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CALIFORNIA UPDATE

LEGISLATIVE ANALYST'S OFFICE

Major Milestones:
25 Years of the State-Local Fiscal Relationship

The past 25 years in California have seen significant changes in the fiscal relationship between state and local government. The time line on the following pages highlights the major events that have altered the state-local fiscal relationship since 1972. The milestones illustrate a number of key themes that have emerged over the past quarter century:

■ Increased Voter Oversight of Revenue

California voters have increased their power over local government tax decisions. In the 1970s, the rapid rise in home values and the subsequent growth in property tax bills created the widespread desire to lower property taxes. This movement culminated in 1978 with the passage of Proposition 13, which reduced property tax revenues by more than 50 percent. In addition, Proposition 13 requires two-thirds voter approval for the passage of new local special taxes. Similar voter approval requirements have been extended over the past two decades for various other types of local revenue sources.

■ Shifts in Program and Funding Responsibility

The Legislature has enacted major shifts of program responsibility and program funding over the past 25 years. In areas such as trial courts and health and welfare, the administration and funding of programs have been altered in an effort to increase efficiency and provide greater flexibility.

■ Reduced Local Flexibility

By giving state government the authority to allocate local property tax revenues, Proposition 13 placed the state in control of one of local governments' primary revenue sources. The two decades since the passage of Proposition 13 have seen the increasing interdependence of state and local fiscal policy and a significant loss of local flexibility. As a result, local governments must now try to respond to citizens' needs with limited fiscal flexibility.

Major Mil

25 Years of the State-Lo

1972

SB 90
Limited local government authority to raise property taxes. Required the state to reimburse local governments for new state-mandated programs.

1978

Proposition 13
Set property tax rate at 1 percent, cutting local government property taxes by over half. Transferred control over property tax allocation to state. Established acquisition-based assessment system. Requires new local special taxes to be approved by two-thirds of voters.

SB 154
Used state's budget surplus to provide a one year "bailout" for local governments.

1979

AB 8
Established ongoing "bailout" for local governments. State assumed many county health and welfare costs, and increased school aid. Developed permanent property tax allocation system. Included a "deflator" to reduce state costs if revenues were insufficient.

Proposition 4
Generally limits local and state spending of tax proceeds to prior-year amount, adjusted for population and inflation (now, per capita personal income growth). Requires state to reimburse local entities for mandated costs.

1988

Brown-Presley Trial Court Funding Act
Increased state funding for county-operated trial courts, through the establishment of block grants.

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1991

Realignment
Major shift of authority from state to counties for mental health and other health programs. Funding changes intended to be fiscally neutral and included: new sales and VLF taxes and changed state/county cost sharing ratios in health and social services programs. Increase in state funding of trial courts, as well as increase in state revenues from court fines.

1992

1993

Education Revenue Augmentation Fund (ERAF)
Annually shifts over $3 billion in
taxes from cities, counties, and sp
districts to schools. Implemented
years to reduce state education cos

Proposition

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Budget

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1981

General Law City Taxing Authority (SB 326)

Gave general law cities the same taxing authority as charter cities.

1982

Medically Indigent Adult Program Shift (AB 799)

Major shift of program responsibility from state to counties. State provided counties 70 percent of state's program costs.

1983

Mello-Roos Community Facilities Act

Created major program to assist communities in financing infrastructure. New special taxes subject to two-thirds voter approval.

State Budgets, 1981 - 83

Despite low state revenues, state did not activate AB 8 deflator. Instead, state permanently repealed three local subventions: liquor license fee, highway carrier's uniform business tax, and financial aid to local agencies.

1984

State Budget

Permanently repealed AB 8 deflator and local government personal property tax subvention. Allocated increase in vehicle license fee (VLF) revenues to local governments.

1986

Proposition 47

Constitutionally guaranteed VLF revenues for cities and counties.

Proposition 62

Requires approval of new local general taxes by two-thirds of governing body and majority of local voters.

1987

General Purpose Sales Tax (AB 999)

Allowed small counties to increase their sales tax by 1/2 percent with two-thirds vote of board of supervisors and majority voter approval. (Extended to all counties in 1990.)

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1996

Proposition 218

Constrains local government ability to raise revenues from taxes, assessments, and fees. Subjects some of these revenue raising methods to increased voter approval requirements.

1997

Welfare Reform

Provides counties with more flexibility regarding (1) delivery of welfare-to-work services and (2) recipient participation requirements. Provides incentives for counties to assist recipients in getting jobs.

Trial Court Funding

Cap placed on county trial court spending, resulting in future increases in state funding. Permits cities to keep revenues from fines and penalties previously submitted to the state's General Fund.

Economic and Revenue Developments

Healthy Economic Growth Continues

As of late 1997, California's economy is experiencing healthy and balanced economic growth. Wage and salary employment is up by over 3 percent this year, the largest gain of the 1990s, and other measures, including personal income and retail spending, are showing similarly healthy gains. Of particular importance, California's real estate markets are clearly rebounding. Home prices are up in most regions of the state, sales are at their strongest pace since 1988, and new construction activity is on the rise. In October, building permits for residential construction reached 134,000, which is up by nearly 30 percent from the prior year. Nonresidential building activity also is strong, reflecting large increases in industrial and office construction.

Slowdown in Asia Poses Risks

The much publicized economic and financial problems in Asia will have some impact on California in 1998, although the extent of the impact is difficult to determine at this time. Some exporters have already reported cutbacks in goods sold to these regions, and growth in total exports of California-produced goods slowed sharply in the first half of 1997, largely reflecting reductions in goods sold in Asia. While these slowdowns have thus far been offset by strength in other sectors of California's economy, a deepening crisis in Asia could have more significant impacts in this state. We will be monitoring these impacts in the months ahead.

Revenues Soft During First Five Months of 1997-98

Revenues collected during the July-through-November period are down $407 million, or 2.2 percent, from the *1997-98 Budget Act* estimate. As we discussed in our November fiscal outlook report, the shortfall does not appear to be indicative of a fundamental weakness in the revenue trend. As noted above, California's economy is growing at a healthy pace, and collections that are closely tied to current economic activity, such as withholding and sales tax receipts, are running ahead of estimates.

The year-to-date shortfall is due to a combination of unusually large corporation tax refunds (which are mostly one-time in nature) and to lower-than-expected quarterly estimated payments from the personal income tax. We believe that the softness in quarterly payments is due to shifts in the timing of such payments, rather than an underlying slowdown in investment and business-related earnings. This is especially true given the current strength in the economy and the high financial-related earnings reported so far this year.

Given these factors, we believe that the underlying trend in revenues remains positive. We will have a better picture of the outlook in December and January. These months include both the last quarterly payments toward 1997 tax liabilities for individuals and corporations, and tax receipts related to retail sales during the key Christmas shopping period.

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