiding concepts:"

1) The local finance system should facilitate balanced, state, regional and local conservation and development policies as well as finance local and regional services.
2) In order to avoid dependence on one revenue source, local governments should derive their revenues form a diversity of sources, including property tax, sales tax and general purpose state subventions.
3) The finance base for local and regional services should be a constitutionally protected, stable and reliable and be sufficient to assure basic services.
4) Increase the transparency of state and local government.

b. Legislative Analyst's Office. On February 3, the Legislative Analyst's Office (LAO) released a report "*Reconsidering AB8: Exploring Alternative Ways to Allocate Property Taxes*." The report offers five alternatives to improve local finance. While property tax reform is at the heart of these alternatives, they suggest much broader changes to local government finance. The LAO identify the following existing problems related to local finance and the property tax allocation in particular:

- ✓ Lack of information impedes government accountability to taxpayers
- ✓ Lack of local control
  - o No (local) ability to raise or lower property tax shares.
  - o System susceptible to state-controlled revenue shifts.
  - o Inability to shift revenues among priorities.
- ✓ Skewed development incentives
  - o Fiscal incentives encourage retail over other uses.
  - o Fiscal incentives encourage the proliferation and misuse of redevelopment.
- ✓ Assessment practices act as a barrier to new businesses
- ✓ Reliance upon non-deductible taxes to finance government services.
- ✓ Competition for resources results in inefficient intergovernmental program coordination.

<u>Attachments:</u>
ADDENDUM: How The Swap Affects Redevelopment Agencies and Cities With Redevelopment
EXHBIT One: Range of Fiscal Impacts of AB1221 by City

ADDENDUM:

How The Swap Affects Redevelopment Agencies and Cities With Redevelopment

Redevelopment agencies collect 8% of property tax revenues in California. But unlike other local governments, redevelopment agencies gather their property tax revenues from the "tax increment" or growth in property tax revenue that occurs within their jurisdiction. Absent the redevelopment agency, this tax increment would be apportioned among the taxing agencies serving the area.

This public financing mechanism is unique to redevelopment and it creates some special considerations when we consider changes to the property tax system, such as the sales tax for property tax swap proposal of AB1221.

The Effect Of The AB1221 Swap On Redevelopment Agency Revenues

AB1221 would swap the allocation of sales tax and property tax revenues among governments, but it would not alter the tax rate. Redevelopment revenues come from the tax increment or growth in tax revenue that occurs within an area. Absent the redevelopment area, the revenues would be allocated according to apportionment shares. Generally, shifting these shares (i.e., reducing the school/state share with an equivalent increase in the city share) will not affect the amount of tax increment going to the redevelopment agency.

A few redevelopment agencies receive sales tax revenue under sales & use tax sharing agreements. In 1996-97, redevelopment agencies received $24 million in sales & use tax revenue. Depending on the terms of each agreement, the reduction in Bradley Burns sales & use tax from the swap may affect these revenues. These agencies would need to examine the agreements and the financial implications and consider amendments.

The Effect Of The Swap Proposal On Other Taxing Entities

The presence of a redevelopment area alters the effect of AB1221 on city and school/state finances. Where a redevelopment agency exists, property tax revenue growth is diverted, but not (generally) sales & use tax revenues. These cities will pick up greater burdens (pay more of the tax increment) for their redevelopment agencies and the schools serving the area will pay that much less. The total amount of increment going to the redevelopment agency will not change.

More Property Tax to Cities Means More Redevelopment Tax Increment Comes From Cities

With a greater share of property tax revenue comes a greater share of tax increment going to redevelopment areas. In the short-run, some cities with substantial redevelopment project areas and substantial sales tax bases may see lower general fund revenue growth as a result. This is primarily because they will contribute additional property tax increment to their redevelopment agencies. However, when these agencies close, these cities will be better off than under the status quo.

An Example.

The City of Durham received $2000 in sales & use tax last year. Next year that revenue source is projected to grow 4% and so it would receive $80 in growth. But the AB1221 would shift half this tax base ($1000 dollar for dollar) for property tax share. So the city would get just $40 in sales & use tax growth (4% on the remaining $1000).

On the property tax side, the City of Durham received $400 last year. Assessed property values are projected to grow by 6% - but in 50% of the city this growth (tax increment) will go to the redevelopment agency, so the city projects a growth in property tax revenue of 3% or $12. AB1221 would boost the property tax base for Durham by $1000 to $1400. At 6%, property tax revenues for the City would grow $84 but because half this goes to the redevelopment agency, it will get just $42.

The net result is that the City will see $10 less revenue under AB1221. But in the absence of the redevelopment agency it would have received $20 more and when the RDA completes its work and closes, the city's larger share will have it financially better off than under the current arrangement. This assumes that, in the future, property values in the city will grow faster than taxable sales.

City of Durham - Year 2 Impact of 50% ST > PT Swap

	Status Quo	AB1221	diff +/-
Sales Tax Base	$ 2,000	1,000	
Sales Tax Growth @ 4%	80	40	(40)
Property Tax Base	400	1,400	
Property Tax Growth @ 6%	24	84	60
less TI to redevelopment	(12)	(42)	(30)
TOTAL	2,492	2,482	(10)

Less Property Tax to Schools Means Less Tax Increment Comes From Schools

Redevelopment has had the effect of depressing the growth in property tax revenue for schools (as well as cities, counties and special districts) by capturing this revenue growth. Just as the swap of sales tax for property tax will mean a slower growing revenue base for some cities, it may mean a faster growing revenue base for some schools (state sales tax/ general fund versus local property tax). California's taxable real property is a more robust and steady revenue base than taxable sales, historically and in the future. But the growth of property tax revenue to some local governments (including cities, counties, special districts and school districts) has been slowed by the presence of redevelopment. The swap relieves schools of the some of the revenue dampening effects of redevelopment.

An Incentive To Complete Redevelopment ?

One of the negative effects of the property tax shifts of the 1990s has been to reduce the incentive for cities to close out their redevelopment agencies - by reducing their property tax shares and thereby the revenue boosts they will receive after the closure. Increasing city shares of the property tax gives cities a greater incentive to succeed with their redevelopment efforts, boosting property values in the process and then complete and close their agencies, reaping the benefits in healthier tax revenues.