

# From Home Rule to Fiscal Rule

*Taking a Measure of Local Government  
Finance in California*

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## *Preface*

This paper was prepared as a source document for the Conference on Local Finance Reform (May 19, 2000). The conference was co-sponsored by the Center for State and Local Taxation at the Institute of Governmental Affairs, University of California, Davis, and the Public Policy Institute of California. This paper provides an overview of PPIC's research on governance and public finance in California. David W. Lyon, President and CEO of PPIC, wrote the introduction. Gary Bjork and Peter Richardson prepared the research summaries that constitute the body of this paper. Each description was released as a separate Research Brief when the report or book it summarized was published. Reports may be ordered directly from PPIC. The full text of each report is also available on the Internet ([www.ppic.org](http://www.ppic.org)). Copies of *When Government Fails: The Orange County Bankruptcy* and *California in the New Millennium: The Changing Social and Political Landscape*, both authored by Mark Baldassare, may be ordered from the University of California Press.



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# *Introduction*

*by David W. Lyon*

*President and CEO*

*Public Policy Institute of California*

Since shaping its first research agenda in 1995, the Public Policy Institute of California has placed an improved understanding of governance and public finance at the top of its list of priorities. There was then—and there still is five years later—a level of frustration about how California’s system of state and local governance and finance works. This frustration runs to the core of virtually every important policy issue enjoined in public debate. Impatient with their elected representatives, California voters in many cases have taken matters into their own hands through the initiative process, profoundly affecting governance and fiscal policies. At PPIC, we have undertaken more than a dozen projects over the past five years to identify the effects of these policies and, in particular, to answer three questions: What have been the fiscal consequences of the various initiatives that have sought to limit the taxing and spending decisions of elected officials? How have these limitations affected the relationship between the state and local governments? How do California’s political institutions and procedures affect relationships and attitudes between citizens and their elected officials?

This document provides an overview of our findings. It presents a much clearer picture than was previously available of what has happened on the public finance front over the past 20 years. The reports summarized here use the year 1978 and the passage of Proposition 13 as a common reference point, but the findings extend far beyond Proposition 13, ranging from the origins of stress between California’s governments in the early 1900s to the emergence of a disdain for political parties and elected representatives in the late 1900s. This introduction provides an overview of 13 reports and two books published by PPIC in the past five years.

The governance and finance research agenda we established included four major objectives. The first was to document some basic facts about the fiscal environment in California. In particular, we wanted to resolve the controversy about the size of the state's revenue burden and to establish whether the revenue data collected and presented by the state accurately portrayed the fiscal activity of local governments. Our second objective was to examine how the fiscal limitation movement and Proposition 13 were affecting the way government operates at the local level. We also wanted to look carefully at two counties that were particularly troubled in the recession of the early 1990s—Orange County and Los Angeles County. And, finally, we initiated a substantial effort—including an ongoing statewide survey of California residents—to gain a better understanding of the relationship between citizens' attitudes and interests, the initiative process, and the development of public policy. Briefly, these are our findings in each of these areas:

1. Voters in California have been largely successful in keeping state and local revenue collections from growing, when measured in terms of the share of personal income that goes to the government. There is indeed a fiscal limitation movement in California, and it manifests itself especially at the local level, where the share of *locally controlled* revenues has declined for all levels of local government.
2. To offset their declining share of locally controlled revenues, local governments (especially cities) have been creative in pursuing alternative sources of revenues—for example, substantially increasing the level of fees they charge for residential development, pursuing property tax revenues through redevelopment agencies, and actively seeking an increase in sales tax revenues by encouraging retail businesses to locate within their jurisdictions. The new revenues generated by these coping mechanisms led to even more voter resistance and the passage of Proposition 218, which placed new limits on local fees, assessments, and taxes.
3. Among local government, counties have suffered the greatest loss of fiscal autonomy, and in many cases their fiscal responsibilities have outstripped their ability to raise local revenues. The fiscal austerity imposed by voters was responsible, in part, for the bankruptcy of Orange County, as well as the fiscal near-meltdown of Los Angeles County during the recession of the early 1990s. To this day, Los Angeles County is severely constrained in its ability to respond to local preferences and needs.
4. The California population has grown rapidly over the past two decades, becoming increasingly multiracial. The state is now facing many critical challenges that require political leadership and consensus, and yet its citizens view government, its representatives, and its processes with cynical disdain. Even with the large number of poorly written or misleading initiatives that appear on the ballot, voters believe that initiatives are better able than elected officials to solve important public policy problems.

## Documenting the Facts

Proposition 13 unleashed a torrent of creative energy by local governments seeking to generate new revenues. From user fees to special assessments, layers of revenue-raising mechanisms were put in place to regain the autonomy historically associated with the ad valorem property tax. Many observers argued that the cap on property taxes motivated local governments to simply seek other revenue sources that more than made up for the loss of property taxes.

A PPIC study by Michael A. Shires, John Ellwood, and Mary Sprague, *Has Proposition 13 Delivered? The Changing Tax Burden in California*, found that although public revenue collections continued to expand in the post-Proposition 13 era, public revenues as a share of personal income actually declined from 15 percent in 1978 to just under 13 percent in 1995. Not all of this reduction can be attributed to the tax limitation movement—the state experienced economic setbacks over this 20-year period that also contributed to some slippage in revenues. From the taxpayers' point of view, however, the initiative process provided some of the relief they were looking for.

A second report by Michael A. Shires, *Patterns in California Government Revenues Since Proposition 13*, documents a dramatic shift in the overall share of state and local revenues controlled by the state. The net result of this shift has been a gradual decline in self-controlled revenues at the local level, be it counties, cities, special districts, school districts, or even higher education. In 1978, for example, counties controlled half of their revenues; in 1995, they controlled only 20 percent. There is no more dramatic example of the loss of “local control” and the significant effect of Proposition 13 on local public finance.

In the mid-1990s, local governments' widespread use of miscellaneous charges, fees, and parcel taxes raised the question of whether the California State Controller's Office was overlooking some of these new sources in its annual report of local finance. After a thorough review of the data, which included more than 7,000 local entities, Michael A. Shires and Melissa Glenn Haber concluded in *A Review of Local Government Revenue Data in California*, “The revenue data accurately portray the range of activity occurring in local government. Thus decisionmakers and analysts can focus on the methodology and substance involved in policy and not worry about shortcomings in the data.”

In addition to providing facts about the public revenue environment after Proposition 13, PPIC examined the claim by some observers that the tax limitation movement, and especially Proposition 13, led to a proliferation of new cities and special districts, thereby fundamentally altering California's local governance structure. These critics argued that, in effect, tax haven “islands” were being created to avoid the burdensome task of meeting ever-growing service demands with shrinking resources. Paul G. Lewis, in *Deep Roots: Local Government Structure in California*, presents data that show there is no dramatic break with historical trends in the post-1978 period. He concludes, “Most population growth in the state continues to be accommodated by existing cities, which regularly expand their boundaries through annexation.” And although reliable historical data on special

districts are less available, he notes that “to a large extent, the creation of new special districts has been offset by the abolition of others.”

Having established these facts about the fiscal limitation movement, PPIC was prepared to examine how the revenue restrictions affected public policy and the governing process.

### **Calibrating the Consequences of the Fiscal Limitation Movement**

The greatest protection provided to homeowners by Proposition 13 is that the assessed value of their property cannot increase by more than 2 percent per year. This protection, however—combined with the fact that when property is sold, it is reassessed at its full market value—is the very feature of Proposition 13 that causes disparity in property tax payments within neighborhoods. Because their assessments may differ by tens of thousands of dollars, two homeowners with very similar houses may be making considerably different contributions to government revenues. Ironically, the recession of the early 1990s did much to reduce the disparity between market values and assessed values, according to a PPIC study by Steven M. Sheffrin and Terri Sexton, *Proposition 13 in Recession and Recovery*. The researchers’ analysis of property values in Los Angeles and San Mateo Counties revealed that there were pronounced inequities between properties purchased before 1980 and those purchased after that date. However, disparities among properties acquired after 1980 were not too different from the disparities found in states with more traditional property tax systems. Whether inequities will be reduced over time will depend on the rate of turnover of properties (particularly those held by the elderly and large businesses) and the rate of inflation.

In another PPIC study, *Who Pays for Development Fees and Exactions?*, Marla Dresch and Steven M. Sheffrin found that the cost of infrastructure for new residential development in Contra Costa County is now being added into the prices of new homes, with development fees ranging from \$20,000 to \$30,000 per home. This heavy reliance on development fees is a relatively new phenomenon in California. Before Proposition 13, cities, counties, and school districts generally relied on property taxes to finance infrastructure (roads, schools, parks, etc.) for new development. Although developers may pass on the full cost of development fees and other exactions to new homebuyers in a strong real estate market, developers in softer markets might have to absorb some or all of these fees. In sum, although development fees represent an important and growing means for augmenting local revenues and ameliorating the costs of new construction, they do not spread the cost of infrastructure across a broad base of taxpayers, as was traditionally the case before Proposition 13.

In addition to state funding and miscellaneous fees and charges, local governments, especially cities, have come to rely more on redevelopment agencies as a new source of revenue. California has 351 redevelopment agencies with over 700 projects under way, virtually all run by city agencies. More than half of these agencies were created after the passage of Proposition 13. Building on federal and state laws created in the 1940s, redevelopment agencies were created to clean up

blighted areas of a city. Their redevelopment creates new property wealth, and a major portion of the increase in property taxes in a redevelopment area is retained by the city. Michael Dardia, in his PPIC report *Subsidizing Redevelopment in California*, found that the revenues involved are substantial. In 1995, redevelopment agencies collected \$1.5 billion in property taxes for their cities—or 8 percent of all property taxes collected in the state. He also found that cities, through their redevelopment agencies, are taking more than their fair share of proceeds from the tax increment program and that redevelopment has been a widespread and relatively popular means for cities to cope with Proposition 13.

Perhaps the most frequently cited example of a consequence of Proposition 13 is the “fiscalization of land use.” Because sales tax revenues accrue to the jurisdiction where the sale occurs, cities vie with each other for new commercial development. In *California Cities and the Local Sales Tax*, Paul G. Lewis and Elisa Barbour discuss how sales tax revenues affect cities’ land-use decisions. Their study included a survey of city managers and other top administrative officials in every city that existed in California in 1998. (The response rate was 70 percent.) They found that city managers throughout the state did indeed rate retail and office uses as the most desirable land uses when considering new development. Single and multifamily residential development are far down the rankings, with heavy industrial development being the least desirable of all. Thus, proposals to build homes and provide high-paying jobs are less attractive to city leaders than are shopping centers and “big-box” stores. The authors also discovered that the ranking among cities in terms of their sales tax success has not changed much in the past 20 years. Moreover, since per capita sales tax collections are, overall, steady or declining, it is likely that cities are competing over a relatively fixed amount of revenue. In other words, the incentives are there to compete, but the returns are not very large at the margin.

The consequences of fiscal limitations are not restricted to strategies by local government to raise new revenues with a minimum of taxpayer resentment. In their study, *Fiscal Rules and State Borrowing Costs: Evidence from California and Other States*, James Poterba and Kim Rueben found that states with tax restrictions or supermajority requirements to increase taxes face higher borrowing costs in the bond market than states without revenue limitations. The authors conclude that the higher costs reflect the additional difficulty California may experience when raising revenue to meet debt payments. The bond market views *expenditure* limits, such as those imposed by the Gann amendment, more favorably because they place a cap on spending and signal a more parsimonious approach to fiscal management. With California’s rapidly growing population and the tremendous cost of improving and expanding the state’s infrastructure in the coming decades, the *design* of fiscal limitation measures might well be as important as the principle itself. Certainly the consequences for the cost of debt could be substantial over the early years of the new century.

The consequences of fiscal rules imposed by the courts, by the legislature, and by voters through the initiative process are probably most apparent and dramatic in the case of school finance. In their report *For Better or For Worse? School Finance*

*Reform in California*, Jon Sonstelie, Eric Brunner, and Kenneth Ardon review how expenditures on public schools have changed over the past 30 years. They argue that public school finance was fundamentally altered by the confluence of two events in the 1970s—a court decision in 1971, *Serrano v. Priest*, which ordered the state to equalize revenue across school districts, and Proposition 13 in 1978, which restricted local property tax collections and shifted control of the property tax from school districts to the state. After an exhaustive review of the evidence, the authors conclude that spending was “leveled down” rather than “leveled up” among school districts; that school districts coped with the funding limitations by hiring fewer teachers, thereby increasing class size; and that student performance has declined since the early 1980s. Although the authors note that declining student achievement cannot necessarily be blamed on fiscal limitation and the switch to state finance, they maintain that the timing of the decline is suggestive. Most important, they also conclude that public education is caught between a system of state finance on the one hand and local governance on the other. This has created a dysfunctional relationship, with the money and spending rules coming from the state while accountability and performance rest with the school districts. At a minimum, this division of functions has led to a considerable degree of mistrust between the state and school districts. At its worst, this division between finance and governance threatens the long-term educational and economic prospects of future generations of Californians.

## Counties and Their Conundrum

In *The State-Local Fiscal Relationship in California: A Changing Balance of Power*, J. Fred Silva and Elisa Barbour document the long-term decline in counties’ ability to control their own revenues and their transition to operating as agents of the state, which began in the early 1900s. In 1916, 80 percent of county expenditures were funded through discretionary revenues that came from property taxes. By the mid-1990s, that percentage had fallen to around 10 percent. External funding from the state and federal governments represents a growing proportion of county budgets, but the monies the counties receive must be used for state and federal mandates—and these mandates are often not fully funded. Thus, as the counties’ property tax revenue has declined, so has their ability to finance their own general-purpose services such as transportation and corrections.

One potential consequence of the limited fund-raising ability of county governments was dramatically revealed in the case of Orange County. To generate local, discretionary revenues, the county treasurer gambled on high-risk securities. His endeavor failed, and the county found itself literally unable to meet its financial obligations—and the state government would not provide a bailout. In *When Government Fails: The Orange County Bankruptcy*, Mark Baldassare concludes that rather than a curious accident of mismanagement in one county, the conditions that brought about the bankruptcy—fiscal austerity, political fragmentation, and voter distrust—“exist, to a greater or lesser degree, in counties across the state and nation.” Although California has enjoyed a healthy economy since 1994 (the year of the

Orange County bankruptcy), another economic downturn and greater fiscal austerity might bring other counties to the brink of such trouble.

Los Angeles County, the largest county in the nation, came very close to a fiscal meltdown during the recession of the early 1990s. Having scrambled for fiscal solvency during these years and still facing an uncertain fiscal future today, especially in the case of public health care, the Los Angeles County government asked PPIC in 1999 to conduct a thorough analysis of its fiscal and organizational environment. The results of this analysis are documented in *Risky Business: Providing Local Public Services in Los Angeles County* by Mark Baldassare, Michael A. Shires, Christopher Hoene, and Aaron Koffman. After examining the county's fiscal data and interviewing county officials and community leaders, the researchers suggested four goals that could help the county chart a successful course in the first years of the new century: more fiscal control, expanded partnerships with cities and the private sector, greater responsiveness to constituents, and increased regional focus. It became clear during the course of the study that there is an abundance of well-considered ideas among civic and government leaders. What was not so clear is whether there is the political and civic will to make the practical changes needed to get the job done.

### **The Initiative Process and the Public Interest**

Proposition 13 was only the first of seven propositions focusing on state-local finance that were passed by the voters over an 18-year period. Each measure was designed to restrict the freedom of state and local government to tax and spend without broad public approval. The emphasis was, not uniquely but most especially, on constraining the taxing and revenue-generating powers of *local* government. Although the business of providing local government services became ever more complicated over this 18-year period, local governments continued to do business—albeit in a more restrained fiscal environment—and to most people, the results seemed neutral to positive.

This state of mind has been revealed consistently in the PPIC statewide surveys conducted by Mark Baldassare over the past two years. A majority of the state's population favors the initiative process and believes that the benefits of Proposition 13 far outweigh its costs. Perhaps the most troubling finding of the surveys, which is discussed in Baldassare's book *California in the New Millennium: The Changing Social and Political Landscape*, is the public's pervasive disillusionment with elected officials. The state's residents believe that their governments are "bloated bureaucracies unable to solve problems, spend the taxpayers' money efficiently, or represent the interests and policy preferences of average voters." In other words, even after 20 years of limiting the ability of government to raise taxes, voters still find fault with their elected representatives in Sacramento. As confusing and impenetrable as the initiative process may be, Californians see it as the one sure means of taking control of their own fate.

The desire of voters to take matters into their own hands is demonstrated by the tremendous increase in statewide initiatives in recent years. Elisabeth R. Gerber, in

her PPIC report *Interest Group Influence in the California Initiative Process*, notes that 106 statewide initiatives were placed on the ballot between 1976 and 1996, compared to just 29 initiatives in the 20 years before 1976. Although Californians believe that special interests often use the initiative process to get what they want, Gerber finds little evidence that economic groups can “buy” what they want through a ballot measure. Her analysis revealed that initiatives receiving most of their support from “economic interests” had only a 22 percent success rate, compared to a 60 percent success rate for initiatives that were supported by broad-based “citizen interests.”

Clearly, citizens throughout the state have assumed an increasing role in the process of public policy decisionmaking, and the large number of initiatives focusing on state and local finance suggest that this is a trend that could well change the way the public sector is financed for many decades to come.

### **Moving Toward Reform**

Public administrators, elected officials, and members of community advisory boards experience day-to-day the complexity of managing local government finances. Their frustrations with balancing budgets, addressing service delivery problems, and just “keeping the lights burning” may lead to a less benign view of local public finance than the impression left by this overview of PPIC’s research. Indeed, most “insiders” feel that 20 years of fiscal limitations and structural tinkering have led the state—and in particular, local governments—from *home rule* to *fiscal rule*. Many also believe that the fiscal rules are so complex and obtuse that only a few specialists really know how the current system works and understand what would happen if even minor changes were implemented.

The objective of PPIC’s research on governance and public finance is to identify the consequences of public policy actions taken over the past 20 years and to provide empirical clarity on the issues currently being debated. It seems likely that we will see some significant changes in fiscal relationships between the state and local governments in the next year or so, given the interests of conferences such as this one and the many initiatives and commissions under way to study this issue. Hopefully, the policy research community can play a significant role in shaping these changes and in ensuring a positive outcome.

## *Documenting the Facts*

# Has Proposition 13 Reduced the California Tax Burden?

In 1978, Californians passed Proposition 13, severely restricting the ability of local governments to raise revenue through property taxes. Since then, voters and public officials have engaged in an almost continual tug-of-war over public finances, with state and local governments seeking creative ways to increase their revenues and taxpayers frequently using the initiative process to prevent it.

One question that has arisen in the debate over public finances is whether citizens are paying more today in taxes and other public fees and charges than they were in the high-tax years preceding Proposition 13. Michael Shires, John Ellwood, and Mary Sprague answer this question in *Has Proposition 13 Delivered? The Changing Tax Burden in California*. Examining fiscal data between 1978 and 1995, they find that, in absolute terms, taxpayers paid the government much more in 1995 than they did in 1978. However, when inflation and relative income are factored into the equation, the public revenue burden for citizens in 1995 was lower than it was in 1978.

## Measuring the Revenue Burden over Time

In the first phase of this study, the researchers identify the specific taxes and charges that constitute the financial burden that California governments impose collectively on state residents. They find that the overall public revenue burden for Californians increased significantly over the 17 years of the study, jumping from \$30 billion in 1978 to \$93 billion in 1995.

To be properly understood, these statistics should be considered in light of the tremendous demographic and economic changes that have reshaped the state and its fiscal landscape over the past two decades. California's population has grown 41 percent, inflation has driven consumer prices up nearly 150 percent, and the overall income of residents

has grown by more than one-half trillion dollars, with per capita personal income increasing from \$8,951 in 1978 to \$23,279 in 1995.

In the second phase of the study, the researchers focus on these issues, measuring the revenue burden in relation to the state's growing income and population. Table 1 shows the results of the income-based measure for five points in time. The results were obtained by dividing the total revenue burden by the overall personal income in the state in each given year.

Table 1—Public Revenues as a Share of Personal Income

1978	1981	1988	1992	1995
15.0%	11.4%	12.2%	13.2%	12.5%

As the table shows, the public revenue burden has varied significantly over time. In 1978, when the voters approved Proposition 13, the public paid 15 percent of its income to state and local governments. By 1981, the governments' share of personal income had fallen dramatically to 11.4 percent. Although it is likely that much of this decline is attributable to Proposition 13, a statewide recession and significant state-level tax cuts also contributed.

During the 1980s and early 1990s, however, the public revenue burden grew, rising to more than 13 percent of total personal income in 1992 when, in response to a deep recession, state and local policymakers increased revenues through fee and tax increases. The revenue burden has since declined to approximately the same level it was in 1988, dropping to 12.5 percent of personal income.

Table 2 presents the results of the population-based measure, obtained by dividing public revenues by the state popu-

lation in a given year. The table shows total tax revenues per person in the state.

Although Table 2 may accurately characterize what average Californians experience when they pay their tax bill from year to year, it does not necessarily serve as a good indicator of the revenue burden, because it fails to take into account the reduced buying power of money over time. When the results are adjusted for inflation, as shown in Table 3, the trends correspond quite closely to those in Table 1. Revenues decline dramatically after the implementation of Proposition 13, then rise gradually through the 1980s, peaking in the early 1990s, then declining by 1995 to levels comparable to those in 1988.

**Table 2—Per Capita Public Revenues (current dollars)**

1978	1981	1988	1992	1995
\$1,340	\$1,421	\$2,298	\$2,864	\$2,910

**Table 3—Per Capita Public Revenues (constant 1995 dollars)**

1978	1981	1988	1992	1995
\$3,305	\$2,498	\$2,944	\$3,057	\$2,910

### Conclusions and Policy Implications

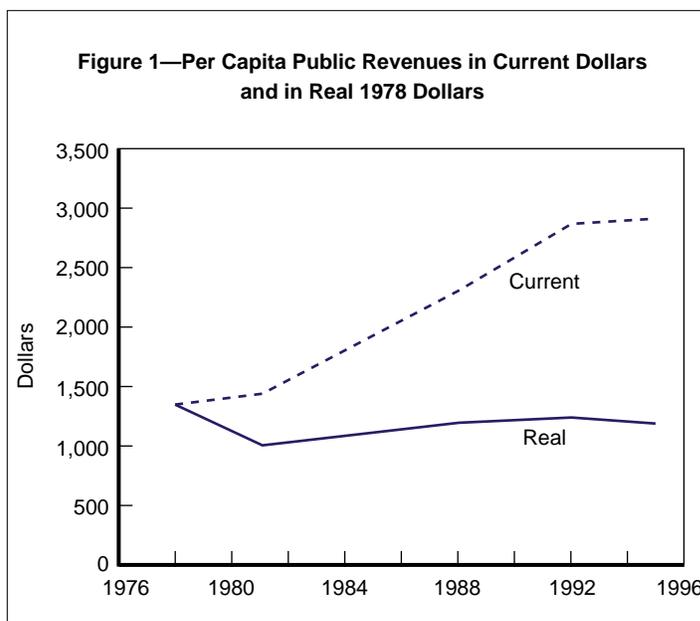
The consistency of the study’s findings across measures and time demonstrates that how one measures the changing revenue burden should not be a central issue in the public finance debate, as it has been at times in the past. Rather, it would be better to focus attention on a more crucial policy question—what is the appropriate size for the state and local revenue burden?

The study has also shown that Proposition 13 did contribute to a significant rollback in the public revenue burden. Although the effects of this rollback continue today, they have been partially offset by rising public revenues during the 1980s and early 1990s.

The revenue burden has never returned to the high levels seen before Proposition 13. Nevertheless, the passage of Proposition 218 in November 1996 suggests that the electorate remains concerned about the growth of public revenues. This initiative mandated supermajority voting requirements for many local assessments and charges.

A number of explanations may account for the public’s perception that they are contributing more to the public coffers every year. For example, much of the growth of the revenue burden in the 1980s and 1990s came from new assessments and increases in local taxes, regulatory fees, and service charges. These high-profile revenues would be likely to create a direct response from the voting public.

Another contributing factor could be the effect of inflation discussed above. As shown in Figure 1, public revenues in noninflation-adjusted dollars have risen relentlessly, even in the period immediately following Proposition 13—and taxpayers and voters are far more likely to think in terms of current dollars than inflation-adjusted dollars. Thus, unless the mood of the public changes, the flat rate of growth in real revenues identified in this study will probably persist.



*The steady rise in current dollar revenues may explain why taxpayers continue to feel the need to curb government taxing and spending.*



# Changes in State and Local Public Finance Since Proposition 13

In June 1978, California voters passed Proposition 13, the first in a long series of ballot initiatives that have constrained state and local governments' ability to raise, allocate, and spend public revenues. In a recent study, *Has Proposition 13 Delivered? The Changing Tax Burden in California*, Michael Shires, John Ellwood, and Mary Sprague found that the total amount of public revenues available to California governments has increased significantly, jumping from \$58 billion in 1978 to \$205 billion in 1995. However, the state's population has also grown by 41 percent, and inflation has driven consumer prices up nearly 150 percent. On a per capita basis, and adjusted for inflation, overall public revenues today are about 85 percent of their pre-Proposition 13 levels. In this follow-up study, *Patterns in California Government Revenues Since Proposition 13*, Michael Shires examines how California governments have fared in their competition for these dollars. The study focuses on three questions:

- How has the share of locally controlled revenues changed?
- How has the spending flexibility of state and local revenues changed?
- How has the composition of state and local revenues changed?

The study answers these questions for each level of government in California: the state, counties, cities, independent special districts, school districts, and public postsecondary education institutions.

## Changes in Local Control of Revenues

The level of government that has the authority to generate revenues is the level that "controls" those revenues. Thus, if a city has the authority to implement a utility tax, it has control of the revenues. In some cases, the state raises

revenues from its citizens and then transfers monies to local governments to fund specific services or provide general support. The state controls these revenues, even though the subordinate government may spend them. One major and paradoxical consequence of Proposition 13 is that although the property tax still continues to be assessed, levied, collected, and distributed at the local level, Proposition 13 made the state the final arbiter in deciding who receives the property tax and how much they receive. Thus, the state controls this substantial source of revenue.

As shown in the table, the share of *self-controlled* revenues has declined for all levels of local government. In effect, the transfer of the property tax allocation authority to the state has meant that subordinate governments have become more dependent on the state for the funds they need to fulfill their obligations.

Cities and public postsecondary education institutions have recaptured some control over their budgets by increasing various taxes and fees. Counties, however, lack the countywide revenue base and, in some instances, the revenue-raising mechanisms that might give them the same

**Percentage of Total Revenues That Are Self-Controlled**

	1978	1981	1988	1992	1995
Counties	50	18	19	19	20
Cities	66	36	43	45	43
Special districts	59	37	49	39	38
School districts	54	7	5	5	6
Higher education	30	15	18	21	24

NOTE: Public service enterprise revenues are excluded from total revenues in this analysis.

*Proposition 13 severely diminished the control local governments have over their revenues.*

resilience. The greatest decline in locally controlled revenues was experienced by school districts, as the property tax was shifted from the control of local school boards to the state legislature.

Many observers believe that the declining share of self-controlled revenues among local governments is unfortunate because it limits their ability to raise revenues for locally desired services. Before Proposition 13, locally elected bodies determined the property tax rate, based on the need to fund local programs and services. Thus, there was significant debate at the local level, both at the ballot box in terms of who was elected to these bodies and at public budget hearings about how the monies should be spent. Proposition 13 changed this scenario, removing the debate from the local arena. Many contend that accountability was also removed, because public officials now can argue that they cannot provide certain services because Sacramento is “calling the shots.”

### *Changes in Spending Discretion*

A second important element of fiscal flexibility is the discretion each level of government has in determining how to spend the money it receives. Revenue flexibility has declined for all levels of local government except special districts.

The decline in discretionary revenues represents an increasing presence of higher levels of government in the local community and growing constraint on the choices of local public officials, who must administer programs mandated by the state and federal governments. Unfunded or partially funded mandates are particularly onerous, because if the level of government mandating a particular program or service does not supply adequate funding, then additional pressure is placed on the receiving government’s discretionary resources to meet the obligations of the mandate.

### *Changes in Revenue Composition*

Proposition 13 changed the composition of state and local revenues in two ways. First, it capped the rate and growth of one of the most important sources of local

revenues in the state. Second, it made it more difficult for local officials to raise new taxes by requiring a two-thirds majority vote at the ballot box. These constraints have forced local governments to turn to other revenue sources, and they have aggressively increased many of the revenue streams available to them, including enterprise revenues, assessments, regulatory fees and taxes, fines and penalties, and general service charges. Enterprise revenues, which are generated by the utility companies that sell water, electricity, natural gas, waste disposal services, and other services to the public, grew by nearly 400 percent between 1978 and 1995. Cities have also been able to raise revenues by increasing other types of taxes. For example, business license taxes, franchise taxes, real property transfer taxes, and transient lodging taxes rose 454 percent between 1978 and 1995.

### *Conclusions*

Changes in public finance since 1978 have significantly expanded the state’s role in the local arena. Some jurisdictions have been able to offset the shift in control of the property tax to the state by increasing local taxes and user fees. Others, most notably schools and counties, have become increasingly reliant on the state and hence are susceptible to its fiscal problems and budget cycles.

The constraints on local governments’ ability to generate revenues may become increasingly problematic as they seek to provide services to a rapidly growing and changing population. Unfunded mandates may further hamper the ability of local governments to respond to local needs and preferences.

Changes in the control, discretion, and composition of public finance have led to considerable political tension between different levels of government, as well as between voters and their governments, as manifested by the limitations imposed on government behavior and spending over the past 20 years through the initiative process. Of course, not all of the changes in the state’s fiscal landscape are attributable to Proposition 13 and its progeny; but most observers will agree that 1978 was a watershed year in the history of public finance in California.

# *State Revenue Data Can Be Used with Confidence*

For more than two decades, Californians have engaged in a great debate about the size, shape, and role of state and local governments. With the 1978 passage of Proposition 13, voters began to use the initiative system to limit the size of their governments, severely constraining the ability of state and local governments to raise revenue locally. In essence, California is engaged in a great experiment, leading the nation in the use of direct democracy to limit representative government. Like all critical experiments, it requires evaluation, and valid evaluation requires reliable data.

Several key studies of the policy issues generated by this experiment have raised concerns about the quality of the data on local public revenues. Many policymakers and analysts throughout the state have hesitated to use the available data, citing three assumptions about their quality: (1) The data do not capture all public entities in the state. (2) They do not accurately reflect the fiscal activity of those they do capture. (3) They are not produced in a timely manner. A 1997 Public Policy Institute of California study by Michael Shires and Melissa Glenn Haber evaluated these claims by analyzing the revenue information that the California State Controller's Office collects and publishes. Their findings end years of doubt about the quality of the state's fiscal data. The study's conclusion: Timeliness remains an issue, but the data are basically sound. The study also makes recommendations for improving the comprehensiveness, accuracy, and timeliness of the data. The findings and recommendations on each issue are summarized below.

## *How Comprehensive Are the Data?*

Because the initiative system has increasingly constrained local governments, some argue that those governments have found creative ways to get around the constraints and that the state's data systems cannot track this creativity. A particular concern is that the systems do not capture some institu-

tions resulting from this creativity—Mello-Roos districts, for example. Thus, studies that use the data underestimate the size of public sector activity. The Institute's analysis found that the data were quite comprehensive. It verified that more than 7,000 local entities, which appear on other authoritative public lists, are included in the State Controller's annual reports. In fact, Mello-Roos or community facility districts (CFDs) are the primary exception: They are not systematically included in the Controller's database. However, in a follow-up analysis of all the CFDs in existence, the study found that their revenues are such a small percentage of total local-government revenues that excluding them represents a trivial source of error—only 0.3 percent.

To make the data more comprehensive, Shires and Glenn Haber recommend that the annual surveys include specific instructions that would lead to inclusion of Mello-Roos districts. They also recommend that the Controller's Office implement a watchdog-type mechanism for identifying new entities that might not be captured under the current reporting scheme.

## *How Accurate Are the Data?*

Put another way, does the information in the Controller's reports accurately represent what's happening in local governments? Since that information comes from questionnaires completed by each entity, interpretation of the instructions could vary enormously across more than 7,000 entities. Moreover, the questionnaires are usually submitted before annual audits are completed. Shires and Glenn Haber verified the survey data against third-party sources of information: the entities' audited data and information tracked by other agencies. In both comparisons, the correspondence between the Controller's Office data and these sources was very high.

Correspondence Between State and Local Data (total revenues in billions of dollars)			
	Counties	Cities	Special Districts
State Controller Audited reports	\$ 22.22 22.50	\$ 16.31 16.08	\$ 9.56 9.42
Difference	\$ 0.28	\$ 0.23	\$ 0.14
Percentage difference	1.2%	1.4%	1.5%

***The study found a high correlation between the audited reports of local entities and the data reported by the State Controller's Office.***

Even though the data are highly accurate, the authors made five recommendations for accuracy improvements:

- Provide more-specific instructions and follow-up regarding capital project funds, debt service, and housing authorities.
- Expand and clarify the reporting of special assessment districts.
- Expand the reporting of school district information.
- Provide detailed fiscal information for community college districts.
- Establish a consistent reporting format for all categories of entities.

### *What Could Be Done to Make the Data More Timely?*

The study did not examine timeliness in great detail because the problem is self-evident: Since each type of entity publishes its data separately, the data become available at different times. The delay can be as long as two years. This is problematic for policymakers and analysts who have much shorter and more-demanding time horizons. Shires and Glenn Haber made two recommendations to the Controller's Office for improving timeliness: Institute Internet/Web-based submission and make the data available immediately—before they have been reviewed. The latter would make the bulk of the material available 90 days after the end of the fiscal year—not more than a year later, which is the current schedule. Unreviewed data would be identified as such and changes made after the Controller's review. Large and complex entities, which are more likely to affect policy choices, should be reviewed first.

### *Implications for Analysis of California's Governance and Finance Issues*

The primary motive of the Public Policy Institute of California in undertaking this study was to determine whether the State Controller's data were of adequate quality, and if not, what changes might make them more usable. While Shires and Glenn Haber recommend a number of changes, the data as they currently exist are usable for further research into more-detailed aspects of state and local governance. The revenue data accurately portray the range of activity occurring in local government. Thus, decisionmakers and analysts can focus on the methodology and substance involved in policy and not worry about shortcomings in the data.

# Has Proposition 13 Increased Fragmentation in Local Government?

Political authority in California is divided among thousands of local jurisdictions: A typical household may find itself simultaneously governed by a county, a city, a school district, and numerous special districts that levy assessments or charge fees to provide services or build community facilities.

Many observers have argued that California's system of local government is too complex and fragmented. They contend that such complexity hinders coordination among government activities, makes it difficult to establish political accountability, and may lead to inefficient provision of services.

Some have further argued that the passage of the Proposition 13 tax limitation in 1978 exacerbated the problem, leading to a proliferation of new cities and special districts and fundamentally altering California's local governance structure.

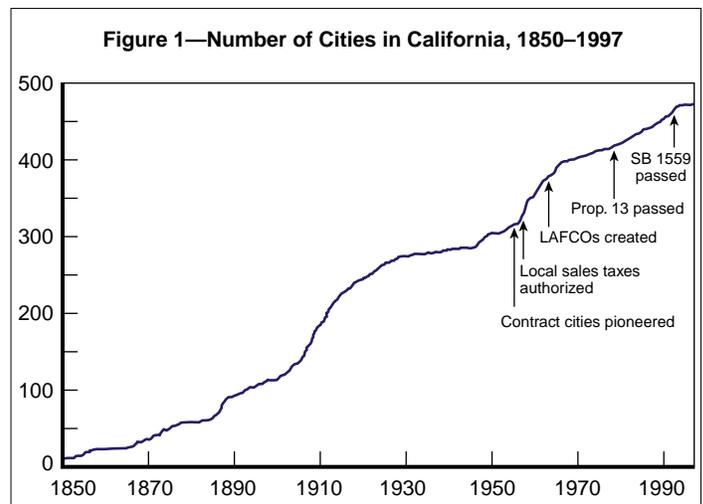
In *Deep Roots: Local Government Structure in California*, Paul Lewis examines the long-term trends in California's local government structure and the possible effects of Proposition 13. He finds that although Proposition 13 played havoc with many local governments' finances, it did not decisively alter the state's overall local government structure. In fact, California's public sector is less fragmented than the national average. The state has many times fewer counties and cities and significantly fewer politically independent special districts per capita, compared to the nation.

## Trends in City Formation

Conventional wisdom in both the academic and popular literature holds that Proposition 13 provided incentives for the widespread creation of new cities and special districts. In the case of cities, incorporation would no longer lead to an increase in property taxes, because Proposition 13 had capped overall rates. And by "seceding" from its financially strapped county, the new city could capture more locally

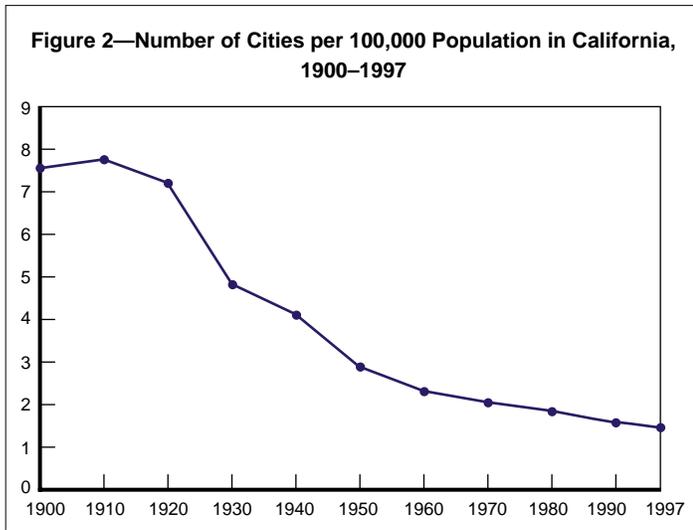
generated revenues for local use. In the case of special districts, fiscally troubled counties and cities might be expected to encourage the creation of new special-purpose governments. The counties and cities could thereby transfer some of their service and revenue-raising burdens to entities that often are less constrained in their ability to issue debt or levy fees and service charges.

The data, however, do not support the conventional wisdom. In fact, the growth rate in the number of new cities has slowed since 1963, when the state created Local Agency Formation Commissions (LAFCOs) in each county to regulate government boundaries and formations. Although 54 new cities have incorporated since 1978, most were in areas of metropolitan Southern California that experienced extremely rapid population growth and suburbanization and thus were natural candidates for additional governments. As Figure 1 shows, there is no dramatic break with historical trends in the post-1978 period. Most population growth in



*Proposition 13 did not counteract the slowdown in new incorporations brought about by the creation of Local Agency Formation Commissions in 1963.*

the state continues to be accommodated by existing cities, which regularly expand their boundaries through annexation. As shown in Figure 2, the number of cities per capita in California has fallen throughout this century.



*In terms of cities per capita, fragmentation has declined steadily in California.*

Reliable and comparable historical data on special districts are less available, but the evidence indicates that the overall number of special districts has increased only gradually since the 1970s. To a large extent, the creation of new special districts has been offset by the abolition of others.

### *A Better Measure of Local Political Structure*

Although historical data on the number of local governments or number of governments per capita are useful, raw counts of this type can be misleading when it comes to measuring the complexity of political structure. For example, a small mosquito-control district would be counted equally with a large public transit district.

To get a better sense of the relative size and responsibilities of local governments, Lewis developed a political fragmentation index, or PFI. The PFI is a measure of the degree to which expenditures are divided among county, city, and special district governments and, as such, provides a sense of the relative amount of activity engaged in by each unit.

By this measure, local political fragmentation increased only slightly between 1972 and 1992. Moreover, shifts in the PFI have been gradual, both on the statewide level and

within most counties. There is no substantial evidence to support a “Proposition 13” effect on local government structure.

### *Variations in Political Structure Across Counties*

The PFI analysis revealed that different parts of the state differ considerably in the complexity of their local political structure. As might be expected, counties with the lowest levels of political fragmentation tend to have a county-dominant government, few large cities, and little reliance on special districts.

Statistical analysis showed that areas that have larger populations and that developed earlier in the state’s history tend to be more fragmented. Areas receiving more of their revenue in the form of intergovernmental aid tend to be less fragmented, perhaps because they have less need to set up new political structures to overcome local revenue shortfalls.

### *Policy Implications*

California has undergone tremendous political, economic, and demographic change over the past 20 years. Yet the state’s system of local governance has remained relatively stable. One possible explanation is that LAFCOs have succeeded in reining in potential fragmentation.

Local governments may also be more malleable and responsive to change than is commonly supposed. Counties, cities, and special districts throughout the state have typically been able to address new issues, empower new constituencies, and respond to a growing and diverse population without experiencing crisis.

This does not mean that state and local policymakers should be complacent about California’s local government system. Rather, they should seriously consider how to enhance the fiscal stability of local governments, keeping in mind this study’s finding that more generous intergovernmental aid appears to reduce the impulse toward local fragmentation. Mechanisms for enhancing regional coordination of growth and infrastructure may also be necessary.

Given this study’s finding that local government structure has changed only gradually over a period of decades, it would seem prudent for California’s leaders to work within existing structures to strengthen local governance and public finance, rather than to propose sweeping reforms to a stable and resilient system.

## *Calibrating the Consequences*



# Proposition 13, the Recession, and the Tax Assessor's Dilemma

Under Proposition 13, the assessed value of property cannot increase by more than 2 percent per year until the property is sold, at which time it is reassessed at its full market value, usually the selling price. Until the early 1990s, inflation in real estate generally exceeded 2 percent per year, creating a widening gap in property taxes between homes bought more recently and those owned for many years.

However, from 1991 through 1995, California experienced a severe recession. Property values fell throughout the state, dropping as much as 30 percent in many places. Although the decline in property values helped to eliminate some of the inequities in the property tax system, reducing the gap between market value and assessed value, it also placed a tremendous strain on California's understaffed and underfunded county assessors' offices. As property values fell, residents and businesses throughout the state inundated county assessors with appeals for reassessment. In their study *Proposition 13 in Recession and Recovery*, Steven M. Sheffrin and Terri A. Sexton analyze the dynamic interplay between market value and assessed value since 1975 and the far-reaching effects it has had on property tax administration in California.

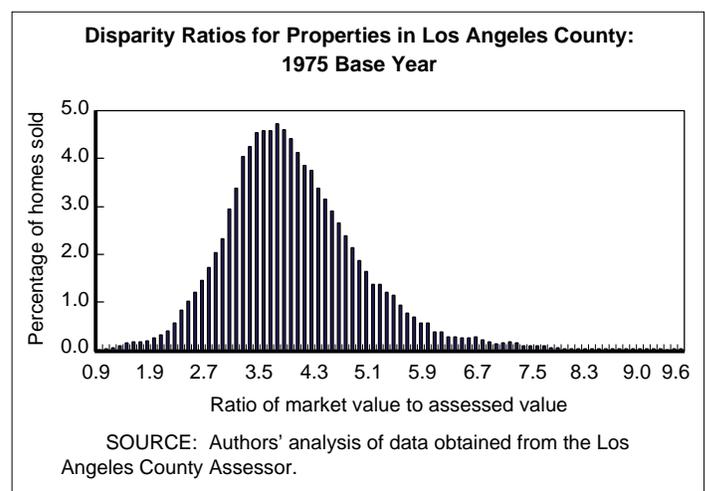
## Research Approach

When Proposition 13 was passed by the voters in 1978, assessments were rolled back to the property values that prevailed in 1975. This was the initial "base year" for all existing properties in the state. When property is sold, it is reassessed and has a new base year. As long as housing price inflation exceeds 2 percent per year, properties with more recent base years will be assessed closer to market value than properties with older base years. The base year is the key piece of information needed to estimate the disparity between market value and assessed value, which the authors define as the disparity ratio. Once they have identified the base year of a property, they can calculate the disparity ratio

by dividing the market value of the property by its assessed value in the preceding year. They did this for properties sold in Los Angeles and San Mateo Counties in 1990–1991 and in 1995–1996, the years bracketing the recession. The analysis involved about 8 million property records for Los Angeles County and 1.4 million for San Mateo County, with base years running from 1975 to 1996.

## Tax Disparities in Los Angeles County

The figure below shows the distribution of disparity ratios for single family, owner-occupied homes in Los Angeles County that had a base year of 1975 and that were sold in 1995–1996. The median disparity ratio for all these homes is 3.84. This means that an average new homebuyer in Los Angeles today will pay almost four times the basic property tax as a household that has been in its home since 1975. The disparity between market and assessed value was much greater in 1991, when the median disparity ratio for 1975 base year property was 5.19 or 26 percent higher than



*Most homes in Los Angeles County owned since 1975 sold for about 3 to 4 times their assessed value in 1995–1996.*

in 1996. The decline in the disparity ratio was a direct consequence of the recession and falling real estate prices.

The fraction of 1975 base year property also decreased substantially during this period. In 1991, 43 percent of all properties in Los Angeles County had 1975 base years. By 1996, the number had fallen to 33 percent. Two primary factors contributed to this decline. First, some of the 1975 base year properties were sold and thus assumed later base years. Second, new construction increased the total number of properties and thereby reduced the 1975 base year percentage. The 1975 base year percentages are key statistics because they are the most important source of property tax disparities. The median disparity ratio in all base years after 1980 currently falls below 1.3, and a 30 percent difference between assessed and market values is not unusual in states using a market-value-based rather than an acquisition-value-based property tax system. In other words, the inequity of the post-Proposition 13 tax system is not that serious in the case of properties with base years after 1980.

Whether inequities in the property tax system will continue to be reduced through turnover and new construction depends largely on two factors. The first is property appreciation. If housing inflation again begins to exceed 2 percent per year on a sustained basis, inequities will increase. The second factor is the stock of 1975 base year housing. Whether the owners of these properties sell or pass the properties on to their children or grandchildren (and thereby maintain the base year) will largely determine whether the number of such properties—those with the greatest disparities—will decrease over time.

### *Property Tax Administration: Overwhelmed*

Before 1991, the assessor's job was relatively easy. For the majority of properties, it was simply a matter of adjusting the previous year's assessed value upward by 2 percent or the rate of inflation, whichever was smaller. However, between 1991 and 1996, hundreds of thousands of property owners who believed that the market value of their property had fallen below the base year value filed appeals for reassessment. Under Proposition 8, a constitutional amendment passed by California voters in 1978, such properties must be reviewed and reassessed each year until the market value again exceeds the factored base year value (base year value plus 2 percent for each subsequent year). If an appeal is not resolved within two years, the assessor is obligated to

enroll the property at the value claimed by the owner of the appeal (which may be artificially low).

At the same time that hundreds of thousands of appeals were being filed, assessors' budgets were being cut. In 1992 and 1993, at the peak of the recession, the Governor reduced the state's financial obligations to schools by shifting \$3.4 billion in property tax revenues from local agencies to schools through the Educational Revenue Augmentation Fund. This led to a significant reduction in counties' share of property tax revenues, which continues to this day. For example, Alameda County saw its revenue share decline from 40 percent to 16 percent, and Orange County keeps only about one nickel of every property tax dollar collected in the county. Although the state enacted certain measures to help counties enhance their property tax administration, including a temporary loan program that has enabled assessors' offices to hire additional staff, many counties are still working through a 12–18 month backlog of cases.

### *Looking Ahead*

Sooner or later, property values will fully recover, assessments will be completely restored to their base year levels, and appeals will decline from their peak levels. But unless the fiscal relationship between the state and its counties changes, property tax administration problems will remain. Because counties' share of property tax revenues is so small, they have little incentive to spend their scarce budgetary dollars on staffing and modernizing assessors' offices, at the expense of other county services.

One solution to the budgetary problems would be to ensure that all recipients of property tax revenue pay a portion of the administrative costs, in proportion to what they receive. This was the essence of a bill passed in 1990, SB 2557. However, in 1991, schools were exempted. According to the allocation of property tax revenues in 1995–1996, schools received over 53 percent of all property tax revenues. Thus, under this proposal, the state would pay 53 percent of property tax administration costs on behalf of schools. However, relieving counties of some of the administrative costs does not provide them with the type of incentives for thorough and accurate assessments that come with having a larger stake in the outcome, namely, property tax revenues. A better (but politically difficult) solution would be to shift property tax revenues back to counties as their primary source of revenue.

# Development Fees and New Homes: Paying the Price in California

National surveys have shown that California leads the nation in imposing fees on new residential development, yet we know surprisingly little about the nature and effects of these fees. To fill this research gap, Marla Dresch and Steven Sheffrin conducted an econometric analysis of development fees in Contra Costa County, focusing on single-family residences constructed between 1992 and the first three months of 1996. Located in the San Francisco Bay area, Contra Costa County is the ninth most populous county in the state.

The researchers found that the fees imposed on new construction are significant, typically falling in the range of \$20,000 to \$30,000 per dwelling. In one community, fees and bond assessments accounted for 19 percent of the mean sales price.

This heavy reliance on development fees, particularly in California, is a relatively new phenomenon. Historically, cities and counties have used property taxes to finance infrastructure—such as roads, schools, and parks—for residential development. In turn, new residents, through their property taxes, would help finance infrastructure for others in the future.

In the wake of Proposition 13, which limits property tax to 1 percent of the assessed value, cities and counties have had to find other ways to finance infrastructure. Unless state funds are used, local governments have only two alternatives: bonds or exactions. Exactions are payments made by a developer to local governments for the right to proceed with a project. Exactions can include development fees, the dedication of public land, the construction or maintenance of public infrastructure, or the provision of public services.

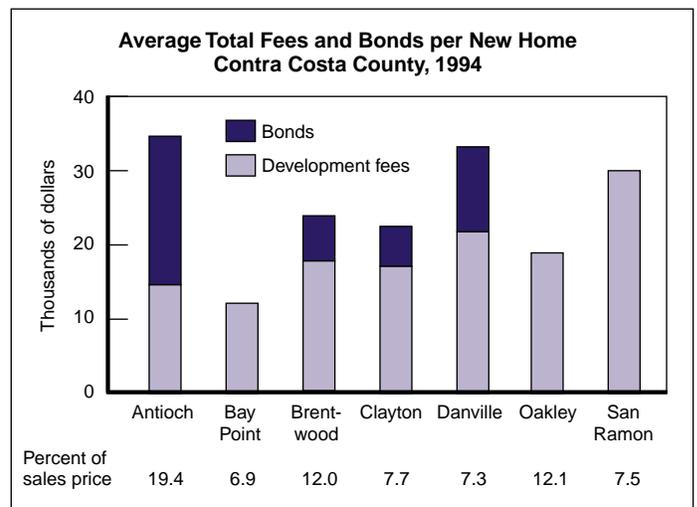
From a consumer's perspective, the difference between bonds and exactions is one of visibility. When new homeowners pay off a bond issued to finance their infrastructure, they are keenly aware of the cost, because bonds are included on property tax bills.

Exactions, however, are invisible, because the home buyer will not know what kinds of projects or fees were levied against the builder or how much of the costs have been passed on to the buyer in the form of higher home prices.

The objective of this study was to measure the size of development fees in one of California's fastest growing counties and to determine who bears the burden of the fees, the developer or the home buyer.

## Methods and Findings

For their study sample, the researchers selected those cities and unincorporated areas in Contra Costa County that had the largest number of new sales and that also had available information on fees. The sample included Danville and San Ramon from the southern area of the county, and Antioch, Bay Point, Brentwood, Clayton, and Oakley from the eastern area.



*Financing of infrastructure varied considerably across cities, both by type of funding and as a percentage of mean sales price.*

The researchers collected information on all of the fees levied against individual homes within a tract: building permits and inspections, water and sewage, traffic, schools, parks, fire, and community development.

They integrated the data on fees into a comprehensive dataset containing the prices and characteristics of the housing, and then estimated statistical models that allowed them to determine what portion of the fees were incorporated into housing prices.

In addition to the substantial amount of the fees, one of the study's most striking findings was that the ability to pass on fees to homeowners can vary within a single county and over a single period of time. Developers in the southern part of the county passed on the full cost of the fees to the home buyer, while developers in the eastern area had to absorb about 75 percent of the fees, passing on only one-fourth of the fees to the buyer.

There are a number of reasons why a developer might not be able to pass along the full amount of the fees to home buyers. For example, if a city or county uses the fees to benefit the general community rather than to provide services that increase the value of homes in the specific development, home buyers may be unwilling to pay the fees and may prefer to purchase a home elsewhere in the community. The same would be true if the fees do not generate services valued by the homeowner.

In the case of Contra Costa County, however, the researchers determined that the difference in the effects of fees on prices was primarily due to disparate economic conditions. Although the study occurred during a declining housing market, there was much more distress in the eastern part of the county. Prices dropped continuously throughout the entire four-year period, forcing developers to absorb a significant fraction of the fees.

### *Policy Implications*

As a result of Proposition 13, the financing of infrastructure for new homes in California is no longer shared by all property owners in a community, but is borne instead, in varying degrees, by developers and new home buyers.

Developers complain that fees and exactions in general have become excessive, increasing the risk of doing business and stifling economic growth. Local government officials argue that these levies are essential to growth: Without them, local government could not provide the infrastructure necessary for new development.

Financing for the construction of schools lies at the very heart of the current debate. Until the mid-1980s, only cities and counties could impose development fees, including school fees. In 1986, the legislature authorized school districts to impose their own fees on new construction. Although school fees were capped, based on the square footage of the new development, subsequent court decisions have ruled that the fee limits apply only to fees levied by school districts and not to those imposed by cities and counties. These legal developments raise the possibility that some communities will sharply increase their use of development fees, which in many cases are already substantial.

The authors note that cities and counties cannot be expected to reduce their reliance on development fees and exactions unless some other source of funding is provided, especially for the construction of schools.

They suggest that Californians need to decide whether it would be more equitable to spread the cost of school construction more widely across the population. Financing mechanisms that could be used to share the burden include state general fund subsidies, as well as state and local general obligation bonds.

Certainly a case could be made that there are general, statewide benefits from education that distinguish it from other infrastructure. K-12 schooling provides benefits to all Californians through a better-educated workforce and by reducing the risks of later dependence on the state. It is more difficult to make this argument with respect to other elements of the infrastructure—water, fire protection, or parks—where benefits are restricted to local residents. Because schools provide a positive good to the broader community, the financing of school construction might well be considered a broader community responsibility.

# *Redevelopment and the Property Tax Revenue Debate*

In California, redevelopment agencies (RDAs) receive over 8 percent of all property taxes collected in the state every year. In FY1994–1995, this amounted to \$1.5 billion. In a state where local government revenues are severely constrained by tax limits, this allotment of property tax revenues is a matter of intense policy debate. Much of the controversy revolves around *tax increment financing*. Once an RDA forms a project area, most of the increase in property taxes in that area goes to the RDA. The rationale for this is that the RDA's improvements in the area are responsible for rising property tax assessments. However, general economic trends could also be contributing to the increase in property values. If so, the tax revenue diverted to the RDA from the county, school districts, and other local entities could be characterized as an involuntary subsidy.

It may be that state policy goals for redevelopment are well served by this subsidy and that other taxing agencies can legitimately be expected to provide it. However, that question cannot be resolved without hard evidence about the size of the subsidy. In *Subsidizing Redevelopment in California*, Michael Dardia examines the purpose, incentives, and operations of RDAs, estimating for the first time how much of the property tax revenue that RDAs receive results from their activities.

## *Origin and Operation of RDAs*

Redevelopment agencies grew out of federal urban renewal programs of the 1940s. The California Community Redevelopment Act of 1945 authorized any city or county to establish an RDA to combat urban blight. Today, California has 351 active RDAs with over 700 projects under way, virtually all of which are run by city agencies, although 15 counties also have active RDAs. The agencies engage in a wide variety of activities—purchasing property, razing and building structures, providing municipal infrastructure such as streets and lighting, developing affordable housing, and renovating downtown commercial areas.

More than half of the RDAs in the state were created after the passage of Proposition 13 in 1978. The fiscal austerity imposed on local governments made the tax revenues available to RDAs more attractive than ever. An RDA receives the property tax increases in a project area for the life of a project—often 30 years or more. Without the project, the property tax revenues would be shared among counties, cities, schools, and special districts.

Recognizing the strain that tax increment financing could cause other local jurisdictions, the state legislature allowed them to negotiate with RDAs to recover some of the tax increment. These payments, called pass-throughs, were negotiated project by project. The RDAs, on average, shared about 14 percent of their tax increment with other jurisdictions in FY1993–1994, with counties receiving about two-thirds of the money. School districts had little incentive to fight for the pass-throughs because the state reimburses schools for any lost property tax revenue. This reimbursement amounts to hundreds of millions of dollars each year, and these costs, along with perceived abuses in the designation of blight, led to reform legislation, AB 1290, in 1993. AB 1290 set a uniform pass-through rate of approximately 33 percent for new projects. This was an implicit recognition that the subsidies flowing to RDAs were too large. However, no estimates of the size of these subsidies existed, so the size of the adjustment relied more on political judgment than on empirical evidence.

## *The Redevelopment Study*

This study sought to answer two questions raised by critics of redevelopment: How blighted are project areas, and how much are RDAs subsidized by tax increment financing? The study focused on redevelopment projects initiated between 1978 and 1982 (the first five years after the passage of Proposition 13). The initial study sample included all counties that started at least three projects within this five-year period. Ten counties with 114 projects met this criteri-

on. Each RDA project area was matched to a Census Block Group in the same city that was similar to the project in terms of poverty and vacancy rates but was not part of any redevelopment project. To evaluate the effect of RDA activities on property values, Dardia compared the change in assessed value for the project areas and the matched areas from 1983 to 1996. Data limitations ultimately led to a final sample of 38 projects in three counties (Los Angeles, San Bernardino, and San Mateo). However, these projects were very similar to the 114 projects in the original sample, so the results from the final sample can be reasonably extrapolated to the original 114 projects.

### Findings

Although there was considerable variation among projects, the average vacancy and poverty rates were higher, and median incomes and median rents were lower, in the project areas than in the rest of the city. However, the extent of blight identified varied greatly among cities, and some RDAs declared that most of their city was blighted. Also notable is that many of the project areas included vacant land: In 20 of the 114 projects, more than 50 percent of the project area was vacant land, suggesting that some RDAs were engaging more in development than redevelopment.

The more critical question this study sought to answer was how much of the property tax revenues the RDAs received was due to their effect on local property values. Overall, the sample projects retained almost 84 percent of these revenues, with other taxing jurisdictions receiving 16 percent. Thus, in aggregate, property values in the project areas should have grown more than six times faster than their matches to account for the amount of tax increment they received. As shown in the figure, only four project areas grew fast enough to justify the RDAs' claim that they were solely responsible for the increase in property taxes.

In dollar value, the 38 projects collectively received \$78 million in tax increment revenues, about \$40 million of which can be explained by the RDAs' effect on property values. Thus, the subsidy from other jurisdictions to the RDAs totaled \$38 million in FY1994–1995.

### Conclusions and Recommendations

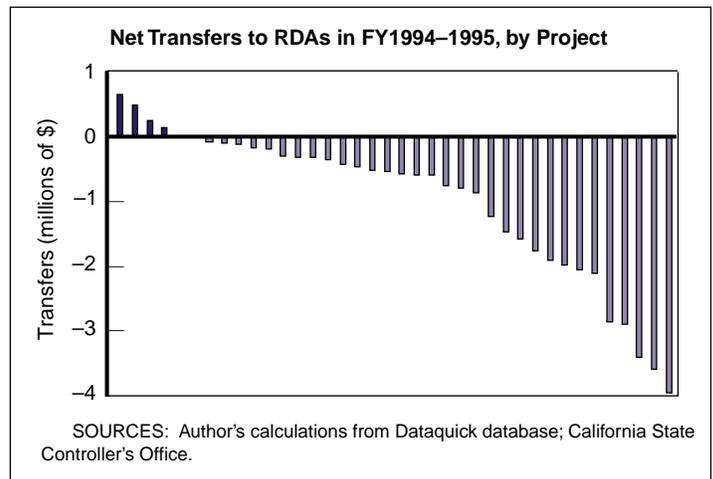
The value placed on redevelopment projects' achievements may outweigh concerns about whether RDAs are heavily subsidized. Nonetheless, it is important to know

how much one level of government is subsidizing another so that competing uses for public dollars can be fairly considered.

This study's results suggest that the existing tax increment system is not an effective way to finance redevelopment. Few projects generate enough increase in assessed value to account for their share of these revenues, and those projects that came closest defined blight broadly and included large amounts of vacant land. Tax incentives can lead cities to designate too many areas as blighted, and if true blight is targeted, an area is unlikely to generate enough revenue to earn the tax increment revenues.

The study makes four recommendations to state lawmakers that should help resolve the controversy surrounding redevelopment:

1. The legislature should formally clarify the goals of redevelopment.
2. The definition of blight should be aligned with the goals of redevelopment and should be made more precise.
3. Some form of oversight authority should be established to monitor RDA behavior.
4. If the legislature intends redevelopment to be self-financing rather than heavily subsidized, the pass-through rate should be increased significantly.



*In "balancing the books" on tax increment financing, the study found that most projects did not generate enough growth in assessed property values to account for the tax increment they received.*

# City Competition for Sales Taxes: Symptom of a Larger Problem?

In 1978, Proposition 13 effectively transferred control of the property tax from local governments to the state. Since then, a number of voter initiatives have further constrained the revenue-raising powers of local governments. For this reason, California cities have increasingly sought to augment their revenues through local sales taxes.

Under what is known as the situs rule, a 1 percent locally levied sales tax is collected by the state but returned to the jurisdiction where the sale occurred. Thus, the situs rule gives cities an incentive to promote the location of retail businesses within their boundaries—an incentive that does not exist for residential or industrial development. Although sales taxes are a modest share of total city revenues, cities regard them highly because they represent a major share of their discretionary income—most of the other revenues they receive are earmarked or restricted for specific uses. Moreover, many local policymakers believe that the income they receive from sales taxes has the potential to grow significantly during good economic times—if they encourage retail development.

In their report *California Cities and the Local Sales Tax*, Paul G. Lewis and Elisa Barbour focus on two crucial questions related to cities' strong interest in sales tax revenues. First, what are the effects of the situs-based sales tax on cities' land-use decisions? Second, which types of communities are doing better or worse in the quest for sales tax revenues?

## Favoring Retail

Many critics, pointing to local government efforts to recruit retail businesses, have worried about public sector “giveaways” to retailers or developers. Critics also complain that the “fiscalization of land use”—development decisions favoring tax-generating activities—has hampered housing and other non-retail development.

To shed light on this issue, the authors conducted a mail survey of city managers and other top administrative officials in each of the 471 California cities in existence in 1998. The response rate was 70 percent. The survey results provide strong evidence that city governments do favor retail development over other land uses when developing vacant land or pursuing redevelopment. The table below shows how survey respondents rated retail and six other land-use categories on a seven-point scale of desirability. Respondents also indicated that retail projects were the most likely to receive favorable zoning changes or financial incentives (such as a waiver or reduction of development fees). Moreover, they rated the desire for sales tax revenues at the top of a list of motivations guiding development decisions—above such factors as job creation and affordable housing.

## Disparities Among Cities' Sales Tax Revenues

In fiscal year 1995–96, per capita sales tax revenues received by California cities ranged from \$2.25 to \$56,892.

**Desirability Score of Various Land Uses for Development and Redevelopment Projects, as Rated by California City Managers on a Scale of 1 to 7**

	New Development	Redevelopment
Retail	6.2	6.4
Office	5.6	5.6
Mixed use	5.5	5.6
Light industrial	5.5	5.0
Single-family residential	4.9	3.8
Multifamily residential	3.6	3.8
Heavy industrial	3.5	3.3

SOURCE: PPIC City Manager Survey, 1998.

*Retail is the most favored land use for both new development and redevelopment.*

A city's success in gaining these revenues can be partly predicted by certain market characteristics. Cities with higher populations, lower densities, fewer people per household, and freeway access tend to have higher per capita sales tax revenues. Cities devoting more of their land to redevelopment projects also do better. However, the relationships between cities' demographic characteristics and sales tax success are not as straightforward. Cities with very low incomes and higher shares of blacks in their populations are less successful, but so are cities with high population growth rates and very high incomes. In the latter case, these "less successful" cities tend to be very wealthy residential suburbs that eschew commercial development. This shows that although the situs rule does systematically favor some cities, it is not necessarily biased in favor of high-status communities.

### *Fighting over a Finite Resource*

In spite of fierce competition for retail business, the hierarchy among cities in terms of their sales tax success has remained relatively stable. Moreover, the total sales tax revenues of all cities, measured in real dollars per capita, were only marginally higher in 1995–96 than in 1971–72. This lack of growth is explained by the relatively fixed nature of retail spending per capita, the many exemptions that state law provides from sales taxation, and the increasing share of consumer spending going to transactions that are not subject to the sales tax (for example, personal services and catalog sales).

Thus, it appears that cities are competing over a relatively fixed amount of per capita revenue. There is only a certain amount of retail activity that can be supported in a region at any given level of population, and cities will not be able to induce "extra" retail development if the additional retailers cannot hope to make a profit.

It is also questionable whether all of the favor cities give to retail business seriously alters retail location. Retailers generally locate in relation to their customer base, transportation accessibility, suppliers, and competitors; and they are likely to locate in certain types of settings, concessions or not. Thus, it appears that the primary effect of cities' preference for retail is a transfer of resources from local government to retailers, developers, and landowners. Given the favorable attention that cities show to retail, it is also likely that residential and industrial development are somewhat more difficult and expensive to develop than would be the case in the absence of a situs-based sales tax.

### *Rethinking the Problem*

The effects of the sales tax on land-use decisions, along with the vast disparities in sales tax revenues among cities, often lead reformers to urge a change in the situs basis for sales tax distribution. One often suggested approach would be to move toward a population-based system for distributing sales tax revenues. This would have several advantages. First, it would reduce some of the extreme disparities in revenues that exist under the current system. Second, it would create an incentive to increase residential population, making housing development more attractive to local governments. Third, it would mean that cities would have less incentive to "chase" retail development, and transfers from government to retailers and developers would be reduced.

However, the population-based approach has disadvantages as well. First, taking funds away from city governments that have managed through entrepreneurial leadership to gain a sales tax advantage seems to punish them for their success. Second, it would increase the tax revenues in wealthy residential enclaves that shun commercial development. Third, the reform would shortchange some cities with very large retail sectors, which often have greater need for public services. Finally, this approach would remove the one major incentive that California cities now have to pursue growth and development.

One might argue that the way toward more balanced development would be to create a local revenue system that provides incentives for other types of growth—not to simply make retail as disfavored as residential and industrial development. In short, scrapping the situs-based system would not solve the broader incentive problems with California's system of local public finance.

Cities often are particularly unenthusiastic about housing because the relatively small share of the property tax they receive is often insufficient to cover the public service costs of homes and apartments. One approach to this problem would be to adjust local finances to make such development less burdensome. Reallocating a substantially greater share of local property taxes to cities and counties—perhaps in exchange for returning other, narrower revenue bases to the state—is one promising approach to this complex problem.

# *Fiscal Rules and Bond Yields: Do Tax Limits Raise the State's Borrowing Costs?*

In his proposed 1999–2000 budget, Governor Gray Davis underscored the growing importance of infrastructure spending as a public policy issue in California:

As California moves into the 21<sup>st</sup> Century we face the dual problem of preserving the schools, highways, bridges, water systems, and housing of today, while also planning and building new facilities for a growing population. There is no choice: we must maintain our current capital investments—“infrastructure”—and make new investments.

Most of this capital investment, which will cost the state between \$25 billion and \$50 billion over the next decade, will be financed with long-term debt. The borrowing costs on this debt will be an important factor in determining the state's overall fiscal burden.

Borrowing costs differ significantly from state to state. In *Fiscal Rules and State Borrowing Costs: Evidence from California and Other States*, James Poterba and Kim Rueben present new evidence on what determines these interstate differences. Focusing on three key factors—the unemployment rate, state fiscal rules, and unexpected deficits—the authors analyze bond market data over the last two decades to calculate the effects of these variables on borrowing costs, especially in California.

## *The Effect of Unemployment*

The authors find a clear relationship between a state's general economic health, as measured by its unemployment rate, and its borrowing costs. Because lenders expect states with economic troubles to have more difficulty servicing their debt, a 1 percent increase in a state's unemployment rate is associated with an increase of about 0.05 percent, or five basis points, in that state's bond yields. (A basis point is one one-hundredth of 1 percent.) In California, for example, the state's unemployment rate dropped from 9.4 percent

in 1993 to 5.9 percent in 1998. The authors estimate that, as a result of that development, the state's borrowing cost declined by 20 basis points, or \$2 million for every billion dollars of debt issued.

## *Fiscal Rules and Their Effects*

More significant from a policy perspective, perhaps, is the study's second major finding: that state fiscal rules, such as California's Gann amendment and Proposition 218, also play an important role in determining borrowing costs. The authors note that states with strict limits on spending or deficits have faced lower borrowing costs during the last two decades than those with looser fiscal rules. Specifically, states with strict anti-deficit fiscal constitutions pay about nine basis points less than other states to issue new debt interest.

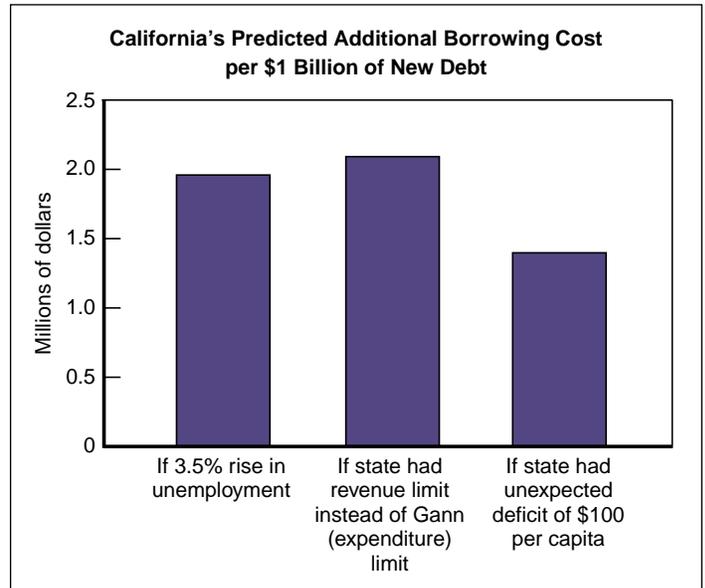
The authors also maintain that the bond market reacts differently to tax restrictions and expenditure limits. States with expenditure limits typically borrow at lower rates, but states with tax restrictions, or those that require supermajorities to increase taxes, face *higher* borrowing costs. The authors conclude that these differences reflect the added difficulty such states may experience when raising revenue to meet debt payments. Controlling for other factors that affect borrowing costs, the authors find that states with tax restrictions pay over 17 basis points more than those without such limits. This premium adds some \$1.75 million dollars of extra interest for every \$1 billion of new debt, or roughly three times the increase associated with a 1 percent rise in unemployment.

Since the passage of Proposition 13 in 1978, a legislative supermajority—in this case, a two-thirds vote in both houses—has been required to enact new taxes in California. Proposition 218, which was adopted in 1996, also provides new mechanisms for voters to restrict local taxes. These

measures put upward pressure on state borrowing costs by increasing the state's credit risk. In contrast, the Gann amendment (Proposition 4) of 1979 limits state and local expenditure growth and does not restrict state revenues; as a result, this measure tends to lower bond yields. The authors estimate that, if California had enacted tax limits rather than expenditure limits in 1979, borrowing costs would have been 20 basis points higher, on average, over the next two decades. In 1997, for example, when California had outstanding state debt of \$43.5 billion, the extra interest would have cost \$90 million.

### *The Cost of Unexpected Deficits*

The study's third major finding concerns unexpected budget deficits and how they affect borrowing costs. Because unexpected deficits make it more difficult for states to service their debt, they are correlated with upward revisions in state bond yields. This effect is particularly pronounced in California, where an unexpected \$100 per capita increase in the state's deficit has historically been associated with an increase of 14 basis points in borrowing costs. Part of this responsiveness can be explained by differences in fiscal rules. Bond yields rise less during periods of financial stress for states with tight anti-deficit rules or restrictive spending rules. Moreover, bond traders seem to be more aware of fiscal changes in states with large amounts of outstanding debt, such as California. This pattern indicates that accurate tax and expenditure forecasts are more important for California than for most other states, which bond analysts follow less closely.



### *Policy Implications*

As California begins a new round of capital investments, it is especially important to understand how the state's fiscal rules affect the overall costs of infrastructure spending. In particular, voters and legislators should recognize the effects of tax limits, expenditure limits, and changes to the state's deficit financing rules on the state's borrowing costs. Because the bond market is especially sensitive to unexpected deficits in California, the state can also minimize these costs by avoiding overly optimistic budget forecasts or by avoiding issuing debt during periods of unexpected deficits.

# *Has School Finance Reform Been Good for California?*

In 1971, California began to reform its system of public school finance. The impetus was *Serrano v. Priest*, a lawsuit brought by the Western Center on Law and Poverty. At that time, California school districts raised most of their revenue by taxing local property. Noting that property tax bases and school spending differed dramatically across school districts, the *Serrano* plaintiffs argued that the state's school finance system violated the equal protection clause of the Fourteenth Amendment. The courts agreed and ordered the state to equalize revenue across districts. Seven years later, California voters passed Proposition 13, which shifted control of the property tax from school districts to the state. Taken together, the *Serrano* decision and Proposition 13 transformed school finance from a locally funded system to one in which the state allocates the bulk of school revenues.

Has this transformation been good for California? In *For Better or For Worse? School Finance Reform in California*, Jon Sonstelie, Eric Brunner, and Kenneth Ardon answer this question by tracing the origins of school finance reform and assessing its chief consequences. Concluding that school finance reform has failed to achieve most of its original goals, the authors ascribe much of this failure to two factors: the reformers' imperfect understanding of the inequities under local finance and the effects of Proposition 13.

## *Serrano and Proposition 13*

The *Serrano* plaintiffs correctly noted large disparities across school districts in per pupil spending. They erred, however, in presuming that these disparities were systematically related to race and income. Although many low-income and minority families lived in low-spending districts, just as many lived in high-spending ones. Thus, reducing revenue inequality at the district level did not help disadvantaged students as a whole.

The effects of Proposition 13 on school finance reform were less direct. Between 1970 and 1997, spending per

pupil in California fell more than 15 percent relative to spending in the rest of the country. Some observers explain this decline by pointing to the growing ethnic gaps between the state's voters and its students. The authors suggest another cause, one that is linked to Proposition 13 and the shift from local to state finance. The local system relied on the property tax, about half of which was levied on commercial, industrial, and agricultural property. As a result, taxes on nonresidential property subsidized local homeowners and renters. By redirecting all property tax revenue to the state, Proposition 13 ended that subsidy and increased the cost of school services to homeowners and renters. This cost increase led to a relative decline in per pupil spending. In the aftermath of Proposition 13, the state distributed revenue more equitably across school districts, but it did so more by leveling down high-spending districts than by raising low-spending ones.

Forced to economize, school districts chose not to cut their teachers' salaries, thereby raising concerns that the teachers' unions in California were too powerful. After comparing these salaries to those in other states and to nonteaching salaries in California, the authors conclude that school districts responded more to market forces than to union power and that salary cuts would have seriously jeopardized their ability to attract and retain competent teachers. Rather than cut salaries, districts hired fewer teachers, which led to a dramatic increase in the state's pupil-teacher ratio. In 1997, that ratio was 38 percent higher than the average for other states.

## *Effects on Student Performance*

In the 1970s and early 1980s, California's students performed as well as students in the rest of the country on standardized tests. Since that time, however, they have performed worse. Several reasons have been offered for this poor performance, including the high pupil-teacher ratio in California and the large percentage of students whose native

language is not English. After analyzing data on the backgrounds of students, however, the authors conclude that demographic differences account for only some of the performance gap between California's students and those in other states. Although the authors note that this poorer performance cannot necessarily be blamed on the switch to state finance, they maintain that the timing of the drop is suggestive.

### The Reactions of Parents

Families have responded in various ways to the perceived decline in public school quality. Some have enrolled their children in private schools; others have donated time and money to public schools. The authors found that both reactions have been modest and mostly confined to high-income families. While private school enrollment rates rose from 14 to 21 percent among families in the top 10 percent of the income distribution, there were no increases at all among families in the bottom 60 percent of that distribution. Likewise, a few public schools in wealthy areas received more than \$500 per student in voluntary contributions, but 90 percent of California's students attended schools in which such contributions amounted to less than \$100 per pupil.

Families also respond to public school quality through their housing choices. If district quality had been equalized under state finance, homebuyers would not continue to pay large premiums for houses in desirable school districts. Yet the authors found a wide range of premiums across school districts in the two counties they studied. These disparities indicate that parents continue to perceive large differences in quality across school districts in those areas.

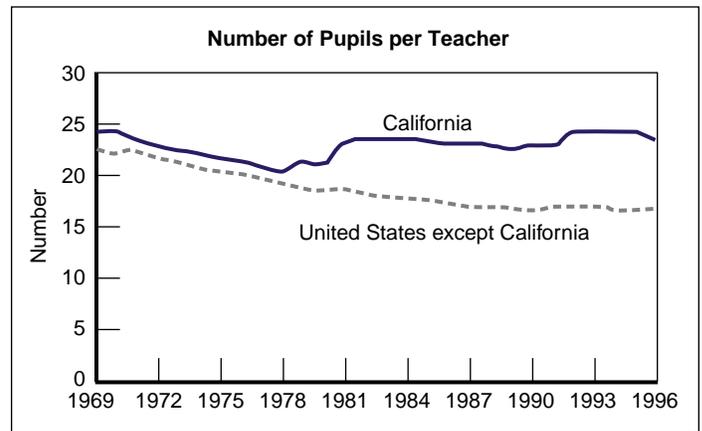
### Policy Implications

Despite the poor outcomes associated with the shift to state finance, the authors note that it may be too early to judge school finance reform negatively. California has changed the way it finances its schools without changing the way it governs them. School boards continue to govern districts, but the state controls how funds are allocated. The authors outline two basic options for coordinating school governance and financing: shifting governance to the state level and devising a system of local finance consistent with the *Serrano* ruling.

One way to implement state governance is to eliminate school districts altogether. Such a system would replace legislative rulemaking with bureaucratic control, making it easier to allocate state resources according to need. This arrangement would also make it easier to hold teachers, principals, and schools accountable to state guidelines. Charter schools are another possibility. Authorized in 1992, charter schools operate according to their own goals and procedures, are exempt from most state regulations, and are entitled to block grants equal to what they would receive from a typical school district. As these schools proliferate, however, the state may come under increasing pressure to regulate them, again raising the question of whether schools can be truly autonomous without controlling their own revenue sources.

If local control is preferable to state governance, school districts could be allowed to raise their own revenue. According to the authors, this option would be compatible with the *Serrano* decision if differences in property wealth were effectively neutralized. For example, the state could distribute its aid so that similar tax rates would produce the same revenue per pupil, regardless of the district's tax base. To implement such a plan, however, voters would have to repeal tax restrictions imposed by Proposition 13.

Significant reform in either direction will not be accomplished easily. Until such reform is undertaken, however, California may have difficulty reversing the current pattern of low spending, large classes, and poor student performance compared to other states.



*Beginning in the late 1970s, the pupil-teacher ratio in California rose 30 percent compared to the ratio in the rest of the United States. The increase coincided with the passage of Proposition 13 and the shift from local to state finance.*

## *Counties and Their Condundrum*



# *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*

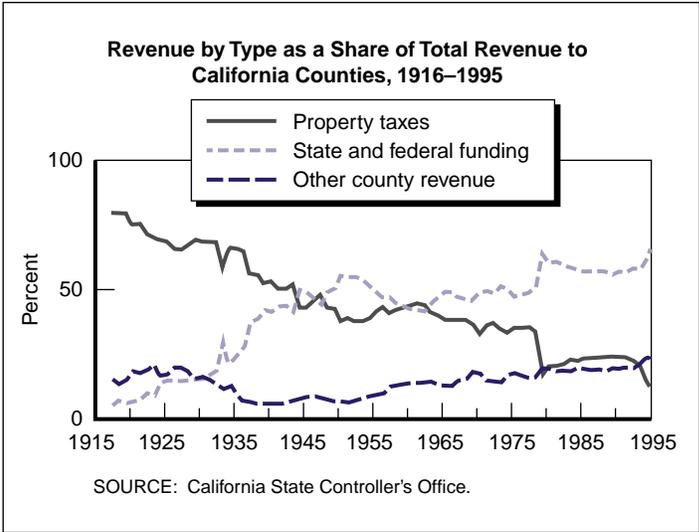
These and other conflicts between state and local government have generated many reform proposals, most of which focus on two areas: the need to redefine the responsibilities of local governments and the need to restore their fiscal authority. Sorting out state and local responsibilities is especially 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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*Sorting out state and local responsibilities is especially important for county governments, whose traditional duties currently outstrip their resources.*

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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.

# *The Orange County Bankruptcy: Who's Next?*

On December 6, 1994, Orange County became the largest municipality in U.S. history to declare bankruptcy: The county treasurer had lost \$1.7 billion of taxpayers' money through investments in risky Wall Street securities. Accustomed to the "New York" model of fiscal stress in older cities with an eroding tax base, the political and financial communities were shocked. Here was a large, growing suburban area, with a reputation for affluence and conservatism, amassing a huge public debt through highly risky speculation in the financial markets and then refusing to honor its debts. Shocked as they were, most observers wrote this off as a fluke, caused by an underqualified county treasurer in a stranger-than-usual California county. It may have been a nasty surprise for Wall Street, they claimed, but not something that could happen again—even in Orange County.

In *When Government Fails: The Orange County Bankruptcy*, PPIC Senior Fellow Mark Baldassare presents compelling evidence to the contrary. In this book, jointly published by PPIC and the University of California Press, Baldassare provides the first comprehensive account of the events that led to the bankruptcy, how the bankruptcy unfolded, and how it was resolved. Orange County may have provided sufficiently dramatic warning of the dangers of Treasurer Bob Citron's kind of investment strategy to deter others from following the same path. However, as Baldassare demonstrates, the conditions and resulting imperatives that drove the county to gamble with public funds remain. As the fervor for smaller government, tax limits, and local autonomy grows and spreads, many more municipalities may find the specter of financial collapse looming—especially when the economy takes its next downturn.

## *The Trail Between Proposition 13 and the Bankruptcy*

The immediate cause of the bankruptcy was Citron's mismanagement of the Orange County investment pool. However, he would not have been driven to strive for such high rates of return on the pool—nor would he have been

able to invest as he did—had it not been for the fiscal austerity in the state that began with Proposition 13. That citizen initiative, and several subsequent initiatives, severely limited the ability of local governments to raise tax revenue. Recognizing the extreme fiscal pressure these initiatives placed on county governments, the state loosened its municipal investment rules—allowing treasurers, for the first time, to use Bob Citron's kind of strategy.

In 1994, the Orange County investment pool had about \$7.6 billion in deposits from the county government and almost 200 local public agencies (cities, school districts, and special districts). Borrowing \$2 for every \$1 on deposit, Citron increased the size of the investment pool to \$20.6 billion. In essence, as the *Wall Street Journal* noted, he was "borrowing short to go long" and investing the dollars in exotic securities whose yields were inversely related to interest rates. Unfortunately, also in 1994, the Federal Reserve Board began and kept on raising interest rates, and Citron kept buying in the hope they would decline. For reasons that Baldassare explains in detail, almost no one was paying attention to what the treasurer was doing and even fewer understood it—until the auditors informed the Board of Supervisors, in November 1994, that he had lost nearly \$1.7 billion.

## *The Enabling Conditions*

How did it happen? Why wasn't anyone watching or questioning the treasurer's activities? Was it just a fluke? Are the county's lawsuits against various Wall Street firms and institutions justified? Could it happen again?

Many people believe that the treasurer and his dealings with Wall Street constitute the necessary and sufficient conditions for what happened and that, absent a Bob Citron, it couldn't happen in their backyards. However, Baldassare's definitive reconstruction and analysis of the situation, events, and outcomes counter that belief. He identifies three key factors in the Orange County context and in the state that

created the necessary conditions for the bankruptcy and the nature of the recovery. Citron was not the cause of the bankruptcy; he was the catalyst that made those three necessary conditions sufficient.

What makes the Orange County bankruptcy significant beyond the borders of the county is that these conditions exist, to a greater or lesser degree, in counties across the state and nation. Baldassare identifies these conditions as *political fragmentation, voter distrust, and fiscal austerity*. The book traces how these three conditions operated before, during, and after the bankruptcy. It also suggests how they continue to jeopardize Orange County's future—even as the California economy has rebounded and the county itself is experiencing unprecedented growth and voter optimism.

### *Lessons Learned*

Having made a compelling case for the potential threat to local governments inherent in these conditions, the book goes on to present 10 policy recommendations that may help prevent, or at least ameliorate, future county crises. Four of the more pressing reforms point to a basic restructuring of government.

*Local governments need to maintain high standards for fiscal oversight and accountability.* As noted in the state auditor's report following the bankruptcy, a number of steps should be taken to ensure that local funds are kept safe and liquid. These include having the Board of Supervisors approve the county's investment fund policies, appointing an independent advisory committee to oversee investment decisions, requiring more frequent and detailed investment reports from the county treasurer, and establishing stricter rules for selecting brokers and investment advisors. Local officials should adjust government structures to make sure they have the proper financial controls in place at all times.

*The State of California should revise the law governing the structure of its counties.* The bankruptcy pointed out an important deficiency in the large counties that operate under general law. They lack strong leadership, and this can hurt their efforts to cope with emergencies. Suburban metropolitan regions would be better served if they had a mayor elected countywide and highly visible to the people. Their government structure would also be improved by having a chief executive officer with authority over the budget and personnel in all county departments.

*State government should closely monitor the fiscal conditions of its local governments, rather than wait for serious problems to surface.* The state controller collects budget data from county governments and presents them in an annual report. These data should be systematically analyzed to determine which counties show abnormal patterns of revenues or expenditures or signs of fiscal distress. State leaders should discuss fiscal problems and solutions with local officials before the situation reaches crisis stage.

*Local officials should be wary about citizens' pressures to implement fiscal policies that are popular in the short run but financially disastrous over time.* Distrustful voters believe there is considerable waste in government bureaucracy and that municipalities should be able to cut taxes without doing harm to local services. Local officials need to do a better job of educating voters about revenues and expenditures. State government should also note that there are no checks and balances against citizen initiatives that can have disastrous effects on county services. Perhaps legislative review and gubernatorial approval should be required for voter-approved initiatives on taxes and spending.

### *State and Local Government Relations Must Change*

Implicit in the above recommendations is the need to reform state and local government relations. County governments are charged with the task of providing many crucial local services. Yet Proposition 13 and its progeny have severely limited their ability to raise revenues to provide these services. The counties' ability to cope (and to some extent that of other local governments) is likely to be further eroded as the federal government devolves more responsibility for programs like welfare to the state—and the state to the counties. In both cases, the funds passed on with the responsibility are likely to be inadequate. State and local fiscal reform can provide greater certainty about who will pay for services and how they will be delivered to the public in the most efficient and effective manner. The Orange County bankruptcy, Baldassare notes, should have served as a wake-up call. Yet, there has been no meaningful restructuring in state and local government relations, and the potential for another county fiscal disaster remains very real.

# *The Fiscal and Organizational Challenges of Providing Public Services in Los Angeles County*

Los Angeles County serves more people than any other county in the nation. It includes almost ten million residents—nearly 30 percent of the state’s population—and is expected to grow by another two million people over the next 20 years. Government officials in the county—as well as throughout the state—have argued that citizens’ initiatives and legislative actions have severely constrained their ability to raise the revenues needed to meet the large and growing demand for public services. To determine the scope of the problem, four PPIC researchers conducted in-depth interviews with local government officials and community leaders and also did an extensive program-based analysis of the county’s finances. In *Risky Business: Providing Local Public Services in Los Angeles County*, Mark Baldassare, Michael Shires, Christopher Hoene, and Aaron Koffman identify the fiscal and organizational strains involved in providing county services; describe the system for financing services at different jurisdictional levels; and suggest alternative fiscal and organizational arrangements for service provision.

## *Perceived Fiscal Strains*

The county government has little control over its revenues and expenditures. In fulfilling the service needs of residents, the county has become increasingly dependent on state and federal money, which usually comes with mandates on how the money is to be spent.

Although the federal, state, and county governments are partners in providing local services, uncertainty about state and federal funding and mandates has created tensions among the various levels of government.

Health care is a chronic and unsolved problem in Los Angeles County. There was a general consensus among those interviewed that providing health care to the county’s large, uninsured population is the most worrisome issue for county government. There was also a consensus that county government does not know how to solve the problem. The paucity of local revenue sources may be leading to develop-

ment decisions that favor commercial growth and local sales tax dollars over housing and economic needs.

Fiscal uncertainties make long-term planning difficult. It is widely believed that county government will find itself in trouble when the economy enters the next downturn. However, the uncertain fiscal environment makes it difficult to plan for this eventuality.

## *Perceived Organizational Stresses*

Local government in Los Angeles County includes the county government (84,000 employees in 37 departments), 88 cities, and over 200 special districts. The result is a multilevel bureaucracy that is difficult for the public to understand and access.

The connections between state revenues and local expenditures are complex, generating public uncertainty about what tax monies go to what services and confusion about which branch of government is responsible for delivering various public services.

Contract cities (i.e., cities that provide public services through contract with the county) are controversial. Some believe that the county should not be in the business of selling local services to cities. Others argue that contract city arrangements have reduced administrative overhead and service redundancies in the region.

There is a widespread recognition that county government should work more closely with cities and other local governments, the private sector, and nonprofits in providing local services.

## *The Fiscal Analysis*

The researchers’ analysis of the county’s finances provided empirical evidence of the fiscal and organizational challenges mentioned in the interviews.

Only a small share of the county's revenues are discretionary, thus limiting the government's ability to respond to local preferences and needs. The county role as an agent of the state and federal governments dominates its activities. Maintenance of effort requirements (i.e., requiring the county to maintain a minimum level of service provision) and matching fund requirements (i.e., mandating that the county complement, by a certain percentage, the funds it receives) are good examples of how the policy choices of the state and federal governments constrain the county's ability to customize programs to better suit local needs.

Services the county provides as an agent of the state and federal government often cost more than the county receives. In fiscal year 1997–98, for example, the expenditures for health care services that the county provided in its agency role exceeded the intergovernmental revenues it received for these purposes by some \$211 million.

The absence of a portfolio of local, discretionary revenues makes county finances more vulnerable to economic shocks than other local governments' finances. The majority of the county's discretionary funds come from the property tax. Thus, the county budget is particularly susceptible to changes that unduly affect this revenue stream, such as downturns in the real estate market and state policy interventions.

Although opponents of the contract city model argue that residents countywide are subsidizing the overhead costs of providing local services through the county, the fiscal analysis indicated that this is either not the case or that there are sufficient other factors—including economies of scale—that justify the contracting of services.

### *Fiscal and Organizational Alternatives*

There is general consensus about what the Los Angeles County government needs to do to get ready for the growth and change that will occur in the 21st century. Four particular goals emerged from the interviews and were validated by analysis of the revenue and expenditure data. The researchers endorse the goals and their importance. However, they do not endorse any of the specific suggestions mentioned in the interviews (and listed below) for arriving at these goals. Rather, they acknowledge that approaches for reaching the goals must depend on the development of a

consensus among state and local government officials, civic leaders, and residents.

**1. More Fiscal Control.** Suggestions from the interviews for increasing fiscal control included giving more property tax revenues to county and local governments, returning control of the property tax to local governments, earmarking a portion of the state income tax for county government, distributing sales tax revenues on a per capita basis, changing from a two-thirds majority vote requirement to a simple majority for approval of tax measures, and reducing minimum-service-level requirements placed on the county by state government.

**2. Expanded Partnerships.** Suggestions included increasing contract relationships with cities and the private sector—especially for providing health care services—and establishing a forum for interaction on service issues between the county, other local governments, and the private sector.

**3. Greater Responsiveness.** Suggestions included increasing the number of county supervisors, electing a county mayor or chief executive officer, making the budget process more understandable to noncounty officials, improving public relations, particularly with the Latino media, increasing the use of the Internet for information and services, and monitoring citizen satisfaction through public opinion surveys.

**4. Increased Regional Focus.** Suggestions included eliminating the county's role as a municipal service provider to unincorporated areas by encouraging annexation or incorporation of these areas, creating a municipal services district for funding and delivering services specifically for these areas, and distributing sales tax revenues on a per capita basis to make these areas more able to finance their own service provision. Other suggestions included expanding the number of locally based county offices to increase the county's presence in the region, prioritizing housing needs, providing a forum for interjurisdictional cooperation, and eliminating the county's involvement with dependent districts.

It became clear in the interviews that there is an abundance of well-considered ideas among civic and government leaders. The next task is for the state and local governments to have a serious dialogue about how to improve the county's ability to finance and provide public services.

*The Initiative and the Public Interest*

# The Changing Social and Political Landscape of California

California in the mid-21st century is going to be a very different state from the California of today. There is every reason to expect that the state's population—currently about 34 million—will exceed 50 million in the next 30 years or so. The proportion of Californians who are white will steadily decline, while Latinos become the dominant racial and ethnic group. Uneven growth will shift the regional balance of the state away from Los Angeles and the San Francisco Bay area toward the Central Valley and Southern California's mega-suburbs. Yet, as California enters an era when it will face some of the toughest challenges in its 150 years of statehood, most of its people have become highly cynical about their elected leaders and many have disengaged themselves from the political process, making public consensus on critical issues more difficult.

In *California in the New Millennium: The Changing Social and Political Landscape*, Mark Baldassare examines three of the most powerful undercurrents altering the character of California—the public's strong and increasing distrust of politicians and the legislative process, the rapidly changing racial and ethnic mix of the state's population, and the growing diversity across its major regions. It is likely that these powerful trends will continue to affect California's politics and public policies for many decades to come.

To gather data for his analysis, Baldassare assembled 12 focus groups and conducted five large statewide public opinion surveys. Participants in the focus groups, which took place throughout the state, were specifically chosen to reflect the regional, racial and ethnic, and political diversity of California. The surveys—conducted during the 1998 California election cycle—interviewed more than 10,000 California residents about their election choices, their policy preferences, and their political, social, and economic opinions.

## Political Distrust

The focus group and survey responses clearly indicate that most Californians are disillusioned with their elected

### Californians on Political Distrust

"Do you know why fewer people vote? They feel that everything is out of their control, that they have no say—so why bother?"

— Orange County resident

"I don't have any confidence in a politician. The only thing politicians think about from the day they get elected is getting reelected."

— San Diego resident

### Californians on Racial and Ethnic Change

"The demographics are changing to the point that there's not going to be any one group as a majority or a minority."

— Sacramento resident

"No matter where you are, there's that racial tension."

— Fresno resident

### Californians on Regional Diversity

"If they took the State of California and cut it in half, maybe two states would be easier to govern than one."

— Los Angeles resident

"The problems in California are so different—they should just go to San Luis Obispo and draw a line straight through to Fresno and separate the state."

— San Francisco resident

Source: Focus group sessions, 1998.

officials. They believe that their governments are bloated bureaucracies unable to solve problems, spend taxpayers' money efficiently, or represent the interests and policy preferences of average voters.

The voters have signaled their disdain for political parties and elected representatives in many ways. They have created an open primary process that allows people to vote for any state candidate they choose (regardless of the candidate's party), enacted term limits, chosen—in growing numbers—to register as independents, and relied on a wide array of citizens' initiatives to create new and far-reaching state policies. Indeed, the voters have taken considerable power away from established political institutions—just at a time when California is facing increasingly complex and troublesome policy issues.

This movement away from representative democracy toward direct democracy is not without its perils. Although the survey responses show that voters believe initiatives are better able than elected officials to solve important problems, the surveys also show that voters often find ballot initiatives complicated, confusing, and prone to reflect special interests rather than the concerns of average residents. This has introduced an element of unpredictability into policymaking, because voters often devote only limited attention to very complicated issues and frequently depend on information that comes from biased sources.

### *Racial and Ethnic Change*

Record levels of immigration for more than two decades have transformed California from a state where a vast majority were white to a multiracial society with a large and growing Latino population. The racial and ethnic change under way is having profound effects on the ability to reach consensus on crucial state issues. Divisions over racial and immigration policies have already surfaced in initiatives—Propositions 187 (denying social services to illegal immigrants), 209 (eliminating public affirmative action programs), and 227 (dismantling bilingual education)—creating social tension and conflicts. Another troubling issue is the political nonengagement of the fastest growing and soon-to-be largest ethnic group in California. The low level of political interest and the limited interest in following government affairs revealed in the surveys seriously limit Latinos' chances of shaping the outcome of elections.

### *Regional Diversity*

The vast and different geographies of California have made it difficult for Californians to develop a sense of oneness. As typified by the political battles of the various regions over water, politicians and the public alike have a history of staking out internal competitions and losing track of their common interests. The ongoing regional population changes add further complications, shaping how the political power in the future will be shared among the various regions. Los Angeles and the San Francisco Bay area are the traditional political and economic powerhouses, but the Central Valley is now the fastest growing region in the state. The other rapidly growing and changing region consists of the mega-suburbs of Orange County and the Inland Empire (Riverside and San Bernardino Counties). These regions all

differ dramatically in their populations, economy, geography, politics, and public concerns. The policy challenges facing each often have little in common, and the lack of political consensus by elected officials representing these major regions impedes public dialogue at a time when there is a great need to reach a statewide consensus on social, environmental, land use, and infrastructure issues.

### *The Future of the Golden State*

In his concluding chapter, Baldassare arrays the problems that Californians are likely to struggle with during the early decades of the new millennium. He also presents a number of policy recommendations and discusses how they can help reduce some of the public's distrust of government and prepare for the racial and ethnic transformation and increasing regional diversity that lie ahead.

For example, one key to a successful future for California is to have both an informed and an involved citizenry. Today, California has neither. Baldassare argues that public, private, and nonprofit groups throughout the state must stimulate civic dialogue and public engagement to help prepare for the tremendous growth and change expected during the next 30 years. These public policy discussions need to deal with people's real concerns about their everyday lives. The topics of sprawl, traffic, housing, and schools need to be connected with state and local governance issues. Government, business, and nonprofit groups must also give high priority to improving race relations. Politicians will have to recognize the importance of representation by different ethnic and racial groups. If racial and ethnic groups do not feel they have the representation they need, then political alienation and distrust of government will reach new heights in the 21st century. This could have repercussions beyond politics, because the social and economic well-being of the state will depend on the success of the ongoing multiethnic experiment in California.

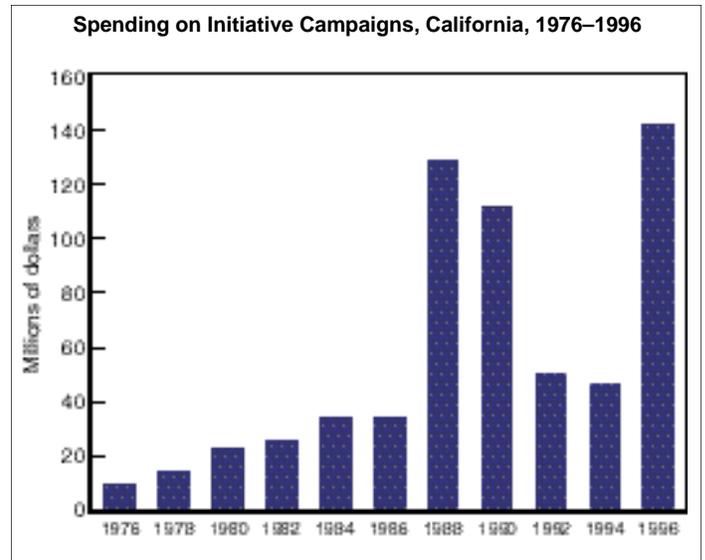
Baldassare sees California at a critical juncture today, with its social and political landscape changing at the same time that a rapidly growing population is beginning to put incredible pressure on the state's resources, challenging elected officials to respond. How successful California will be in meeting its future is far from certain, but we are at a crucial point in time, Baldassare says, "when thoughtful, tough-minded planning and careful preparation can make a difference."

# How Interest Groups Use the Initiative Process in California

Progressive Era reformers designed the initiative process around the turn of the century to circumvent the power of wealthy economic interests in the state legislature. Today, many observers argue that the initiative process has been captured, paradoxically, by those very sorts of special interests. Elisabeth R. Gerber, however, provides compelling evidence to the contrary in *Interest Group Influence in the California Initiative Process*. Her analysis indicates that economic groups do not have the unbridled influence commonly claimed by critics of this form of legislation. Economic groups are generally unable to enlist the sympathy of a sufficiently large number of people to pass new laws through the ballot box. In fact, vast sums of money poured into a campaign by special interest groups, such as the insurance or tobacco industries, may be self-defeating, suggesting to voters that the proposed legislation is unlikely to be in their own best interest. Hence, economic groups' use of the initiative process is largely limited to blocking measures or to signaling their preferences to the state legislature. In contrast, citizen groups, which often deal with social issues that involve strong emotional appeal and which rely on a coalition of support from many diverse interests, have a relatively easier time passing ballot measures.

## Why There Is Concern

Perhaps the most dramatic change in the California political system over the past two decades has been the increasing use of the initiative process. Between 1976 and 1996, Californians voted on 106 statewide ballot initiatives. By comparison, in the preceding two decades, from 1954 to 1974, only 29 initiatives were placed on the ballot. The growth in the number of initiatives has been matched by a similar growth in spending on initiative campaigns, which peaked at an all-time high of \$140 million in 1996, as shown in the figure. Although concern about the influence of money in politics is not new, several factors make spending on initiatives seem more worrisome. First, contributions to



*The large sums of money spent on initiative campaigns have raised the question of whether economic interests are able to "buy" favorable initiative legislation.*

and spending by initiative campaigns are constitutionally unlimited. Second, most initiatives deal with new and complex issues, which voters may not well understand. Thus, voters may rely heavily on information provided by interest groups during the campaign. Third, a large majority of the money spent in initiative campaigns comes from special interest groups whose motivations and preferences are often at odds with broad-based citizen interests.

## Differences in Spending by Economic Groups and Citizen Groups

To analyze differences between economic groups and citizen groups in both behavior and outcomes, the author examined all contributions over \$250 to support or oppose California statewide ballot measures between 1988 and 1990. This included tens of thousands of contributions targeted at 31 initiatives in four elections.

*Spending Patterns.* Economic interests generally spend to preserve the status quo, whereas citizen interests spend to promote change. As Table 1 shows, economic interests spent over 78 percent of their \$99 million in contributions to defeat ballot measures and thereby preserve the existing environment. In contrast, citizen interests spent overwhelmingly to support the passage of initiative measures, with 88 percent of their \$33 million in contributions supporting proposed changes in the status quo.

**Table 1—Spending For and Against Initiatives**

Contributor Type	Total Amount	% For	% Against
Economic	\$98,680,452	22	78
Citizen	\$33,483,959	88	12

*Initiative Passage Rates.* Economic interests not only devote few resources to support initiatives but also have low success rates in passing those they do support. Whereas citizen groups are able to pass 60 percent of the initiatives they support, economic groups are able to pass only 22 percent.

*Initiative Failure Rates.* Economic and citizen interests are both moderately successful in defeating initiatives. Fifty-eight percent of the measures opposed by economic groups fail to pass, compared to 59 percent of the measures opposed by citizen groups.

These statistics reflect the overall success rates of economic and citizen interest groups in passing and defeating initiatives. However, the initiative process is not dichotomous, with citizens always on one side of an issue and economic groups on the other. Hence, it is useful to also examine how initiatives fare when the various combinations of contributors are taken into account.

The first column of Table 2 shows that measures supported by some citizen groups and opposed by others passed 43 percent of the time. Propositions supported by citizen groups and opposed by economic groups passed at an even higher rate, 64 percent. The second column of the table reports passage rates of measures that received greater support from economic groups. When opposed by citizen groups, these measures passed 29 percent of the time. When economic measures were opposed by other economic groups, they passed only 20 percent of the time. These results reflect the tough sledding economic groups in California face, even in preserving the status quo.

**Table 2—Percentage of Initiatives Passing by Group Support and Opposition**

	Citizen Support	Economic Support
Citizen opposition	43	29
Economic opposition	64	20

## Conclusions and Policy Discussion

Despite their vast monetary resources, economic interests are severely constrained in their ability to pass new laws through the initiative process. They use the process most often and most effectively to fight ballot propositions they oppose. However, interest groups (whether citizen groups or economic groups) may also use the initiative process to influence policy in more indirect ways. For example, they may use the process to signal to policymakers their preferences on certain issues. Thus, the initiative process provides economic groups with an additional tool for augmenting their already substantial influence in the legislative process.

The study's findings have several implications for political reform. They suggest that those who are concerned about the role of money in the initiative process should worry less about trying to limit the amount of money that special interest groups spend and focus instead on (1) empowering citizen interests in the face of economic group opposition and (2) limiting the power of economic interests in the *legislative* process.

One reform that would empower citizen interests is the indirect initiative. In this political process, a citizen group faced with an adverse initiative proposed by economic interests could simply petition the state legislature to consider an alternative measure. If the legislature passes the measure, it becomes law; otherwise, it is placed on the ballot and treated as a direct initiative, subject to campaign opposition.

Reforms that would limit the power of economic interests in the legislative process include allowing some public financing of candidate campaigns or changing campaign finance laws to increase the role of party funding in state legislative campaigns. Both of these reforms would reduce the reliance of state legislative candidates on the monetary resources offered by economic interest groups and potentially decrease their influence over legislators' behavior.

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