Occasional Papers

Proposition 13: Some Unintended Consequences

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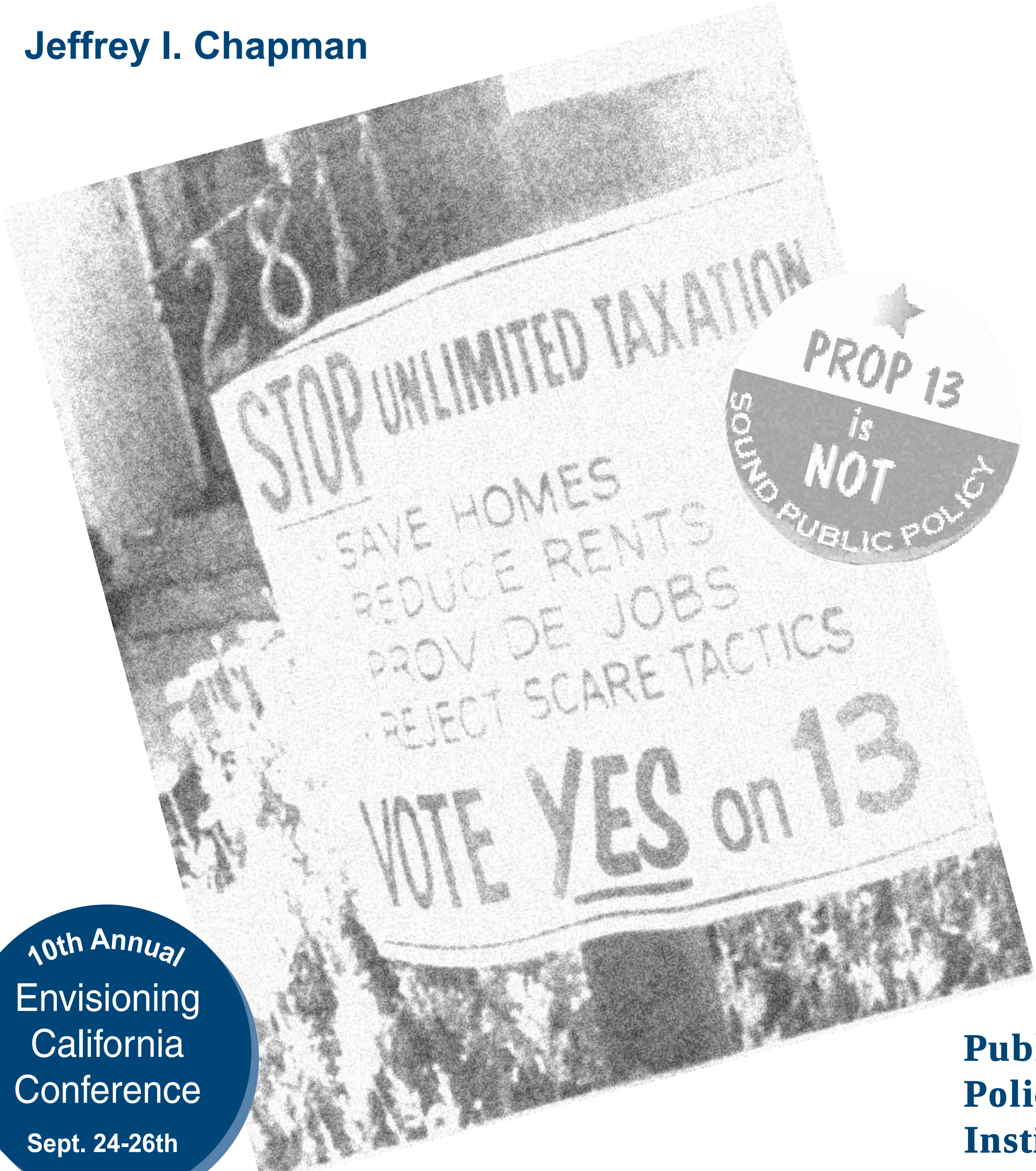

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Preface

The Public Policy Institute of California commissioned this paper to provide an overview of Proposition 13 and to motivate discussion of this initiative at the Tenth Annual Envisioning California Conference. The author, Jeffrey I. Chapman, is a Professor of Public Administration in the School of Policy, Planning, and Development at the University of Southern California. This paper discusses the consequences of an initiative that may well be one of the most significant to be passed in the history of the state. The paper reflects Professor Chapman's deep knowledge of the subject and also presents his views about appropriate directions for policy. We believe it will stimulate useful debate on the consequences of Proposition 13 and future policy directions. At the same time, we should note that the views expressed in the paper are the author's and do not represent positions taken by the Institute. PPIC's ongoing body of research in governance and public finance is establishing an empirical basis for addressing many of the issues raised here. As in all of our work, we aim to do so in a way that is consistent with PPIC's nonpartisan status.

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1. Introduction

Proposition 13’s proponents argued that it was a simple property tax reform. Yet its effects were not simple, altogether expected, or always benign. To better understand the consequences, both intended and unintended, this paper will briefly discuss the implementation of Proposition 13 and the subsequent changes in local finance. It will then identify three major unanticipated consequences of the proposition and suggest some policy options that might be considered in dealing with them.

Chapter 2 provides an overview of the events that led to the adoption of Proposition 13 and reviews the actions of the state government in establishing the new local finance system. Chapter 3 describes three consequences that were not part of the debate on Proposition 13 or a central focus of the legislature's implementation actions. Chapter 4 suggests a policy agenda for addressing these unintended consequences.

2. The Adoption and Implementation of Proposition 13: A Chronology

The Adoption of Proposition 13

Rising home prices, leading to an increase in property taxes, coupled with legislative inaction, were trends that generally existed through much of the five years predating Proposition 13. When the California legislature adjourned in the fall of 1977 without passing any significant property tax reforms, even though 22 different reform plans were proposed, voters quickly signed the circulating initiative petitions for the Jarvis-Gann proposition (Jarvis-Gann became known as Proposition 13 because of its number on the 1978 ballot). Proponents argued that the proposition was both a property tax relief measure and a necessary constraint upon the size of government. The legislature reconvened and passed a potential reform (which necessitated a constitutional change) that would appear along with Proposition 13 on the June ballot. Proposition 13 easily passed. The legislature's plan did not.

Although poorly written, the basic rules of Proposition 13 were relatively straightforward. The maximum property tax rate was set at 1 percent of the value of the property. The value of the property was set at its 1975-76 level but was allowed to increase by the rate of inflation, up to 2 percent each year. Property could be revalued only upon a change of ownership. No new *ad valorem* property taxes could be imposed. Any special taxes (which were not defined) needed to be approved by two-thirds of the voters. Finally, the distribution of the property taxes that were collected was to be done "according to law," and since no such law existed, one had to be created. Prior to the adoption of Proposition 13, local agencies established their own separate property tax rates and received the proceeds of the tax. For the first time in the state's history, the state was put in charge of allocating the proceeds of the locally levied property tax, with the rate and base defined by the statewide initiative.

Implementing a New State-Local Finance System

The election that included the passage of Proposition 13 was only three weeks away from the beginning of the 1978-79 fiscal year. Facing a reduction of over $6 billion in property tax revenues for school districts and other local governments, the legislature and the governor responded quickly, passing SB 154. Although this was a one-year implementation statute, it instituted two actions that affected future state responses. First, it increased the state's role in delivering and financing local services by providing block grants to cover the revenue losses of local governments that experienced a reduction in their property tax revenues. Since counties acted as agents of the state, in addition to providing local services, the state also "bought-out" parts of various state-mandated programs, reducing county costs. Second, SB 154 established a formula for the distribution of the remaining property taxes. Prior to Proposition 13, a property tax payer paid different tax rates to the local agencies providing services, including several special districts, one or more school districts, a city, and the county. Proposition 13 mandated one tax rate—1 percent of the assessed value of the property. Since there was one countywide tax rate, the legislature was confronted with the dilemma of allocating a smaller property tax pie to the same number of governments.

Following a year of study and legislative hearings, the legislature, in 1979, adopted AB 8, a long-term response to the fiscal austerity introduced by Proposition 13. AB 8 is still the basic operating legislation, although it has been amended several times. Much of AB 8 is based on SB 154, although the bill is a very complex piece of legislation covering a multitude of topics, including retirement contributions, one-year adjustments, deflator components, and new ways of allocating the collected property taxes.

There were four principal parts of AB 8, three of which are still important:[1]

- A guarantee to cities, counties, and special districts that they would receive their SB 154 property tax allocation plus an adjusted amount of the block-grant aid they received in 1978. The funding for this allocation came from a shift of about one-third of the school property taxes to other local governments. In addition, revenues from assessed value growth in a jurisdiction were allocated proportionally to local governments and schools, based on where the growth occurred. This allocation formula quickly became very complex and is still continually subject to tinkering.
- The state totally bought out the county share of many of the major health and welfare programs, with partial buy-outs of others, such as AFDC.
- State aid to schools was increased to offset the property tax shift to the other local governments. This was used as a way of equalizing school expenditures.

Proposition 13 and AB 8 generated two important outcomes. First, the property tax is no longer a local tax. Proposition 13 sets the rate and base; AB 8—a state law—allocates who gets the receipts. The amount of property tax received by a local agency is a function of its relative share of property tax levied prior to Proposition 13. For example, a city that previously had a relatively high tax rate receives a larger share of the fixed countywide 1 percent property tax rate. Aside from annexation or incorporation, the only way that local governments can affect property tax receipts is through economic development, and even in these cases, they receive only a portion of the revenues. Second, there is a large amount of variation in the allocation of the tax. As Table 1 shows, in 1996-97, cities, on average, received 11 cents out of every property tax dollar collected, counties received 19 cents, schools 52 cents, and other districts 18 cents. Compared to 1977-78, counties get a good deal less while "other" districts get much more. The inter-county range of shares among local governments has generally increased since 1977-78; for example, school districts now receive, on average by county, between 27 and 76 cents out of every dollar. In 1977-78, they received between 34 and 64 cents.[2]

Of course, social institutions continually evolve in response to changing constraints, opportunities, and preferences. And such has been the case for the system of state and local finance in California over the twenty years since the passage of Proposition 13, with the occurrence of at least ten specific fiscal decisions by the legislature and voters.[3] Table 2 illustrates the variety of fiscal

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[1] The fourth element, a trigger mechanism to cut state aid if funds were not available (called the "deflator") was never used.

[2] Within each county, there is a wide range among the specific jurisdictions; for example, the no and low tax cities receive a much smaller share of the property tax allocation than other cities.

[3] John J. Kirlin, Jeffrey I. Chapman, and Peter Asmus, 1994, "California Policy Choices: the Context," in John J. Kirlin and Jeffrey I. Chapman, eds., *California Policy Choices,* Vol. 9, Sacramento and Los Angeles: University of Southern California.

decisions and events that have influenced this evolution.[4] Two themes, however, underlie nearly all of these events: first, a sense of ongoing fiscal constraint imposed by voters attempting to limit government taxing and spending; and second, an increase in state control over local finance that has occurred because of the imposition of many of the voter restrictions. These restrictions included Proposition 13 and Proposition 4 in 1979, which established a system of spending limits. The increase in state control was possible because of the ability of the state to raise revenues at a time when the ability of local governments to raise general purpose taxes had become limited.

Table 1
Allocation of General Property Tax Dollar
(in cents)

		1977-78	1985-86	1996-97
City	Average	10	13	11
	Range	0-15	0-23	0-20
County	Average	30	33	19
	Range	17-74	18-71	10-64
School	Average	53	37	52
	Range	34-64	9-61	27-76
Other	Average	7	7	18
	Range	2-20	3-30	2-29

All averages are statewide averages; all ranges are among counties.
Source: State Board of Equalization, *Annual Report*, miscellaneous years, Table 15

Table 2
Chronology of Fiscal Events

1978	Passage of Proposition 13; passage of SB 154
1979	Passage of AB 8; passage of Proposition 4 (Gann Limit Initiative)
1982	First Certificate of Participation issued; passage of Mello-Roos Act
1986	Passage of Proposition 62 (tax limit), initially held unconstitutional
1988	Passage of Proposition 98
1988	Peak of defense expenditures in California
1988-93	Major droughts, earthquakes, and fires affect California
1990	Passage of Proposition 111; peak of illegal immigration
1991-92	Realignment of functions and revenues among state and local governments
1992-93 and 1993-94	Property tax shift to help state budget (establishment of ERAF)
1993	Trough of unemployment from recession; passage of Proposition 172 (sales tax); redevelopment reform, blight defined
1995	Proposition 62 upheld by California Supreme Court
1996	Passage of Proposition 218 (tax limitation strengthening Proposition 62)
1997	Trial Court financing reform
1998	Vehicle license fee reduced in a complex manner

[4] During this time, California has experienced droughts, freezes, floods, forest fires, urban fires, earthquakes, riots, military base closures, and a recession that was the worst in the state's history since the depression of the 1930s.

In addition to AB 8, 1979 also saw the passage of the Government Spending Limit—Proposition 4 (Gann Limit Initiative). This initiative restricted appropriations for governments, attempted to force the state into paying for imposed mandates, and implicitly encouraged the use of fees for new services because these would not be included under the limit. The limit is less important now because the 1990s recession slowed the growth in tax revenues, while the spending limitation itself continued to grow.[5] In addition, the legislature quickly found ways around the mandated funding provision. Nonetheless, the legitimization of the use of fees became important for local governments.[6]

As tax and expenditure limitations on local government were added in the late 1970s, and as the state influence over local government continued to grow, it is not surprising that the composition of county and city revenues and expenditures would change.

The Changing World of City and County Finance

To understand how the implementation of Proposition 13 has changed the way cities and counties do the public's business, the importance of revenue sources as components of total revenues and the importance of expenditure decisions as components of total expenditures for each level of local government must be examined.

Counties

Counties have multiple roles in California. Since they are the administrative arm of the state, they are responsible for public assistance, public protection, and health. Counties are also responsible for delivering local services and providing local facilities to their unincorporated communities, including law enforcement, waste collection, and roads and parks. At times, counties contract with cities or other public, non-profit, or private agencies to provide some of these services. Counties also perform countywide activities such as assessing and collecting property taxes and operating jails.

Table 3 shows the changes in importance for the components of county revenues. As expected, the role of the property tax has diminished, falling from 33 percent to 12 percent of aggregate county revenues. Almost entirely offsetting this percentage change has been the increase in importance of state funds, which now constitute 42 percent of county revenues. Perhaps as interesting is the fact that there has been no change in the importance of user charges over this period, although the "other" revenue category has more than doubled and now exceeds the property tax component of the budget.[7] One claim that counties often advance is that a very high percentage of their revenue is uncontrollable—i.e., much of the revenue is already earmarked for state- or federally-mandated programs, with the counties having little say in how it will be spent. If this is true, then Proposition 13, which essentially made the property tax uncontrollable at the county level, led to an increase in uncontrollable revenues from about 50 percent of county revenues in 1978 to nearly 76 percent in 1996.[8]

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[5] Four out of 470 cities and none out of 58 counties were at their spending limit in 1995-96.

[6] An unintended but beneficial consequence of Proposition 4 was that it encouraged jurisdictions to establish sinking funds for depreciation and replacement purposes for some of their capital stock. This occurred because depreciation is a legitimate service delivery expense and so could be part of the foundation for establishing a fee.

[7] Other revenues consist of licenses and permits, fines, interest revenues, and miscellaneous revenues.

[8] This is obviously a very simplistic cut. Some state and federal revenues have some elements of controllability if counties took full advantage of accepting the responsibilities of control.

Table 3
Revenue Source Importance, Counties

% of Aggregate County Revenue		
Category	1977-78	1995-96
Property Tax	33	12
Other Taxes	3	3
State Funds	24	42
Federal Funds	26	22
Charges	9	9
Other	5	12
TOTAL	100	100

Source: Author's calculations from State Controller's Reports

Table 4 shows the changes in various expenditure categories for the total of the counties. The two obvious changes are the decline in general government expenditures and the increase in protection expenditures. Proposition 13 passed, in part, because voters believed that the government used resources inefficiently and had a bloated bureaucracy that could be eliminated.[9] General government expenditures include this bureaucracy, and the decline in expenditures in this category reflects a formal response to the desire of voters. However, while the general government overhead category has fallen in importance, nothing much is known about the internal bureaucracy of the service delivery functions of the county. For example, although the importance of the protection function has increased, we cannot know (at least without undertaking case studies) whether the entire increase is an increase in direct service delivery or whether there is now some additional administrative overhead included in the service.

Table 4
Expenditure Importance, Counties

% of Expenditures		
Category	1977-78	1995-96
General Government	19	9
Protection	19	28
Health and Sanitation	14	14
Public Assistance	40	40
Other	8	9
TOTAL	100	100

Source: Author's calculations from State Controller's Reports

The decline in importance of general government overhead might have unintended consequences. A decline in general government can be easily translated into such events as slower permit processing, poor tax administration, or weak responses to regulatory needs. Or if a citizen attempts to contact the county for help with a particular problem, because of the cutback in general

[9] Jack Citrin, 1979. "Do People Want Something for Nothing: Public Opinion on Taxes and Government Spending," *National Tax Journal,* Vol. 32, No. 2 (supplement).

government support it may be more difficult for him to access the system or, once accessed, to find the correct individual to solve the particular problem. If these difficulties multiply, the extent of citizen discontent with county government increases and citizens become either alienated or angry. The first may lead to lower voter turnout at elections; the latter may lead to more voter constraints on government or pressure for micromanagement by legislators, who are anxious to appear to be responding to upset citizens and particular special interest groups.

Cities

Cities are a powerful component of government in California, reflecting the strong belief of the 1879 California Constitutional Convention that cities' home rule capabilities should be protected.[10] California cities focus on ensuring the provision of local services and facilities, with the provision either directly undertaken by the city or contracted for with the county or other public, not-for-profit, or private agencies.

Table 5 compares the sources of city revenues in 1977-78 and 1995-96.[11] In contrast to the counties, the property tax was for cities a less crucial although not unimportant element of local revenue in 1977-78. By 1995-96, the property tax had dropped behind all other sources of revenues in importance for cities. But there were also major shifts in other revenue sources, with declines in the importance of sales taxes and intergovernmental revenues compensated for by increases in service charges and other revenues.[12] Together, service charges and enterprise revenues were the most important sources of revenue in both of these time periods. By 1995-96, over 68 percent of city revenues came from service charges, enterprise income, and other revenues, much of which are under the control of the city. It is reasonable to conclude that city residents are paying for a substantial portion of their services through the price system composed of fees and charges rather than through general citywide taxes such as the property tax.

Table 5
Revenue Source Importance, Cities

% of Aggregate City Revenue		
Category	1977-78	1995-96
Property Tax	16	8
Sales Tax	11	9
Intergovernmental Aid	24	14
Service Charges	6	11
Enterprise Income	26	29
Other	17	29
TOTAL	100	100

Source: Author's calculations from State Controller's Reports

[10] Alvin D. Sokolow and Peter Detwiler, forthcoming, "State-Local Relations in California," in Plato Rigos, Dale Krane, and Mel Hill, eds., *Home Rule in America: A Fifty State Handbook* Washington, D.C.: Congressional Quarterly Press, p. 9.

[11] Several adjustments were made to the basic Controller data to enable comparisons between these two years. This was necessary because the *Controller's Reports* changed format in 1980-81. Contact the author for details.

[12] Other revenues include such items as franchise taxes, licenses and permits, interest earnings, and sales of property.

Table 6 illustrates the changing importance of city expenditure components. Cities, like counties, have also dramatically cut general government expenditures. They have also cut library and parks, water, gas, and electricity expenditures. Perhaps most surprising is the fact that the percent spent on police has barely changed—it was 15 percent of city expenditures in 1977-78 and 16 percent in 1995-96. Together, however, the public utility/enterprise set of activities now accounts for about 36 percent of total city expenditures, an increase from the 30 percent of 1977-78. It may be that the public prefers city expenditures on these activities; it may be that there are earmarked funds for at least some of the infrastructure (for example, gas tax money for roads and sales tax money for transportation systems) that encourage cities to divert additional resources to these projects; or it may be that because so many of these activities also generate revenue they just grew without conscious decisionmaking.

Finally, the myriad of "other" expenditures has only slightly increased as a percent of the budget over 18 years, although it has remained the largest component of expenditures.[13] What this might be indicating is that cities are adding expenditure categories in a variety of areas which may benefit specific interest groups. From a microperspective, these increases may be difficult for the public to discern; however, they do apparently accumulate to a large sum. They are not hidden, but they are not the focus of much public attention.

Table 6
Expenditure Importance, Cities

Category	% of Expenditures 1977-78	1995-96
General Government	13	7
Police	15	16
Library/Parks	10	6
Water, Gas, Electricity	23	18
Other Enterprise	7	18
Other	32	35
TOTAL	100	100

Source: Author's calculations from State Controller's Reports

[13] "Other" expenditures include such items as fire protection, emergency medical services, animal regulation, streets and highways, storm drains, planning, regulation, etc.

3. Some Unanticipated Consequences of Proposition 13

As illustrated in the preceding chapter, there were shifts in sources of revenues for counties and cities and in the way those revenues were spent. But what was not shown, nor could be shown from the data, are three distinct, unanticipated consequences of Proposition 13. These consequences resulted from attempts to maintain revenue flows that were sufficient to fund expenditures demanded by citizens. They reflect the changing nature of public and private institutions over time, and they also reflect the intelligence of many individuals who have dedicated large parts of their professional lives to finding loopholes in Proposition 13 and its implementing legislation. Although these three consequences are listed separately, they are often interrelated and sometimes reflect causality.

Consequence Number One: The Fiscalization of Land Use

Although formally named by Misczynski in 1986, the concept of examining land use decisions in the context of their revenue and expenditure consequences has certainly been recognized since the advent of municipal incorporation and zoning laws.[14] Because Proposition 13 reduced the revenues that would be received from property taxes from any particular development (industrial, commercial, or residential), local jurisdictions began to pay even more attention to the fiscal outcomes of land use decisions. In particular, land uses that generated revenues in addition to property taxes became more important. To the extent that land use decisions are now driven by their fiscal consequences, fiscalization has occurred. There are at least three specific instances of fiscalization activities that have been adopted by local government, as discussed below.

The Sales Tax and Land Use Choices

Local governments receive sales taxes based on two formulas. The principal method, which originated in the Bradley-Burns Sales and Use Tax Act of 1955, generates sales tax revenues as a function of the dollar volume of sales that occurs in a specific jurisdiction. Under this Act, for every dollar of sales, the local government in whose jurisdiction the sale occurred, receives one cent, which goes into the general fund.[15] To the extent that local governments make land use decisions based on this sales tax revenue, they are acting consistently with the concept of fiscalization of land use.

Those local governments that feel fiscal stress or that desire to maximize revenues pay close attention to commercial activity. Of course, there are cities that do not like retail activity and carefully zone out major retail centers, just as there are cities that will do anything in their power to generate large sales tax revenues. (In 1996-97, per capita sales tax revenues ranged from $2.57 in Bradbury to $55,504 in Vernon). There are two popular ways (at least among elected officials) of

[14] Dean Misczynski, 1986, "The Fiscalization of Land Use," in John J. Kirlin and Donald R. Winkler, eds., *California Policy Choices*, Vol. 3, Sacramento, California: University of Southern California.

[15] Counties only get the one cent if the sale occurs in an unincorporated area. In addition, counties also receive 1/2 cent for each dollar of sales within the county, which is then divided by formula among all local governments within that county based on the ERAF shift and which is dedicated to public safety. See the property tax shift discussion under the third set of consequences for more discussion of this 1/2 cent.

generating a large amount of sales taxes from a small area: "big-box" retail and car dealerships.[16] It is not surprising, then, to see cities compete for these types of activities. Most jurisdictions trying to maximize sales tax revenues choose to encourage these types of development over residential development, which generates sales tax revenue only to the extent that the new residents shop in the same city in which they live. It is not surprising to observe the owners of big-box retail and car dealerships attempting to obtain economic incentives for locating in a particular jurisdiction.

Redevelopment as a Municipal Revenue Generator

Beginning in the early 1950s, California became the first state to use the technique of tax increment financing as a development tool. Under this process, a local jurisdiction first forms a redevelopment agency, which is authorized by statute under the general provisions of the state constitution. This agency then declares a section of the jurisdiction to be "blighted." Any increase in the property tax receipts (the property tax increment) that occurs after this designation is shared by the redevelopment agency and overlapping jurisdictions (by formula since 1994). The goal is to ensure that redevelopment does occur and thus a tax increment will be generated. For this to occur, debt is issued by the redevelopment agency, with the proceeds of the debt issuance going to improve the blighted area. As this improvement is occurring, developers are moving in and causing an increase in property value, which in turn generates the property tax increment. This tax increment funds the debt.

Although the initial predictions concerning the efficacy of the technique were negative, the dire concerns were not realized.[17] Rather, the use of this technique expanded: there were 197 agencies in 1980 with 300 project areas; by the end of 1996, there were 399 agencies with 744 project areas. The total increment generated by the projects was about $1.4 billion.[18] It may be that after Proposition 13, many cities attempted to use tax increment financing to alleviate some of the fiscal pressures caused by the initiative.[19] Certainly, much of the redevelopment was used to attract commercial activities that would generate substantial sales tax revenues, while new housing was often not encouraged because it generated less sales taxes and produced a smaller tax increment.

There are at least three reasons for the increasing use of this tool to fight off fiscal stress. First, until 1993, blight was a very loosely defined concept, and so almost any parcel, whatever its state, could be deemed blighted and thus in need of redevelopment. Under certain conditions, even undeveloped land could be considered blighted (for example, if it were in a flood plain).[20]

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[16] Shopping malls are also very popular but tend to use more land.

[17] Merrill Lynch Pierce Fenner and Smith, Inc, 1979, *California's Tax Allocation Bonds: Victims of Proposition 13,* (October), New York: Merrill Lynch Pierce Fenner and Smith, Fixed Income Research.

[18] Note that if the area were not blighted and the same amount of growth would have occurred without the redevelopment agency, then about $700 million would have gone to the school districts that included the area since schools get about 50 percent of the collected property tax. Since the state backfills school finance (up to a specified level), this becomes a very large state redevelopment program that the citizen never recognizes.

[19] Other studies, using other states as the data source, come to a similar conclusion that redevelopment activities increase as local public fiscal stress increases. See Joyce Y. Man, 1999, "Fiscal Pressure, Tax Competition, and the Adoption of Tax Increment Financing," *Urban Studies*, Vol. 37, No. 7.

[20] Blight is now more rigorously defined in statute, although the potential for misuse is still clearly present.

Undeveloped land, of course, generates very large tax increments as it is developed. Second, the use of redevelopment debt to finance infrastructure does not need voter approval. Residents are often unaware of the magnitude of the debt that has been issued or the size of the increment. Since about 80 percent of the total redevelopment projects are greater than 100 acres,[21] the projects are likely to include vacant or undeveloped land and therefore need new infrastructure. Tax increment financing helps to provide the financing for this infrastructure. Finally, redevelopment activities can be used as a weapon in the interjurisdictional fight for economic growth. Companies can be encouraged to relocate with the promised benefits of new infrastructure to be provided by the redevelopment agency. To the extent that this is a business relocation decision rather than a new development decision, it is a negative sum game, simply because of the transaction costs involved.

An obvious question concerning this type of redevelopment activity is whether or not it works in stimulating economic redevelopment. The few studies that analyze this indicate that the technique does work—property values do increase faster in redevelopment areas than in non-redevelopment areas, but one study finds that less than 50 percent of the increase occurs because of the use of the technique.[22]

Development Fees: Internalizing the Costs of Public Capital and Services

Prior to Proposition 13, infrastructure for new developments was often financed by community-wide, broad-based taxes and debt. After Proposition 13, there was a movement away from these methods to those methods that raised revenues from the new development itself. Development fees were often part of this method of internalizing the costs of the new infrastructure and service needs.

Although development fees have been increasing in importance in both slow and fast growing areas, their scope is much larger in new, fast growing areas.[23] Because California has experienced such rapid growth over the past decades, and given the fiscalization constraints, it is not surprising that development fees have risen rapidly since Proposition 13.

In theory, development fees are strictly regulated in California. Before a fee can be imposed or increased, the local government must identify its purpose and use, determine how there is a reasonable relationship between the development project and the fee's use, and determine that there is a reasonable relationship between the amount of the fee and the cost of the infrastructure financed by the fee.[24] In addition to cities and counties, since 1986 school districts can also impose fees on

[21] California State Controller, 1997, *Community Redevelopment Agencies Annual Report, 1995-96* Sacramento, CA.

[22] See Michael Dardia, 1998, *Subsidizing Redevelopment in California,* San Francisco: Public Policy Institute of California. Further, Joyce Y. Man and Mark Rosentraub, "Tax Increment Financing: Municipal Adoption and Effects on Property Value Growth," forthcoming in *Public Finance Review,* find, for Indiana, that median owner-occupied housing values were about eleven percent higher in tax-increment districts because of the redevelopment activities.

[23] See Alan A. Altshuler and J.A. Gomez-Ibanez, 1993, *Regulation for Revenue: The Political Economy of Land Use Exaction.* Washington, D.C.: The Brookings Institution; see also Marla Dresch and Steven M. Sheffrin, 1997a, *Who Pays for Exactions and Development Fees?* San Francisco: The Public Policy Institute of California. The more general term for this type of finance is *exaction.* Exactions are either developer payments or dedications of specific areas for public use (for example, parks and streets). The developer offers exactions in return for governmental approval to proceed with the project.

[24] These are the main conditions. There are several other restrictions, including determining the need for the infrastructure as well as accounting and reporting disclosure techniques. Also note that fees cannot be based on the *ad valorem* value of the property.

both residential and commercial/industrial new construction. As of July 1996, the maximum for these fees was $1.84 per square foot for residential projects and 30 cents per square foot for commercial and industrial developments.[25] In addition, whenever cities and counties engage in legislative land use activities, such as amending the general plan or changing zoning, they can impose their own school construction fees in addition to the fees imposed by the school district. The total of school, city, and county fees faced by some developers, have exceeded $9 per square foot.[26] The controversy surrounding the 1998-99 state budget partially revolves around these fees for schools, with some proponents of fee mitigation also arguing that General Obligations bonds should have a lower approval threshold than a 2/3 vote.[27]

Dresch and Sheffrin have conducted the most detailed analysis of development fees in California.[28] Studying fees in Conta Costa County between 1992 and 1995, they found that average development fees per unit ranged from $252 for community redevelopment purposes to nearly $13,000 for water and sewage. There are also permit fees, traffic fees, fire fees, park fees, and school fees imposed by school districts. These fees totaled over $16,000 per dwelling unit in the east Contra Costa county area and over $24,000 per unit in the west county area.[29] Dresch and Sheffrin also found variation when they reaggregated the fees by city, discovering a difference of nearly $7,000 per dwelling unit between the highest and lowest fee-charging jurisdictions in the east county and a difference of about $8,000 per unit in the west county.[30]

A final component of any fee discussion concerns its incidence.[31] It is not unusual to find developers arguing that, on the one hand, fees are eating up their profits and driving them out of business and then, on the other hand, arguing that the fees will increase the price of the home and thus the poor mortgage holder will be paying off developer fees (with interest!) over the next thirty years. The true determination of the incidence is a difficult empirical problem. Again, Dresch and Sheffrin's study bears citing—they found that in eastern Contra Costa County, for every dollar of fees, housing prices went up by 25 cents, and for the western county, each dollar of fees generated an increase in housing prices of $1.88 (although the latter figure was statistically not significantly different from $1.00). They also found that in the eastern part of the county, a dollar increase in fees and assessments on new homes increased the price of exiting homes by 23 cents, perhaps because higher prices for new homes influenced the price of older homes or because the expenditures from

[25] The legislative intent was to have a threefold way of financing schools—state General Obligation bonds, local General Obligation bonds, and development fees

[26] See Marla Dresch and Steven Sheffrin, 1997b, "The Role of Development Fees and Exactions in Local Public Finance," *State Tax Notes*, December 1, 1411-1416.

[27] The final agreement was that in exchange for putting a $9.2 billion school bond issue on the November 1998 ballot, restrictions would be placed on developer fees and the 2/3 vote requirement would be kept intact.

[28] Dresch and Sheffrin, 1997b, *op. cit.*

[29] The average selling price of an east county house was about $200,000; the average selling price for a west county house was about $400,000.

[30] A City of Davis study, as cited in Dresch and Sheffrin (1997b), found that there can also be variation of fees within a city, with an 1,800 square foot house paying between $8,600 and $10,000 in major project financing fees, depending upon its location in the city. More importantly, at least for Davis residents, are the costs of Mello-Roos financing, which range from zero in one section of town to over $22,000 in another section. See the subsequent discussion of Mello-Roos financing.

[31] For a sophisticated theoretical incidence analysis of fees and assessment districts, see John Yinger, 1998, "The Incidence of Development Fees and Special Assessments," *National Tax Journal*, Vol. LI, No. 1, (March).

the fees and assessments provided community-wide benefits which were capitalized into the prices of older homes. Confounding the analysis was the decline in housing prices throughout California during portions of the study period.

In any case, it is clear that fees and dedications now play an important role in California's local finance. These fees are often hidden from the homeowner, and their incidence is at times, unclear. They are controversial, but the increase in their use is closely related to government trying to avoid a fall in revenues because of the Proposition 13 constraints.

Consequence Number Two: The Growth of Arcane Finance Techniques

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. 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. This next section of the paper will illustrate this trend, examining five different examples of complex financing techniques.

Assembly Bill 8 and the Allocation of Property Tax.

Over the last 19 years, the AB 8 property tax allocation system has become more complex. It is continually tweaked to take into account particular exigencies of local jurisdictions—for example, cities with low or no property taxes or enterprise and nonenterprise special districts. In addition, the numbers within the nine-step AB 8 property tax allocation formula, over time, become extraordinarily difficult to track, and thus reliability is sometimes questionable. Within a few years of AB 8's introduction, state auditors found significant discrepancies between what they thought the allocation should be and what the local governments were actually receiving.[32]

As noted earlier, parts of AB 8 involved bail-out and buy-out provisions. Over time, while the costs of these provisions mounted, local governments began to regard these activities as entitlements. When the state entered a recession in the early 1990s and notified local governments that the property tax allocation they were receiving was not an entitlement and then shifted the allocation to fund education, there was great consternation on the part of local governments, especially counties. The Education Revenue Augmentation Fund discussion under the third set of consequences will re-examine this particular property tax shift.

The result of this complex and creaky method of distribution is a tendency for local officials to accept the resulting allocation as an exogenous input into the budgetary process. This further encourages the belief that the property tax is a state, not local, tax and encourages a continual search for other revenue streams that are more dependable and controllable. This does not imply that the property tax is an unimportant source of revenue for localities—it is just to say that the portion they receive from it is very difficult to determine in a simple manner.

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[32] As a city finance director remarked, in commenting on the allocation of redevelopment revenue, "...if you've ever read [Sections 95 through 100 of the Revenue and Taxation Code (R&T)], you already know that obtaining a good understanding of the R&T may never be possible." Greg Johnson, 1998, "County Auditor's Association Changes Guidelines for Calculating Property Tax Administration Costs," *CSMFO Mini-News,* April.

Education Finance

Education finance was difficult to understand even before the passage of Proposition 13. Prior to the Serrano court cases, school funding was a shared state-local arrangement, with the state guaranteeing a base level of general purpose funds for each pupil and the local districts using their control of property taxes to raise the per pupil funding to the amount the district wanted to spend. The Serrano court cases, which began in 1968 and finally concluded in the mid-1980s, focused on the property tax and its alleged inequities as a funding source for school districts and mandated a financing plan that was not property tax dependent.[33] Between Serrano and 1978, the state became more heavily involved in school finance and complex formulas considering both foundation support and revenue limits. Although school districts did have limited ability to raise the property tax , it was clear that any property tax reform passed by the legislature would have to deal with a non-property-tax school finance plan.

After the passage of Proposition 13, educational finance was re-addressed, with school districts receiving a portion of the property tax (through the AB 8 allocation formula) and direct payments from the state. Until about 1985, California's spending per average daily attendance was roughly equal to the U.S. average. Starting in about 1985, California's spending began to increase at a slower rate, and it actually fell during the early 1990s. In 1988, in an attempt to maintain stability in school funding, the California Teachers Association sponsored Proposition 98, which established a minimum floor for funding K-14 schools (at the time of passage, this was about 40 percent of the state's General Fund). This funding constitutes about three-fourths of overall K-12 funding. Because it was tied to the state's budget, it indirectly affected the state's fiscal relationships with other entities; as spending on schools increased, less was available for other types of state expenditures. By 1989, the Proposition 98 formula was found to be too binding, and in 1990 the formula was modified by Proposition 111, which reduced the school financial aid requirements if certain fiscal stresses existed at the state level. In particular, in no- or low-revenue growth years, the state was allowed to modify the formula through a complex series of adjustments.

There are now three formulas that can be used to determine the minimum level of funding, with the largest amount of money calculated by any of the formulas being what the schools actually get. There are five major factors involved in the calculations: General Fund revenues, state population, personal income, local property taxes, and K-12 average daily attendance. These factors change during the year, and thus there are changes in the minimum guarantee. The Governor then must provide "settle-up" money to ensure that any increase in the previous year's guarantee is funded. The current minimum, reflecting changes since the original Proposition 98, is about 34.5 rather than 40 percent of General Fund revenues.[34]

Retrospectively, in many of the years since 1988, Proposition 98 has acted as more of a ceiling than a floor. The minimum was funded and then the state turned to other activities. Even funding this minimum caused pain during the California recession, and many budget games (some of which were stopped by the Courts) were played to ensure that the mandated floor would be reached. Proposition 98 funding and its implications have now become as difficult to understand as AB 8. For

[33] *Serrano v. Priest,* 96 Cal. Rptr. (60) (1971). See also *Serrano v. Priest*, 135 Cal. Rptr. 45.
[34] The lower minimum reflects the ERAF property tax shifts of 1992-93 and 1993-94, which will be discussed later in the paper.

example, the new vehicle license fee tax reduction was implemented partially because it has no Proposition 98 implications, since it is not a General Fund revenue source.

In the past, local school districts were always heavily dependent on state aid (and faced state mandates). However, with Proposition 13 eliminating the ability of local school districts to raise property tax rates for their schools, and with Proposition 98 establishing a floor (or ceiling, depending on the economy and legislature), for all practical purposes, aggregate school finance is now almost entirely centralized at the state level, and school districts are now passive recipients of state revenues.

Financing Capital Facilities

Prior to Proposition 13, capital finance was relatively straightforward. If a local government wanted new infrastructure, it would go to the voters and ask for approval of either a General Obligation bond or a revenue bond. Or, it would save enough money to engage in pay-as-you-go financing. For the first eight years after Proposition 13, the first option was constitutionally unavailable; the second option was unpalatable because of the fear of voter revolt; and the third option was impossible because of shrinking discretionary general purpose revenues, including the property tax.[35] To further complicate matters, there is a difference between the problems of capital finance in a developed area and capital finance in an undeveloped area. In developed areas, where little new construction occurs and development fees are not usually large enough to support the necessary infrastructure, two techniques have evolved. The first has already been discussed—the increased use of redevelopment finance through the use of tax increment financing techniques. The second has been to use Certificates of Participation (COPs). In the decade between 1985 and 1995, about $28 billion in General Obligation bonds were issued by California state and local government, compared to about $40 billion in COPs.

The Certificate of Participation has several attributes which make it easy to use. Its issuance does not require a vote of the general public; it can be initiated and passed by a local legislative body. Technically, the COP is issued by a non-profit body established by the relevant legislative body. The non-profit organization then takes the proceeds from the issuance and provides the infrastructure or other capital (for example, city halls or police cars are sometimes purchased using a COP technique). The legislative body has previously agreed to rent the asset from the non-profit, and thus the non-profit receives an income stream to be used to retire the debt, with the COP holder being paid through a trustee. The money that is used by the legislative body to pay the non-profit for the use of the infrastructure comes from the General Fund, although there are many cases of jurisdictions finding other funding sources for this flow of rents. For example, if the jurisdiction has another asset that is generating an income flow (such as an airport or harbor), that income stream can be pledged as a revenue source. Because the COP is not a debt instrument, but rather a multi-year promise of sharing a revenue stream, this instrument does not count against any legal limitations on the amount of debt that can be issued by the jurisdiction. COPs can become quite complex and are not well known by the public, but because they are so easy to issue (until recently, some jurisdictions approved them on the consent calendar), they have become exceedingly popular at all levels of California

[35] In 1986, the voters approved an amendment to Proposition 13 that allowed the issuance of General Obligation bonds approved by a two-thirds vote.

government. Approximately $7 billion of COPs were issued in 1996 and 1997.[36] Note though, that ease of issue does not imply ease of understanding, either by the public or legislative body.

Historically, infrastructure for new development was funded by debt issued and paid for by existing residents through the General Obligation bond process. Now, it is much more likely that the new development will have to finance its own infrastructure as well as fight off efforts of existing residents to have the new development provide some goods and services (for example, parks) for the entire community.[37]

In addition to the previously discussed development fees, another method of financing infrastructure for new developments is a new type of debt instrument—the Mello-Roos bond. About $6 billion of Mello-Roos debt was issued between 1985 and 1995.[38]

Mello-Roos debt (named after the two legislators who carried the legislation in 1982) is used to finance any infrastructure or selected services in a geographically defined piece of land called a community facilities district. This area, which is usually undeveloped, can be irregularly shaped and may be drawn with "holes" to exclude particular sections (usually, the excluded sections are those that are developed). Two-thirds of the voters of the area, or landowners representing two-thirds of the land in the area (who have votes distributed based on the amount of land they own), can vote to issue debt for capital improvements in the community facilities district (or to finance service provisions). Upon issuance of the debt, a lien is placed against the property in the area. As the property is subdivided, each individual homeowner is responsible for the payment of a share of the debt (which shows up on the homeowner's property tax bill). Initially, this share did not have to be disclosed when the property was bought, but legislation has been enacted to force disclosure. The local jurisdiction is not the agency that issues the debt and is therefore not legally responsible for the security of the debt.

Operationally, Mello-Roos debt has replaced at least some of the property tax that the homeowner might have faced prior to Proposition 13 (the part that related to General Obligation financing). Since Mello-Roos debt is more expensive than General Obligation debt because of its higher risk, the payment by the homeowner is higher than what would have been faced prior to Proposition 13. Anecdotally, there are stories of homeowners making Mello-Roos payments that are larger than their property tax payments, and there are billboard signs for new developments that advertise "No Mello-Roos." In 1996, $600 million of Mello-Roos debt was issued; in 1997, $677 million was issued.

Assessment Districts

Another method of financing government activities is the establishment of an assessment district that has the ability to levy a charge that pays for a public facility or service in direct relationship to the benefit that the facility or service confers on the property. These charges or assessments are authorized by more than a dozen specific laws, and nearly every type of governmental jurisdiction can use one type of assessment district or another. Since the benefits of

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[36] For a case study on the misuse of COPs in California, see Craig L. Johnson and John L. Mikesell, 1994, "Certificates of Participation and Capital Markets: Lessons from Brevard County and Richmond Unified School District," *Public Budgeting and Finance,* Vol. 14, No. 3.

[37] Construction taxes are legal in California and have been used to finance community-wide benefits. See Dresch and Sheffrin, 1997b, *op. cit.*

[38] Mello-Roos debt can be used in developed areas but seldom is because of the difficulty of approval.

the investment or service financed by the district precisely equal its costs, there should be no net effect on the prices of either land or housing because of the district.

There are apparently thousands of different assessment districts throughout the state. They are used to finance everything from landscape development to flood control infrastructure to the maintenance of sewers. Citizens typically see assessments once a year on their property tax bills and then attempt to figure out what the cryptic notations really mean. Slightly over $1 billion in special assessment debt was issued during 1997; however, only about $250 million was issued during the first six months of this year, possibly reflecting the impact of Proposition 218.[39] Before the passage of Proposition 218, property owner protests were the only traditional way to stop the formation of assessment districts. Now, an affirmative vote of the property owners is needed to begin the district's implementation, which might possibly lead to even longer ballots.[40] And, with the reduced number of people voting and with supermajorities being demanded, there is a greater likelihood of a slowdown in benefit assessment financing.

Entrepreneurial Activities

The fiscal stress associated with the decline of property tax revenues gave rise, at least in some jurisdictions, to the implementation of public entrepreneurism. With the publication of the Kirlin and Kirlin seminal volume in 1982, being called a public entrepreneur became legitimate and local administrators throughout California began to publicly call themselves such.[41] Public entrepreneurs are willing to take more risks and are more aggressive in undertaking activities that increase the revenue flows in their jurisdiction.

One set of entrepreneurial activities revolved around generating new economic development. The increase in redevelopment finance activities has already been mentioned, but there are several other ways in which a jurisdiction can stimulate development and reap the benefits of increased sales taxes, employment, and at least some property taxes. There are at least three different (but often interlocked) methods through which this can be accomplished.

1. Become a partner with a private developer. At least one jurisdiction in California partnered with a private developer in building a shopping mall. As the profitability of the shopping mall changes, the city receives a changing revenue stream. In exchange for this revenue stream, the city helped change some of the zoning restrictions and provided some of the infrastructure. If the shopping mall makes no profit, there is no revenue stream, so the city is taking a legitimate risk.

2. Give a direct tax subsidy to a private firm or developer. In these cases, tax abatements are used either to entice a firm to locate in a particular area or to ensure that an existing firm does not leave the area.[42] There are instances in which public utility rates for some firms have been slightly

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[39] California Debt and Investment Advisory Commission, 1998a and 1998b, *Debt Line,* Vol. 17, Nos. 7 and 8, July and August. Proposition 218 is the most recent tax limitation measure passed by California voters.

[40] Assessment ballots do not require a supermajority vote; however, the votes are weighted by the dollar amount of the property owner's assessment liability.

[41] See John J. Kirlin and Anne Kirlin, 1982, *Public Choices—Private Resources.* Sacramento, CA: California Tax Foundation. It is interesting that the term "civic entrepreneur" is now being used by private sector individuals who are attempting to solve public problems.

[42] The debate is still ongoing as to the efficacy of these techniques. See William F. Fox and Matthew N. Murray, 1998, "Incentives, Firm Location Decisions and Regional Economic Performance," in

increased in order to lower rates for a firm that the city wanted to keep.[43] In other cases, the jurisdiction hopes that the economic growth that tax subsidies stimulate (or at least maintain) will offset the initial loss in tax revenues. To the extent that these subsidy techniques work to attract a firm from within the state, this is a zero (or even negative) sum game, since one jurisdiction's gain is another jurisdiction's loss.[44] Redevelopment financing is often utilized as part of the attraction process.

3. Enter into sophisticated public-private development agreements. These are neither full-fledged partnerships nor direct tax subsidies. Rather, they are complex contracts in which the jurisdiction negotiates with a developer or series of developers. The jurisdiction agrees to provide certain services, help finance others, perhaps through assessment districts or tax increment financing, and ensure adequate zoning for the needs of the developers. In turn, the developers contract to provide specific types of housing and industry. One goal of many of these agreements is to ensure that lawsuits will not stop the development.

In all three of these activities, the contracts and agreements are very complex, technical, and not easy for the citizen to accurately analyze. In many cases, hundreds of millions of dollars are committed through these agreements and subsidies. In some cases, they may not work out as initially intended; for example, the arrangements between the City of Oakland, Alameda County, and the (then) Los Angeles Raiders football team has already generated several unexpected short-term fiscal consequences.

There is another type of fiscal entrepreneurship that rarely occurs, but when it does, chaos erupts. This is when the jurisdiction's treasurer uses high-risk sophisticated products that are available for investment purposes (Chapman, 1996). In Orange County, for several years the Treasurer generated returns on investments that far exceeded the returns obtained by other County Treasurers. He was able to do this through the use of some very complex derivative products made available by some investment firms. The revenue flow certainly helped the county avoid some of the fiscal problems generated by Proposition 13; however, since other counties did not follow Orange County's lead, it is difficult to attribute this investment strategy to Proposition 13 fiscal stress. In any case, interest rates did not follow the pattern that the Treasurer forecasted and the county lost over $1.6 billion.[45] It is not altogether clear that the Orange County elected officials or the participants in the investment pool (school districts and some other special districts) completely understood the types of investments that the Treasurer was making. Nor is it clear that they knew what investment strategies were being followed.

Helen F. Ladd, ed., *Local Government Tax and Land Use Policies in the United States.* Northampton, MA: Edward Elgar.

[43] Mike McCarthy and Lynn Graebner, 1997, "County Subsidy of Industrial Utility Rates Violates Proposition 218," *Sacramento Business Journal,* Vol. 14, No. 8, May 12.

[44] Some of these techniques might now be illegal under Proposition 218 (see McCarthy and Graebner, *op. cit.*).

[45] For a detailed examination of this, see Mark Baldassare, 1998, *When Government Fails: The Orange County Bankruptcy.* Berkeley: University of California Press and the Public Policy Institute of California.

Consequence Number 3: Increase in State Control over County Finance

Because the state had a large surplus in 1977-78, it was able to institute a series of financing shifts that allowed it to buy-out, bail-out, and otherwise help local governments. Over time, sometimes intentionally and sometimes unintentionally, the state has made a series of decisions that has led to it being a dominant financial player in local governments' financial decisionmaking. As illustrated earlier, this is especially true in the case of counties. The state reached this position through a myriad small decisions and the two major ones discussed below.[46]

Control of the Property Tax

The first sign of a new era in state-local relations came in 1979 when the state established a long-term fiscal relief plan that involved the transfer of property tax from school districts to other local governments. Then, in 1988, as part of a realignment of the financing of the trial courts, the legislature shifted property taxes from counties to selected cities that had either no shares or very small shares of the property tax (these are known as the "no and low" property tax cities).

The set of state activities that indicated increased state control of local finance were the two formula changes in the property tax allocation, one in 1992-93 and the other in 1993-94. The net result of these changes was an ongoing shift of property taxes away from cities, counties, and special districts to schools.[47] The increase in the schools' property tax revenues decreased the obligation from the state's General Fund to the schools. The absolute level of school finance was not affected, but the state's responsibility was reduced, while counties and cities felt the pain.

The rationale for this shift can be traced back to AB 8. In that legislation, as earlier noted, the state gave relief to local jurisdictions to offset losses suffered under Proposition 13. AB 8 reduced county health and welfare costs by increasing state aid and also shifted some of the property tax revenues from schools to cities, counties, and special districts. The state backfilled the schools' property tax loss with money from the General Fund. The state computes that the current value of this annual AB 8 relief to local governments exceeds $6 billion. When this is compared to the new property tax shifts which are now about $3.4 billion per year, the state's rationale is understood—local government is still receiving a net bail-out from the state for Proposition 13.[48] Of course, those local governments that had spent the last fifteen years using this money believed that it would never end, and they were deeply affected when the shift occurred.

This shift was not simple. County auditors are required to deposit some of the property taxes that had previously gone to the local jurisdictions into a new, countywide fund for schools called the "Educational Revenue Augmentation Fund" (ERAF). The ERAF funds are then distributed, by formula, to schools. The shift of property taxes into this fund essentially reflects the AB 8 benefits that local jurisdictions had received and, as such, it led to a wide variety in the distribution of the tax money—for example, almost twenty percent of the cities saw no shift in 1993-94 because they were incorporated after 1978 and so never received any AB 8 assistance. The average county lost about

[46] As mentioned earlier, the state has also continued to enact a series of Trial Court financing reforms, with the latest, enacted in 1997-98, generating about $350 million in relief to cities and counties beginning in 1998-99.

[47] Redevelopment districts also initially lost some property tax revenues; however, this loss was quickly phased out.

[48] Legislative Analyst's Office, 1996a, "Reversing the Property Tax Shifts," April 2, Sacramento, California.

40 percent of its property taxes (about $50 to $70 per capita), although some counties lost considerably more—for example, Los Angeles County lost about $100 per capita.[49]

Some mitigating measures were passed that helped local governments accommodate at least a portion of the shift. The 1/2 cent sales tax that the state imposed to help solve the 1991-92 budget gap and that was to sunset in July 1993 was ultimately retained (it took a statewide vote in November 1993 to do so) and was given to the counties to re-allocate to the cities and the county based on the extent of property tax transfers. In 1995-96, this 1/2 cent sales tax raised about $1.5 billion for counties and about $90 million for cities, offsetting about half of the ERAF shift. There is a good deal of variation among counties in these replacement revenues—for example, Alpine County had about 99 percent of its ERAF shift replaced, Sierra County had about 30 percent replaced, and Los Angeles County had about 40 percent replaced.[50] This sales tax is earmarked for public safety and now has a maintenance of effort requirement. There were also some increases in the vehicle license fee subventions to cities and counties and a mandate relief bill that allowed counties to reduce General Assistance by about 25 percent if the county could demonstrate that it was in significant financial distress.

Again, note the centralization of fiscal power in this history. Clearly, the property tax is now really a state tax—combined, cities and counties now get only 30 cents out of every dollar paid in property taxes. Further, the state ignored chances to lessen the shift in property tax revenues and has continued with its own agenda. Even in its mitigating help, the state has mandated how the sales tax revenues are to be spent.

Sorting Out the State-County Relationship

Although Proposition 13 highlighted the controversy between state and local control, the issue of the state-county relationship has been with us since the adoption of the 1849 constitution. As mentioned earlier, counties act as agents of the state for a variety of health and social service programs. This relationship varies on a program by program basis and changes over time. For example, the 1991-92 state budget initially faced a $14.3 billion gap between expected revenues and ongoing expenditure requirements. As part of the solution of this deficit, the state "realigned" some responsibilities between the state and the counties. The counties would receive extra revenues and, in return, would absorb extra responsibilities from the state. This was a formal response to a series of ad hoc cost and revenue shifts from the state to the counties during the 1980s that led to a complex system of health and welfare finance.[51] Realignment was an attempt to sort out this system in a more rational manner.

Realignment had three components: program transfers from the state to the counties; changes in some cost-sharing ratios between the state and the counties, and increases in the state sales tax and vehicle license fees that were earmarked for the transferred programs. The major activities transferred included mental health, public health, and indigent health programs. The cost-sharing changes, some of which were quite dramatic, were nearly all in the social service area. For example,

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[49] Legislative Analyst's Office, 1996a, *Ibid.*

[50] These are 1993-94 numbers, after Proposition 172 had taken full effect. For 1997-98, Alpine had dropped to 57 percent of its ERAF shift, Sierra had risen to 57 percent, and Los Angeles had about 46 percent of its losses replaced. Also note that Trial Court funding relief is not included in these calculations.

[51] See the Legislative Analyst's analysis of realignment in "Making Government Make Sense", 1993, *The 1993-94 Budget: Perspectives and Issues,* Sacramento, California: Legislative Analyst's Office.

AFDC-Foster Care went from 95 percent state-funded to 40 percent state-funded, In-Home Supported Services went from 97 percent state- funded to 65 percent state-funded, and the state welfare-to-work program (GAIN) went from 100 percent state-funded to 70 percent. The state did increase its share for AFDC-Family Group and for county administration. The state did not relinquish its authority to set eligibility criteria for these programs, so counties did not recognize an increase in control for the crucial elements. The total increase in county expenditures was estimated to be slightly more than $2.2 billion.[52]

To cover this cost increase, the state raised its sales tax by 1/2 cent and increased the revenues to the counties from vehicle license fees, increasing the depreciation schedule so that higher valued vehicles paid more in fees for a longer time. The revenue stream that the counties received from these sources was generally earmarked for specific programs, and they had only a limited ability to transfer revenues among programs. Originally, it was anticipated that there would be enough money raised by these increases in taxes and fees so that the counties would be held harmless. However, principally because of the recession, there was an immediate shortfall of about $150 million, and this would grow to about $229 million in the following year.[53]

Realignment did provide a steady stream of revenue to the counties, and a degree of flexibility in its use. Some also claim that it was a beneficial change for the counties, even if the revenues were not as high as anticipated, because the state did not take the opportunity to make severe cuts in social services. Some mental health practitioners believe that the new-found stability in the revenues for their programs have led to better resource allocation planning. In addition, some of the more expensive interventions in the foster care programs have declined.[54]

There has been no formal evaluation of realignment, although several years ago the Legislative Analyst gave it generally acceptable reviews, with the caution that it was still evolving and careful oversight was necessary (LAO, 1993). This caution needs to be re-emphasized today—some of the programs no longer exist (for example, AFDC has been replaced by TANF) and with the expanding economy, revenue flows have obviously changed. Overall, realignment is a positive step in helping define state-county relationships. It illustrates that unexpected changes can be positive as well as negative. However, the underlying relationships, while perhaps clarified, have not changed: the county is still the agent of the state in providing services, the state still sets eligibility criteria for most welfare programs and sets the formula for how services are to be financed; for example, as the counties discovered this year, the state can change the vehicle license fee. Since it is unlikely that any county could successfully increase its sales tax rate to fund health and welfare programs, and since property taxes are immutable, the counties are still controlled by the state.

[52] Legislative Analyst's Office, 1992, *The 1992-93 Budget: Perspectives and Issues,* Sacramento, California, p. 107.
[53] Karen Coker Kesslar, 1994, "Realignment Data Project Report #1," March 6. (Unpublished).
[54] Jeffrey I. Chapman, 1995, "California: The Enduring Crises," in Steven D. Gold (ed.), *The Fiscal Crises of the States.* Washington, D.C.: Georgetown University Press.

4. Conclusion: Dealing with the Unintended Consequences

The three sets of consequences identified in this paper (fiscalization of land use, development of arcane finance techniques, and the increase of state control over local finance) were not immediately anticipated when Proposition 13 passed. Taken together, these consequences have had dramatic effects on governance in California. Land use decisions are often based on fiscal effects, the public finances of the state are impenetrable to citizens as well as many experts, and cities and counties have found themselves with less fiscal autonomy and thus are less likely to be able to respond to citizen needs and preferences. Outlined below is a policy and research agenda that policymakers and interested citizens might consider for addressing these consequences.

Public Policy Reform Agenda

The core provisions of Proposition 13, the 1 percent tax rate limit, the acquisition-based assessment system, and the vote requirements for state and local taxes will not be repealed in the foreseeable future. Any public finance policy reforms must take place in that context. Further, if a closer connection between the government and the citizenry is to be made, any reforms must also deal with the system design questions of how legitimate decisions should be made and carried out. The following, non-mutually exclusive policy agenda should prove useful in confronting some of the unintended consequences of Proposition 13.

Dealing with the Fiscalization of Land Use

Any reforms in this area should recognize that economic growth, job creation, and environmental protection should be considered in land use decisions. Raising the level of discussion to include more than simply the local budgetary benefits of a particular land use choice would be an important first step.

1. Review development projects in a broader context.

Because of the increased importance of sales taxes for cities, there is a tendency for local governments to encourage retail over residential construction. Yet, California's population continues to increase, and somehow these new residents must be housed. Developing a regional context for making choices between competing land uses would be a step toward balancing the economic and environmental needs of California's urban regions. For example, instead of focusing on where development cannot occur, focus on where it should occur.

2. Revise the current local sales tax allocation.

To prevent each jurisdiction from doing everything it can to attract retail commercial development, often at the expense of alternative land uses, the fiscal effects on land uses could be reduced by distributing a portion of the locally levied sales tax on a basis other than the situs basis as it is now. For example, if in an urban county an increment of the local sales tax was distributed on a countywide basis, this increment could be allocated according to local agreements among the cities and the county based on local needs. A new system for allocating a part of the approximately $4 billion in locally levied sales taxes could go a long way toward ending the competition that has developed over retail commercial development.

3. Clearly define the role of redevelopment.

Redevelopment activities and the role of redevelopment agencies are still controversial. Part of this controversy comes from the agencies' initial charge to eliminate blight—a concept that apparently is very difficult to define. Part of the controversy comes from the difficulty in determining whether the agencies actually increase development, and part stems from the fiscal pass-throughs and indirect (and hidden) state role in their financing. The precise task of redevelopment agencies must be clarified; for example, should they continue to be constrained to deal only with blight or should their mission be broadened to include the stimulation of new economic development.

Arcane Finance Questions and Options

Government needs money to do things, and somehow the money comes in. The system, at least today, does work—but at a cost. This 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. Under the current system, this is nearly impossible.

1. Revise the property tax allocation system.

The property tax allocation system contained in AB 8 needs to be reconsidered in light of the fact that the mix of local agencies and the services they provide and finance is different from what existed when the allocation system was designed 20 years ago (part of this change has occurred, of course, because of the existence of AB 8). Certainly a principal objective of a new system should be simplicity. A more comprehensive solution could be developed if a new property tax allocation system were developed along with a revised sales tax allocation system.

2. Ensure that new debt instruments are understood and issued within reason.

Certificates of Participation, Mello-Roos districts, and other financing instruments are all part of contemporary development finance. People in office should be challenged by voters to explain publicly what they are doing when they vote to issue COPs or allow developers to issue Mello-Roos debt. Legislative actions that issue debt should be publicized and a running total of issued debt should be released to the press after each legislative hearing. However, there is no need to go to the voters every time a new issue is considered. A policy of "reasonableness" is worthwhile in this area.

3. Revise the K-14 finance system by providing more local discretion.

K-14 education is financed in an extremely complex manner. There has been some movement toward simplifying some components of this system through the increased use of block grants, but the system itself is a true "black box." K-14 education finance should be simplified and then explained. The ultimate goal of a reconsideration of the financing mechanisms should be to increase discretion at both the district and individual school levels. To hold the education system accountable for its product without giving it the ability to make choices is inherently unfair. Part of the ability to implement change revolves around financial discretion.

State-Local Finance Questions and Options

State and local governments are entwined in a complex system. There are two aspects of this system that merit attention. One is the control of locally levied taxes by the entity that levies the tax, and the other is the alignment of state programs that need local administration. The latter issue principally involves the state-county relationship.

1. Establish a forum for state-local relations.

There needs to be a formal and public recognition of the financial interdependencies of the state, counties, cities, school districts, and special districts. California should, like a majority of other states, establish an independent State Advisory Commission on Intergovernmental Relations. The California Council on Intergovernmental Relations served such a role until the mid 1970s when it was terminated. This commission could do everything from keeping data in an accessible format to conducting special studies on particular subjects. Any major legislation that has an intergovernmental fiscal aspect should be analyzed by this commission.

In order to continue the sorting out of the state-county relationship, the commission would also serve as a forum to continue the discussion of the "realignment" of state and county financing and program responsibility. In addition, this forum would be the proper place to develop a comprehensive reallocation of state and local government responsibilities. This recommendation is similar to that of the California Constitution Revision Commission, which called for the development and adoption by the legislature of a State-Local Realignment Plan.

2. Enhance local control over local finances.

There is a constant dynamic tension between the state and local governments. In some respects, this benefits the people of California because it ultimately forces each unit of government to justify its actions. However, this tension has also led to a decline in the ability of the governments in California to act for the benefit of residents. Further, residents have become disconnected from the taxes or charges they pay and the local officials spending their money. This situation could be improved by ensuring a greater degree of local autonomy that is still responsive to state goals. Local governments need a revenue source that is stable, predictable, and controllable; and the use of that source must be accountable to the citizens. Before Proposition 13, that source was the property tax. A revenue source for local governments that would better connect the taxpayer and the governmental agency would go a long way toward restoring community-based decisionmaking and mitigate the negative effects of the state-controlled local finance system.

Policy Research Agenda

There is limited research dealing with the growing disconnection between citizens and their governments. If the public finance system is the major determinant of development, if the local finance system is not easily understood, so that it is unclear how taxes and fees are used, and if local governments cannot respond to differing or changing citizen preferences because of state control of local finances, then citizens can easily develop a profound distrust of government. It is not that the voter believes that government is inherently evil; rather, the citizen simply doesn't understand how government relates to the individual and may believe that it is out of control, irrelevant, or unthinking and unperceptive. A research agenda focusing on the effects these unintended consequences have on citizen behaviors should be developed, centered around the following informal questions:

- Does the distrust and constraints faced by elected officials as well as public administrators result from these fiscal effects?

- Is the decline in voting participation rates related to these same effects?
- Are there specific projects that are not undertaken because of the lack of understanding as well as distrust of the finance system?

The unanticipated consequences of Proposition 13 increased the complexity of the public finance system, and the implications of this financial complexity affect our entire system of governance. These implications need to be examined.

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