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February 1997

## Tax Issues



### The Genesis of Proposition 218: A History of Local Taxing Authority

*By David R. Doerr*

The roots of Proposition 218, approved by voters last fall, go back to the passage of Proposition 13 in 1978, and beyond. Contrary to popular belief, counties and most cities have more non-property tax discretionary taxing authority under Proposition 218 than they had before passage of Proposition 13. The assessment and property-related fee limits in Proposition 218 stem from local government excesses in the 1980s and 1990s, and the limits on assessments are procedural (mechanics of voting and how votes are to be tallied) and substantive.

Tax limitations on local government were not invented by Proposition 13.

Other than an ad valorem property tax and hotel/motel occupancy taxes, counties and general law (most) cities had virtually no local discretionary taxing authority before 1978. And, as a result of then-Governor Ronald Reagan's property tax reform legislation of 1972 (SB 90, Dills), tight



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property tax rate limits on cities and counties were in effect.

In addition, the Bradley-Burns Uniform Local Sales Tax Act allowed cities and counties access to a 1 percent local sales tax. However, as the rate was limited to 1 percent and tied to state administration, there was virtually no discretion over this revenue source. The rate was a fixed 1 percent for the two decades preceding Proposition 13 (except in a few unusual instances where the rate dropped to zero in small counties.)

Unlike general law cities, charter cities (there are now 94) had slightly broader taxing authority prior to Proposition 13 than they do now. They could levy a few special taxes (business license tax, utility user tax, hotel/motel occupancy tax, realty transfer tax, etc.) by action solely of the governing board.

However, charter cities had limited discretion or were prohibited from levying any significant tax: Income taxes were prohibited; the sales tax was fixed under the Bradley-Burns scheme, and ad valorem property tax rate limits were in effect. Charter cities could not levy alcoholic beverage, cigarette, motor vehicle fuel or insurance taxes. Nor could they levy parcel property taxes.

No one would seriously argue that it was the intent of Howard Jarvis and Paul Gann in drafting Proposition 13 to expand the discretionary, non-ad valorem taxing power of cities and counties. Yet, that is exactly what happened.

What happened after passage of Proposition 13 led directly to the passage of Proposition 218. This is that part of the story.

The cause of all the trouble is the California Constitution's Section 4 of Article XIII A (Proposition 13), which states: "Cities, counties and special districts, by a two-thirds vote of the qualified electors of such district, may impose special taxes on such district, except ad valorem taxes on real property or a transaction tax or sales tax on the sale of real property within such city, county or special district."

"Special taxes" were undefined in Proposition 13. It is possible that Mr. Jarvis and Mr. Gann (both now deceased) believed the distinction between a special and general tax was the scope of tax. A general tax was thought of as a tax applied to all. A special tax was viewed as a more limited tax on a specific product or class of taxpayers.

In the context of Proposition 13, this is the definition that makes sense. Discretion to raise "general" income and sales taxes was already limited by law and Proposition 13 put the cap on the "general" ad valorem tax. Proponents probably wanted to cap the "special" utility user and business license taxes that charter cities could levy, so that opponents of the measure could not charge in the campaign that local governments would raise other taxes to offset lower property taxes.

In the June 1978 election ballot pamphlet, proponents stated that Proposition 13 required *all* other taxes to be approved by a two-thirds vote of the people.

However, legislative counsel suggested another possible interpretation of Section 4, saying it might be interpreted to mean a special tax would be determined by its purpose, rather than its nature: If the proceeds of the tax were earmarked, it would be a special tax; if not, it would be

considered a general tax. Proponents strongly disagreed with this view.

In the immediate aftermath of Proposition 13's passage, virtually all local taxing units accepted the two-thirds vote requirement. Because the Legislature and taxpayer advocates both believed two-thirds voter approval would be needed to pass taxes that charter cities had the authority to levy, legislation was passed in 1979 (SB 785, Foran) allowing general law cities to impose special taxes. In a trailer bill to the 1982 Budget Act, this authority was expanded to authorize "the governing body of any city to levy any tax which may be levied by a charter city ... (which would include general taxes)."

During the early years, cities and counties had entered into negotiations with taxpayer groups, in an effort called "Project Independence," seeking to reduce voter approval requirements for certain taxes to a majority vote.

Also during this period, the first parcel property taxes appeared. Although prohibited by the Constitution (Article XIII, Section 1) prior to the passage of Proposition 13, they became legal under an interpretation that Section 4 authorized their levy as "special taxes." The legislative counsel pointed out that the ad valorem tax had been defined by the courts to be a "general" tax and that the "special" tax authorizations in Proposition 13 allowed parcel property taxes.

By 1982, the situation changed. The Rose Bird-led Supreme Court, with Associate Justice Frank Richardson dissenting, defined a special tax not by the type of tax it is but by how the money is spent, adopting the legislative counsel's interpretation. If spent for a "special purpose," it is a special tax

*(City and County of San Francisco v. Farrell).*

The *Farrell* decision was bad news for taxpayers. Now, general law cities, which could not even levy utility user taxes, business license taxes, etc., prior to passage of Proposition 13, could impose taxes without any voter approval requirement. Ironically, the decision was also bad news for proponents of local transportation improvements. A general tax (the sales tax) earmarked for transportation was be interpreted to require a two-thirds vote (*Santa Clara County Transportation Authority v. Guardino, 1995*). Under the alternative definition of general and special taxes, a sales tax (which would have been considered a general tax) increase for transit would have required only a majority vote - pursuant to then-existing statutes.

A Cal-Tax survey two years after the *Farrell* decision found that of 150 cities with more than 80 percent of the state's population, 138 increased taxes without voter approval (which yielded some \$300 million over two years).

In response to the *Farrell* decision, the Jarvis organization launched a new initiative in 1984. Proposition 36 required any local tax increase be approved by a two-thirds popular vote. Voters rejected the proposal. Major factors in the defeat were provisions voiding previously voter-approved, but unsold general obligation bonds, and requiring two-thirds voter approval for any fee increase (not just property-related fees) above the increase in cost of living.

Another initiative, substantially scaled back from the 1984 version, was placed on the June 1986 ballot and approved by voters. Proposition 62 provided that, for all government jurisdictions, including charter

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cities, increases of "general" taxes must have majority voter approval and increases in "special" taxes would continue to require two-thirds voter approval.

As Proposition 62 was a statutory initiative, a number of local governments challenged the constitutionality of the plan, saying it could not apply to charter cities and required an illegal referendum on taxes.

During court debate on Proposition 62, the Legislature extended local taxing authority to counties (SB 2557, Maddy of 1990) to impose utility user taxes and business license taxes. The bill conditioned such levies on "any applicable voter approval requirement." Since Proposition 62 was in effect at the time, it was assumed that its voter-approval requirements would cover county tax levies.

In 1991, however, an appellate court held Proposition 62's voter-approval requirements to be an unconstitutional referendum (*Woodlake v. Logan*). Again, taxpayers found that not only general law cities, but now counties, too, could impose by board action - without voter approval - new taxes that they were precluded from levying before 1978.

After passage of Proposition 13, local governments also expanded the use of "assessments" on property to generate revenue. These assessments went far beyond the traditional scope, where projects to be funded directly benefited property (such as roads, sidewalks, sewers, etc.). Activities formerly funded by general tax revenues were now paid for from benefit assessments.

A 6-1 California Supreme Court decision on December 10, 1992 (*Knox v. Orland*), upheld the validity of a special assessment district to maintain facilities at five city

parks. It included property outside the city, 20 miles from such parks. This precedent encouraged even faster growth in assessment financing.

Data from State Controller Office publications show that from the passage of Proposition 13 through 1992-93, city benefit assessments climbed 976 percent, to an annual levy of \$304 million.

Property-related fees also became more of a problem, as some local governments, with creative word smithing, decided to label taxes as fees and impose them without voter approval. With non-voted local taxes proliferating, significant increases in assessments and expansion of property-related fees, the Jarvis organization prepared plans for a constitutional amendment to resolve any constitutional questions in Proposition 62, and to control special assessments and property-related fees.

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Meanwhile, the California Supreme Court, in its 1995 *Guardino* decision, found Proposition 62 to be constitutional, and not an illegal referendum. However, most large cities and counties ignored the decision and continued to levy taxes imposed without voter approval. Charter cities argued that they were not subject to the *Guardino* decision.

Faced with continued uncertainty over the scope of Proposition 62 and faced with mounting assessments and fees, the Jarvis organization pressed ahead with a new initiative, Proposition 218, to resolve a number of these issues and to establish once and for all voters' right to vote on local tax increases. The initiative also made procedural changes in the way assessments are approved. In general, assessments have always been subject to a majority protest procedure. Proposition 218 establishes a

formal voting procedure for such protests, which had been lacking. Votes in favor of an assessment must exceed votes in protest against the assessment.

Last November 5, Proposition 218 was approved by a comfortable margin, with more than 56 percent of the vote in support.

## THE AFTERMATH

*Editor's Note: Media accounts after the November election described Proposition 218 as a little-noticed sleeper with a haymaker punch. Local government officials were depicted as scrambling to pick up the pieces. Actually, local policy makers knew full well what this initiative was all about. It just lacked the publicity surrounding other measures on the same ballot, such as the initiative that legalized medicinal use of marijuana. However, as with many ballot measures, 218 may turn out to be a full employment act for lawyers specializing in local government finance.*

Among developments since November: a report on the impact by the Legislative Analyst's Office (LAO); a how-to-cope guide from the League of California Cities, and, yes, litigation, and the threat of litigation. There also will be bills introduced in the Legislature in the two-year session that is just under way.

The LAO's December report, "Understanding Proposition 218," concluded that most revenues of local government are not directly affected by Proposition 218, and the maximum long-term impact is not likely to exceed a 5 percent reduction.

In the report, analyst Marianne O'Malley said Proposition 218's provisions affect a "relatively small subset" of local government revenues, such as new and

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some recently imposed "general" taxes; all new or increased assessments and some existing assessments, and certain property-related fees. Local government revenues exceed \$50 billion annually.

**5 percent annual decrease in aggregate local government own-source revenues."**

Thus, Ms. O'Malley wrote, "It is highly unlikely that the measure could cause more than a 5 percent annual decrease in *aggregate* local government own-source revenues." The impact could be more significant, however, on some governments "highly reliant upon the types of assessments and fees that would be restricted by this measure."

The analyst also said that, beginning this year, local governments will reduce or eliminate certain existing general government-purpose assessments and fees, as required by the initiative. This will reduce local government revenues by at least \$100 million in the 1997-98 fiscal year. Additional revenue losses, "potentially exceeding \$100 million annually," could occur unless voters ratify existing assessments and taxes, the report said.

The report states that some important provisions are not completely clear and summarizes major questions that must be resolved, possibly through legislation or litigation. These questions include:

**Property-related fees.** What is included in the definition of property-related fees? Do they include water charges based on metered use? Do they include regulatory fees, such as rent control administrative fees? Do they include lease payments and other such charges on government-owned assets?

**Assessments.** What is a "special benefit" and how can it be distinguished from a "general benefit?" How broadly should local governments interpret exemptions for

sidewalks, streets, sewers, water, flood control, drainage systems and vector control, and election requirements? Can local government set general assessment rate categories, or must it determine the actual cost of service to every parcel?

**Elections.** What procedures should govern assessment and fee elections? Who may vote on referenda to repeal assessments, fees or taxes? How will a renter's eligibility to vote be determined? Who gets to vote when a parcel is owned by multiple parties, or by a government entity?

**Taxes.** Are Mello-Roos taxes affected? How should assessments imposed under Mello-Roos law be treated? Is the requirement that certain existing taxes be ratified by the voters an unconstitutional referendum on taxes?

**Debt.** Could local initiatives jeopardize a revenue stream pledged to the payment of existing or future debt?

(The complete report is available on the LAO's World Wide Web site (<http://www.lao.ca.gov>). To request an LAO publication, call 916-445-2375.)

From the League of California Cities: an 86-page "Implementation Guide" was issued in January. The league prefaced its guide with opinion that the initiative makes changes in government finances that are so sweeping as to constitute a constitutional revision. This, of course, would require approval by the Legislature or a constitutional convention before submission to voters.

"In sum, questions concerning 218 will take years to resolve," said the guide.

**On the legal front:** The Los Angeles City Council voted 8-3 on November 15 to sue

against the initiative's provision that limits eligibility to vote on assessments to those property owners who would pay. More than two months later, no suit had been filed by the city.

Los Angeles County on December 17 filed the first court action that would impact Proposition 218. The Superior Court complaint seeks to validate the levy and collection of a fire suppression benefit assessment within the Consolidated Fire Protection District of the county beyond July 1, 1997.

Cities of San Diego and Loomis (Placer County) have adopted, or were considering, non-property based assessments on businesses, based on their beliefs that such business improvement districts are outside the scope of Proposition 218's voter-approval requirements.

A number of local governments were planning to take non-voter-approved taxes to the polls this year for validation elections, as required by the initiative.

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