RESEARCH BRIEF
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Should Local Fiscal Authority Be Strengthened?

A recent decision in a lawsuit filed by California's counties against the state is the latest in a series of conflicts between state and local government. At issue is the $3.6 billion in property tax revenue that cities and counties claim the state wrongfully withheld from them during the recession of the early 1990s. In *The State-Local Fiscal Relationship in California: A Changing Balance of Power*, J. Fred Silva and Elisa Barbour place such conflicts in a useful historical context. Their report explores long-standing tensions related to issues of fiscal authority and describes how Proposition 13, which altered the way property taxes were assessed and distributed, aggravated these tensions by shifting the balance of fiscal power toward the state. After tracking changes in city and county revenue streams over the course of the century, the authors discuss current options to restore the balance between state and local government.

A Shifting Balance of Power: Public Finance in California Before Proposition 13

The relationship between state and local government in California has always been contentious. Before 1900, local governments had very limited powers to tax and spend. During the Progressive Era, however, advocates for local government established two legal principles: home rule power, or the right of cities to draw up their own charters and govern municipal affairs; and the separation of sources doctrine, which formally marked off state and local revenue streams. These principles guided California fiscal policy from the First World War to 1978.

Although the overall balance between state and local governments remained stable during this time, city and county governments changed considerably and along different lines. Much more than counties, cities achieved and maintained fiscal independence from the state. By the end of the Second World War, most city revenue came from utilities, sales taxes, and other sources of local revenue, while only 10 percent came from state or federal sources. Over time, cities came to rely less on property taxes, which made up 36 percent of city revenue in 1945 but only 16 percent in 1978.

County governments followed a different course. Beginning with the New Deal, they assumed a prominent role in administering state and federal programs in health care and social services. As county governments increasingly became agents of the state, their revenue profiles also changed. In 1932, 82 percent of their funds came from own-source revenue. By the end of the Second World War, however, federal and state funding formed about 50 percent of that total, and an even higher proportion of their budgets had to be spent according to state or federal guidelines. In addition to administering state and federal programs, counties also acted as general-purpose governments, funding transportation, corrections, and other services with property tax revenues.

The Era of Limits: Proposition 13 and Its Aftermath

The effects of Proposition 13 on local government were unprecedented. In one year, property tax revenues to local governments were cut in half. Counties were hit hardest because they relied almost exclusively on property taxes for their discretionary revenue. While county budgets contracted 25 percent between 1978 and 1980, city revenues dropped less than 10 percent. In addition to shrinking these budgets substantially, Proposition 13 gave the state more control over the distribution of property tax revenues, thereby weakening the separation of sources doctrine.

In the immediate aftermath of Proposition 13, the state implemented a fiscal relief plan for city and county governments. Under that plan, the state assumed more financial responsibility for state programs that had been financed in part by property taxes. It also reallocated property tax revenue from primary and secondary education to cities and counties. The state reversed course, however, when the economy slid into recession in the early 1990s. To keep the state solvent and satisfy mandatory spending floors for education, which voters passed in 1988, the state revised the allocation formula to direct more property tax revenue to school districts and away from cities and counties. This

revision prompted California's counties, whose discretionary revenue declined 25 percent between 1992 and 1995, to file their lawsuit against the state. In October 1999, a Sonoma County Superior Court judge ruled that the state had no right to redirect $3.6 billion in property tax revenue away from local governments.

The Future of the State-Local Relationship: The Need for Reform

These and other conflicts between state and local government have generated many reform proposals, most of which focus on two areas: the need to redefine the responsibilities of local governments and the need to restore their fiscal authority. Sorting out state and local responsibilities is especially important for county governments, whose traditional duties currently outstrip their resources. One solution is to restore the fiscal authority cities and counties exercised before the passage of Proposition 13. When combined with a thorough review of local responsibilities, this reform would enable counties to maintain their dual role as agents of the state and general-purpose governments. It would also allow for more effective policymaking above the city level.

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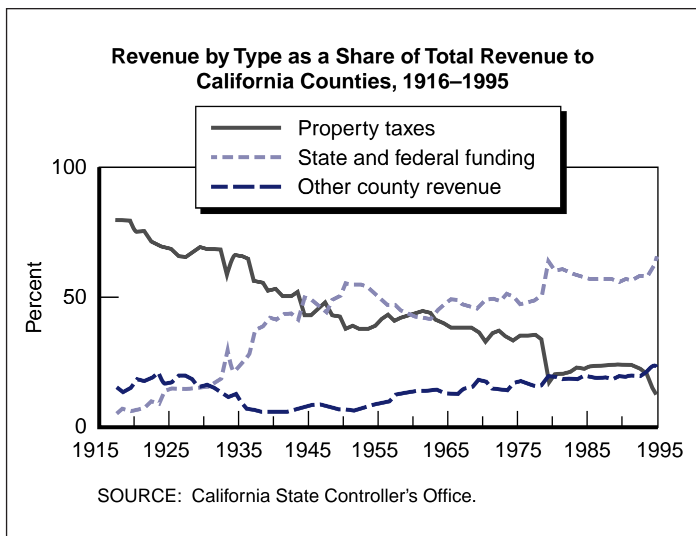
Another option is for the state to assume an even larger role in local government finance. In theory, this option could maximize statewide efficiency and equity in the allocation of public resources. However, the state government has not always exercised its redistributive power in this way.



External funding makes up a growing percentage of county budgets, but these funds must be used for state and federal mandates. As property tax revenue has declined, so has county government's ability to finance its own services.

During the early 1990s, it exerted its power over the property tax to maintain its own fiscal health during a period of economic stress. Given this history, many proposals would separate local property tax revenue from the state budget. Proponents argue that such reforms would enhance efficiency, accountability, and innovation in local government. Opponents counter that local control over raising revenue is not a prerequisite for accountability on the expenditure side.

The report concludes that the current system of public finance in California reflects neither the potential benefits of a state-run system nor those of a decentralized system based on a separation of sources. Instead, the system copes with fiscal stress through cost-shifting and competition between levels of government.

This research brief summarizes a report by J. Fred Silva and Elisa Barbour, The State-Local Fiscal Relationship in California: A Changing Balance of Power. *The report may be ordered by calling (800) 232-5343 [mainland U.S.] or (415) 291-4415 [Canada, Hawaii, overseas]. A copy of the full text is also available on the Internet (www.ppic.org). ThePublic Policy Institute of California is a private, nonprofit organization dedicated to independent, nonpartisan research on economic, social, and political issues that affect the lives of Californians.*

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