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TO: LEAGUE OF CALIFORNIA CITIES FISCAL REFORM TASK FORCE

FROM: MICHAEL COLEMAN

SUBJECT: CONTROLLER'S SMART/SMARTER PLAN FOR LOCAL GOVERNMENT FINANCE REFORM

DATE: *REV 18 JAN 00*

As you know, State Controller Kathleen Connell has released a report containing a proposal for the restructuring of local government finance. Last year the Controller assembled a group of local government, business and labor representatives to discuss the topic. However, despite the title and names attached, I think it would be accurate to say that this is the Controller's report and proposal - not that of the task force members.[1]

KATHLEEN CONNELL's "SMART" PROPOSAL

1. Restructure state and local sales and property taxes

a. ERAF Return. Return $450 million annually ERAF based on current annual base ERAF loss for each individual city, county and special district - without regard to Proposition 172 or other state subventions.

b. ERAF Cap. As an alternative to the $450 million base shift, the report recommends - a $300 million base shift with a "hard cap." This apparently means a cap on ERAF dollar growth. The Controller allows that this cap could be lifted - tied to Proposition 98 suspension - given state fiscal difficulties (a page borrowed from the Consensus Project).

c. Sales Tax Reallocation. Reallocate 10% of the current 1 cent Bradley Burns to agencies based on proportion of statewide population. All future growth in these sales tax revenues would also be allocated based on the agency's proportion of statewide population. The Controller suggests that this part of the plan could be done without the ERAF return component - but advises against it.

2. Unfunded Mandate Reform. The Controller proposes a new procedure to enforce the funding by the state of mandates it creates for local governments.

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[1] The proposal was written and released by the Controller's Office without prior review or discussion by the Task Force members.

3. Accountability. The Controller proposes the use of "Bilateral compacts" in which local governments would be required to demonstrate results of programs funded with state dollars. The Controller suggests that these compacts should use the most current budgeting and auditing tools including performance-based budgeting and performance-based auditing.

KATHLEEN CONNELL's "SMARTER" AMENDMENT

After the publication of the SMART proposal, the Controller made numerous appearances around the state including presentations to the League's Fiscal Reform Task Force and the League Board of Directors. City officials had a lot to say about her plan and she soon pledged to make some revisions in response.

The SMART plan suggested that 1) there would be just a handful of cities that would loose money under the proposal, 2) these are probably cities that abused the system by aggressively pursuing sales tax generators, and 3) local agencies within each county should get together and decide how to mitigate these losses. City officials have been quick to point out the major flaws in each of these assertions.

The SMARTER amendment proposes an "equalization" formula to mitigate the losses from the shift of sales tax to per capita distribution. This component really doesn't equalize anything, it simply - in each county - takes a pro-rata share from the "winners" and distributes these funds to zero-out any loss to any individual agency in the base year. A city's portion of ERAF return is effectively also used to offset the loss of base year revenue from the sales tax reallocation.

ANALYSIS

The Controller's Plan Essentially Eliminates The Situs Rule Upon Implementation.

The notion that this plan somehow phases in a per capita distribution is false. Because all future growth of sales and use tax revenue would be distributed on a per capita basis, the situs rule is effectively eliminated from the first day the plan is implemented. Yes, each city would get 90% of the base year revenue it received in prior years (years when distribution was situs based), but future allocations of this base (which decline over time) are actually connected to this historical level - not to future situs activity.

The League of California Cities has a standing policy, recently reaffirmed by the Fiscal Reform Task Force and the Board of Directors, in support of the situs (point-of-sale) rule for sales tax.

As a result of this change, housing development proposals would generate more revenue to cover their service costs (by virtue of the residential population they accommodate).

However, non-residential development would not. In fact, retail and other commercial uses that generate taxable sales would likely generate more service costs than revenues, making them undesirable proposals to cities. The fiscal viability (public service costs versus city revenues) of office and industrial projects, which is currently poor in many areas of California, would not be improved by this proposal. <u>In summary, the Controller's proposal merely exchanges the current undesirable fiscal incentives for a set of undesirable disincentives.</u>

Counties are the Big Winners Here.

The numbers show that 83% of the $450 million annual infusion goes to counties, about 9% to cities. This results in part from the fact that ERAF was more heavily exacted on counties - and the Controller does not take Proposition 172 (which disproportionately benefited counties) into account. It also results from the shift of sales tax allocation to a population basis. Cities now get 87% of the Bradley Burns sales tax revenue. But about 81% of Californians live in cities. So the transition to a population based formula will mean less money overall for cities and more money overall for counties. There are, of course, some individual exceptions. Some counties, including San Francisco, San Mateo, Alpine and Sacramento lose revenue from the sales tax reallocation. But these agencies get more than enough ERAF return back to cover the loss.

Aggregate Approach Masks Magnitude of City Losses

The SMART report looks at the financial impact on local agencies aggregated at the county level. But by viewing things in the aggregate this way, the magnitude of the individual agency net losses is underestimated. The Controller's SMART report was printed before the Controller or anyone had actually estimated the individual city fiscal impacts of the proposal.

Among cities, the sales tax reallocation causes big losses for many. Moreover, many of these cities lose far more in sales tax revenue than they gain in ERAF return. Consequently, they are net losers under the proposal. The total cost to zero out the losses among the 150 net loser cities is over **$48 million** per year. This would bring negatively impacted cities to a zero impact in the first year. However, their future year "losses" as a result of the per capita distribution of sales tax growth would not be mitigated.

In the initial SMART report, the Controller acknowledged that some cities are net losers (actually there are more than 150 net losers among cities), but dismissed the issue without sympathy:

> *There are a handful of cities will be significantly impacted during the transition. These are the cities which have overloaded their commercial centers with vast auto malls and have failed to fully develop their residential and non-retail*

> *business and industrial areas. Cities that have historically abused retail fiscalization the most will have the greatest challenges during transition.*

Controller Connell made several appearances before local government groups including presentations to the League's Fiscal Reform Task Force and the League Board of Directors. Evidently she was listening because the subsequently released "SMARTER" report proposes that all base year losses of individual cities zeroed out by a proportional reduction in the base year gains of cities and the county in the same county.

Some Problematic Assumptions

The Controller's approach appears to be based on several erroneous assumptions:

#1: *The Controller apparently assumes that fiscalization is purely a result of the point of sale allocation of sales tax. She seems to believe that if we eliminate the point of sale allocation, we won't have fiscalization.* By allocating future sales tax revenue growth on per capita, the Controller effectively abandons the situs (point-of-sale) rule for sales tax. The proposal appears misunderstand the fiscalization issue.

All forms of local government revenue have economic implications. In approving a land use development, a thoughtful city council will consider the service costs and revenues that will result from the development and ask "will the additional revenues cover the additional costs of service?" By shifting sales tax, the largest source of discretionary city revenue to a population basis, fiscalization is not removed, it is simply changed. Under such a system, residential land uses that accommodate increased population would now more than pay for themselves, and commercial uses (including retail, industrial, office, etc) will usually not - depending on the share of property tax revenue that the city receives (and that varies widely), and the service responsibilities of the city (especially if the city is full service or not). In the absence of a dramatic increase in city property tax shares (in EXCESS of ERAF return) the likely result of the **SMART plan will be to damage our commercial economic development efforts.**

#2: *The Controller states that cities that will be harmed by this proposal were abusing the system with bad land use decisions (see quote top of this page).* The Controller apparently did not review the list of 150 cities (quite a handful) that will be net losers prior to coming to her conclusion. The net loser cities (to be made even in the base year under the SMARTER amendment) include many for which evidence of "abuse" may be hard to come by.

SUMMARY

There are several laudable elements of the SMART plan. These are:

+ ERAF return - although it fails to consider Proposition 172 mitigation
+ Mandate Reform - although the proposal needs more specificity
+ Accountability - in concept

However, in my opinion, her major fiscal proposal, to reallocate the sales tax on population, runs contrary to League policy or the public interest.

MC

The California State Controller's SMART and SMARTER reports are available at http://www.sco.ca.gov/pubs/#smart