KEYNOTE SPEECH TO THE INDEPENDENT CITIES ASSOCIATION'S TWENTY-THIRD ANNUAL SEMINAR

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LEGISLATIVE ANALYST

STATE OF CALIFORNIA

925 L STREET, SUITE 650

SACRAMENTO, CALIFORNIA 95814

Keynote Speech to the Independent Cities
Association's Twenty-Third Annual Seminar

Ranch Bernardo, California - May 13, 1983

I. Introduction

A. Icebreakers

1. Comments on the setting for the conference

2. Comments on the state of state-city relations

B. Purpose of My Remarks

1. Describe:

a. the fiscal context in which decisions on the 1983-84 state budget will be made, and

b. what this context implies for fiscal relief.

c. In doing so, I'll be looking at both sides of the question:

(1) What the state can afford to give

(2) What you can expect to receive

2. Look beyond the 1983 Budget Act and discuss the nature of the state's relationship with the 432 cities in California, including the 44 represented by your association

C. Follow-Up

1. I don't want my visit with you to be a monologue

a. I expect that you'll have some questions about what I have to say--I'll do my best to answer them candidly

b. I hope you'll have some observations of your own about the nature of state-city relations in California today--I'd like to hear them

2. If we don't get to all of your questions and observations this morning, before you must turn your attention to the prospect of cutting your budget by 10 percent, I hope you will make a note of them so we can discuss them later on today or tomorrow

II. The Fiscal Context: 1983-84

A. Overview

1. In talking about the budget outlook for the next 14 months, let me start by saying that the picture facing us today is more complicated and confusing than any I can recall--I hope you will bear with me as I try to sort it out.

2. In contemplating the context in which next year's budget for the State of California will be written, I have found it necessary to reorient my thinking about the budget process

a. This year's process does not conform to the norm

b. Let me tell you why

2. When I began my professional career with what was then called the Bureau of the Budget (now OMB) nearly 14 years ago, I quickly learned that putting budgets together involved two fundamental steps:

a. First, you have to shoehorn a size 13 foot into a much smaller shoe

(1) At the federal level, the shoe--which represents federal revenues--comes in only one size--the size being determined by the combination of existing tax laws and the economic outlook for the nation's economy

(2) While in my days with the federal government a modest deficit was acceptable, it was largely revenues that determined the level of expenditures in the budget

(3) Put another way, revenues represented the independent variable in the budgetary equation, and expenditures represented the dependent variable

b. The next step in the process, after squeezing the foot into the much-smaller shoe, involved drafting an explanation of the budget designed to convince interested parties that less was really more

(1) And, of course, this effort invariably failed with those on the receiving end

(2) That's because less generally is less

4. Well, if you approach the state's budget deliberations assuming (1) that the level of revenues determines the level of expenditures and (2) that less is less, rather than more, you're not going to understand most of what is happening in Sacramento during the next six months

5. This is because the enactment of AB 28x has changed completely the dynamics of this year's budget process

B. AB 28x

1. When the Legislature, in enacting AB 28x convinced the 44 members of this association to contribute $6 million toward closing the gap in this year's state budget, it did two other things as well

a. First, it took out an <u>insurance policy</u> against the primary hazard facing the budget: the risk that state revenues will fall short of what the state's fiscal advisers--I'm one--anticipate at the time the budget is adopted

(1) As you know, it is these shortfalls that have plagued state finances--and, therefore, your finances--in each of the last two years

(2) The insurance policy contained in AB 28x provides for an <u>automatic</u> 1-cent increase in the state sales tax, effective November 1, <u>if</u> there is a revenue during July, August, and September that exceeds $100 million

(3) If this one-cent increase goes into effect it will generate about $400 million in additional revenues during 1983-84

(4) Here's where the less-is-more anomaly comes into play

(5) If revenues during the first three months of the new fiscal year <u>are</u> $100 million <u>less</u> than anticipated in the Governor's Budget, revenues for the year as a whole could turn out to be $800 million <u>more</u> than anticipated

b. The second important feature of, AB 28x is another automatic sales tax trigger--this one scheduled to increase the tax rate by one cent on February 1 <u>if</u> certain conditions materialize

(1) In effect, what the Legislature did here was put another player into the defensive backfield to play

safety (if I can use a football analogy) with respect to the deficit in this year's state budget

(2) Our best estimate is that the state will end this year and thus carryover into next year a deficit in its General Fund of approximately $1.1 billion

(3) Everybody agrees that the deficit must be tackled--that is, financed--by June 30, 1984

(4) And everybody agrees that the state shouldn't have to rely on a goal line stand a year from this June in order to keep its budget out of the red--that it should build in at least a $100 million cushion at the end of next year

(5) So how do we get from a $1.1 billion carryover deficit to a $100 million surplus on June 30, 1984?

   (a) The Governor's Budget provides a solution for <u>part</u> of the problem

      (i) he leaves unspent $700 million in 1983-84 revenues, with the intention of applying these revenues against the carryover deficit

      (ii) Let me quickly add, however, that most of this $700 million--about $ million of it--will never get to the state's treasury unless the Legislature buys all of those tax loophole proposals made by the Governor on Wednesday

(b) Even if the Legislature does make the changes in law needed to yield the full $700 million, by my calculations were still $400 million short of reaching the mandatory $100 million end-of-year surplus.

(c) This part of the problem could be tackled in one of two ways

(i) If the economy perks-up enough, it could generate <u>more</u> money than the Governor's Budget anticipates and thereby help reduce or eliminate this $400 million problem, or

(ii) Alternatively, further cuts could be made in the expenditure side of the <u>Governor's</u> Budget

(5) Here's where that extra player in the defensive alignment comes in

(a) If the combination of revenue growth and expenditure cuts is not able to bring down the prospective deficit and leave the state with a $100 million surplus, a one-cent increase in the state's sales tax, will be asked to do the job, beginning on February 1, 1984

(b) If the increase goes into effect it could increase state revenues during 1983-84 by $600 million

(6) This is why the usual dominance of revenues over expenditures doesn't hold this year

(a) Because of the way this second sales tax trigger works, an increase in state expenditures can produce an increase in state revenues

(b) If, for example, the Legislature adds enough money to the Governor's Budget so that the projected end-of-year balance in the General Fund is less than the $100 million cushion called for by AB 28x, a one-cent increase in sales tax, will automatically be triggered, generating additional revenues that will help finance the added spending

C. What the Legislature Can Afford to Give Cities

1. Why am I telling you all this?

a. Because these two sales tax triggers have implications for how much fiscal relief the Legislature can afford to give you

b. I'll get to the second part of the equation--what you can expect from the state--in just a moment

2. The November 1 trigger is relevant to the discussion of what the Legislature can afford to give you, for two reasons:

a. First, the existence of this trigger--this insurance policy--means that the Legislature does not have to maintain as large a contingency reserve as it otherwise would. Consequently, the Legislature will not have to hold down funding for cities and other recipients of state funds as much as it would otherwise in order to build up a kitty to protect the budget against revenue shortfalls

   b. Second, the trigger makes it less likely that the budget will have to be reopened later in the year to avoid a deficit as it has had to be in each of the last two years. This makes your subventions less vulnerable to cutbacks <u>after</u> the budget has been signed.

3. More important, from your standpoint, is the <u>February 1</u> trigger

   a. The existence of this trigger means that the Legislature has somewhat more wiggle room in putting together a budget for 1983-84, and thus does not <u>have</u> to cut state expenditures, including those for fiscal relief, as much as it would otherwise have to in order to avoid a deficit at the end of the year

   b. To the extent Members of the Legislature do not consider an increase in the sales tax to be an anathema--and many members do not--the compulsion to cut expenditures is considerably weaker

   c. In other words, members who feel that an increase in the sales tax is warranted can secure an increase <u>without</u> having to cast a vote for it--the increase--is already on the books!

   d. All the members favoring a tax increase need to do to make it happen is to <u>assume</u> that revenues will be $600 million higher than the Governor does--and the trigger provides a means to make revenues $600 million higher!

e. This does not mean that the level of revenues is irrelevant to this year's budget process--far from it:

   (1) A sales tax increase going into effect on February 1 picks up only $600 million

   (2) And, as we see it, $400 million of this amount may be needed to plug holes in the Governor's Budget, leaving only $200 million for spending augmentations

f. Still, the Legislature has much more maneuvering room than it might appear from simply reading the Governor's Budget

4. Of course, what the Legislature adds to the Governor's Budget, the Governor can delete, using his blue pencil

5. In acting on the budget, however, there are a few things that are beyond his reach

   a. One of them is fiscal relief to cities!

   b. This is because a change in law is required to reduce subventions to cities, and only the Legislature can change the law

6. So, to get back to the question I started with--how much can the state afford to give cities? I conclude as follows:

   a. _If_ the Legislature buys the Governor's proposals to close tax loopholes--one big if with $ million riding on it,

   b. And _if_ the Legislature wants to force the Governor's hand on a sales tax increase

   c. There's about $200 million in uncommitted funds up for grabs, relative to the Governor's spending plan

d. This could go up to nearly $400 million if we can figure out a way to recover a big chunk of dough which the courts made us give back to PERS

e. Thus, the Legislature could restore some of the $400 million in fiscal relief cuts proposed by the Governor, under the best of circumstances

D. What Can Cities Expect from the State?

1. Now let us now turn to the question of what you can expect from the state in the form of fiscal relief

2. The proposed cut in fiscal relief

a. I have brought with me copies of a print-out showing how the $400 million cut in fiscal relief promised to cities and counties by AB 8 would be allocated among the members of this association

b. As the table indicates, this translates into a cut of $142 million from the $168 million in fiscal relief promised to the 44 cities comprising this association--a reduction of more than 84 percent

c. This would leave 27 cities with no bailout, while three other cities would continue to face a negative bailout

3. Will the Legislature go along with the Governor's proposal, or will it use some of its $200 million wiggle room to backfill?

4. My response:

a. At this point, nobody can say with any assurances what will happen, since the overall budget picture is still murky

b. I suspect, however, that cities cannot expect a great deal of sympathy from the Legislature when the final decisions on the budget are made

c. Or more accurately, you can expect alot of sympathy, but not alot of money

d. There are four reasons why I feel this way

   (1) First, it is just not realistic to expect that the Legislature is going to buy the Governor's budget programs

      (a) The cuts in social welfare programs and the fee increases that the Governor proposes to lay on college students are very unpopular

      (b) And you've got to be a real optimistic to think that all of those loophole closings will fly

      (c) Thus, the $200 million is going to be soaked up by these two sponges long before the Legislature ever turns to fiscal relief

      (d) In fact, rejecting the Governor's proposal to charge fees at community colleges would soak up more than half of the $200 million in wiggle room

   (2) Second, during the last three years, enormous stresses have built up within the state's budget (as they have within your budgets)

      (a) These stresses have been caused by unprecedented reductions in the purchasing power of the state's budget (exclusive of fiscal relief)

(b) These reductions in purchasing power are considerably greater than local governments acknowledge

(i) In fact, the volume of services that would be provided by the Governor's Budget is 25 percent less on a per capita basis than what the state provided just three-years ago (net of fiscal relief)

(ii) If you net out fiscal relief, the state's budget today is actually below where it was in 1973-74 when expressed (on a real per capita basis)

(iii) The consequences of this reduction in purchasing power is that the competition for funds is more intense now than it has been in years

(3) Third, there is a strong consensus within the Legislature for pumping more money into K-12 education

(a) Because education is such a large chunk of the state's budget--36 percent--it takes alot of money to bring about a perceptible change in education funding

(b) Just to restore the purchasing power of the 1979-80 budget for K-12 education would require nearly $1.2 billion in new money (versus 1982-83)

(c) Even if taxes (other than the sales tax) are raised to generate more money for the state's General Fund, I would expect most of the additional money to be soaked up by education

(4) Fourth, rightly or wrongly--I tend to think rightly--the Legislature believes that cities have options for increasing revenues that other important claimants on the state budget do not have, making you less dependent on state largess

(a) Charter <u>and</u> general law cities have a broad array of taxing powers

(i) while individually, these sources may not be major,

(ii) collectively they are significant

(b) <u>Carmen v. Alvord</u> has given many of you the power to increase the property tax rate (even though this may cost you some of the revenues that you have already received)

(c) Finally, the <u>Farrell</u> decision has taken you off the hook from having to get "yes" votes from two-thirds of the voters in order to raise "special taxes."

e. For these reasons, I think what the cities belonging to this association received this year from the state--about $56 million--is the upper limit on what you can expect next year

f. I wouldn't be surprised, however, if the Legislature went even further than what the Governor proposes and <u>eliminates</u> fiscal relief to cities entirely

(1) At the funding level the Governor is talking about, cities would receive only $36 million in fiscal relief

(2) Of this amount, 80 percent would go to just 5 cities, and

(3) The 41 other cities would divide up the $7 million that's left

(4) And 286 cities would get noting or less than nothing

E. Summary

1. To return to the question of what you can expect from the state, my answer is "not much" and maybe nothing

2. This is due to the combination of

a. Fiscal stringency, and

b. My sense is that cities don't stand very high in the Legislature's pecking order when it comes to doling out the funds

III. The Outlook for State-City Relations

A. Overview

1. At this point, let me shift gears and talk about a much broader and more important issue than the amount of fiscal relief to be provided in the 1983-84 budget: the nature of the state's relationship with local governments--particularly cities.

2. Many of you know where I stand on this score: I believe that the nature of the current relationship is unsound and needs to be changed

3. Let me share with you

   a. What I think the major problems with this relationship are today,

   b. What I think ought to be done about these problems, and

   c. What I think are some of the obstacles to constructive change

B. Problems

1. Overview

   a. I'm sure you could put together a long list of the problems that you feel weaken the relationship between the state and local governments in California

   b. To me, they all boil down to two major problems

2. First, local governments do not have sufficient fiscal flexibility to respond to the needs and demands of their residents

   a. This is very evident in the case of counties and non-enterprise special districts

      (1) To me, fiscal flexibility requires access to a broad based source of revenues such as you have when you can tax one of the big three: income, spending (sales), or wealth (including property)

      (2) The ability to impose zoning fees, and hotel occupancy taxes isn't enough to provide for the degree of responsiveness I believe is desirable

   b. Cities, of course, have considerably greater access to revenues than do counties, particularly given the court's decision on the Farrell case

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c. Even so, I see a need to broaden the revenue base to which cities have access

2. Second, local governments are often required to use some of the fiscal room that they have to pay for services that are required by the state to provide

   a. Obviously, here I am referring to unfinanced or underfinanced state mandates

   b. Although I tend to think the problem is not as widespread as some would have us believe, it's sufficiently widespread to be a source of concern

3. Clearly, these are more serious problems at the county level than they are at the city level, but they are serious problems at your level as well

C. Manifestation of these Problems

1. The combination of limited revenue-raising authority and the heavy chains clamped on to the revenues that are raised at the local level has a number of undesirable consequences, but to me five stand out:

   a. By making local governments dependent upon the state for a portion of their revenues, the current system of public finance in California makes the revenue picture all that much more <u>unstable</u>.

   b. By limiting the ability of local governments to raise revenues and allocate them in accordance with local priorities, the current system undercuts government <u>responsiveness</u>

c. By weakening the link between where revenues are raised and where they are spent, the current system reduces the accountability of government

d. By driving a wedge between where decisions are made and where they are implemented, the current system reduces the incentives for governmental efficiency

e. By elevating many problems to Sacramento for resolution, the current system raises serious questions regarding equity

2. In addition, the limitation on the use of the property tax to amortize new debt forces localities to either use circuitous means for financing public facilities or put needed projects on hold

D. Responses to the Problem

1. What the solution is not

a. What do we do about this mess?

b. To me--and this is a personal view--Project Independence, as it currently is structured, is not the answer, although aspects of it would help redress the balance between the state and local governments

c. My problem with Project Independence is that:

(1) While it would make your revenues more stable--a desirable outcome--it would do so by making the state's budget situation more unstable

(2) In addition, by locking in the split between where revenues are raised and where they are spent, this

feature of Project Independence would do nothing to improve governmental accountability or responsiveness

(3) As far as the Legislature is concerned, the first of these problems probably will doom Project Independence in its current form

2. Frankly, I think it is unrealistic for you to expect the state to turn over more state-raised money to city councils and boards of supervisors for expenditures

   a. There is a strong feeling in Sacramento that the agony of taxation should go with the ecstasy of expenditure

   b. Hence, I doubt that you can expect what many view as something for nothing

3. What the solution to the problems with the current system <u>ought</u> to include, in my opinion, is two things

   a. First, local governments must be given access to a richer vein of potential revenues than they now have

      (1) One alternative for doing this <u>can</u> be found in Project Independence--a grant of authority to counties to impose a countywide sales tax

      (2) A better alternative, in my opinion, is to authorize cities and counties to impose an income tax surcharge that the state would collect as part of the income tax collection process

         (a) This authority would improve the responsiveness and accountability of government, as well as the stability of local revenues

(b) It has been used successfully in Maryland, as well as in other states

(c) It would, of course, require local officials to take the heat for an increase in taxes--a feature that may not hold alot of appeal for you

(d) Nevertheless, it rates a high score using my criteria, and has far more salability in the Legislature than the option of turning over part of the state's revenue base to local governments

(3) In addition, I think it is essential that we amend the State's Constitution to at least restore your ability to issue and sell general obligation bonds by raising the property tax rate

b. The second step that I think would improve the current system of public finance in California would involve taking a more constructive approach toward the funding of state mandates--on the state's part to be sure, but also on local government's part

(1) Overall, I think the intent of the reimbursement principle is sound

(a) Where the intent is carried out, it promotes accountability in government and avoids an awful lot of bad laws

(b) It is where the intent is either violated or carried to illogical extremes that we run into problems

(2) Looking first at the state's approach to mandates, I think we need to do two things:

(a) First, we at the state level need to shift our efforts <u>from</u> trying to beat the system <u>to</u> making it work

(1) Specifically, we need to discontinue the current practice of telling local governments to do something while deferring consideration of reimbursement to a later day

(2) This is the same kind of something-for-nothing attitude that I see in the proposal to turn over part of the state's tax base to local governments;

(3) Not only does this approach treat you unfairly;

(4) It results in the Legislature addressing issues without having complete information on the consequences of the actions it is contemplating

(5) It also bucks issues regarding spending priorities to the state's court system--which is the <u>worst</u> forum to resolve these issues that I know of

(b) Second, I think the state should take the lead in establishing a cooperative process for identifying unnecessary mandates

(i) This would require a committee of the Legislature to review existing mandates on an ongoing basis

(ii) It would also lay a heavy burden on you, by requiring local government officials to be candid in assessing what existing mandates accomplish

(iii) Put another way, you would have to identify specific mandates that you believe warrant review--generalizations about "oppressive mandates" wouldn't be helpful

(3) While most of the responsibility for making the reimbursement principle work falls to the state, the approach taken by local government could also stand some improvement

(a) First, I think it would be constructive if we could narrow the range of issues that we lock horns over

(i) one way of doing this would be for local governments to accept the idea that increases in local costs do not automatically signify the existence of a reimbursable state mandate

(ii) When, for example, the state requires an increase in workers' compensation benefits to restore the purchasing power of those benefits to what it was when benefit levels were last mandated, the state is hit with a claim for reimbursement

(iii) To my way of thinking, reimbursement in these cases is neither required by the law nor reasonable to expect

(iv) The arguments over reimbursement in these cases, however, increases the amount of contentiousness in the SB 90 process-which probably does not help make the Legislature receptive to <u>legitimate</u> requests for reimbursement

(b) Second, I think local governments should agree to some refinements in the reimbursement principle that, in my judgment, would make it work better--although at, perhaps, some additional costs to local government

(i) For example, it does not make sense to me to apply the reimbursement requirement to mandates that affect <u>all</u> employers or <u>all</u> consumers--public and private, as we frequently do with respect to lifeline utility rates, workers' compensation mileage rates, etc.

(ii) Similarly, I'm not sure it makes sense to spend the funds needed to ascertain reimbursable costs when the claims involved are relatively small in these cases unit reimbursements would seem to be in our joint interest

(c) In any event, the SB 90 reimbursement principle is a concept worth preserving, and it will take some "give" at both the state and local levels to keep it functioning

E. Obstacles to Change

1. Overview

a. What are the prospects for change, either along the lines of Project Independence or what I have suggested?

b. At this point, I am not terribly optimistic

c. As I see it, there are two primary obstacles to change--financial constraints and political constraints

2. Financial Constraints

a. It is always easier to make changes when the size of the pie is growing

b. This is not the case right now, and may not be for the next several years

c. This will make it more difficult for the Legislature to increase local government's fiscal flexibility, for two reasons:

(1) First, the perception in the Capitol is that even providing cities and counties with more access to the local tax base smacks of a state tax increase, causing

the voters may hold the Legislature responsible for any increase in taxes that occurs at the local level

(2) Second, the members see the state competing with local governments for the same tax base, so that in their view giving locals more access to funds would reduce the state's fiscal flexibility

3. Political Constraints

   a. For the locals to have more control over their own budgets the Legislature will have to give up some of the control it now enjoys

   b. Many members don't find this prospect appealing, for obvious reasons; they like the idea of local groups bringing their demands to Sacramento

   c. They may, however, think differently if city councils and board of supervisors become more successful at holding the Legislature responsible for unpleasant things that occur in their communities

IV. Closing