



An Assessment:

# Governor's Local Government Proposal

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The administration's local government proposal would make far-reaching changes to state-local finance. Our review of the proposal indicates that it would greatly increase the stability of local finance and increase accountability in the mandate process. We also find, however, that the proposal locks in place the current flawed state-local fiscal structure, imposes added fiscal stress on many local governments, and is not structured in a fashion that addresses long-term state fiscal goals. For the Legislature's consideration, we provide various recommendations to bring the proposal into greater alignment with legislative goals and state fiscal objectives. ■

### Acknowledgments

This report was prepared by Mark Ibele and Marianne O'Malley. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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## INTRODUCTION

In its May Revision, the administration proposes that the Legislature place before the statewide voters in November a constitutional amendment to enact far-reaching changes to state-local finance and intergovernmental relations. Over time, the proposed constitutional provisions would significantly influence state decision-making regarding cities, counties, special districts, and redevelopment agencies. (With the exception of provisions relating to a proposed tax swap, K-14 districts are largely unaffected by the measure.)

In general, the measure greatly restricts state authority to reduce noneducation local government taxes, except for a \$1.3 billion shift from these agencies in 2004-05 and 2005-06. The measure also includes a complex swap of vehicle license fee (VLF) “backfill” revenues for K-14 property taxes and places into the State Constitution: (1) the current VLF rate of 0.65 percent, (2) certain existing statutory

provisions relating to local finance, and (3) reforms to the mandate reimbursement process. Figure 1 summarizes the major provisions of the local government proposal.

While the administration is still developing the constitutional language (and related statutory changes), the Legislature will need to begin its review shortly given the measure’s link to the 2004-05 state budget and the upcoming deadlines for placing a measure on the November ballot. Accordingly, to assist the Legislature, we provide a summary and initial assessment of the proposal as described in materials provided by the administration and preliminary language provided on May 21, 2004. (We note that some minor elements of the proposal have changed since our summary of the proposal in the *Overview of the 2004-05 May Revision*.) As additional information and specific language for the measure becomes available, we will provide the Legislature with additional analyses.

**Figure 1**

### Major Provisions of the Administration’s Local Government Initiative

Policy Area	Provisions
<b>Protection of Major Local Government Revenues</b>	<ul style="list-style-type: none"> <li>• State may not reduce the rate of the sales tax, or reallocate or delay any local government’s share of revenues from the property tax, sales tax, or vehicle license fee (VLF), except as provided below under “State Fiscal Relief.”</li> <li>• Places the current VLF rate (0.65 percent) into the constitution as the maximum rate.</li> </ul>
<b>State Fiscal Relief</b>	<ul style="list-style-type: none"> <li>• Authorizes a \$1.3 billion shift of local government revenues in 2004-05 and 2005-06.</li> </ul>
<b>VLF Backfill for Property Tax Swap</b>	<ul style="list-style-type: none"> <li>• Shifts \$4.1 billion of K-14 district property taxes to cities and counties as replacement for VLF “backfill” revenues. (As a result, the state would have higher spending on schools—to compensate for the property tax loss—and commensurate lower spending on VLF backfill payments.)</li> </ul>
<b>Mandates</b>	<ul style="list-style-type: none"> <li>• Unfunded mandates sunset automatically, unless they pertain to educational programs or employee rights or benefits.</li> <li>• Mandates may not be suspended in the budget.</li> <li>• State pays backlog of noneducation mandates over five years, beginning in 2006-07.</li> <li>• The process for determining noneducation mandates is expedited.</li> </ul>

## WHAT DOES THE GOVERNOR PROPOSE?

### Two-Year Budget Relief

Under the administration’s proposal, noneducation local governments would contribute \$1.3 billion in 2004-05 and 2005-06 to their respective county Educational Revenue Augmentation Fund (ERAF) accounts. County auditors would allocate these property tax revenues to K-14 districts, which in turn would offset a comparable amount of state education spending. (Please see the appendix for some background information on ERAF and other local government financial terms used in this report.)

Figure 2 provides information regarding the proposed allocation of the \$1.3 billion across cities, counties, special districts, and redevelopment agencies. The administration indicates that these methodologies were developed in conjunction with the following local government statewide associations: League of California Cities,

California State Association of Counties, California Special Districts’ Association, and California Redevelopment Association.

**Figure 2**  
**Allocation of \$1.3 Billion Revenue Shift**

Agencies—Amount	Allocation
<b>Cities— \$350 Million</b>	<ul style="list-style-type: none"> <li>• One-third of the \$350 million reflects each city’s proportionate share of statewide city vehicle license fee (VLF) revenues. Another one-third reflects each city’s share of property taxes. The final one-third reflects each city’s share of sales taxes.</li> <li>• Each city’s reduction must be at least 2 percent—and not more than 4 percent—of the city’s general-purpose revenues.</li> </ul>
<b>Counties— \$350 Million</b>	<ul style="list-style-type: none"> <li>• Each county’s reduction reflects its proportionate share of 2003-04 county nonrealignment VLF. Three small counties (Trinity, Del Norte, and Lassen) are subject to a smaller reduction. In general, the county allocation formula is similar to imposing reductions on a population basis.</li> </ul>
<b>Independent Special Districts— \$350 Million</b>	<ul style="list-style-type: none"> <li>• Enterprise special districts (largely water and waste disposal districts) shift 40 percent of their property taxes, up to a maximum of \$225 million.</li> <li>• Nonenterprise special districts—with the exception of fire, police, healthcare, and library districts—shift 25 percent of their property taxes, up to a maximum of \$125 million.</li> <li>• Fire, police, healthcare, and library districts are exempt from the shift.</li> <li>• If this methodology fails to generate \$350 million statewide, the percentage reductions are increased proportionately.</li> </ul>
<b>Redevelopment Agencies— \$250 Million</b>	<ul style="list-style-type: none"> <li>• Half of the amount (\$125 million) is allocated among redevelopment agencies based on their relative share of gross tax increment revenues. The other half is allocated based on tax increment net of revenues “passed-through” to other agencies. This formula is similar to the ERAF methodology in current law.</li> <li>• If an agency fails to make its payment to ERAF, the city or county sponsoring agency makes the payment.</li> </ul>

### **Reduced State Authority Over Local Finance**

Under current law and the California Constitution, the state has significant authority over the rate and/or allocation of most major local taxes, including the property tax, the 1 percent local “Bradley-Burns” sales tax, optional local sales taxes, and the VLF. The administration’s proposal would greatly limit state authority over local finance by preventing the Legislature from enacting laws that reduced, delayed, or reallocated any noneducation local government’s share of revenues from the VLF, sales tax, or property tax. The measure also would preclude the Legislature from enacting a law to increase the VLF rate over its current 0.65 percent rate.

Finally, the administration also proposes to place into the Constitution certain existing financial provisions or requirements relating to local finance. These include requirements that the state (1) pay \$1.2 billion in 2006-07 for the VLF “gap loan” (as discussed in the appendix), (2) guarantee replacement property taxes during the period that part of the local sales tax is used to pay Proposition 57’s fiscal recovery bonds (as discussed in the appendix regarding the “triple flip”), (3) reestablish local government’s full authority to impose a 1 percent Bradley-Burns sales tax rate when the fiscal recovery period ends, and (4) pay the backlog of noneducation mandate claims in five installments, beginning in 2006-07 (approximately \$1.6 billion).

### **Complex Swap of VLF and Property Tax Revenues**

The May Revision proposes major changes regarding city and county VLF revenues and K-14 district property taxes by:

- Eliminating the state’s obligation to appropriate funds to backfill local governments for the difference between the 0.65 percent rate paid by vehicle owners and the original 2 percent rate.
- Modifying laws regarding the allocation of VLF revenues.
- Replacing city and county reduced VLF revenues with a portion of K-14 property taxes.

Figure 3 (see next page) summarizes the tax swap. As shown in the figure, VLF backfill payments would be eliminated, thereby reducing VLF fund revenues by two-thirds. County health and social services realignment programs would receive the same dollar amount of VLF revenues as under existing law, but general-purpose VLF revenues to cities and counties would change significantly. Counties would no longer receive general-purpose VLF revenues. Cities would receive the remaining nonrealignment VLF revenues, net of the state’s administrative costs, or about \$227 million.

To offset these city and county VLF reductions, county auditors would reallocate property taxes from schools and community colleges to cities and counties, with K-14 district property tax losses offset through increased state education apportionments. (These property tax allocations from K-14 districts to cities and counties would be in addition to the property tax allocation required under existing law to replace reduced city and county sales taxes under the triple flip.)

**“Hold Harmless” Provisions.** Any shift of this magnitude affects local governments differently due to unique conditions and factors

in various communities. Seeking to maintain the current level of resources for *all* local governments and K-14 districts, the administration proposes a wide variety of hold harmless provisions, including provisions to exempt from the tax swap “basic aid” K-14 districts (those districts that receive unusually high amounts of property taxes).

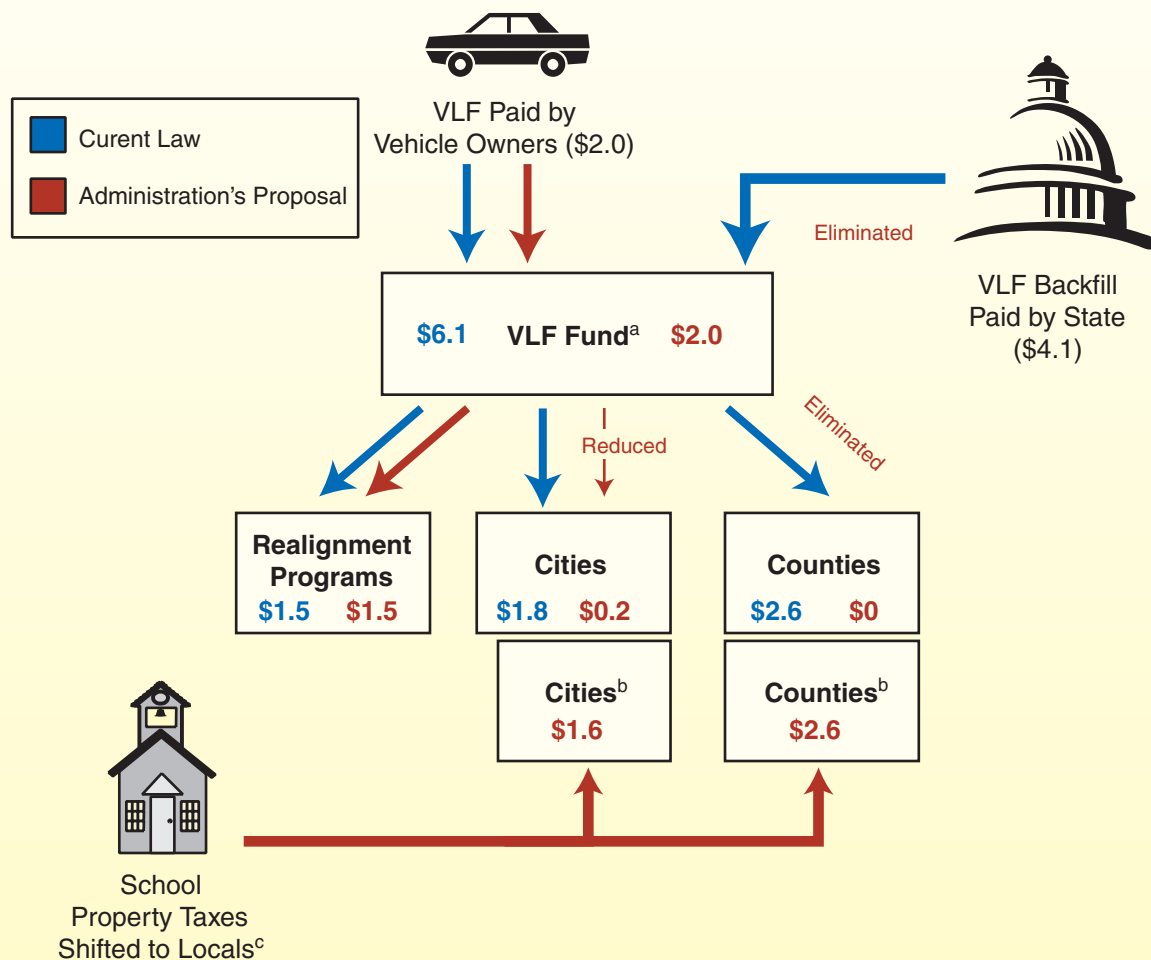
### Significant Mandate Reform

The Constitution currently requires the state to reimburse local agencies (including K-14 districts) if the state mandates a new program or higher level of service. Under current law, local agencies file “test claims” with the Commission on State Mandates. If the commission finds a mandate, it adopts a mandate reimbursement

Figure 3

### VLF for Property Tax Swap

(Dollars in Billions)  
2004-05



<sup>a</sup>In addition to payments to cities and counties the fund supports various state administrative expenses.

<sup>b</sup>Property taxes shifted to cities and counties would offset the loss in their ongoing VLF revenues. In 2004-05 and 2005-06, however, the property taxes shifted would be less to provide state fiscal relief.

<sup>c</sup>Property tax shift is in addition to the shift required under current law pursuant to the triple flip.

methodology, and reports the mandate's estimated statewide cost to the Legislature.

Because of the complexity of this process, it takes several years for the commission to process a claim. In addition, although the Constitution requires the state to reimburse local agencies for mandates, the state does not incur any significant consequences if it defers reimbursements to a later date. Existing law also permits the state to avoid incurring a mandate liability in any year in which the Legislature suspends a mandate requirement in the budget act.

**Administration's Proposal.** The administration proposes an array of changes that would be applicable only to *noneducation* mandates. First, the commission would have four months to determine whether a noneducation test claim constitutes a mandate. If the commission found a mandate, the Department of Finance (DOF) would determine the reimbursement methodology and propose the amount needed to reimburse local governments. If funding at the amount the DOF determines is not provided in the next state budget or subsequent state budgets, the mandate would terminate in 90 days, unless the mandate related to employee rights or benefits. The measure also would preclude the Governor from vetoing a mandate appropriation. Finally, the administration proposes to widen the definition of a mandate to include, among other items, situations when the state transfers partial funding responsibility for a joint state-county program. This would limit state authority to alter existing cost sharing agreements, such as for mental health or in-home supportive services programs.

### **Other Elements of Proposal**

**Other Local Initiative on Ballot.** Earlier this year, a coalition of statewide local government

associations submitted signatures to the Secretary of State to qualify "The Local Taxpayers and Public Safety Protection Act" (LTPSPA) for the November 2004 ballot. Although the LTPSPA is similar to the administration's proposal in many respects, the LTPSPA would *rescind* any state budget action taken this year that reduced noneducation local agency's property taxes. The administration's proposal, in contrast, permits the state to redirect \$2.6 billion of local government property tax revenues over the coming two years. The administration's measure also (1) places greater restrictions on state authority over local finance than does the LTPSPA and (2) takes a different approach to reforming the mandate process. As part of the agreement between the administration and the statewide local government associations, we understand that the associations have agreed to support the administration's proposal instead of the LTPSPA if both measures appear on the November ballot. If the administration's proposal does not appear on the November ballot, the local government associations have indicated that they will support the LTPSPA.

**Future State-Local Realignment.** As part of its proposal, the administration indicated its intent to propose additional state-local program realignment in 2006-07. As we discussed in the *2003-04 Perspectives and Issues* (please see page 123), given the size and diversity of California, we think realignment of some state programs could improve program outcomes. We note, however, that the administration's proposal to widen the mandate definition would constrain the Legislature's flexibility in realigning the fiscal obligations for jointly financed programs.

## LAO ASSESSMENT

Our review of the preliminary materials provided by the administration indicates that the proposed constitutional provisions would increase the stability of local finance and increase accountability in the mandate process. The proposal also contains elements, however, that appear contrary to the Legislature’s long-term policy objectives, lack obvious policy rationales, or are not consistent with state and local fiscal interests. We summarize our concerns in Figure 4 and discuss these matters below.

the California Legislature may enact laws to change the rate and/or allocation of the VLF, local sales tax, and property tax. Over the years, the state has used this authority to address policy concerns, such as changing (1) the share of property taxes allocated to schools after the passage of Proposition 13 in order to increase resources to cities, counties, and nonenterprise special districts; (2) the allocation of property taxes and VLF revenues to cities that had been assigned a very low share of the property taxes under tax allocation laws; and (3) the amount of

revenues required to be “passed-through” by redevelopment agencies to other local agencies. During periods of state fiscal difficulty, however, the state also has used this authority to transfer some of its fiscal burdens to local governments. For example, in 1992-93

the state began shifting city, county, and special district property taxes to K-14 districts (via ERAF) as a means of offsetting state education costs. Because of the fiscal impact of these and other state actions, local governments have long sought “protection” against future state changes in local finance.

**Reforming Local Finance.** Over the last two decades, the Legislature and administration have expressed interest in addressing concerns regarding local finance. For example,

**Figure 4**

### Major Concerns Regarding Administration’s Local Finance Proposal

- ✓ Existing local finance system locked in place.
- ✓ Rationale for complex tax swap not clear.
- ✓ Major local fiscal effect for short-term state relief.
- ✓ Mandate proposal shows promise, needs work.

### EXISTING LOCAL FINANCE SYSTEM LOCKED IN PLACE

The May Revision proposal highlights tensions between two longstanding interests relating to local finance: (1) local government fiscal protection and (2) local finance reform.

**Protecting Local Government Revenues.** In contrast to most other states, California law gives state government, rather than local governments or their residents, significant authority over major local revenues. Specifically,



Chapter 94, Statutes of 1999 (AB 676, Brewer), stated that:

California’s system for allocating property taxes does not reflect (1) modern needs and preferences of local communities or (2) the relative need for funding by cities, counties, special districts, redevelopment agencies, and schools to carry out their mandated and discretionary services. In addition, the current system centralizes control over property tax allocation in Sacramento and gives the state full authority to reallocate property taxes to offset state education funding obligations. The Legislature wishes to revamp the current system of property tax allocation to do the following: (1) increase taxpayer knowledge of the allocation of property taxes, (2) provide greater local control over property tax allocation, and (3) give cities and counties greater fiscal incentives to approve land developments other than retail developments.

As discussed further below, the administration’s proposal would greatly limit the Legislature’s authority to reform local finance.

### **How Does the Administration’s Proposal Address Fiscal Protection and Reform?**

The administration’s proposal offers significant protection to noneducation local governments’ revenues, but greatly reduces the Legislature’s authority to reform local government finance. Specifically, our review of the administration’s proposal indicates that the Legislature apparently could not change such basic components of local finance as:

- The manner in which the local sales tax is allocated among local agencies.

- The current “AB 8” methodology for allocating property taxes among local governments.
- The VLF or sales tax rate, including sales tax rate reductions in exchange for a broadening of the sales tax base.

We also note that while the measure decreases the Legislature’s authority over local finance, the measure does not provide any increase in local resident authority over local taxes. For example, residents would continue to have virtually no authority over the *allocation* of local property taxes. Thus, residents could not decide to shift some local property taxes from a water enterprise special district to their library district. Similarly, residents of a county could not decide to have a portion of their local sales taxes allocated on a population basis, rather than the existing point of sale (*situs*) basis. Instead, the measure locks the existing local fiscal system in place, requiring future constitutional amendments any time change is needed or desired.

### **LAO Recommendation: Protect Aggregate Local Revenues but Maintain Authority Over Local Finance**

Given some past state actions to modify local finance laws for the fiscal benefit of the state, local government’s interest in safeguarding local tax revenues is both understandable and reasonable. The state, however, has an important interest in the viability of local fiscal affairs and a key role to play in state-local finance issues. The administration’s proposal would curtail this role by freezing in place current revenue structures. While this approach

provides certainty for local governments (and the state), it does so at the expense of placing severe constraints on the ability of state and local governments and their residents to work together to improve the shared fiscal landscape.

We urge the Legislature to consider policies that offer local fiscal protection, but still allow the Legislature and local residents to modify revenue sources and allocations. Instead of placing restrictions on the ability of the state to alter existing fiscal structures and institutions, we recommend the Legislature consider policies that protect local revenue streams in the *aggregate*, yet maintain authority to alter these taxes and the allocation of these revenues among local governments. This would insure that the state no longer used local funds for state fiscal relief.

### **RATIONALE FOR COMPLEX TAX SWAP NOT CLEAR**

The proposed shift of VLF backfill revenues for K-14 property taxes is extraordinarily complex. To date, the administration has not articulated a rationale for this swap, although others have attributed its purpose as seeking to: (1) protect local government revenues against possible future delays in state payment of VLF backfill revenues and/or (2) improve local government land use incentives. As we discuss below, the tax swap does not appear to be justified by either of these rationales.

***Swap Not Necessary to Provide Local Protection.*** In the current year, local governments sustained revenue reductions when payment of the VLF backfill was delayed. If the goal of the proposed swap is to give local governments protection against future delays or nonpayment of VLF backfill payments, there is a simpler solution: the Legislature could propose a

VLF backfill guarantee be amended into the Constitution.

***Existing Land Use Incentives.*** California cities and counties rely on three major statewide taxes, the VLF, property tax, and sales tax, and some smaller, locally imposed taxes. When considering future land developments, cities and counties typically consider their potential effects on these sources of revenues. Local governments usually report that they receive the greatest revenues from retail developments and, accordingly, face fiscal incentives to promote retail developments over other developments. Local governments, in contrast, frequently indicate that housing developments do not generate sufficient revenues to offset the costs to provide municipal services to new residents.

***No Obvious Improvement to Land Use Incentives.*** To give cities and counties incentives to approve a balance of land developments (including housing), many local government observers have suggested the state decrease city and county reliance upon the *sales tax* and increase their reliance on the *property tax*. The administration, however, proposes to trade *VLF revenues* for *property taxes*. Overall, we do not see why this swap would improve local government land use incentives. In the case of housing developments, for example, cities and counties would receive higher property tax revenues, but much of this increase would be offset by greatly reduced VLF revenues, a tax allocated on a population basis. Moreover, we note that local governments do not receive property taxes from public housing developments, whereas they receive VLF revenues for the people residing in these developments.

### **LAO Recommendation: Unless Policy Benefit Is Evident, Reject Tax Swap**

To date, we see no information suggesting that the highly complex tax swap would be beneficial to the state or to local governments. Absent evidence to the contrary, we recommend the Legislature delete this tax swap from this proposal. We note that the local government association initiative does not include a comparable tax swap. As an alternative, the Legislature could amend the Constitution to guarantee the annual VLF backfill.

### **MAJOR LOCAL FISCAL IMPACT FOR SHORT-TERM STATE RELIEF**

For some agencies, the requirement to contribute their share of the \$1.3 billion in 2004-05 and 2005-06 will pose significant financial burdens. For example, certain independent recreation and park districts would lose more than 15 percent of their total revenues in 2004-05 and 2005-06. Cities and counties—some facing considerable fiscal pressures of their own—also will sustain significant reductions in general purpose revenues. Finally, with the exception of enterprise special districts (which have broad authority to raise replacement revenues through user fees) local communities are likely to experience service reductions during the two years that their property taxes would be reduced. Given the fiscal effect of the administration's measure on local governments, it is important to assess the extent to which this proposal is structured in a manner that offers state fiscal relief while imposing the least harm on local governments.

**State Budget Relief Is Short Term.** The administration's proposal offers substantial state budgetary relief for two years. As we discuss in our *Overview of the 2004-05 May Revision*, however, the state's fiscal problem spans a much longer period. We note that in 2006-07, after the temporary \$1.3 billion relief from local governments ends, the state is scheduled to pay (1) the \$1.2 billion VLF gap loan and (2) the first of five installments to reimburse local government mandate obligations (a debt that is likely to total \$1.6 billion by 2006-07). Together, these local government-related obligations will pose a significant challenge for the state beginning in 2006-07.

**Potential Higher State Education Costs.** The proposed reduction in property taxes for K-14 districts could result in higher costs for the state than under current law. While it is difficult to predict how the property tax and VLF will perform in the future, we note that property tax growth over the last four years has been quite robust, averaging close to 8 percent annually. The VLF, in contrast, has grown at a rate closer to 6 percent annually over the same period. To the extent that the property tax continues to grow at a rate faster than the VLF, local governments would benefit, but the state would experience increased education funding obligations. Assuming these growth rates prevail through 2006-07 (when the plan is fully implemented), this tax swap could result in higher state K-14 expenditures of almost \$200 million annually. This increased expenditure obligation would continue to increase over time.

### **LAO Recommendation: Restructure Relief Package**

In view of these factors, we recommend that the Legislature consider altering the proposal in order to restructure the burden on local governments and, in the process, stretch out state budgetary relief over a longer period of time. We recommend that the Legislature consider (1) reducing revenue shifts from those local governments that are less able to generate replacement revenues, (2) maximizing local control by reducing special purpose subventions rather than general purpose revenues and authorizing some local decision-making over property tax allocation, and (3) redistributing state budget savings from 2004-05 and 2005-06 into future years.

Below, we present an alternative that incorporates these features. The alternative would maintain the administration's proposed \$2.6 billion in budget relief, but restructure the proposal to redistribute the impact on local governments and provide state relief over a longer period of time. It is important to note that there are numerous other alternatives that could result in similar benefits for both the state and local governments. Our suggested alternative consists of the following components:

- **Property Tax Shift.** Our alternative would exempt cities and counties from the property tax shift, but retain the administration's proposed \$250 million reduction for redevelopment agencies in 2004-05 and 2005-06. In addition, it would include an ongoing annual property tax reduction of \$220 million for special districts. This special district reduction would be implemented by

county boards of supervisors based on their review of independent special districts' capacity to offset tax reductions through user fees or efficiency improvements. This special district property tax reduction primarily would affect water and waste disposal enterprise special districts and is consistent with long-standing statement of legislative intent (Government Code Section 16270).

- **Special State Subventions.** To maximize local fiscal flexibility, our alternative would not reduce city or county property taxes, but instead eliminate special purpose funding of \$200 million that these local governments receive under the Citizens' Option for Public Safety and the Juvenile Justice Grant programs.
- **Existing State Obligations.** Our alternative would call for the state to repay its VLF gap loan in three equal \$400 million payments beginning in 2006-07, instead of a lump sum of \$1.2 billion in that year. In addition, our alternative retains the administration's proposed treatment of mandates by reimbursing local governments for these costs in five equal annual installments beginning in 2006-07.

Figure 5 shows the state budget impact of the two proposals. The figure displays the revenue impacts of the property tax shift and the reduction in special subvention payments, as well as the state's payment of existing local government VLF and mandate obligations. As shown in the figure, the administration's plan would result in savings of \$1.3 billion in each of the first two years, compared with the

\$670 million of savings in each of these years in our alternative. In 2006-07, however, the state would repay the VLF gap loan (pursuant to current law) and make the first mandate payment (pursuant to the administration’s proposal) for a total of approximately \$1.55 billion. In contrast, our alternative would require the VLF gap loan to be paid over a three-year period and partially offsets these liabilities by the ongoing property tax reductions for special districts. The administration’s mandate repayment would be included in our alternative as well.

The administration’s proposal and our alternative would result in identical total losses for local governments from 2004-05 through 2008-09, but the distribution of these losses would differ significantly. Specifically:

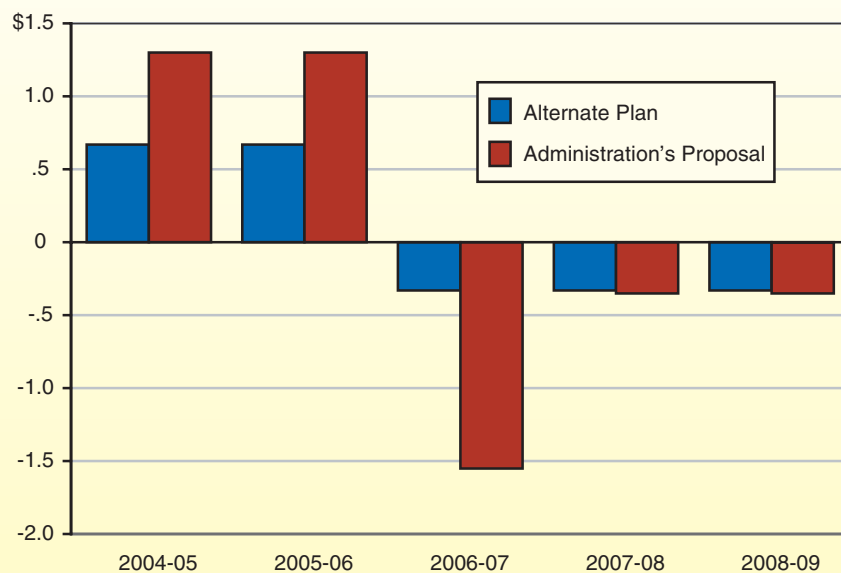
- Cities and counties would not lose general purpose revenues but would lose \$200 million in resources annually, due to the elimination of special purpose subvention payments.
- Redevelopment agencies would be treated the same as under the administration’s proposal.
- Special districts’ property tax shifts would be ongoing and locally determined. During the first two years, our proposal would result in a lower property tax loss for special districts than the administration’s proposal, but higher losses thereafter due to the ongoing nature of the shift.

For the state, the alternative presented above would provide substantially lower budget savings during the initial two years, compared to the administration’s proposal, but would result in significant budget relief in subsequent years. By altering various components of the proposal (and making changes to existing state obligations), our alternative provides an easier fiscal transition in 2006-07.

**Figure 5**

**Alternative Structure Could Ease State Fiscal Stress**

*Budget Impacts of Local Government Proposals<sup>a</sup>*  
(In Billions)



<sup>a</sup>Includes impacts of existing VLF gap loan repayment and mandate obligation proposal.

**MANDATE PROPOSAL SHOWS PROMISE, NEEDS WORK**

While critical details regarding the administration’s mandate proposal are still under development, two elements of the plan would significantly improve the state’s mandate reimbursement process. We discuss these elements, along with some concerns regarding the proposal, below.

***Tearing Up the Mandate Credit Card.***

Usually, when the state faces difficulties funding a program, the state modifies or repeals the program. In the case of mandates, however, state actions to *defer* mandates costs result in local agencies being required to implement programs without funding—representing essentially an involuntary loan from local governments to the state. In addition, state actions to *defer* mandates costs tend to reduce the state’s incentives to review and reduce mandate program costs.

In our view, adopting the administration’s proposal to sunset most unfunded mandates would increase state accountability regarding mandates. (We also note that legal challenges relating to the state’s failure to fund mandates are pending in lower courts and it is conceivable that future court rulings regarding unfunded mandates could constrain the Legislature’s authority

more broadly than the administration’s proposal.)

***Ending Mandate Suspension Process.***

Legislative actions to suspend mandates in the annual budget frequently result in unreimbursed local costs because it makes it very difficult for local agencies (or others) to understand the requirements of state laws. As an example, Figure 6 explains the steps a local agency official would need to take to know how long a stray dog must be held at a shelter before it could be euthanized. In addition, local agencies often incur unreimbursed local costs under the suspension process because it is difficult to change local policies immediately after a mandate is suspended. In our view, the administration’s proposal to reform a system that makes state laws difficult to understand and imposes unreimbursed costs on local agencies is appropriate and commendable.

**Figure 6**

**Steps Required to Understand State Law Regarding the Holding Period for Stray Dogs**

- Read Section 31108(a) of the Food and Agricultural Code: “The required holding period for a stray dog impounded pursuant to this division shall be six business days ...”
- Review annual Commission on State Mandates reports to the Legislature to determine if this requirement was found to be a state-reimbursable mandate. (In this case, the requirement was found to be part of the “Animal Control” mandate.)
- Determine which state agency was assigned responsibility for the mandate. (In this case, the Department of Food and Agriculture.)
- Review state budget act appropriations for the affected state agency to determine if the mandate has been suspended that fiscal year. (For 2003-04, the Animal Control mandate was suspended.)
- If the mandate has been suspended, review the applicable code section as it stood before the revision was enacted that created the mandate. (In this case, the previous code sections were stricken from the codes, but they generally required a three-day holding period.)

**Concerns Regarding Administration’s Mandate Proposal.** Based on the materials available at this time, we note several areas of concern regarding the administration’s proposal. Specifically, it:

- Further complicates the mandate reimbursement system by creating a dual process for mandate determinations: the existing, slow process for education mandates and an expedited process for city, county, and special district mandates.
- Does not explain why unfunded employee-related mandates should continue to have the force of law while unfunded public health, public safety, elections, and all other mandates should sunset.
- Rushes the mandate determination process, making it difficult for the commission to render mandate determinations that meet the legal standards required by courts.
- Assigns the difficult and controversial responsibility of estimating mandate costs to the Department of Finance. Because of potential conflicts of interest, this task is probably more suited to the State Controller’s Office.

### **LAO Recommendation: Revise Mandate Proposal to Link Authority and Responsibility**

For about a year, the Assembly Special Committee on Mandates has been reviewing individual state mandates and the mandate process. In April 2004, drawing from testimony provided from a wide array of parties and our previous mandate analyses, our office presented a proposal for an accountable, expedited mandate process. Figure 7 (see next page) summarizes our proposal, which contains many similarities to the administration’s proposal, most notably the establishment of an automatic sunset requirement and the repeal of the mandate suspension process.

Other elements of our proposal, however, differ notably from the administration’s proposal, including our common treatment of all mandates (education, noneducation, and labor relations), the assigned roles and responsibilities of state agencies, and the process for determining a reimbursement methodology. In general, while we find much about the administration’s proposal to recommend, we think the conceptual approach outlined in our alternative offers significant advantages. These advantages are highlighted in Figure 8 (see page 17). Accordingly, we recommend the Legislature substitute it for the administration’s approach.

## **CONCLUSION**

The administration has proposed a significant local government package with provisions that help address the state’s budgetary difficulties, alter long-term state-local

fiscal interactions, and reform the mandate process. Our review of the proposal indicates that it would increase the stability of local finance and increase accountability in the

Figure 7

### A Mandate Reimbursement Process With Greater Emphasis on Accountability and Results

Time	Action	Maximum Elapsed Time (In Months)
	The Legislature passes a law, a state agency promulgates a regulation, the Governor signs an executive order.	
Up to 12 months	Local agencies may file a claim up to one year after (1) a mandate is created or (2) they experience increased costs.	12
Up to 12 months	Reconfigured Commission on State Mandates (CSM) deliberates. State and local agencies fund CSM activities through reimbursements and fees.	24
Up to 4 months	If CSM finds a mandate, the State Controller's Office (SCO), with assistance from an ongoing local agency advisory body, develops a "reasonable reimbursement methodology" that balances accuracy with simplicity—and specifies a future date when revision to the methodology shall be considered.	28
Up to 2 months	The CSM reviews the proposed SCO reimbursement methodology. The CSM may return the methodology to SCO for revision if it finds the methodology inconsistent with the CSM mandate determination.	30
Up to 2 months	If necessary, the SCO reviews CSM comments and may make changes to its methodology.	32
Up to 2 months	The CSM either approves the SCO methodology or adopts findings identifying its concerns with the methodology. The CSM reports the mandate, the SCO methodology, and any concerns to the Legislature and administration.	30 - 34
Up to 6 months	The Legislature funds the mandate (either in legislation or the budget act) and specifies the reimbursement methodology. If the Legislature does not fund the mandate, the SCO shall notify affected local agencies that the mandate is invalid, pursuant to state statute. Legislative Counsel prepares draft legislation for the chairs of the local government policy committees to introduce to codify the repeal of the mandate.	36 - 40
Annually thereafter	Local agencies submit claims for mandate reimbursement in the fiscal year after costs are incurred. The Governor proposes and Legislature appropriates funding for mandates in the annual budget bill, including any funding needed to pay prior-year mandate deficiencies. The annual suspension process in the budget bill is repealed. If mandate reimbursement is not provided, the mandate is invalid. (As in above, the SCO will notify local agencies and Legislative Counsel will prepare draft legislation for the chairs of the local government policy committees to introduce to codify the repeal of the mandate.) If a valid local claim is unpaid for more than two years after submittal, a local agency may bring action in superior court to have the mandate declared invalid.	



**Figure 8****Advantage of LAO Mandate Approach Over Administration's Proposal**

- ✓ Creates a single, expedited process for all mandates.
- ✓ Greatly simplifies the mandate claiming process.
- ✓ Avoids conflicts of interest in developing mandate cost estimates and reimbursement methodologies.
- ✓ Strengthens the mandates determination process by increasing state agency participation, restructuring the commission, and establishing reasonable deadlines.

mandate process. We also find, however, that the proposal lacks overall policy coherence and, in exchange for short-term state fiscal relief, locks in place the current flawed state-local fiscal structure.

Accordingly, we recommend the Legislature review the proposal with the objective of bringing it into greater alignment with legislative goals and state fiscal objectives. Specifically, we recommend the Legislature:

- Modify the local government finance protection provisions of the measure to protect local government *aggregate* tax revenues, but not the specific allocations among California's thousands of local agencies.

- Reject the administration's VLF for K-14 property tax swap, unless the administration provides a compelling policy rationale for this complex transaction.
- Restructure the \$1.3 billion property tax shift proposal to reduce the fiscal

effect on local government general-purpose revenues, target those impacts on local governments best able to bear them, and address the state's long-term budgetary pressures.

- Maintain two major provisions of the administration's mandate proposal (automatic sunset of unfunded mandates and elimination of the mandate suspension process), but revise other elements of the proposal in order to increase accountability.

AN LAO REPORT

## APPENDIX

### Vehicle License Fee (VLF)

The VLF is an annual fee on the ownership of a registered vehicle in California, levied in lieu of taxing vehicles as personal property. Revenues from the VLF are dedicated to local governments. The fee is based on the depreciated value of the vehicle according to a set schedule. Vehicle owners currently pay a 0.65 percent rate, with the difference between this and the former 2 percent rate paid by the state General Fund (see “VLF Backfill”).

### VLF Backfill

In 1998, the Legislature adopted a schedule of VLF rate reductions, which resulted in the rate falling from 2 percent to 0.65 percent by 2000. In conjunction with these VLF reductions, cities and counties continued to receive the same amount of revenue that they would have under the 2 percent rate, with the reduced VLF revenues from vehicle owners replaced by General Fund revenues or backfill. Under current law, the backfill for 2004-05 is estimated to be \$4.1 billion.

### VLF Gap Loan

The previous administration made a determination in June 2003 that there were insufficient funds for the state to continue making General Fund backfill payments to local governments. The backfill ceased and the VLF rate paid by vehicle owners increased to 2 percent approximately three months later. The “gap” period between when the backfill ceased and the increased VLF rate occurred resulted in a loss in local revenue of \$1.2 billion, essentially representing a loan to the state scheduled to be

repaid to local governments in 2006-07. By executive order, the current administration returned the rate to 0.65 percent in November 2004.

### ERAF

In 1992-93, the state directed each county auditor to establish an Educational Revenue Augmentation Fund (ERAF) and annually transfer to this fund property taxes that otherwise would be allocated to cities, counties, and special districts. In 1993-94, the state increased the annual amount of property taxes shifted from these local agencies. In 2003-04, the amount of property taxes deposited to ERAF totals about \$5 billion. The state’s original purpose in creating ERAF was to allocate the property tax funds to K-14 districts, thereby offsetting state education spending. As part of the “Triple Flip” agreement discussed below, however, the state pledged to use some ERAF revenues to replace transferred city and county sales tax revenues.

### Triple Flip

The state’s Economic Recovery Bonds, approved by the voters in March 2004, are secured by a pledge of revenues from an increase in the state’s share of the sales and use tax of one-quarter cent beginning July 1, 2004. The share of the tax going to local governments will be reduced by the same amount and, in exchange, local governments will receive an increased share of the local property tax (and K-14 districts a reduced share) during the time the one-quarter cent is being used to pay off the bonds (estimated to be between 9 and 14 years). This shift in revenues between the state and local governments is known as the “triple flip.”

