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Local Government

Allocating the Property Tax

Editor's Note: Some say it is now or never for reforming the fiscal relationships among governments in California. For proponents of change, it would seem that the prosperous economy has lined up the moons and the stars for action by the state Legislature this year. Mainly, there has to be an abundance of revenue, so that the inevitable "losers" in any transformation are compensated, or made whole. Change is more achievable when all parties are perceived to be "winners."

Following is a report from Legislative Analyst Elizabeth Hill, which was required by an act of the Legislature in 1999. In a recent briefing of the executive committee of the Cal-Tax Board of Directors, Marianne O'Malley, principal fiscal and policy analyst in the Legislative Analyst's Office, compared the condition of the law governing property tax allocation to opening the freezer and finding something put there some two decades earlier. It's not likely to taste as good as it did, and you might just want to throw it out.

Another reason local government finance is less than delectable should be obvious when you examine your property tax bill. Much of it is understandable, as to how much goes for sidewalks or sewage bonds or school bonds. But what about that basic 1 percent of the property tax that goes to local government? Where does it go? What does it buy? Even officials elected to run cities and counties can be hard-pressed to come up with a complete answer. The money is divided among myriad public service interests in ways that cannot be changed at the local level, even when local policymakers are convinced and the public agrees that the money would be better spent on something else.

Here is a condensed version of the Legislative Analyst's Office report on the subject, originally released in February:

Chapter 94 declares that California's system for allocating property taxes is "seriously flawed" and states legislative intent to revamp the property tax allocation system.

Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes

California's property owners pay over \$20 billion of property taxes each year. These tax revenues - the third largest source of tax revenues in California - are then allocated among several thousand local governments, pursuant to a complex state statute. While significant legislation pertaining to the property tax allocation system has been enacted over the years, the allocation system is still commonly referred to as "AB 8," after the Assembly bill that first implemented the system in 1979.

Over the years, the Legislature, local governments, the business community, and the public have become increasingly critical of the state's property tax allocation system because (1) it does not allocate revenues in a way that reflects modern needs and preferences of local communities and (2) it centralizes authority over local revenues in Sacramento.

To respond to these concerns, the Legislature enacted Chapter 94, Statutes of 1999 (AB 676, Brewer). Chapter 94 declares that California's system for allocating property taxes is "seriously flawed" and states legislative intent to revamp the property tax allocation system to:

- Increase taxpayer knowledge of the allocation of property taxes.
- Provide greater local control over property tax allocation.
- Give local governments greater fiscal incentives to approve land developments other than retail developments.

To assist the Legislature in this effort, Chapter 94 directed the LAO to develop alternatives for restructuring the property tax allocation system.

Why Is it So Difficult to Improve the Allocation System?

The problems with the state's property tax allocation system articulated in Chapter 94 are not new or unknown. These problems have been recognized and discussed by countless local government commissions, committees, and working groups for the last 20 years. Despite the large degree of consensus on the problems, enacting reform has proven elusive because it requires making difficult tradeoffs across multiple worthy policy objectives. That is, in most cases, making progress towards one desirable reform objective requires taking a step away from another.

Our review of previous reform efforts highlights four key areas of policy tension inherent in local finance and property tax allocation system reform proposals:

- Property Tax Rate: Taxpayer Stability versus Local Control.
- Property Tax Allocation: Local versus State Control.

In developing its proposal to revamp property tax allocation, the Legislature will confront these policy tensions - and will need to strike a balance that meets its policy preferences.

- Focus of Government: Special Purpose Agencies versus General Purpose Governments.
- Local Finance: Reform versus Fiscal Stability.

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What are the Alternatives?

Alternative I: Set Uniform Rates

Chapter 94 requires the LAO to consider the option of "establishing a minimum percentage of the property tax to be allocated to each California county." This concept of assigning local governments a minimum share of the property tax has been discussed over the years. The Legislature took a step in this direction in passing Chapter 1211, Statutes of 1987 (SB 709, Lockyer), guaranteeing a minimum share of property taxes to certain cities that did not levy a property tax rate (or levied only a very low rate) prior to Proposition 13. The Legislature also has considered bills to increase certain counties' shares of property taxes.

One difficulty associated with these "minimum percentage" proposals is that there is no common set of governmental responsibilities. Some cities, for instance, provide a wide array of services: police, fire, and parks and recreation. Other cities provide public protection and land use planning, but rely on the county or special districts to provide other services to their residents. Similarly, in some counties most people live within the boundaries of full-service cities. Other counties, by serving unincorporated areas, provide municipal services to a large number of their residents. As a result, assigning the same property tax share to all cities and counties disadvantages those local agencies with more service responsibilities. We note, for example, that an analysis performed by the League of California Cities found that, after correcting for their typically lower service obligations, cities with low shares of the property tax often receive a higher share of the property tax than many other cities.

If the Legislature wishes to revamp the property tax allocation to improve uniformity in the distribution of property taxes, the Legislature should acknowledge the differences in local government service obligations. Accordingly, this first alternative outlines a process by which the Legislature could assign shares of the property tax that reflect the number of services provided by the local government.

How It Would Work

Based on a statewide study of local government costs to provide services, the Legislature could enact a statute assigning specific shares of the property tax

for each service. For example, the statute might assign K-14 finance a 50 percent share of the property tax; countywide services a 25 percent share; fire and police/sheriff 10 percent shares each; and library, parks and recreation, and other services a share of the remaining 5 percent.

Any individual government's share of the property tax, in turn, would reflect the number of services it provides. For example, a city that provides a full array of municipal services might receive 25 percent of the property taxes collected within its borders (10 percent each for police and fire, and 5 percent for other services). Conversely, a city that relies more extensively on special districts might receive a 10 percent share (for police services). Similarly, a county might receive 45 percent to 50 percent of the property tax collected from properties in its unincorporated area, but only 25 percent of the property tax in areas included within a city's boundaries.

The Legislature would have many options in implementing this alternative. For example, the Legislature could specify that the scheduled shares apply only:

- To the *growth* in property taxes, leaving the existing \$20 billion "base" of property taxes allocated as it has in the past.
- To governments where it would *increase* their share of property taxes.
- To governments where the current per-capita amount of property taxes is lower than average.

Alternatively, the Legislature could develop a statewide uniform schedule, applicable to only a specific county or counties on a trial basis.

Discussion

Under this alternative, the differences in property tax shares, which largely stem from local taxation and governmental organization decisions of a generation ago, would be replaced by differences reflecting current service responsibilities. In addition, taxpayers throughout the state would have a much easier task understanding how their tax dollars are distributed, possibly improving local government accountability.

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The major disadvantages of this proposal, relative to the goals specified in Chapter 94, pertain to its failure to increase local control or improve development incentives. Specifically, the uniform schedule of property tax shares would be enacted in Sacramento and is unlikely to represent local priorities or the needs of all communities, especially over time. In addition, this alternative does not alter the fiscal incentives local governments face to approve retail land uses. This is because the alternative does not:

- Decrease the reliance of cities or counties (agencies with the power to approve land developments) on situs-based sales taxes.
- Necessarily increase city and county reliance upon the property tax, a tax that provides more "neutral" fiscal incentives for local governments.

In terms of the four tensions discussed above, this alternative makes little change from the status quo. The proposal is balanced towards maintaining property tax rate stability, state control over tax allocation, and maintaining the role of special purpose governments. Finally, the extent to which the proposal was balanced towards reform or fiscal stability would depend on the implementation of the measure. For example, if the schedule applied only to the growth in property taxes, the extent of fiscal disruption and reform would be modest.

Alternative II: Local Control Over ERAF

Currently, about 18 cents of every property tax dollar paid is allocated to the Education Revenue Augmentation Fund (ERAF) created as part of the early 1990s property tax shift. Money from ERAF is allocated to K14 schools in each county. Under this alternative, the state would reduce the overall property tax rate from 1 percent of assessed value to 0.9 percent. Cities, counties, and special districts would not sustain any property tax revenue losses as a result of this change. The only effect of the tax reduction would be to decrease revenues allocated to ERAF. The state would be obligated to offset school losses with increased General Fund dollars.

After reducing the property tax rate from 1 percent of assessed value to 0.9 percent, the Legislature would instruct cities and/or counties that it is their decision whether to (1) increase city or county property taxes up to the maximum 1 percent rate and/or (2) pass on the tax cut as property tax relief to property owners in their communities.

What Vote Would Be Needed to Increase the Tax Rate? Provided the maximum property tax rate did not exceed 1 percent, Proposition 218 appears to give this tax-adjusting authority to city councils and boards of supervisors, without requiring a vote of the local electorate.

Discussion

Communities that prefer lower taxes can have their property taxes reduced. Communities that prefer higher levels of city or county services can forgo a tax cut and enjoy higher levels of local services. Should local preferences change over time, the local tax rate could change as well.

This alternative makes less progress towards Chapter 94's other goals. Specifically, taxpayer understanding of the allocation system would be

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limited because most tax revenues still would be allocated under the AB 8 formulas. In addition, the alternative only modestly improves local government's skewed land-use development incentives.

Alternative III: Property Taxes For Municipal Services and Schools

Under this option, the allocation of every property's tax bill would be identical - half to local municipal services and half to schools. For the half allocated to schools, the funds would be deposited into a countywide fund. From this fund, schools throughout the county would receive an allocation. As with current law, the state's General Fund would supplement these funds and schools would be held harmless. For the remaining half of the property tax, the funds would be allocated to the city in which the property is located. For unincorporated areas, the county would receive the funds to carry out its role as the property's municipal service provider.

City or county (in the case of unincorporated areas) representatives would be responsible for providing (or contracting for) a defined set of municipal services for their residents, such as police, fire, parks, libraries, etc. Cities or counties could elect to allocate a portion of their property taxes to special districts and/or redevelopment agencies.

Because this alternative provides such a large share of the property tax to municipal service providers, counties would need a replacement revenue source to pay for countywide services. This alternative shifts most city Bradley-Burns sales tax and some city VLF revenues to counties for this purpose. Counties would receive sales tax revenues from sales taking place anywhere within their borders, not just from sales occurring in unincorporated areas.

Discussion

For taxpayers, understanding their property tax bills and holding their elected officials accountable would become significantly easier. If they were unhappy with the level of support being dedicated to a particular service, their city council or board of supervisors would have the power to redirect resources away from another service.

By redirecting the Bradley-Burns sales tax away from cities to counties, the incentives for land use practices that unduly favor retail establishments would be greatly reduced.

Alternative IV: Re-Balance Tax Burden

Under this alternative, a number of revenue sources are changed significantly to: reduce the state's reliance upon nondeductible taxes, provide a more balanced set of local government fiscal incentives regarding land use, give communities local control over the property tax rate and allocation, and

Thus, businesses, on average, could expect to pay approximately the same amount of taxes as today.

reduce the barriers to entry for new businesses under an acquisition based assessment system. As summarized in Figure 3, the alternative makes changes to the sales tax, the property tax, and the VLF.

Summary of Alternative IV: Re-Balance Tax Burden

Reduce Sales Taxes by 1.25 Percent (\$5 Billion)

- Reduction split between state (0.75 percent) and local (0.50 percent) rates.
- Under current law, state's loss of revenue would be largely offset by reduced state spending from future vehicle license fee (VLF) reductions not going into effect.

Increase City and County Property Tax Revenues (\$1.3 Billion)

- In exchange for the receipt of these new revenues, local governments would forego the revenues from the existing VLF backfill.

Increase Local Control Over Property Tax Rate

- Each local entity would be authorized to raise or lower its own property tax rate.
- Taxpayer protections would include the requirement of a local charter and a 2 percent maximum annual increase.

Assess Nonresidential Property at Market Value (\$2 Billion)

- Business personal property and state assessed property (like public utilities) are already assessed in this manner.

Discussion

The combination of changes proposed by this alternative would yield an improved system of local government finance that relies less on the sales tax and returns control over the property tax to local governments.

How Would Individuals Fare Under this Alternative? This alternative would give a sizable tax reduction to individuals in the form of a sales tax reduction. While taxpayers would forego additional VLF reductions, the sales tax reduction would be about twice as large as the future VLF cuts. Furthermore, VLF payments are deductible for many taxpayers whereas sales tax payments are not. In addition, taxpayers would be able to see the current allocation of the property tax through entity by entity rates and decide

whether that allocation met their preferences. Each community could decide for itself whether it wanted to maintain the one percent rate cap or opt for a modest modification. Communities would also have a much easier task reallocating revenues, or eliminating the property tax share allocated to some local governments.

How Would Businesses Fare Under this Alternative? Under the current property tax system, business properties - on average - are assessed at about 80 percent of market value. Thus, the change in assessment practices would increase their property tax liabilities by about 25 percent. This increase in property tax liability, however, would be significantly offset by a large decrease in sales tax liability. Thus, businesses, on average, could expect to pay approximately the same amount of taxes as today. Unlike the current system, however, new businesses would not be at a competitive disadvantage with regards to property tax payments.

How Would Governments Fare Under this Alternative? Local governments in the aggregate would be held fiscally neutral under this alternative, even without increasing the base property tax rate. Local government land use incentives also would be significantly improved.

The state would experience a revenue loss resulting from the sales tax reduction. These state losses would be partially offset, however, by increased property taxes associated with the change of assessment for nonresidential property and savings from not implementing further VLF reductions. The alternative would likely increase state costs several hundreds of millions of dollars annually.

Alternative V: Making Government Make Sense (MGMS)

This fifth alternative addresses the goals of Chapter 94 and the problem of inefficient intergovernmental program coordination, discussed earlier in this report. Specifically, this alternative provides for significant fiscal changes and a realignment of the duties of state and local government. This alternative illustrates how the issues of local finance, governance, and program reform may be addressed together.

How It Would Work

A series of guiding principles underlie the MGMS proposal and direct its reforms. Specifically:

- Maximize the separation between state and local duties.
- Whenever possible, transfer program responsibilities to the level of government closest to the people.
- Focus state responsibility on programs where uniformity is needed - or where statewide benefits are to be achieved.

- Ensure that program funding responsibility and program policy control reside at the same level of government.
- Rely on financial incentives to promote intergovernmental coordination.
- Match state goals for economic development with fiscal incentives facing local communities.

The MGMS alternative relies upon these principles as it examines each governmental program and assigns principal responsibility for the program to the state - or a *single* local government entity. For most purposes, this alternative eliminates the differences between city and county program responsibilities. Thus, a city is responsible for providing *all* local services to city residents and a county is responsible for providing all services to residents of the unincorporated area. Special districts and redevelopment agencies are not assigned duties by the state, but may be delegated responsibilities by cities or counties.

Alternative V also significantly modifies the state-local financing system to reflect the changes in program responsibility and the statement of principles. Specifically, this alternative shifts a very large share of property taxes from schools to cities and counties to offset (1) the net fiscal effect of the program shifts and (2) a transfer of all of the local Bradley-Burns sales tax to the state. In order to equalize opportunities for community success, each community's allocation of property taxes would be redetermined by the state. This allocation of property taxes would consider local needs for municipal and community-based services. After this initial allocation by the state, local governments would be authorized to raise or lower their property tax rates by majority vote of the local electorate.

Discussion

This alternative makes significant progress towards the goals specified in Chapter 94. Specifically, taxpayers would have a clear understanding about the allocation of property taxes - and control over this allocation. The vast majority of any property tax bill would be allocated to a single agency - the city, or county, if the property was in an unincorporated area. Locally elected officials would be responsible for using these property taxes to pay for a wide array of local municipal and community-based services. If taxpayers wished their local government to have a higher or lower level of property taxes, taxpayers could modify the property tax rate accordingly. Finally, by shifting so much property taxes to local government and eliminating local reliance upon the Bradley-Burns sales tax, this fifth alternative substantially improves local land use incentives.

While this alternative meets all of the goals of Chapter 94 and realigns program responsibilities to focus accountability and achieve greater results,

Finally, by shifting so much property taxes to local government and eliminating local reliance upon the Bradley-Burns sales tax, this fifth alternative substantially improves local land use incentives.

MGMS clearly demonstrates the tension between reform and fiscal stability discussed earlier in this report. Simply put, the alternative entails very significant governance and finance changes. In terms of the other tensions discussed earlier in the report, this alternative emphasizes the goal of local control over the property tax (its rate and allocation) and promotes general purpose governments.

Moving Forward to a Solution

Given the policy tradeoffs inherent in the five alternatives and the failures to implement past reform proposals, is there hope for local finance and property tax allocation reform in the near term? We believe there is reason for optimism if the following considerations are kept in mind.

No Perfect Solution Exists

None of the five alternatives is the perfect solution to California's property tax allocation problems. In fact, the longer the current system remains unchanged, the worse the problems become. Local governments adjust to the counterproductive fiscal incentives inherent in the current finance system, and residents turn increasingly to the state to address local concerns.

Need for Focused Attention

If the Legislature considers each reform proposal individually, each proposal likely would be rejected because entities negatively affected by it will mount strong opposition, emphasizing the proposal's imperfections. However, the Legislature could increase the likelihood of enacting reform by:

- creating a joint committee, charged with evaluating all reform proposals.
- requiring the committee to recommend the best alternative within a specific time period.

This focused attention, given to all reform proposals by a single body, would facilitate the process of appraising the strengths and limitations of reform options. This process also would increase the likelihood of compromise, innovation, and ultimately enacting an agreeable solution.

Many previous reform efforts have failed due in large part to their attempts to be fiscally neutral.

Set Aside Funds

Many previous reform efforts have failed due in large part to their attempts to be fiscally neutral. Chapter 94, in contrast, acknowledges the desirability of providing resources to facilitate reform. Setting aside funds could ease the transition to a new system.

The magnitude of dollars needed for this purpose is difficult to determine before the Legislature has developed a local reform proposal reflecting its priorities. Given the billions of tax dollars potentially subject to reallocation

and the thousands of local governments involved, however, resources in the range of hundreds of millions of dollars may be necessary to minimize the fiscal disruption associated with local finance reform.

The full report is available at www.lao.ca.gov or by calling 916/445-2375.
