Policy Brief

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Reversing the Property Tax Shifts

SUMMARY

In 1992-93 and 1993-94, the state shifted about $4 billion in property taxes from certain local agencies to schools. These actions allowed the state to reduce its General Fund spending on schools. California's overall level of school spending was not affected by this shift of tax dollars.

While the property tax shifts played an important role in resolving the state's budget imbalances of the early 1990s, the property tax shifts have:

- *Diminished local capacity to respond to constituent needs and priorities.*
- *Encouraged counties to cut back on their property tax collection efforts.*
- *Decreased city and county incentives to promote new land developments.*

This policy brief provides an overview of the property tax shifts of 1992-93 and 1993-94—and examines four alternatives for reversing them. These proposals provide varying levels of relief to local agencies, and they also have different impacts on school spending and state taxation.

Our review indicates that the concept of allocating additional property taxes to local agencies has merit. Accordingly, we recommend that the Legislature consider mechanisms for reversing all or a portion of the tax shifts as it evaluates the state's budget priorities and proposals for changing state taxation.

Should the Legislature wish to restore property taxes to local agencies, we recommend that the Legislature provide this fiscal relief in a manner consistent with its objectives for local government, the economy, and the state-local relationship.

Legislative Analyst's Office April 2, 1996

Reversing the Property Tax Shifts

In 1992-93 and 1993-94, in response to severe state budget deficits, the Legislature and administration shifted about $4 billion of property taxes from cities, counties, special districts, and redevelopment agencies to schools. These increased school property taxes, in turn, decreased the state's General Fund (GF) obligation for funding schools. The overall level of school financing was not affected by this replacement of state GF revenues with local property tax revenues.

The property tax shifts have caused nonschool local agencies to reduce a wide variety of local programs. The shifts have also reduced local agency incentives to maintain the property tax collection system and to promote new business and residential land developments in their communities.

Currently, there is considerable legislative interest in "reversing" the property tax shifts in order to mitigate their ill effects. This policy brief provides an overview of the property tax shifts, and discusses alternatives for reducing the amount of tax revenues shifted from cities, counties, and special districts.

BACKGROUND

Purpose of the Property Tax Shifts

Between 1991-92 and 1994-95, the state faced annual budget gaps of between $4 billion and $14 billion. As Figure 1 indicates, the Legislature and administration closed these budget gaps by raising fees and taxes, reducing programs, shifting property taxes from local government, and taking actions to defer costs or shift costs to the federal government. Shifting property taxes to schools helped close the state's budget gap because it reduced Proposition 98-required GF school expenditures (K-12 and community colleges).

How the Property Tax Shifts Worked

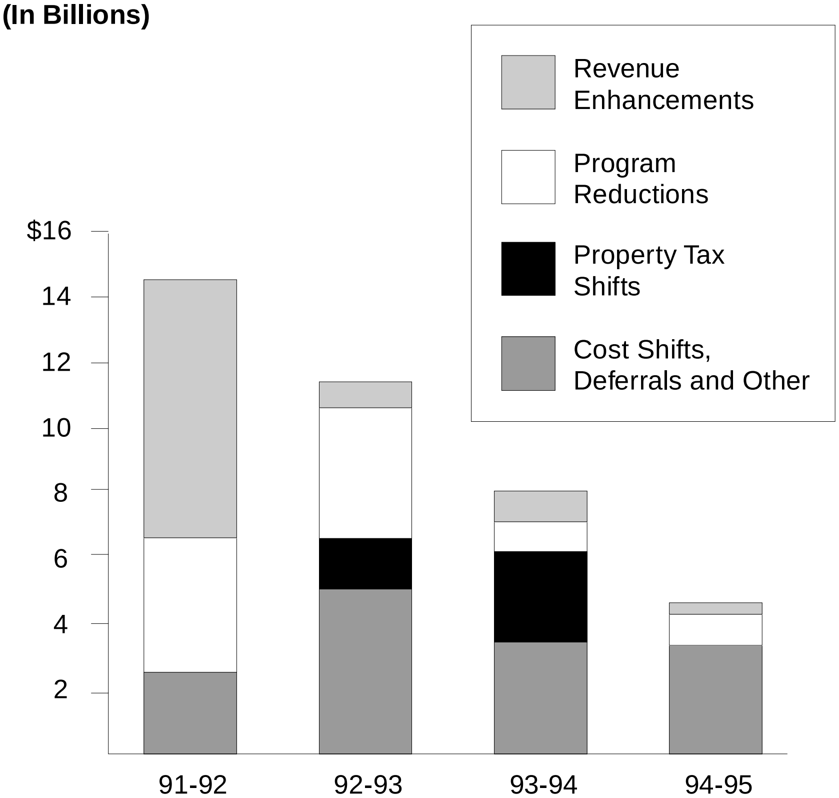
Two sets of state laws played a part in making the property tax shift work as a mechanism to help close the state's budget gap.

Property Tax Allocation Law. In each county, the auditor allocates property tax revenues to schools, cities, special districts, redevelopment agencies, and the county itself. The method of distributing property taxes among local agencies is set by state law, as required by Article XIII A of the California Constitution (Proposition 13).

Figure 1

Strategies to Address Budget Gaps 1991-92 Through 1994-95

(In Billions)



School Funding Law. Under Proposition 98, constitutionally mandated levels of K-14 spending are financed with local property taxes and state GF monies. Specifically, the state provides GF revenues to school districts sufficient to close any gap between the amount of local property taxes distributed to K-14 schools and the mandated level of school spending.

Reducing State Costs. In order to reduce state GF costs for schools in 1992-93 and 1993-94, the Legislature and administration changed the laws regarding the allocation of property taxes. Specifically, the state required auditors to deposit some of the property taxes that previously had been allocated to nonschool local agencies into a newly created county-wide fund for schools, the "Educational Revenue Augmentation Fund" (ERAF). Property taxes from the ERAF are distributed to schools thereby offsetting the need for state school aid. As shown in Figure 2, the property tax shift shrank the nonschool local agency share of the property tax "pie" and expanded the school share. The overall level of school funding was not affected.

Amount of Property Tax Shift

As Figure 3 indicates, the total shifts in 1992-93 and 1993-94 were proposed to be $1.4 billion and $2.6 billion, respectively. Due to various factors described below, we estimate that the 1995-96 value of these property tax shifts is $3.6 billion, somewhat less than the two shifts combined. More than two-thirds of the shift is from counties.

Why the 1995-96 Shift Is Lower Than Previous Years Combined. Our estimate of the ongoing value of the shifts in 1995-96 is less than the combination of the 1992-93 and 1993-94 shifts for several reasons:

- Several components of the property tax shifts have sunset ($365 million).
- Certain property tax transfers were less than anticipated (about $150 million).
- Subsequent legislation has reduced the amount of the shift by about $20 million.
- The shift legislation authorized (until 1997-98) a $20 million reduction from the amounts due from disaster-damaged cities and counties.

Partially offsetting these actions, on the other hand, is a small amount of growth in the property tax base. Under current law, the amount of the property tax shift increases with growth in assessed value.

Allocation of Shift Amounts

The Legislature and administration used a wide variety of methodologies to allocate the property tax shifts, as shown in Figure 4 (see page 6). Most of the formulas reflected an attempt to "take-back" part or all of the benefit the state provided to cities, counties, and special districts after passage of Proposition 13. Specifically, Ch 282/79 (AB 8, L. Greene) provided financial relief to local agencies to offset most of the losses local agencies would have incurred due to passage of Proposition 13. This measure, often referred to as the "AB 8 bailout," did the following:

- Reduced county health and welfare program costs, primarily by lowering or eliminating county costs for indigent health, Medi-Cal, SSI/SSP, and AFDC. The current value of these program cost reductions exceeds $4 billion.

Figure 2

Reallocating the Property Tax Pie
The Impact of the 1992-93 and 1993-94 Shifts

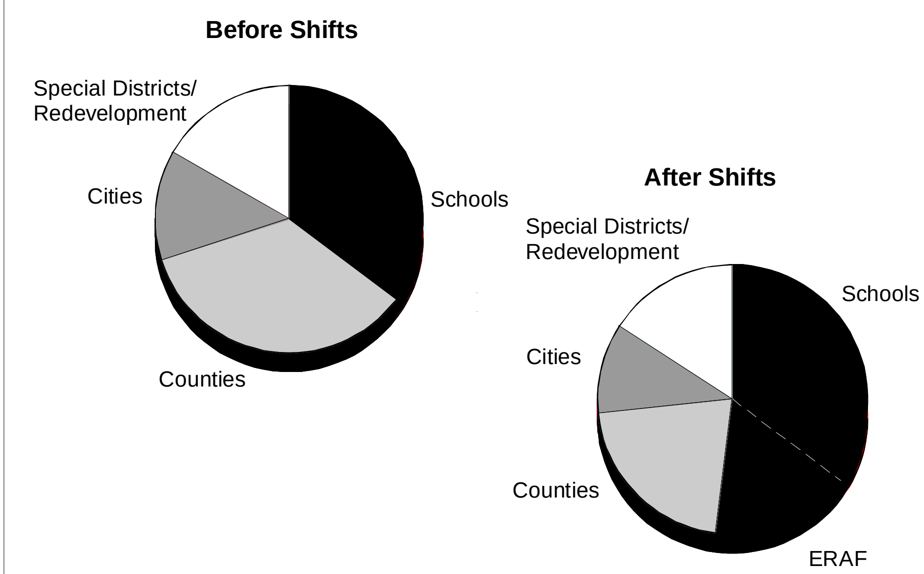


Figure 3

What Is the Current Value of the Property Tax Shift?

(In Millions)

	1992-93 Shift	1993-94 Shift	1995-96 Value Ongoing Shifts[a]
Counties	$585	$2,023	$2,616
Cities	240	313	571
Special Districts	375	244	489
Redevelopment	200	65	—
Totals	**$1,400**	**$2,645**	**$3,677**
Less legislation and disaster relief	—	—	-43
Totals, adjusted	**$1,400**	**$2,645**	**$3,634**

[a] These amounts are not the sum of the previous two columns for various reasons (see text).

- Shifted property taxes from schools to cities, counties and special districts, replacing the school's lost revenues with increased state GF revenues. The current value of these property tax shifts to nonschool local agencies exceeds $2 billion.

Figure 4

Allocating the Property Tax Shifts[a]

(Shift Amounts in Millions)

Shift	1992-93 Basis	Shift	1993-94 Basis
	Counties		
$525	Each county shift specified in statute. Shift amounts developed by county agreement and are largely proportionate to county shares of AB 8 benefits.	$1,998	Shift amount allocated in proportion to two factors: • County share of taxable sales. • County revenue change under a restructuring proposal that considered: AB 8 benefits to counties and special districts, enterprise district property taxes, and certain federal funds.
$60	One-time shift of $1.92 per resident.	$25	Permanent shift of 78 cents per resident.
	Cities		
$200	Shift set at 9 percent of city 1991-92 property tax revenues.	$288	Shifts amounts based on remaining AB 8 benefits. Maximum shift set at $19.31 per resident.
$40	One-time shift of $1.65 per resident.	$25	Permanent shift of 99 cents per resident.
	Special Districts[b]		
$375	Shift amount set at: 40 percent of a district's 1991-92 property taxes, up to a maximum of 10 percent of district total revenues in 1989-90.	$244	Shift allocated to reflect AB 8 benefits.
	Exempted: Multi-county, hospital, and city-dependent districts.		Exempted: Multi-county, police, hospital, transit, veterans' memorial, water wholesaler, and districts not receiving AB 8 benefits.
	Lower shift amounts required from fire and water districts.		Lower shift amounts required from fire and city-dependent districts.
	Redevelopment Agencies		
$200	Agencies lost 15 percent of gross property taxes. Shift sunset in 1993-94.	$65	Shift amounts allocated in proportion to agency property taxes, net of taxes passed through to other agencies. Shift sunset in 1994-95.

[a] All shifts are ongoing, unless otherwise indicated.
[b] Actual shift was $146 million less that proposed.

Because each agency's share of the 1992-93 and 1993-94 property tax shifts largely reflected its relative share of AB 8 benefits, there is considerable variation in the distribution of the property tax shift amounts. Nearly one in five cities, for example, received virtually no property tax shift in 1993-94 because these cities were formed after 1978, and did not receive any AB 8 benefits. Conversely, many older cities lost significant amounts because they benefited disproportionately from AB 8. Similarly, while we estimate that the *average* county lost about 40 percent of its property taxes (about $50-$70 per capita), some counties lost considerably different amounts. For example, Los Angeles County lost about $100 per capita.

Offsetting Measures

Recognizing that the property tax shifts would have a significant impact on nonschool local agencies, the Legislature and administration enacted a variety of mitigating measures. The most notable measure is Proposition 172. This measure provides half-cent sales tax funds to counties (about $1.5 billion in 1995-96) and cities (about $90 million) for local public safety programs, thereby offsetting about half of the ongoing shift from cities and counties.

In addition, the Legislature increased vehicle license fee subventions to cities and counties, and provided relief from certain "state-mandates." The most significant mandate relief measure from a cost-reduction standpoint is Ch 72/93 (SB 1033). This measure authorizes counties to reduce general assistance grant levels by about 25 percent if the Commission on State Mandates approves a county claim that it is in "significant financial distress." Finally, the Legislature enacted bills which reduced or eliminated the property tax shifts for specific agencies, such as police protection and veterans' memorial special districts.

IMPACT OF THE PROPERTY TAX SHIFTS

Despite the mitigation measures adopted by the Legislature, the property tax shifts have negatively affected nonschool local agencies in several ways.

Effect on Local Programs

The property tax shifts reduced nonschool local agency discretionary funds, in some cases by as much as 50 percent. This revenue reduction, in turn, has required local agencies to reduce a wide range of programs, including libraries, parks, health, social services, general assistance, property tax administration, and community development. (Public safety expenditures generally have not been reduced due to the funding made available by Proposition 172.) The revenue reductions have also exacerbated the very considerable fiscal strain faced by many counties—and some cities, special districts, and redevelopment agencies.

Reduced Levels of Property Tax Administration

Administering the property tax entails a wide range of activities, including annually assessing property, reassessing property when it changes ownership, reviewing appeals, and ensuring that new properties and improvements are entered onto the property tax roll. Counties are responsible for administering this tax collection system. Under current law, schools are exempt from the requirement that all agencies receiving property taxes pay a proportionate share of property tax administration costs. As a result, counties pay a disproportionate share of the tax collection system's costs, and do not receive a proportionate share of the benefits realized from investments in the tax system.

The property tax shifts of 1992-93 and 1993-94 aggravated this situation, giving counties an even greater disincentive to invest in the property tax collection system because counties now receive about 22 percent of the tax proceeds, yet pay nearly three-quarters of the administration costs.

Since the property tax shifts, the Legislature has taken two actions to address this problem. In 1994-95, the Legislature appropriated $25 million to counties to augment their property tax collection efforts. In 1995-96, the Legislature authorized a three-year program to provide up to $60 million annually in off-budget, forgivable loans to counties to increase property tax collection efforts.

While these funds have helped, counties continue to face significant economic incentives to under-invest in the property tax collection system. If unaddressed, this failure to adequately maintain the property tax system not only translates into lower property tax revenues (and therefore higher state expenditures for schools) but, also undermines peoples' faith in the fairness of the property tax system.

Diminished Incentive to Promote Land Developments

In reviewing proposed new major residential and business developments, cities and counties typically analyze whether the property and sales tax revenues generated by the development are likely to be sufficient to offset the increased local services required by the development. To the extent a development imposes costs that exceed expected tax revenues, cities and counties frequently require developers to pay fees, agree to the imposition of assessments, or take other actions to ensure that the development does not pose a fiscal burden to the community.

Because the 1992-93 and 1993-94 shifts significantly decreased city and county shares of the property tax generated by new developments, local agencies now face a greater need to require developers to mitigate the fiscal impact of their projects. These increased fiscal and other requirements on developers serve as a disincentive to land developments.

Proposals for Reversing the Shifts

Currently, there are several proposals for reversing the property tax shifts in order to mitigate the problems discussed above. These proposals are:

- ***Freeze Shift.*** Freeze the amounts local agencies are required to deposit to the ERAF at 1994-95 levels. Local agencies benefit by keeping the amounts of the ERAF growth. *SB 1865 (Craven) and AB 2797 (Aguiar)*.

- ***Top Brackets.*** Reinstate the state's top 10 percent and 11 percent rates on personal income. Deposit funds into the ERAF, offsetting local contributions to the ERAF by a like amount. *AB 2406 (Villaraigosa).*

- ***General Fund Growth.*** Annually reduce local agency-required contributions to the ERAF by an amount equal to *half* the state's GF revenue growth (net of Proposition 98 school requirements). Each year's ERAF reduction would be permanent and cumulative. *Proposed amendments to AB 2828 (Sweeney*).

- ***Citizen's Option for Public Safety Program.*** Permanently reduce local contributions to the ERAF by redirecting funds included in the Budget Bill (Item 9210) for the Citizen's Option for Public Safety Program (COPS). *Option offered by Legislative Analyst's Office in 1996-97 Perspectives and Issues (please see page 125).*

These proposals are not exclusive. Should the Legislature wish, it could adopt *all* the options simultaneously. Each proposal, however, raises several important questions, as discussed below.

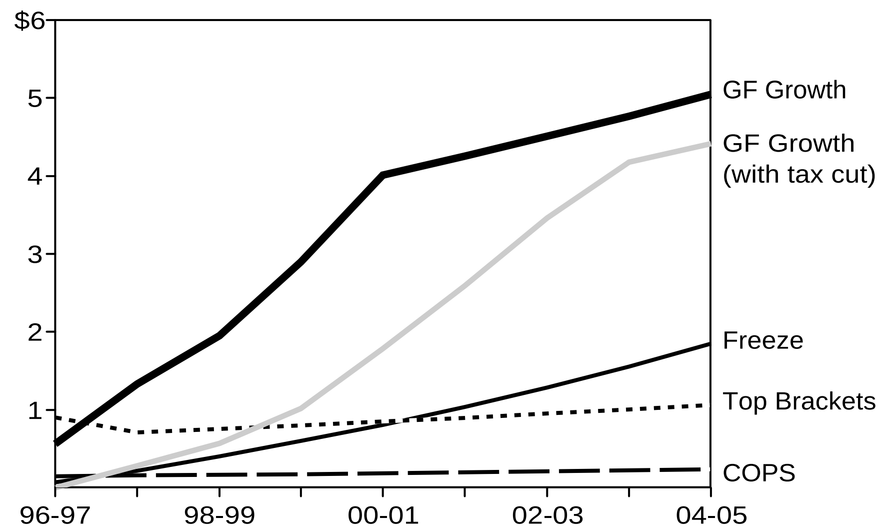
How Much Money Would Be Shifted to Local Agencies?

In Figure 5 (see page 10), we provide our estimates of the fiscal relief provided to local agencies under the various proposals. We estimate that the GF Growth option would provide the greatest fiscal relief to local agencies—eliminating all property tax shifts within five years (assuming the Governor's tax cut proposal is not adopted) or seven years (with the tax cut). The Freeze Shift option would provide $72 million in fiscal relief to local agencies in 1996-97, rising to $1.9 billion in ten years. (Using the lower Department of Finance projections for assessed value growth, the Freeze Shift option would provide $54 million in benefits in 1996-97.) Both the Top Brackets and the COPS options provide relatively constant annual fiscal relief to local agencies, of about $800 million and $150 million, respectively.

Figure 5

Property Tax Shift Reversal Options Annual Local Benefits

(In Billions)



Which Agencies Would Benefit From the Shift Reversal?

Both the GF Growth and the Top Bracket options provide relief to local agencies in accordance with their share of the ongoing reduction of property taxes. Thus, counties would receive about 72 percent of the relief funds, and the remainder would be split between cities and special districts. The Freeze Shift option provides greater fiscal relief to local agencies in growing areas (such as in Marin, Napa, and Sonoma Counties). Local agencies in areas where assessed value is flat (such as Lassen County has been over the last three years) would not benefit.

Would the Proposal Affect Schools, State Costs, or Taxes?

Figure 6 illustrates how each of the proposals affects state taxation, public school funding, and funding for nonschool state programs. The Top Brackets option, for example, in-

Figure 6

Impact of Property Tax Reversal Options on State School Spending Requirements and Taxation

(In Millions)

Estimated 1996-97 Local Relief	Does the Option Affect: Overall Level of School Funding?	Funding for Other State Programs?	State Taxation?
Freeze Shift			
$72	No.	Yes. State share of school costs increases by full amount of local fiscal relief. This leaves fewer General Fund revenues available for nonschool programs.	No.
Top Brackets			
$905	Yes. Increases levels by roughly half the level of local relief.	Yes. State share of school costs increases by roughly half the amount of local fiscal relief. This leaves fewer General Fund revenues available for nonschool programs.	Yes. Reinstates top income brackets.
General Fund Growth			
$562	No.	Yes. Same as "Freeze Shift."	No.
Citizens' Option for Public Safety (COPS)			
$150	No.	Yes. Same as "Freeze Shift."	No.

creases state taxes over the levels specified in current law and provides these funds to local agencies. By increasing the level of state taxes, however, the measure also increases Proposition 98-required school funding by roughly half the amount of the additional tax revenues. In order to accommodate this increased level of required state school spending, the state would need to reduce funds for nonschool programs by a commensurate amount.

The Freeze Shift, GF Growth, and COPS options do not increase state taxation or the overall level of funding for schools. Each of these options, however, requires the state to increase its share of school funding by an amount equal to the fiscal relief provided to local agencies. This increased spending on schools would require the state to reduce spending on other programs.

CONCLUSION

While the property tax shifts played an important role to closing the state's serious budget gaps in the early 1990s, the shifts have:

- Reduced local government's ability to respond to constituent needs and priorities.

- Encouraged counties to cut back on their property tax collection efforts.

- Decreased city and county incentives to approve new land developments.

As a result, we believe the concept of reversing the property tax shifts has merit. We recommend that the Legislature consider mechanisms for reversing all or part of the shifts as it evaluates short-term and long-term state budget priorities and proposals for changing state tax rates.

Should the Legislature wish to implement a reversal of the property tax shifts, we recommend that it provide the fiscal relief in a manner consistent with legislative objectives for local government, the economy, and the state-local relationship. Specifically, the Legislature need not reverse the property tax shift evenly across local agencies. Instead, the Legislature could provide the fiscal relief:

- As part of a state-local program realignment.

- To agencies that approve land developments.

- To agencies that receive unusually low shares of the property tax, or have limited fiscal capacity.

- As an incentive to local agencies which meet specific state goals.

This report was prepared by Marianne O'Malley with the assistance of Matt Newman, under the supervision of Mac Taylor.

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The Legislative Analyst's Office is located at 925 L Street, Suite 1000, Sacramento, CA 95814.