

***Growth Challenges and
Local Government Finance:
A Primer for the Sacramento Valley***

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1. Introduction¹

The purpose of this paper is to provide a primer on the relationship between community growth and development and the fiscal pressures faced by cities and counties in delivering local services. In recent decades, local revenue from the sales tax has become a larger share of cities' discretionary revenue. Hence, there has been pressure to maximize the retail sales tax base in the community as a way to provide a growing resource for financing local services that citizens want in order to maintain their quality of life. We review issues of urban growth and local public finance and lay out several approaches to the issue, in the hope that this document will assist in the dialogue as the cities and counties of the Sacramento Valley region consider the challenges involved.

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2. Growth—A Fact of Life in California and the Sacramento Region

- **Moderate to rapid development seems virtually inevitable in California.** In recent decades, the state has been adding about 5 million new residents per decade. Since no one expects growth to stop—and since U.S. constitutional law guarantees Americans the right to migrate across state boundaries—many Californians are looking for new ways to manage growth in order to reduce its negative consequences and take advantage of its benefits.
- Between the 1990 and 2000 Censuses, the **six-county Sacramento region added 332,261 residents, increasing its population at a rate of 20.7 percent.** Although the sheer amount of population growth was highest in Sacramento County (182,280), the **rate of growth was fastest in Placer County (43.8%).**
- Throughout much of California, **housing production has fallen behind the rate of population increase**, a factor that contributes to high purchase prices and rents. The state Department of Housing and Community Development reports that statewide housing production between 1995 and 1997 trailed demand by 145,000 units. “If these trends continue, California will build less than 60 percent of the new housing units needed to accommodate projected 1997-2020 population and household growth.”²
- In addition to housing affordability, another major regional challenge is **competition and occasional animosity between local jurisdictions** over certain lucrative types of new development. Prime among these are shopping centers, “big box” stores, and auto dealerships.

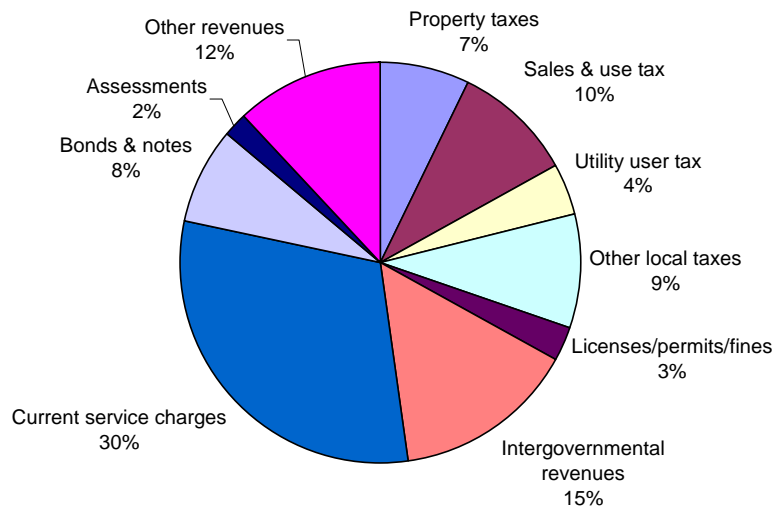
² Department of Housing and Community Development, *Raising the Roof: California Housing Development Projections and Constraints, 1997-2020*, 2000, p. 3.

3. Growth and Local Public Finance: What Do Taxes Have to Do with It?

- Local governments bear most of the burden of servicing and providing infrastructure for new growth. They feel pressure to retain and improve their existing levels of services. Cities and counties also bear much of the burden of generating their own revenues to fund these services.
- As the chart below shows (using fiscal year 1997-98 data), cities in the Sacramento region rely on numerous revenue sources.³ However, **by law, most of this total is restricted to specific purposes.** For example, current service charges (such as water or garbage charges) are used to fund those particular services. This means that local taxes (property, sales and use, utility user, and some of “other local taxes”) comprise the bulk of “general revenues.” Such funds are valued highly, because they may be used at the discretion of the local government for local priorities or new programs.
- In many states, the **property tax** is the largest source of local general revenues. This reliance on the property tax gives local governments in such states an incentive to host **high-value properties** within their boundaries—for example, office buildings, industry, or luxury homes.

³ Source: Calculated from California State Controller, *Cities Annual Report, 1997-98*. We thank Hugh Louch of PPIC for preparing the Sacramento-region data.

Revenue Sources for Cities in the Six-County Sacramento Region, 1997-98



- But the property tax plays much less of a role in funding city governments in California. There are two main reasons for this:
 - As part of California’s famous “tax revolt,” **Proposition 13 (1978) limited property tax rates to 1 percent** of assessed valuations, and limited assessment increases to 2 percent annually, until the property is sold. Proposition 13 also took away the authority for cities and counties to set their own property tax rates, **giving the state the authority to determine how the tax on any given property should be apportioned** to the city, county, school district, and other entities (such as fire districts) serving that property.
 - In the early 1990s, during California’s budget crisis, a state law was passed creating an Educational Revenue Augmentation Fund (ERAF) in each county. This was a mechanism to **shift property tax revenues away from cities and counties toward school districts**—so that the state government could reduce its burden for funding public schools. Though intended as an emergency measure, ERAF has never been reversed, although the state has provided some smaller new funding sources to cities and counties for *specific* purposes, such as public safety.
- By contrast, in California the local sales tax—along with fees and charges—plays an unusually large role in financing local governments.

The **local portion of the sales tax is awarded on a “situs” basis**—that is, to the jurisdiction in which the sale occurs. It is highlighted in the table below:

| Components of California's Overall Sales Tax Rate | |
|---|---|
| <u>Rate (%)</u> | <u>Purpose</u> |
| 5.75 | State sales tax rate , consisting of: |
| 4.75 | State general fund (will revert to 5% next year) |
| 0.50 | Local Revenue Fund: to counties for health and welfare responsibilities |
| 0.50 | Public Safety Fund: to counties, some cities |
| 1.25 | Local sales tax rate , consisting of: |
| 1.00 | Local sales tax: to general fund of jurisdiction where sale occurs |
| 0.25 | Transportation tax: to county where sale occurs |
| Up to 1.25 | Voter-approved rate for local special taxes (optional) |
| 7.00 to 8.25 | Total rate |

- **City and county officials complain that few sources of local revenue are actually subject to local control.** Of the items that *are* in local control:
 - **Impact fees on new construction tend to raise the costs of housing**, in some cases substantially. A PPIC study of new home transactions in Contra Costa County indicated that the costs of a new home were frequently increased by \$20,000 to \$30,000 due to such fees.⁴
 - Sales tax revenues are subject to some local control because they are collected on a situs basis, and local land-use decisions may influence retail development within local boundaries. **A dependence on sales taxes creates an incentive for local governments to host retail development**, since each dollar of local sales generates a penny of local sales tax revenue.

⁴ Marla Dresch and Steven M, Sheffrin, *Who Pays for Development Fees and Exactions?* Public Policy Institute of California, 1997.

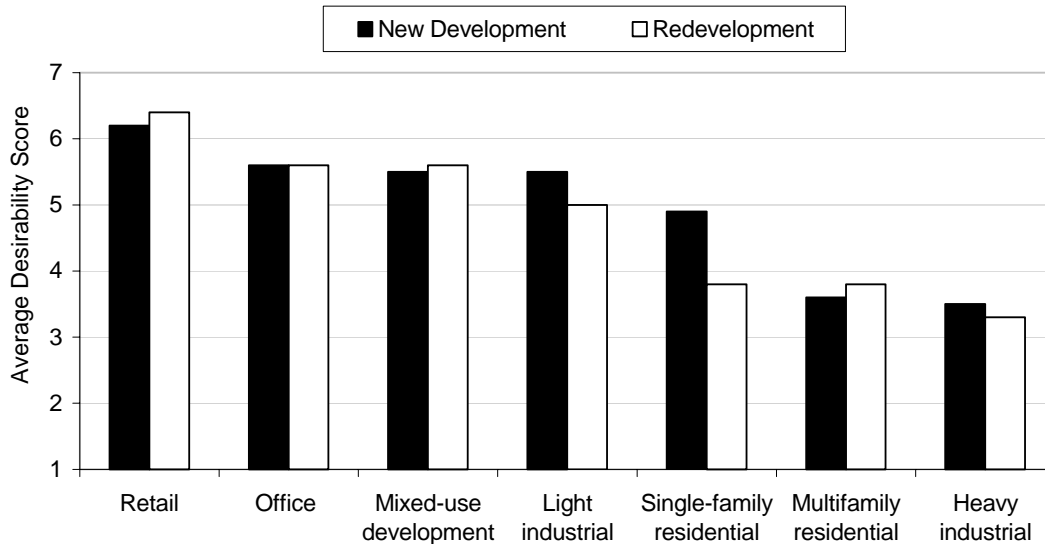
4. How These Factors Affect the Region's Landscape

- Many observers complain that local government land-use decisions in California have become increasingly “**fiscalized.**” In other words, development decisions are made with the prime consideration being the effects on the local treasury, rather than what makes good planning sense for the community and the region. (In fairness, this accusation is made about growth decisions in many other states as well.)
- In PPIC’s mail survey of 330 city managers in California in 1998, **retail development was seen as the most desirable type of land use** for the respondents’ cities.⁵ This was true both for new development on vacant land, and in city redevelopment areas (see the figure on p. 10). Overall, responses from cities in the Sacramento region were similar to the statewide average.
- Retail land uses are seen as most desirable despite the fact that retail typically is “locally serving” rather than “export oriented”—meaning that its effects on the economic development of the area (new jobs, new wealth) are limited.⁶
- Similarly, the **ability of new development projects to generate sales tax revenues was rated most important**, among 18 possible considerations, in affecting cities’ strategies for attracting growth and responding to developer proposals. Such goals as creating jobs, contributing to the regional economy, meeting affordable housing needs, or preserving agricultural land rated significantly lower in importance, according to the survey respondents.

⁵ The survey question read as follows: “Given your city’s overall strategies and plans for land use and future development, how desirable to your city administration would each of these types of new development be? In other words, how sought-after are these types of development in your city, in general? Please rank each of the following. Circle a number between 1, which is ‘very undesirable,’ and 7, which is ‘very desirable.’” An analogous question asked about the city administration’s strategies and plans for redevelopment areas.

⁶ Paul G. Lewis and Elisa Barbour, *California Cities and the Local Sales Tax*, Public Policy Institute of California, 1999.

Desirability of Various Land Uses to California City Managers for Development and Redevelopment Projects



Source: PPIC City Manager Survey, 1998.

Local governments' enthusiasm for large-scale retail development has highlighted a number of policy issues and controversies in California, among them:

- The proliferation of **“big box stores”** that may lead to declining sales at existing stores in the area.
- **Possible under-provision or less favored treatment of housing or industry** as compared to retail.
- **Competition between new retail centers in outlying areas and existing retail centers** in mature communities. In some cases, the older retail facilities are in decline.
- Large retail facilities at the **fringe of a region**, which may lead to increased auto travel or loss of valued open space.
- **Jurisdictional squabbles** between local governments over specific retail projects, which have included city/county conflicts over proposed annexations, protracted debates over the incorporation of new cities, and competition for specific major retail stores and “auto malls.” Assembly Bill 178, passed into law in 1999, restricts the ability of cities and counties to use public funds or investments to lure away major retailers or auto dealerships from nearby communities.

5. The Scramble for Retail Development and Sales Taxes: Winners and Losers

- Clearly, retail stores can't be spontaneously generated, no matter how much local governments might want them. At a given level of wealth, **a region's population can support only a certain level of sales.**
- **Some communities have "natural advantages"** in attracting retail development. Our research indicates that cities with high levels of sales per capita tend, for example, to have freeway access, a large population base, and an upper-middle income profile. (There are exceptions to the rule, however.)
- In the Sacramento region, there are **fairly large disparities** in the amount of sales per capita—and thus, in the amount of sales tax revenues per capita—received by cities and counties, as the table below shows.

2001 Estimated Sales Tax Revenues, Per Capita⁷

| | | | |
|-------|----------------------------------|-------|----------------------------------|
| \$354 | Roseville | \$120 | Citrus Heights |
| \$329 | West Sacramento | \$115 | Isleton |
| \$296 | Colfax | \$105 | Unincorporated Placer County |
| \$284 | Placerville | \$99 | Unincorporated Yolo County |
| \$224 | Folsom | \$84 | Davis |
| \$223 | Auburn | \$83 | Elk Grove |
| \$157 | Woodland | \$78 | Lincoln |
| \$155 | Marysville | \$74 | Unincorporated Sutter County |
| \$151 | Yuba City | \$57 | Unincorporated. El Dorado County |
| \$146 | Sacramento | \$45 | Galt |
| \$141 | Unincorporated Sacramento County | \$40 | Wheatland |
| \$138 | S. Lake Tahoe | \$40 | Unincorporated Yuba County |
| \$134 | Rocklin | \$28 | Winters |
| \$127 | Loomis | \$19 | Live Oak |

If sales tax revenues in the region were instead distributed to cities and to counties (unincorporated) **on the basis of population, the estimated per capita sales tax revenue of each jurisdiction would have been \$140.** This amount would be higher than the revenues that 17 jurisdictions expect to receive, but less than the expected sales-tax receipts of

⁷ Economic and Planning Systems, memorandum to city managers and county executives, 6/6/01. Per capita sales tax revenues for 2001-02 were estimated by inflating 1998-99 revenues at 2.5 percent for three years.

11 communities. This comparison illustrates that a relatively small number of jurisdictions in the Sacramento area account for a particularly heavy share of retail sales in the region.

- Sales tax revenues grew rapidly during the economic prosperity of the past several years. But the **sales tax is a fairly volatile source of revenue over the long term**. During the recessions of the early 1980s and early 1990s, per capita sales tax revenues in the state's cities (adjusted for inflation) fell substantially.
- Although recruitment of a new mall or auto dealer may boost a jurisdiction's revenues now, there is no guarantee that the benefits will be long-lasting. **Retail markets change**, some stores close, and older shopping centers sometimes become obsolete. A jurisdiction's future success in maintaining its current position also depends on how fast its population increases, relative to increases in local sales.
- **Cities with large amounts of retail facilities do experience extra costs in providing public services**, due to the large number of nonresidents visiting the community. Demands on public safety increase (since retail-heavy towns tend to have more crimes per resident), as do the burdens placed on local transportation and other infrastructure. These service burdens are an argument that many city officials use to argue against any redistribution of sales tax revenues from the "situs" community.

6. Are There Options for Addressing this “Fiscalization of Land Use”?

There are a variety of alternatives available to local governments that could address the need for a stable funding source for providing local services and that would reduce the "weight" given to specific land uses due to their positive or negative impact on the local revenue base. Some of these options require state authorization and some can be implemented by local action without state involvement.

- **Option #1: Increase local reliance on property taxes.**

If, as in many other states, the property tax were to comprise a higher share of local revenues—and sales taxes comparatively less—then local governments might be more interested in high-value properties of *all types*—office buildings, research and development, light manufacturing, and market-rate housing. This could provide some balance to the current emphasis on retail growth. Policy/political considerations include:

- Proposition 13’s limits on the property tax rate and limits on reassessment remain extremely popular with voters and are unlikely to be changed. A September 1998 statewide survey by PPIC found that most elements of Proposition 13 were still favored by Californians.
- However, there have been discussions among state legislators about the possibility of **“rolling back” the ERAF property tax shift** of the early 1990s and capping or reversing the property tax revenues shifted away from cities and counties. As the state faces renewed budgetary stringency, however, such an action seems increasingly unlikely.
- A number of study groups have proposed **“swapping”** some of the local sales tax now flowing to cities and counties for an increased share of the property tax. These proposals also appear to be stalled.
- This option can be accomplished by a state statute that would change the allocation of the property tax for specific jurisdictions in the Sacramento Valley.

- ***Option #2: Decrease local reliance on the situs-based sales tax.***

By redistributing sales-tax revenues among the local governments in a region, the aim of this option is to try to **reduce local governments' incentive to aggressively recruit retail land uses.**

- Under the provisions of Proposition 11, passed in 1998, city councils and county boards of supervisors can engage in **voluntary agreements to share sales taxes.** Thus far, very few jurisdictions have done so, perhaps because cities that are “doing well” have little incentive to share.
 - Another option would be for regional leaders to come to some agreement on “pooling” some of the sales-tax revenues in the Sacramento area. All or part of the **growth** in sales tax revenues could be distributed on a per capita basis to each jurisdiction. Or, a regional pool of sales-tax revenues could be used to reward communities that engage in “regionally friendly” development activity. For example, funds could be disbursed to communities that approve the construction of affordable housing units, or more dense developments adjacent to mass-transit stops. Such pooling, it is often thought, would reduce the incentive of any particular local government to pursue retail development, since the “rewards” would be shared with other localities.
 - Such a process, with locally adopted provisions, could potentially be accomplished without state authorization.
- ***Option #3: Develop a new revenue source targeted to regionwide problems.***

Some participants in the policy debate have suggested a different tactic in addressing regional problems and disparities among local governments—an alternative that does not involve sharing sales taxes or moving toward more reliance on property taxes. This approach involves developing a new, regionwide revenue source from impact fees assessed on new development. Such revenues could then be shared among the localities in the region and/or targeted to emerging regional needs, such as transportation infrastructure.

- A transportation impact fee levied on new development in the Sacramento region would gather revenues largely from areas of new growth, whereas the proceeds of the fee could be directed to areas of greatest need. In this sense, this option, like option #2, is broadly redistributive and could work to reduce some of the revenue disparities among jurisdictions.
- Also, as with option #2, all or part of the regional revenues could be directed to a “pool” to be used for infrastructure investments of regionwide importance.
- However, option #3 **would seem to have little effect on the “fiscalization” of development decisions.** New and existing retail development would still be heavily valued as a source of situs-based sales tax revenues, which would remain with the jurisdiction where the sale occurs. Lower-cost housing might still be viewed as a type of growth that fails to “pay its way” for the local jurisdiction, since the new impact fee levied on it would go to the region. And by adding another fee to developers’ costs, new housing might rise in price.
- A **legal issue** that must be resolved with a regional impact fee concerns the so-called “nexus” requirement. That is, courts require that there must be a connection (or nexus) between the activity that is subject to a tax or fee and the service burdens of the jurisdiction levying that tax or fee. In short, if local governments are to levy an impact fee, they need to demonstrate in some way that the fee is proportional to the financial burdens that the new development places upon the jurisdiction. This may be a challenge if the revenue is fully shared with the other local governments in the region. The nexus problem might be avoided if some regional governmental body levied the fee. However, any proposal for a regional taxing authority is likely to prove controversial.
- Thus far, many cities and counties have been reluctant to embrace reforms of the local finance system. There are a number of reasons for this: a desire to protect existing local revenues from state or regional “tinkering,” the lack of local control over other revenue sources, and uncertainty about future growth trends. In addition, some jurisdictions that have enjoyed particularly healthy growth in sales tax revenues in recent years feel that the existing finance system is working well for them.