(as opposed to across) fiscal years, unless interyear borrowing is simply unavoidable;

(3) ***Establish a statutory ceiling on the amount of short-term external borrowing which can be undertaken without specific legislative authorization;***

(4) ***Authorize the issuance of secured, as well as unsecured, short-term debt for cash-management purposes; and***

(5) ***Authorize the Treasurer to borrow from external resources even if internal funds are available, whenever external borrowing is less costly.***

Background

It is not uncommon for the General Fund to borrow money on a *short-term* basis in the course of a fiscal year. This need arises because of differences between when revenues are actually received and when the state's bills must be paid. This type of borrowing, which can be necessary even when a year-end budget surplus is anticipated, is part of the cash management process and, when responsibly undertaken and monitored, it is a proper way of handling the state's short-run cash deficiencies. Of course, the use of short-term borrowing can be abused, such as when a government resorts to such borrowing in order to fund on-going operating costs without having any credible programs for repaying the debt. Such was the predicament which New York City put itself into some years ago.

Traditionally, California has been able to avoid issuing short-term debt instruments in order to satisy its short-term needs for cash. This is because the General Fund has several other sources of borrowable funds—namely, the Reserve for Economic Uncertainties, the state's various special funds, and the Pooled Money Investment Account (PMIA). It is only when these *internal* sources of borrowing are exhausted that the General Fund has had to engage in *external* short-term borrowing.

During 1982–83, exactly such a situation developed. Because the state's internal borrowing capacity was not adequate to meet its cash requirements, the Controller issued $400 million in unsecured "revenue anticipation warrants" to private sector investors. Both the Department of Finance and the Controller agree that additional external borrowing will be necessary in the current year. If there is no legislative action to balance the 1982–83 budget, external borrowing is expected to peak at over $900 million in May 1983. These borrowings will be accomplished by issuing secured or unsecured short-term notes, possibly in conjunction with "registered warrants" (that is, checks which cannot be cashed immediately) issued to those to whom the state owes payments, such as state employees and various program beneficiaries. The exact amount of external borrowing that will be needed prior to the end of the current year, and the exact form it will take, are not known at this time. It is clear, however, that a need to borrow significant amounts will confront the state prior to year-end.

Policy Issues

We believe that the Legislature may wish to consider and resolve a number of specific policy issues regarding short-term borrowing. These issues have not been resolved in the past primarily because the need for external borrowing has only developed recently. Five issues seem especially important:

1. ***Which state official should be responsible for managing short-term external borrowing?*** We recommend that the State Treasurer be designated as this official, given his office's experience in marketing debt. Currently, the State Controller is managing external short-term borrowing by the state.
2. ***Should short-term external borrowing for cash-management purposes be "rolled-over" between fiscal years?*** This issue involves the question of when short-term borrowing should be permitted to finance a year-end budget deficit, even if this financing is for only a "short period of time." We recommend that, in general, all short-term borrowing undertaken for cash management purposes be repaid by year-end, and that short-term borrowing across fiscal years *not* be allowed. Of course, there may be cases where borrowing to finance a deficit may be unavoidable, such as when a deficit is not anticipated early enough in the fiscal year to permit a realignment of revenues and expenditures, or when actions taken to eliminate a deficit are revealed to have been inadequate when the books on the fiscal year are closed. (This, in fact, is what happened in 1981–82.) In such cases, we recommend that the short-term borrowing be accompanied by a *specific plan* for repaying the debt, such as through a temporary increase in taxes.
3. ***Should there be a statutory ceiling on the amount of short-term external borrowing which can be undertaken without specific legislative authorization?*** Currently, the Controller is permitted to issue unsecured debt in whatever amounts are needed to pay the state's bills. We believe that the Legislature may wish to impose a ceiling on the amount of discretionary borrowing that may be undertaken. The ceiling should be set high enough to enable the official who manages short-term borrowing to have the flexibility necessary to handle *normal* cash-flow imbalances, but low enough to protect the state against excessive debt issuance in times when alternative approaches, such as revenue increases or expenditure decreases, are more appropriately pursued.

   Such a ceiling would improve legislative oversight over short-term borrowing activities. We therefore recommend that the Legislature enact such a ceiling in conjunction with any expansion of short-term borrowing authority.
4. ***What type of short-term debt should be issued for cash management purposes?*** Under current law, the Controller has standing authority to issue only *unsecured* debt in cases where external borrowing is necessary to address cash management problems. We recommend that the Legislature authorize the issuance of limited amounts of *secured* debt, such as tax anticipation and/or revenue anticipation notes, because secured debt might be more easily marketed, and might carry a lower interest cost to the taxpayers. Debt security could include anticipated revenues from one or more specified income sources.
5. ***Should the state be permitted to borrow externally before it has exhausted its internal borrowing capabilities?*** Current law does not require that General Fund borrowing from external sources occur only *after* all internal borrowing sources have been exhausted. In the past, however, the state's practice has been to use external borrowing as a last resort. Once the General Fund begins to borrow from the

PMIA, it must pay interest on the amount borrowed at a rate equal to the current PMIA yield. This yield can *exceed* the interest rate which must be paid on external short-term borrowing, largely because the PMIA holds many long-term, high-yielding financial assets. For example, in December 1982, the average yield on the pool was over 10 percent, whereas the revenue anticipation warrants marketed by the Controller in November carried an interest rate of approximately 5 percent. Thus, there are situations in which the state would be able to *reduce* borrowing costs by borrowing *externally instead of internally.* For this reason, we recommend that any legislation to expand the state's short-term borrowing capabilities explicitly provide that the Treasurer may borrow externally whenever he determines that it is a lower cost alternative to internal borrowing.

B. LONG-TERM BORROWING

What Should Be the Legislature's Policy Regarding Long-term Borrowing?

As discussed in Part II, the state undertakes borrowing through the issuance of long-term tax-exempt bonds. Unlike short-term borrowing, which is a tool for cash management, long-term bonds with maturities of up to 50 years are used to finance the acquisition of capital equipment and facilities, including highways, water systems, prisons, and office buildings.

In last year's *Analysis,* we indicated that there are a number of problems and policy issues regarding the use of tax-exempt bonds by governments to finance capital outlays. Given the importance of these issues, we prepared a report on the general subject of long-term borrowing. This report, entitled *The Use of Tax-Exempt Bonds in California: Policy Issues and Recommendations,* was transmitted to the Legislature earlier this session. The report provides an *overview* of tax-exempt borrowing, identifies *policy issues* regarding the use of tax-exempt bonds, and presents *recommendations* for improving state policy governing the use of tax-exempt financing.

Policy Issues Regarding Tax-Exempt Bonds

We believe that the major policy issues regarding tax-exempt bonds fall into five general categories:

- ***First, what programs*** should tax-exempt bonds be used to finance? Addressing this issue involves identifying (a) on what *basis* programs should be chosen as potential candidates for subsidies, (b) whether subsidies are actually *needed* for these programs to proceed, and (c) whether the tax exemption granted to interest on municipal bonds is the *best method* for providing these subsidies.
- ***Second, how much*** tax-exempt debt should be *issued* and how should it be *allocated* between different programs?
- ***Third,*** what *technical constraints* should the state impose on tax-exempt bond issues? Specific questions in this category involve (a) the bidding rules used to sell bonds, (b) the restrictions imposed on interest rates, price discounts, maturity structures, and call provisions, and (c) the method used to place bonds (competitive bids or negotiated sales).
- ***Fourth,*** what should be the *role of the state government in local*

borrowing activities? and

- ***Fifth,*** should California *continue to exempt* from state taxation the interest earned on state and local government bonds? This issue raises questions about (a) whether the state should subsidize capital outlay projects in the first place, (b) what the tax exemption actually does and does not accomplish, and (c) whether alternative approaches to subsidization might be preferable to exempting interest on government-issued bonds.

These policy issues all relate in one way or another to the ability of California's governments to market a sufficient quantity of long-term bonds to meet their capital outlay spending priorities, to minimize the costs to taxpayers of servicing this debt, and to structure debt issues in a manner which maximizes budgetary flexibility.

Recommendations Regarding Tax-Exempt Borrowing

We suggest that the Legislature consider the recommendations which appear in our December 1982 report entitled: "The Use of Tax Exempt Bonds in California: Policy Issues and Recommendations."

Our report, cited above, develops and presents 21 specific recommendations regarding tax-exempt borrowing in California. Because the subject of tax-exempt debt financing is an extremely broad and complex one, our recommendations by no means cover all of the issues involving tax-exempt borrowing which the Legislature might wish to consider. These recommendations, however, provide a starting point for addressing legislative policy issues related to tax-exempt financing.

The principal recommendations contained in our report are as follows:

- We recommend that the Legislature review existing state policies governing the *purposes* for which tax-exempt bonds may be issued, and develop a clearer picture of the state's overall capital outlay financing *needs* and the relative *priority* of each of these needs. This review could be accomplished through one or more oversight hearings conducted by the appropriate committees of the Legislature.
- We recommend that the Legislature amend existing law to (a) *remove open-ended bond authorizations* under the state's revenue bond programs, and (b) provide that unused bond authorizations *lapse automatically* after a specified period of time. Adoption of these recommendations would facilitate increased legislative control and oversight of the state's bond programs.
- We recommend that the Legislature adopt some form of state *debt ceiling.*
- We recommend that the Legislature place on the ballot for voter approval a constitutional amendment permitting localities to increase temporarily their *property tax rates* above the current 1 percent limit, for the express purpose of amortizing debt issued to finance voter-approved public facilities. The 1 percent limit on the property tax rate imposed by Proposition 13 (June 1978 ballot) has made new local general obligation bonds extinct, thereby creating many inequities with respect to how capital outlay projects in California are financed and raising the cost to the taxpayers of financing certain capital projects.
- We recommend that, if the Legislature decides to continue subsidizing governmental borrowing by exempting interest earned on state

and local government bonds from the income tax, it explore the advantages and disadvantages of extending this exemption to *businesses* subject to the California franchise tax. It may be in the state's best interest to extend the exemption to businesses because the market for its bonds would be broadened and its interest costs might be reduced. We also recommend that the tax exemption be extended to that portion of *capital gains* income on bonds which is anticipated when bonds are *purchased*, and therefore incorporated into bond prices. Such anticipated capital gains should be treated identically to normal interest income on bonds, which is exempt from taxation.

- We recommend that the Legislature require state authorities, whenever they sell a general obligation or revenue bond issue, to select the winning bidder using the true interest cost (TIC) criterion, *subject to* appropriate bidding constraints. Although the TIC criterion is now being used in awarding all state general obligation bond issues, apparently it is *not* minimizing interest costs to the state because of certain competitive imperfections in the underwriting industry. This problem, however, can be *lessened* by imposing certain *additional* constraints on the bidders. Therefore, state officials who sell bonds should design and utilize such constraints.
- We recommend that the Legislature (a) consider several options to revise those provisions of existing law that establish *interest rate ceilings* on certain types of bond programs, (b) allow *reasonable price discounts* when state bond issues are sold to underwriters (at present, price discounts are *not* permitted on most general obligation bond sales to underwriters), (c) amend existing law to require that, whenever possible, the maximum maturity on a bond issue approximate the *useful life* of the project or activity being financed, and (d) *standardize* the technical provisions applicable to state bond programs so that they are consistent with current legislative priorities. Currently, many of the differences in the technical provisions that apply to different state revenue bond programs appear to exist for no particular reason.
- We recommend that the Legislature reconsider the provisions of current law that require state general obligation bonds to be sold *competitively* in every instance as opposed to a *negotiated sale,* and that it amend state law to encourage underwriting of revenue bonds by commercial banks.
- Regarding the state's involvement in *local* government debt-related activities, we recommend that the Legislature (a) take various actions to improve the collection, tabulation, and dissemination of data regarding local government debt-related activities, and (b) explore ways in which the state can provide technical and administrative assistance on a *reimbursable* basis to local government borrowers, *when* they request such assistance. (We do *not,* however, believe that more direct forms of state involvement in local debt matters are warranted.)
- We recommend that the Legislature (as well as local governments) explore the potential economic benefits to be gained from *leasing* certain capital equipment and facilities instead of acquiring them through bond-financed construction or purchase.
- If the Legislature decides to continue subsidizing local borrowing, we recommend that it consider several options which are a more cost-

effective means of providing this subsidy. For example, a more *direct* form of subsidy would reduce the inefficiencies that are inherent in the tax exemption, and broaden the market for municipal debt. Such a change would require an amendment to the California Constitution.

- We recommend that the Legislature take action to eliminate the state tax exemption for interest earned on *state* bonds, because the revenues lost by the state as a result of attempting to "subsidize itself" through the tax exemption are larger than the savings the state achieves by borrowing in the tax-exempt market. Such a change also would require an amendment to the California Constitution.
- Lastly, we recommend that the Legislature establish a *formal mechanism for overseeing* on an ongoing basis all bond-related matters in a comprehensive and consistent fashion. One method of doing this would be for each fiscal committee to establish a subcommittee whose sole responsibility would be to review all bond-related matters coming before the full committee.

These and our other bond-related recommendations are discussed in more specific detail in our bond report.

IV. LOCAL GOVERNMENT FINANCE ISSUES

A. LOCAL FISCAL RELIEF ISSUES

To What Extent Should the Legislature Reduce the Amount of Fiscal Relief Provided to Cities, Counties, and Special Districts?

What is Fiscal Relief?

The term fiscal relief or "bailout" refers to the funds which the state has provided local government since the passage of Proposition 13 on account of the reductions in local property tax revenues brought about by that measure. With respect to city and county governments and special districts, this bailout corresponds to the increased share of ongoing property tax revenues given to these units of government by AB 8 (1979–80 session), less the ongoing revenue loss resulting from the repeal of three subventions by SB 102 in 1981–82. For county governments, fiscal relief also includes the amounts which would have been expended as the county share of health and welfare program costs under the formulas in effect prior to Proposition 13, plus the increase in state subventions for county health services.

AB 8 reduced, on an ongoing basis, the amount of property tax revenue received by school districts, and redirected these funds to cities, counties and special districts. School districts did not experience any loss of revenue, however, because under existing law the state "guarantees" a specific level of funds (the "revenue limit") for each school district. The additional local property tax revenues grow each year, in line with the growth of taxable assessed value.

A "reverse bailout" occurs when the amount of any funding reductions imposed on a local agency by the state exceeds the value of the fiscal relief it is receiving pursuant to AB 8. When this occurs, it is argued that local agencies actually are "bailing out" the state; hence, the derivation of the term "reverse bailout".

AB 8 Deflator

At the same time that the Legislature committed itself to a permanent program of fiscal relief, it also established a mechanism commonly known as the "AB 8 deflator." The deflator is intended to reduce the level of fiscal relief automatically in times when state revenues are inadequate to maintain the ongoing "baseline" level of state expenditures.

The deflator becomes activated when projected state revenues fall below an inflation-adjusted base level of state expenditures. As established in statute, when the deflator goes into effect, the State Controller is *required* to reduce motor vehicle in-lieu subventions, cigarette tax subventions, business inventory reimbursement subventions, and trailer coach subventions by an amount sufficient to make up one-half of the difference described above. The other one-half is taken from apportionments to K–12 schools and community colleges.

Deflator in Effect for 1983–84. Based upon the most recent revenue and expenditure forecasts by the Department of Finance, the AB 8 deflator mechanism will be "triggered" for the 1983–84 fiscal year. According to the Governor's Budget, this mechanism, which was suspended for both 1981–82 and 1982–83, would require reductions of $2,898 million in aid to local agencies and school districts. Half of this amount ($1,449 million) would be taken from K–14 school district apportionments. The other half would be taken from cities, counties and special districts, in proportion to their share of the four specific subventions.

Although the Governor's Budget identifies deflator reductions of $2,898 million, our analysis indicates that only $2,360 million in reductions could actually be made, because only $1,180 million in subventions to local agencies are available to be reduced. According to the statute, the reduction for school agencies cannot exceed the reduction for local agencies, even if funds are available. The $2,360 million is $538 million, or 23 percent, less than the amount identified in the budget.

Table 65 compares reductions in local government fiscal relief (excluding schools) that would occur under the Governor's proposal and those that would otherwise result from the AB 8 deflator.

Table 65
Changes in AB 8 Fiscal Relief:
Comparison of Governor's Proposal and AB 8 Deflator
1983–84
(in millions)

		Governor's Proposal		*AB 8 Deflator*	
	Fiscal Relief Current Law	*Reduction*	*Percent Change*	*Reduction*	*Percent Change*
Cities	$346	−$255	−73.7%	−$524	−151.5%
Counties	2,432	−47	−1.9	−605	−24.9
Special Districts	340	—	—	−51	−15.3
Total	$3,118	−$302	−9.7%	−$1,180	−37.8%

Governor's Proposal

The budget proposes to reduce local fiscal relief and other aid by $320 million. The budget contains no proposals which would increase the net fiscal resources available to local governments.

The $320 million in reductions reflect:

- A $300 million reduction in vehicle license fee subventions to cities and counties. Cities would lose $255 million, while counties would lose $45 million.
- An $18 million reduction in business inventory payments to cities, counties, and special districts. This would be achieved by eliminating the statutory COLA, estimated at 6.3 percent, for the budget year.
- A $2.2 million reduction in funding for County Health Services, due to a reduction in the statutory COLA from 3.6 percent to 3.0 percent.
- No identifiable fiscal impact from the Governor's proposals to replace specified categorical programs with block grant funding. (The proposal lacks sufficient detail for us to analyze its potential fiscal effect on either the state or local agencies.)

Table 66 illustrates the distribution of these reductions among the different types of local agencies (excluding schools).

The budget identifies a *potential* additional $100 million reduction in unspecified local subventions, to the extent that additional actions are necessary to balance the 1982–83 budget. The budget does not provide any details as to how this Phase 2 reduction, if approved, would be apportioned.

Table 66
Proposed Changes in Local Fiscal Relief and Other Local Aid
1983–84
(in millions)

Reductions	*Cities*	*Counties*	*Special Districts*	*Total*
Fiscal Relief:				
Vehicle License Fees	−$255	−$45	—	−$300
County Health Services	—	−2	—	−2
Subtotal, Local Fiscal Relief	−$255	−$47	—	−$302
Other Local Aid:				
Business Inventory	−$4	−$11	−$3	−$18
Total, Reductions	−$259	−$58	−$3	−$320

The budget proposes to apportion the reductions identified in Table 66 using the same formula which was used in the current year to reduce fiscal relief, with the following exceptions:

- No "special factors" funding is provided. In the current year, for example, the reductions computed for the Cities of Oakland and San Jose were mitigated by $3 million and $1.6 million, respectively, as a result of special factors.
- No funding is provided for the 31 "no property tax" cities. These are cities which existed but did not levy a property tax prior to Proposition 13. As a result of the repeal of three small subventions as part of the 1981–82 fiscal relief reductions, these cities lost some $2.2 million in subvention funds, although they had never received any fiscal relief from the state. In order to hold these cities harmless from this "reverse" bailout, approximately $2.2 million was distributed to the no property tax cities in 1981–82 and 1982–83. Under the Governor's proposal for 1983–84, they would not receive this assistance.

Proposed Formula Does Not Result in Proposed Savings. Although the Governor proposes a reduction of $300 million for cities and counties, our analysis indicates that the actual formula proposed in the budget companion bill—SB 124—to accomplish this reduction would yield a total savings to the state of only $287 million, or $13 million less than the budget indicates. The $287 million reduction consists of a $242 million reduction for cities and a $45 million reduction for counties.

Our analysis further indicates that under the Governor's proposal, 206 cities would lose an amount equivalent to their estimated net bailout for 1983–84. No city or county, however, would experience a reduction that exceeds the value of its net bailout. Table 67 identifies for cities and counties as a whole, the total value of fiscal relief in 1983–84, and the corresponding reduction that is reflected in the budget.

Table 67
Fiscal Relief to Cities and Counties in 1983–84
Before and After Governor's Proposal
(in millions)

	1983–84 Fiscal relief	*Reductions Per Governor's Budget*	*Remaining Fiscal Relief*	
			Amount	*Percent*
Cities	$346	$255	$91	26%
Counties	2,432	47	2,385	98
Total	$2,778.1	$302	$2,476	89%

Factors the Legislature Should Consider in Providing Local Fiscal Relief

In 1978–79, immediately following the adoption of Proposition 13, local governments were given one-time cash grants (SB 154). These funds were allocated generally in proportion to the amount of property tax revenues lost by each local government. Consequently, entities which lost the most as a result of Proposition 13 received the most block grant funding, regardless of their ability to adapt to these revenue losses. That is, this methodology did not consider the relative "fiscal status" of local governments.

In 1979–80, the cash grants were eliminated in favor of a permanent shift of property tax revenues to cities, counties, and special districts (AB 8) with the level of relief being determined based on the amount of relief the local entity had received under SB 154. In 1981–82 and 1982–83, the Legislature reduced the amount of fiscal relief below the level provided for by AB 8. In decreasing the amount of AB 8 fiscal relief, the Legislature generally made reductions based on the level of assistance each local entity was scheduled to receive. In short, the reductions from each entity was proportional to the amount of fiscal relief going to that entity.

The Governor's Budget proposes the reductions in fiscal relief for 1983–84 be made in the same way as they were made in 1981–82 and 1982–83: those agencies which benefitted the most from fiscal relief would experience the largest reductions.

The main difficulty with the approach proposed by the Governor is that the reductions are based on each agency's share of fiscal relief in 1978–79, and ignore any subsequent change in the agency's *relative* fiscal condition. To apportion the cuts according to grants initially received in 1978–79, therefore, could result in small cuts for cities and counties which are now relatively better off than others, and large cuts for less-well-off cities and counties.

It is our opinion that the existing system of apportioning reductions in fiscal relief does not provide for an equitable distribution of funds among local agencies. There is a substantial amount of evidence available today that we believe supports this conclusion. Some local governments, for example, have actually reduced their property tax rate and other tax rates, while continuing to receive fiscal relief from the state. Other local governments have never shared in the fiscal relief reductions made by the Legislature during the last several years, even though their budgets show significant surpluses. These and other circumstances document the need to reexamine the distribution of aid to local governments.

In considering the Governor's proposal to reduce fiscal relief, the Legislature needs to consider the extent to which it wishes to establish priorities for the *combined* state and local sector. Under the existing system of categorical programs, mandates, and restricted subventions, the Legislature, to a great extent, exercises control over the mix and level of services provided locally. Under alternative arrangments, the Legislature may not have this type of control, but the need for state assistance could be reduced.

B. REVENUE ENHANCEMENTS

Should the Legislature Give Local Government Greater Access to Revenues?

California Supreme Court Decisions Enhance Local Revenue-Raising Ability

As a result of three recent California Supreme Court decisions, the ability of local governments to raise additional revenues has been significantly enhanced. In the cases *LACTC v. Richmond, San Francisco v. Farrell,* and *Carman v. Alvord,* the California Supreme Court clarified several ambiguous phrases used in Article XIII A of the California Constitution, added by Proposition 13 in 1978. Public reaction to these decisions has varied widely. From one perspective, these decisions merely permit local governments to impose reasonable tax increases to maintain existing public services. Looking at the decisions from another perspective, however, the decisions have altered dramatically the ground rules under which Proposition 13 was conceived and implemented.

Article XIII A of the California Constitution places several limits on local taxes. Specifically, the measure limits increases in a property's assessed value for property tax purposes to no more than 2 percent annually, except in cases where a property is purchased or newly constructed. The measure also limits property taxes to 1 percent of assessed value; taxes in excess of the 1 percent limit may, however, be levied to pay interest and redemption charges on indebtedness approved by voters prior to June 1978. Finally, Article XIII A provides that cities, counties, and special districts may impose, by a two-thirds vote of the electorate, "special taxes." Such special taxes may not, however, consist of ad valorem property taxes or sales or transactions taxes on real property.

1. Special Taxes and the Two-Thirds Vote Requirement

Two of the court's decisions dealt with the two-thirds vote requirement for special taxes. In *LACTC v. Richmond,* the court held that an additional 0.5 cent local sales tax, levied by the Los Angeles County Transportation Commission for public transit purposes and approved by a 54 percent majority at a local election, was valid. In a divided opinion, the court reasoned that, because Proposition 13 was primarily concerned with property tax relief, the term "special district" as used by the measure applied only to those special districts which were empowered to levy property taxes. Because LACTC did not have such power, the court concluded, it did not constitute a "special district" within the meaning of Proposition 13 and, consequently, the two-thirds vote requirement did not apply.

In *San Francisco v. Farrell,* the court directly addressed the issue of what constitutes a "special tax" for purposes of Proposition 13. In another divided opinion, the court held that "special taxes" were distinguished from other taxes not by the type of tax nor by the object of taxation, but rather by the *uses* to which the tax revenues were put. Thus, the court held that the term "special tax" applies only to a tax whose proceeds are earmarked for a special purpose. Because San Francisco's payroll and gross receipts tax revenues were deposited in the city's general fund, the court concluded that an increase in that tax, approved by 55 percent of the city's voters at a local election, was also valid.

Both *Richmond* and *Farrell* increase the abilities of local governments to raise revenues from local sources. *Richmond* provides that any local government entity which does not have the power to levy a property tax is not bound by the two-thirds vote requirement of Proposition 13. *Farrell* provides that local governments may levy additional taxes (other than the prohibited ad valorem property taxes and real estate sales or transactions taxes), and that the levy of such taxes is not subject to the two-thirds vote requirement, provided that the tax proceeds are not earmarked for a special purpose.

While the *Farrell* decision appears, on its face, to offer local governments a wider range of possibilities for raising additional revenues, as a practical matter it will have a direct impact only on city governments. This is because other local government entities generally require *statutory authority* to raise additional revenues. Chartered cities have long enjoyed the ability to exercise independent taxing authority, as a result of the "municipal affairs" clause of the State Constitution. In 1982, the Legislature extended this taxing authority to general law cities as well. In effect, the Legislature empowered general law cities to levy the traditional charter city taxes—utility users taxes, admissions taxes, and parking taxes. General law cities already were authorized to levy business license and transient occupancy taxes, although they may now levy the latter at rates higher than those set by statute, as a result of the Legislature's action.

Perhaps more importantly, however, the Supreme Court's decision would seem to offer city government the opportunity to levy *new* types of taxes, such as per household or street frontage taxes, without the need for voter approval. It is uncertain the extent to which such taxes will actually be imposed, but they do represent a potentially significant source of additional revenue.

Counties, school districts, and special districts generally do not have statutory authority to levy new taxes at present, so the *Farrell* decision will have no impact on them in the absence of legislative action. Even with such action, however, the extent to which the *Farrell* decision might be applied to these units of government is unclear. As the court did not define what constitutes "revenue earmarked for a special purpose," there is some degree of uncertainty as to how specialized in function a governmental entity might be, yet still be considered to fulfill general purposes as well.

In October 1982, the Legislative Counsel stated in a written opinion (No. 16903) that a school district may take advantage of the *Farrell* decision to levy a tax for district general purposes, without specific approval by local voters:

"We also note that the payroll and gross receipts tax considered in *Farrell* was levied by the City and County of San Francisco for the specific purpose of supporting the operations of the City and County of San Francisco, yet it was held not to be a special tax within the meaning of . . . Article XIII A. We think that a court would, by analogy, hold that a tax levied by a school district for deposit in the general fund of that district and for use for general purposes is not a special tax subject to the two-thirds vote requirement. . . . "

The opinion further states that, while school districts currently have the authority to *enact* a special tax without voter approval, they cannot *collect* such a tax until authorized to do so by the Legislature.

2. Pension Obligations and Voter-Approved Indebtedness

In the third major decision relating to Proposition 13 rendered during 1982, the California Supreme Court held in *Carman v. Alvord* that a property tax rate in excess of 1 percent, which was imposed by the City of San Gabriel for the purpose of funding its employees' pension plan, was legal under the provisions of Article XIII A. As noted, Article XIII A excludes from the 1 percent property tax rate limitation "ad valorem taxes or special assessments to pay the interest and redemption charges on any indebtedness approved by the voters prior to the time [this section] becomes effective." In a unanimous opinion, the court held in *Carman* that, where a city's voters had approved, prior to June 1, 1978, a ballot measure authorizing the city (a) to join the State Employees' Retirement System (later PERS) and (b) to impose a special tax to meet its obligation to the system, a property tax levied for this purpose comes within this exclusion.

The Supreme Court's decision in *Carman* is not, however, without ambiguity. It is unclear, for example, whether the term "voter-approved indebtedness" extends only to pension plans in which *both* the plan and a specific tax levy to fund it were approved by voters, or whether voter approval of the plan *alone* is sufficient (as a literal reading of Article XIII A would appear to indicate). In addition, it is not entirely clear what constitutes "voter approval." For example, of California's 58 counties, 20 belong to the pension system created by the 1937 County Retirement Act. Amendments to the act, added in 1947, provided that counties could elect to join the system *either* by a popular vote *or* by a four-fifths vote of the county board of supervisors (Government Code Section 31500). Because the act makes no distinction among counties based on the manner in which they joined the 1937 Act system, it may be argued that membership by a vote of the board of supervisors is essentially equivalent to membership by a vote of the people, thereby meeting the test of voter approval. Similarly, California cities are authorized by statute to establish pension plans, subject to the approval of *either* a majority vote of the electorate *or* a two-thirds vote of the city's legislative body (Government Code Section 45306). A city council's authorization of a pension plan therefore may also, arguably, constitute "voter approval."

The court recognizes, but leaves unresolved, both issues—the necessity of voter approval of a special tax and the question of whether the approval of the pension system by a local governing body may ever constitute "voter approval"—as the following passage from the *Carman* opinion indicates:

> Plaintiff argues that [the court's] holding could create a "nonuniform" scheme of taxation, fortuitously protecting only those pension plans authorized by a vote of the public, *though voter approval never was required* (citation). As we have seen, there is a basis for distinguishing voter-approved debt (citation). In any event, in a single case we cannot resolve all article XIII A's anomalies (citation). *Nor need we decide how pension taxes authorized only by the governing body of a local agency might be treated.* Here we conclude only that section 1, subdivision (b) of article XIII A exempts from the tax limits those pensions *and corresponding tax levies* approved by the voters before the limitation became effective (31 Cal.3d 318, 333, emphasis added).

Fiscal Effect. We estimate that California cities and counties will expend approximately $1.5 billion to fund pension obligations in 1983–84. Of this amount, we estimate that approximately $850 million is associated with pension plans approved by voters prior to the enactment of Proposition 13 in 1978, and thus potentially could be funded through additional property taxes in excess of 1 percent as a result of the *Carman* decision.

Table 68 shows our estimates of the amount of annual pension costs in California's largest cities and counties which *probably* could be funded through additional property taxes. For purposes of the table, we have assumed that all cities and counties in which voters approved pension plans prior to June 1978 would be able to fund them through an additional property tax levy. Property tax rate increases would require only a simple majority vote of the city council or county board of supervisors. As shown in the table, five cities (Los Angeles, San Francisco, Long Beach, Oakland, and San Jose) have estimated annual pension-related costs in excess of $25 million each.

Table 68 also shows the increase in local property tax rates which would be required to fund these annual costs out of additional property taxes. These tax rate increases range from a low of only 2.6 cents per $100 of assessed value in Santa Clara County to 61.7 cents per $100 of assessed value in the City and County of San Francisco.

In the event the Legislature chooses to change the current system for allocating fiscal relief so as to give greater recognition to relative needs and relative fiscal capabilities, it might wish to consider reflecting the *Carman* decision in the new system. Taking account of the authority to fund pension obligations out of increased property tax levies to which certain cities and counties now have access may be justified for two reasons. First, state assistance payments to local governments are primarily intended to address revenue shortfalls which persist after all other local revenue-raising options are exhausted. Given the existence of this untapped revenue source, state assistance in helping cities and counties finance their local pension costs may no longer be justified. Second, by requiring local governments to finance pension-related indebtedness out of their own revenue sources, statewide tax equity would be enhanced. Under the present system, residents of cities and counties which have been unusually generous in granting pension benefits to their employees are able to export some of their pension-related costs to residents of those cities and counties which have kept their pension costs under control. Since most of the benefits associated with granting their public employees generous pension benefits (such as reductions in employee turnover) accrue primarily to residents of those localities, it would seem appropriate to expect those granting these benefits to pay the full costs using local (rather than state) resources. This would also, arguably, create a greater incentive for those jurisdictions which have been unusually generous to bring their pension costs under control in the future.

Table 68
Potential Impact of Supreme Court Decision Allowing Local Government to Fund Pension Indebtedness From Additional Property Taxes [a]

Cities	*Locally Fundable Annual Pension Cost (millions)*	*Assessed Value (millions)*	*Estimated Additional Tax Rate to Fund Pension Debt*
Los Angeles	$273	$81,447	$0.335
San Diego	18	25,061	0.072
San Francisco [b]	150	24,302	0.617
San Jose	26	17,811	0.146
Long Beach	43	10,897	0.395
Oakland	33 [c]	8,010	0.087 [d]
Sacramento	10	6,884	0.145
Anaheim	8	7,276	0.110
Fresno	4	5,809	0.069
Santa Ana	5	5,330	0.094
Counties			
Los Angeles	N.A.	$212,962	—
Orange	$35	71,304	$0.049
San Diego	35	56,041	0.062
Santa Clara	12	45,700	0.026
Alameda	N.A.	29,871	—
Sacramento	N.A.	19,695	—
San Bernardino	14	24,329	0.058
Contra Costa	24	24,768	0.097
Riverside	N.A.	22,260	—
San Mateo	14	23,669	0.059

[a] Based on 1982–83 data for 10 largest cities and 10 largest counties.
[b] City and county.
[c] $26 million currently funded by special property tax.
[d] Rate based on funding $7 million not currently funded by special property tax.
N.A.: Not applicable—pension plan not approved by voters prior to June 1978.

Providing Greater Local Flexibility

It is important that cities and counties have flexibility to respond to the demands put upon them by their residents. Currently, their opportunity to do so is severely restricted.

Cities. Historically, charter cities have had the authority to raise or levy virtually any type of tax not precluded by state law or city charter. In the current year, this authority has been extended to general law cities, as well. Both types of cities, however, are subject to the restrictions contained in Proposition 13—that is, they may not increase the ad valorem property tax rate and they cannot increase a "special tax" without two-thirds voter approval. Within these bounds, cities have wide flexibility to increase revenues.

Counties. On the other hand, counties do not enjoy the same authority as cities have to levy new taxes; they must first obtain specific statutory authorization from the Legislature. Further, in those program areas where counties do have the authority to levy fees to defray their costs, statutory limits often exist which either set specific fees or fee maximums, thereby limiting the amount of revenue that counties can raise. These statutory amounts often are not adequate to permit full cost recovery.

Given the limited fiscal flexibility available to counties, when the state imposes new requirements on counties without providing additional funding, counties have only a limited ability to augment their revenues in order to offset the additional costs. Consequently, these new costs must be funded through existing revenues, often to the detriment of other county-funded programs. In effect, the imposition of state requirements on the counties without the provision of additional funding is tantamount to the state appropriating local funds for state purposes.

Consequently, we conclude that if counties are to be able to respond to the needs and desires of their citizens, three policy changes are needed:

1. County voters should be given greater discretion to tax themselves in order to finance local services.

2. Legislation should be enacted removing statutory limits imposed on fees administered and collected by counties for services they perform. Alternatively, statutes regulating fees could be amended allowing counties to impose fees at levels sufficient to cover the cost of providing the services for which the fees are charged. For example:

- County boards of supervisors currently are not authorized to impose or collect fees for services provided by the county sealer of weights and measures. Our analysis indicates that, on a statewide basis, authorization to impose such fees could generate a revenue increase for counties of between $1 million and $3 million annually.
- Section 26721 of the Government Code specifies the fee ($14) for any legally required process or notice served by a public officer or employee. Specified private process servers, however, are authorized under Section 1032.8 of the Code of Civil Procedure to recover "such sums as are reasonably incurred in effecting service." This distinction between public and private process servers is estimated to cost local governments approximately $7 million annually in foregone revenues.
- The Government Code also provides the specific fee for numerous miscellaneous civil filing fees. We cannot estimate how much increased revenue could be generated from the fees. At a minimum, if fees could be set to cover costs it would not be necessary for local agencies to seek legislative authority each time a minor fee warrants adjustment.

3. New requirements imposed on counties by the state should be accompanied by funding support.

Impact of the Governor's Proposal on Local General Purpose Revenues

One measure of a local government's fiscal condition, although a limited measure at best, is the growth in its general purpose revenues. General purpose revenues are those revenues which are not tied to the support of any particular program or activity. They are "no strings attached" revenues that may be used by local government to fund locally determined priorities. By definition, therefore, general purpose revenues exclude receipts tied to programs over which local agencies have no control, and consequently, provide an indication of the relative extent to which local agencies can address local needs for services.

Specifically, general purpose revenues include the proceeds from local taxes, interest earnings, bailout monies, state discretionary subventions such as tax relief and shared revenues, and federal revenue sharing funds. They exclude local fees and charges for services provided, as these funds are authorized specifically to cover the cost of the particular service.

The Governor's Budget projects that general purpose revenues for cities will grow by 4.3 percent in 1983–84. This projection takes into account (1) the Governor's proposed $255 million reduction in vehicle license fees, and (2) the expiration of federal revenue sharing funds in October, 1983. For counties, the Governor's Budget projects an increase in general purpose revenues of 3.5 percent. Again, this projection allows for (1) the $45 million reduction in vehicle license fees proposed in the Governor's 1983–84 Budget, and (2) the expiration of federal revenue sharing effective October, 1983. The growth projections identified above do not reflect (1) the Governor's proposal to reduce subventions by $54 million each to cities and counties in the *current* year, or (2) the potential additional $100 million reduction the Governor has identified as an option for eliminating the current year deficit. Table 69 identifies projected general purpose revenue growth, under these alternative circumstances.

Table 69
Local General Purpose Revenue Growth 1982–83 and 1983–84

	1982–83 (Over Prior Year)		*1983–84 (Over Prior Year)* [a]		
	January 1982 Estimate	*January 1983 Estimate*	*With $300 Million Reduction in 1983–84* [b]	*With $400 Million Reduction in 1983–84* [c]	*Under Existing Law (No Reductions)*
Cities:					
If $54 million reduced in 1982–83	—	1.6%	5.5%	3.7%	—
If $54 million not reduced in 1982–83	10.5%	2.7	4.3	2.6	9.6%
Counties:					
If $54 million reduced in 1982–83	—	4.7	4.5	4.1	—
If $54 million not reduced in 1982–83	10.8	6.0	3.5	2.7	4.5

Source: Department of Finance.
[a] Assumes termination of federal revenue sharing effective October 1983.
[b] Assumes reductions of $255 million for cities and $45 million for counties.
[c] Assumes reductions of $340 million for cities and $60 million for counties.

Table 70 compares general purpose revenue growth for cities, counties, and the state over the period 1980–81 to 1983–84. During this time, the state's general purpose revenues increased at an average annual rate of 5.7 percent. Close behind were the counties,which realized an average annual increase in revenues of 5.1 percent. City general purposes revenues increased at an average annual rate of 3.9 percent during this period.

In the case of county governments, however, the comparison of general purpose revenue growth overstates the ability of counties to maintain local services. This is because some of the increase effectively *must* be allocated to state-mandated programs, in order to comply with state requirements. Consequently, these funds are not really available to support local programs. Approximately 85 percent of county budgets represent costs associated with state-mandated or controlled programs, although the counties have considerable discretion over certain components of these costs (such as salary increases).

Table 70
Comparison of General Purpose Revenue Growth
1980–81 Through 1983–84
(in millions)

	1980–81		*1981–82*		*1982–83*		*1983–84*	
	Amount	*Percent Change*	*Amount*	*Percent Change*	*Amount*	*Percent Change*	*Amount*	*Percent Change*
State	$19,023.1	5.8%	$20,960.3	10.2%	$20,489.7	−2.3%	$22,479.4	9.7%
Counties........	4,063.7	11.1	4,302.2	5.9	4,558.2	6.0	4,716.6	3.5
Cities..............	4,502.0	12.2	4,712.8	4.7	4,841.5	2.7	5,051.4	4.3

Source: Department of Finance.

Local Government Compensation and Employment

The ability of local government to increase the size and pay of its workforce is another measure of its fiscal health. In an effort to see how this ability has changed in 1982–83, we surveyed California's 8 largest cities and 14 largest counties. Information was collected from each jurisdiction to identify the current change in local compensation and employment. The analysis which follows is a *summary* of the major findings from our survey.

The data fall into three major categories:

Salary and Benefit Increases given to employees as a percent of base pay. These increases represent percentage adjustments in base salary. In a few cases, these increases also reflect employer retirement contributions previously deducted from an employee's salary.

Expenditures for Salaries and Benefits actually made in 1981–82 and budgeted for 1982–83. These expenditures represent the total cost to local jurisdictions to compensate employees for their work, including payroll-related benefits such as social security.The usefulness of the data on expenditure changes is limited by many factors, including (a) possible inaccuracy in reported data, (b) differences in the way similar items of expenditure are categorized by the jurisdictions in our sample, and (c) availability of *actual* expenditures for 1981–82.

Levels of Employment, reflecting the maximum number of positions authorized within local budgets for 1981–82 and 1982–83. Most of the jurisdictions include in their personnel figures both part-time and full-time permanent positions. A few cities and counties, however, express positions as full-time equivalents (FTE). FTE positions are simply the sum of all full-time positions, counted in whole numbers, and part-time positions, counted as fractions of full-time positions.

Changes in Employee Compensation

In order to obtain as representative information as possible, we requested salary and benefit data for the following three bargaining units which generally include the majority of each local government's employees: (1) *the largest nonsafety bargaining unit,* generally consisting of clerical workers; (2) *the nonsupervisory fire unit* for all cities and those counties which provide fire service; and (3) *the nonsupervisory law enforcement unit,* which is usually the deputy sheriff unit in counties and the police officer unit in cities. For our analysis, we consolidated this information so that our results distinguish only between two categories of personnel: safety (the fire and law enforcement units) and nonsafety (the largest unit).

Table 71

Local Government Survey

	Average Salary Increases Received During 1982–83 (percent change)		*Multi-Year Agreements (Yes or No)*
	Safety	*Nonsafety*	
Cities:			
Anaheim	6.0%	6.0%	Y
Fresno	12.5	7.9	N
Long Beach	8.3 [a]	7.0	Y
Los Angeles	6.0 [a]	8.0	Y
Oakland	6.5	7.0	Y [b]
Sacramento [c]	0	0	Y
San Diego	10.0	8.0	N
San Jose	9.0	8.0	Y
Total Average	7.3%	6.5%	
Counties:			
Alameda [a]	4.4 [d]	8.0 [e]	Y
Contra Costa	N/S	8.0	Y [b]
Fresno	N/S [d]	4.8	Y [b]
Kern	5.1	5.1	N
Los Angeles	10.2	8.1	Y
Orange	7.6 [d]	7.8	Y
Riverside	N/S [d]	0	N
Sacramento	9.6 [d]	5.0	Y [b]
San Bernardino	8.2 [d]	7.3 [e]	Y
San Diego	N/S [d]	6.5	N
San Francisco	5.9	10.1	N
San Mateo	6.1 [a]	1.7 [a]	Y
Santa Clara	9.5 [a]	8.0	Y
Ventura	5.9 [a]	7.3	Y
Total Average	7.2%	6.3%	

[a] Total increase by end of 1982–83 greater than average increase shown because of mid-year increases or negotiations settled on calendar year basis.

[b] Multi-year contract for nonsafety or safety but not both.

[c] The first year of the multi-year agreement calls for no increase. An 8 percent increase is scheduled for 1983–84.

[d] Increase given to deputy sheriff unit only either because fire unit is still in negotiations or county does not provide fire service.

[e] Effective June 1982.

N/S = No settlement to date.

As shown in Table 71 the *average salary increase* in 1982–83 for all of the cities in the sample was 7.3 percent for safety employees, and 6.5 percent for nonsafety employees. In the counties surveyed, salaries of safety employees increased an average of 7.2 percent, while other county employees received an average increase of 6.3 percent.

Sixteen of the twenty-two jurisdictions have granted multi-year increases to all or part of their employees. Multi-year contracts cover a period of years, specifying increases to be effective at future dates during those years. Once settled, multi-year increases are "automatically" triggered by the contract and cannot be reduced by action of the local governing body. Thus, an increase for 1982–83 granted pursuant to a multi-year agreement settled in 1980 may not be indicative of an agency's fiscal strength in 1982–83.

Of the 16 jurisdictions with multi-year agreements, 13 have contracts commencing in years prior to 1982–83. The size of current year increases then reflects:

- The fiscal strength of the local entity *at the time of settlement;* and
- The fiscal strength anticipated through the duration of the contract period, based on projections of future revenue and expenditure growth.

For the Cities of Los Angeles, Oakland, and Sacramento, 1982–83 marks the first year of their multi-year contracts. This is significant because these jurisdictions made salary commitments for 1982–83 and future years with complete cognizance of their current fiscal condition. Thus, the magnitude of these increases is a direct reflection of their current fiscal health and the bargaining strength of the local employee organizations.

Six of the local entities in our sample, as shown in Table 71, do not have multi-year contracts, and consequently have granted increases for 1982–83 only. As with the three cities discussed above, the size of increases granted by these jurisdictions may be used as an indicator of their fiscal strength.

Changes in Expenditures for Salaries and Benefits

Based on the amounts originally budgeted for 1982–83, expenditures for salaries and benefits increased over actual expenditures in 1981–82 by an average of 9.2 percent for the surveyed cities and 7.7 percent for the surveyed counties. The increase is probably higher for some jurisdictions, due to adjustments in expenditure levels following midyear negotiations. To the extent that increases in salaries and benefits are negotiated or phased-in after the budget has been adopted, the expenditure levels reported in the survey understate actual spending expected by the end of the year. Recognizing this possibility, most local jurisdictions, unlike the state, do not reflect salary savings from employee turnover and vacancies in their budgets. In addition, these figures are based on budgets as adopted, and many local jurisdictions have implemented midyear expenditure cutbacks in order to offset declines in revenue.

Of the total salary and benefit change in 1982–83, *salary* expenditures were budgeted to increase an average of 8.4 percent for the surveyed cities and 6.8 percent for the surveyed counties. Expenditures for all *fringe benefits,* including health insurance and retirement, are budgeted to increase an average 14.0 percent for cities and 7.0 percent for counties in the current year. This means that cities will have increased their spending for employee benefits roughly 6.0 percent over the increased spending for employee salaries. Counties, on the other hand, have increased spending for salaries and benefits at approximately the same rate. The fact that the increase in benefit expenditures exceeds the increase in salary expenditures underscores the growing significance of benefits in the collective bargaining process.

Changes in Employment

Changes in employee compensation do not occur in a vacuum. In fact, increases in salaries and benefits may be offset by reductions in personnel. Productivity gains, brought about in part by the increased salaries, may offset personnel reductions. To gain a better sense of local fiscal conditions, we have collected employment data for: (1) the cities and counties in our survey sample; and (2) all cities and counties in California. Taken together, this information provides a meaningful context for understanding the trends in local employment.

The Survey Sample. The changes in levels of employment authorized in each entity's budget between 1981–82 and 1982–83 indicate that for cities, the number of authorized positions (the ceiling on employment) has dropped an average of −0.4 percent from the 1981–82 level. Counties have experienced a sharper decline, with an average reduction of −2.8 percent in authorized positions from the prior year.

For comparative purposes, we have utilized data published by the U.S. Department of Commerce, Census Bureau to obtain the average rates of change in employment from 1978 to 1981 for all of the cities and counties in our sample. During this period, total employment in the surveyed cities dropped an average of −3.6 percent annually. Full-time equivalent employment declined less dramatically, at an average annual rate of −2.7 percent from 1978 to 1981. Total employment in the counties surveyed increased 2.1 percent during the same period. The average rate of change in county full-time equivalent employment also increased, though at a slower rate of 0.4 percent annually.

By comparing the rates of change reported in the survey for 1981–82 to 1982–83 with the trend from 1978 to 1981, we can draw the following conclusions:

- City employment has followed a continual downward trend from 1978 to the present.
- The trend in county employment has been less consistent, though the data indicate a small increase from 1978 to 1982.

All Local Jurisdictions in California. Data summarized from the Employment Development Department (EDD) for all cities and counties in California confirms our conclusions about the survey sample, by showing that from 1978 to 1982:

- All city employment has been *declining* at an annual rate of −1.5 percent.
- All county employment has been *climbing* at a slow pace of 0.4 percent annually.

Overall Trends in Local Government Employment. While the data presented so far seem to establish a consistent pattern of reductions in city employment and little growth in county employment during the post-Proposition 13 period, there is a major deficiency in the data. The information from the U.S. Census Bureau and the state Employment Development Department includes jobs created under the Comprehensive Employment and Training Act (CETA). As "work training" positions, these jobs, by definition, were temporary. Thus, the loss of CETA positions distorts the actual change in regular positions from 1978 to 1982.

Unfortunately data are not available which allows us to distinguish CETA positions from non-CETA positions for cities and for counties, in each year since 1978. Our review of all city and county employment, *including CETA,* suggests that CETA positions accounted for a greater proportion of city employment than of county employment.

By ignoring the reduction of CETA positions in *city and county employment combined,* the data shows that:

- On an annual basis, total city and county employment has *increased* at an average annual rate of 1.9 percent between 1978 and 1982.
- On an cumulative basis, total city and county employment in March 1982 is *up* 11.2 percent, or 40,000 employees from March 1978.

Our analysis indicates that most of this growth has occurred in county employment, while cities reflect stable to minor increases in employment over the post-Proposition 13 period.

C. FUNDING FOR STATE MANDATED LOCAL PROGRAMS

How Can the Legislature Assure that State-Mandated Programs Continue to Serve Statewide Objectives in a Cost-Effective Manner?

Chapter 1406, Statutes of 1972 (SB 90), required the state, under certain circumstances, to reimburse local governments for state mandated costs and lost sales and property tax revenues. Under this measure, local governments could submit claims for reimbursement to the state in cases where the mandating statute acknowledged an obligation on the state's part to cover the increased costs (or revenue loss) resulting from the mandate.

Legislation enacted since SB 90 has significantly broadened the reimbursement program. Local governments and school districts may now appeal to the state Board of Control for reimbursement of a wide variety of unfunded mandates, regardless of any prior legislative determinations on the issue. Even more significantly, the voters' approval of Proposition 4 on the November 1979 ballot has elevated the reimbursement principle to a constitutional guarantee. This guarantee is only now undergoing its first test in the California courts.

Legislative Action on Claims Bills

Under the existing reimbursment process, the Board of Control reviews claims from local agencies which allege that chaptered legislation contains a state mandate. If the Board of Control determines that a mandate exists, it must develop parameters and guidelines which delineate the types of costs for which local agencies may claim reimbursement. Once adopted by the board, the approved claims are presented to the Legislature in a claims bill for an appropriation.

Changes to the claims bill process were made by the companion bills to the 1982 Budget Act, Ch 327/82 and Ch 1638/82. Chapter 327, Statutes of 1982, requires the Legislature to either provide the funding requested in the claims bill, or to include one of several specified findings.

The Legislature made several such findings in lieu of providing funds when it acted on the most recent claims bill, Ch 1586/82 (AB 2675). As a result, local agencies, the administration, and the parties involved in the mandate process were provided with specific reasons for the individual legislative actions. On the other hand, funding was not provided to reimburse local governments for mandated costs in connection with six programs, even though the claims would appear to be legitimate.

Ultimately, these and many other claims that previously were denied state reimbursement will have to be paid, because of the constitutional requirement for reimbursement. By not appropriating funds to reimburse local governments and school districts for mandated costs in the claims bill, the Legislature may delay, but probably cannot avoid providing reimbursement.

The lack of timely reimbursement for mandated costs may create problems for the programs mandated by the Legislature. In fact, the denial of funds could allow the courts to, in effect, repeal the program by enjoining the state from enforcing the mandated requirements. To the extent that the Legislature's action to deny funding for mandated costs reflects its priority regarding these programs, it would seem to be in the Legislature's interest to specifically repeal the requirements, thereby avoiding further claims and any litigations that may arise with respect to them.

Status of Counties' Law Suit Against the State

The County Supervisors Association of California and 38 counties have sued the state, alleging that the state enacted 15 unfunded mandates in violation of Section 6, Article XIII B of the California Constitution. The counties assert that these 15 statutes each mandate a new program or higher level of service to be performed by the counties. The counties maintain that in each instance, the Legislature has failed to provide the funds needed to cover the costs of performing these new functions. Based on the Legislature's action in denying reimbursement for other mandated costs, the counties maintain that the normal reimbursement process will not yield state reimbursement for these mandated costs. Therefore, they are asking the court to declare the statutes invalid and unenforceable.

In presenting the state's case, the Attorney General contends that the counties have failed to exhaust the administrative process for obtaining reimbursements, and therefore are obligated to continue complying with all statutes enacted by the Legislature. To further support the state's position, the Attorney General concludes that the State Constitution is silent on the question of whether the claims process must be followed, and therefore local governments are required to utilize the process completely before contesting a mandate in the court. Therefore, he believes that the counties must complete the claims process before they can challenge a legislative decision concerning funding for mandated costs. Opening arguments were made in November 1982 in the Superior Court. Final oral arguments were to be heard in January, with the court rendering a decision by the middle of February.

Growth of State Mandates

Since 1975, when the state began keeping records on state mandated costs, approximately 2,400 bills have been enacted which contain a mandated local program. According to the Department of Finance, however, 106 of these bills have contained an appropriation to pay for the mandated cost.

State expenditures for state-mandated costs have grown from $2.9 million in 1973–74 to approximately $90 million in 1982–83. The Department of Finance estimates that the local government claims bill to be introduced during the current session, for payment in the budget year, will include approximately $184.5 million in funds to pay mandated cost claims. In addition, the budget for 1983–84 proposes to appropriate $75.1 million for state-mandated program costs incurred in the budget year. Therefore, *total funding for state-mandated local programs could amount to $260 million for the budget year,* assuming that the claims bill is enacted as recommended by the Board of Control. Table 72 details the total cost of state-mandated local programs from the inception of the program.

Table 72
State-Mandated Local Programs
Total Costs
1974–75 to 1983–84
(in thousands)

Year	*Budget Appropriation*	*Claims Bill*	*Totals*
1974–75	$16,743	—	$16,743
1975–76	9,680	—	9,680
1976–77	18,356	—	18,356
1977–78	45,297	—	45,297
1978–79	48,749	—	48,749
1979–80	80,591	$8,207	88,798
1980–81	77,714	11,091	88,805
1981–82	69,913	21,576	91,489
1982–83	53,526	36,588	90,114 [a]
1983–84	75,112	184,500 [b]	259,612

[a] Based on claims approved by the Board of Control through December 1982.
[b] Based on Department of Finance Estimate.

Procedures for Reevaluating the Effectiveness of Existing State-Mandated Local Programs

As noted above, almost 2,400 bills containing a state mandated local program, have been enacted since 1975 but only 106 of these bills contained an appropriation to pay for the mandated costs.

In many cases, the state appropriately disclaimed responsibility for providing reimbursement of the mandated costs. Some of these statutes also provided *savings* to local government in an amount sufficient to offset the costs, so that there were no net increased costs to the local agency that warranted reimbursement. In the bulk of these cases, however, it was simply not possible to know in advance the extent to which any increased costs would be incurred.

The costs associated with state mandates, like the tax expenditures discussed earlier in this document, generally are insulated from the budget process and the trade-offs that characterize this process. This is because, once a state-mandated program is enacted, its efficacy usually is not subject to subsequent review by the Legislature. The Legislature *may* have an opportunity to review the performance of some of these programs when local agencies seek to obtain reimbursement through the Board of Control. The number of such programs reviewed in this manner, however, is limited, relative to the number of programs mandated to date.

The Legislature has recognized the need for some ongoing review of state-mandated programs. On two occasions, it has directed our office to examine specific state mandated local programs and make recommendations to the Legislature as to whether these programs should be modified or repealed. In addition, our office has been given an ongoing responsibility to review annually all state mandated programs which receive initial state funding through the Board of Control process each year.

In our most recent report, *State Reimbursement of Mandated Local Costs: A Review of Statutes During January 1978–June 1981* (April 1982), we recommended that four of the five mandates examined pursuant to the Legislature's directive be modified, in order to achieve a more efficient use of state and local funds.

We believe the identification and repeal of existing state-mandated local programs which are no longer cost-effective could significantly reduce government expenditures at all levels. The state, however, is not in a good position to identify those mandates that are unnecessary or are not constructive because it does not administer the programs directly or observe their results first hand. Although local governments frequently testify on the problems caused by the imposition of these mandates, they generally refrain from offering any evaluations of *specific* mandates that they administered or from presenting a case for eliminating these mandates.

For this reason, we recommend that a process be established whereby the state and local governments, in a cooperative effort, seek to identify unnecessary mandates. This could be implemented by assigning to a legislative committee the responsibility for receiving evaluations of existing mandates from local agencies. This committee could review these evaluations and make recommendations for modification or repeal to the Legislature as a whole. In this way, local governments could identify those programs with a low priority or inadequate accomplishments, and present a case for modification or repeal. Since, for the most part, these programs currently are financed by local governments, it should be in their interest to make recommendations for changes so that the savings generated through this process could be used for other local purposes having a higher priority.

Statutory Expenditure Requirements

Eliminating unnecessary program requirements which are *not directly related to the service provided* is another way the Legislature can reduce local expenditures and consequently free up local revenues. For example, the state mandates and counties provide a variety of public health services, such as family planning, maternal and child health and prenatal clinics. In general, each of these programs has its own specific eligibility requirements as prescribed by the state, and its own program for determining eligibility. If these eligibility requirements were made uniform and the eligibility determination processes consolidated, it would not be necessary to screen applicants separately for each program, thereby reducing administrative costs. Further, many of the community-health-related programs are required to provide to both the state and federal government statistical information on the services provided and the clients served. In addition to the federal information form, state administrative regulations prescribe a separate information form for each of the programs. To the extent that California used either (1) a uniform information form for all programs or (2) the federal form, administrative duties could be reduced and savings realized.

D. THE STATE AND LOCAL RELATIONSHIP: A NEED FOR REFORM

Does the Nature of the State's Relationship with Local Government Warrant a Reassessment?

The budget proposes that a new partnership be formed between the state and local government, with the goal of restoring to local government the position it held prior to the passage of Proposition 13.

The administration has developed two specific proposals in an effort to restore to local government the role it played prior to Proposition 13. The first proposal, as discussed earlier in this document, would consolidate funding for categorical programs into three state block grants in the following areas: education, public health, and alcohol and drugs. In addition, the Governor is proposing to modify an existing block grant program in county justice system subventions. Block grants *potentially* could reduce the costs to both the state and local governments of providing services in these and other areas. The block grant concept has another significant impact that does not show up in state or local budgets. It increases local control over how state funds are used, and thereby reduces the Legislature's control. Whether the savings from program consolidation and the increased responsiveness to local conditions and priorities are sufficient to offset the loss of control at the state level is something only the Legislature can determine.

The second proposal contained in the budget calls for the establishment of a task force to review the state and local relationship, and to propose a plan to implement a new partnership. This task force would be made up of representatives of both government and the private sector. The task force would not be unlike one established by the Legislature pursuant to Ch 831/82 (AB 3231) for the purpose of restructuring state and local program responsibilities. The final report from this effort is anticipated in February 1983.

We believe that it is both appropriate and desirable to review and evaluate the existing relationship between the state and local governments. While the budget does not contain any suggestions as to the specific changes in this relationship which might be sought, it does provide a platform on which the relationship can be reassessed. We believe this reassessment should specifically consider the following interrelated issues:

- ***Accountability for Program Costs and Benefits.*** Under the existing relationship, neither the state nor local governments are directly responsible for the results of many programs. The state promulgates the program requirements and provides much of the funding, while counties provide the service. The state is not directly accountable because it does not provide the service. The counties are not directly accountable because the program is state conceived and state mandated, and much of the financial support comes from state or federal funds. As a result, it is difficult for the public to hold anyone accountable for program performance.
- ***Incentives to Manage Resources Efficiently.*** Because those who actually disburse the funds under many state-local programs have only a modest stake in the cost of those programs, current funding arrangements do little to encourage cost-effective program administration. In fact, it may even have the opposite results in some cases. Often, the level of state and/or federal funds received by a county in one year

is dependent on the amount the county actually spent in the prior year. This creates an incentive to spend funds that may not be needed in one year, so that a subsequent years' funding will not be jeopardized.

- ***Accountability for Budgetary Decisions.*** The existing system also makes it difficult to pinpoint which agency—be it the state or local government—is accountable for budgetary decisions. For example, when the state reduces state support for a specific program operated by local governments, it is a local service that is reduced. Local governments must then bear the brunt of explaining the reduction in services. Conversely, some local governments that chose to maintain pre-Proposition 13 service levels, despite a lack of adequate funds on an ongoing basis, blame reductions in state assistance for the service reductions that ultimately must be made.
- ***Ability to Effect Economies and Efficiencies.*** The ability to effect economies and efficiencies is restricted by the current relationship, because the agencies providing the service, and consequently those best able to identify and implement changes to promote efficiencies and economies, are not the agencies with either the incentive or the authority to effect such changes. Meanwhile, the state is in a position of overseeing a single program implemented as many as 58 different ways.
- ***Ability to Set Priorities.*** The ability to set priorities and address local needs is all but lost under the existing system, given that many local agencies lack the ability to increase the resources available for responding to the needs of their residents.

E. LOCAL FINANCING OF CAPITAL IMPROVEMENTS

How Can the Legislature Help Local Government Obtain The Capital They Need to Provide and Maintain Public Facilities?

A growing concern among local governments is that their public works facilities—the systems of roads, bridges, sewers, water lines, transit facilities, and other capital projects on which community residents depend—have deteriorated to the point where they are badly in need of repair. Local governments are also concerned over the deterioration of public facilities because it is seen as posing a significant barrier to economic growth. This situation, referred to commonly as "the infrastructure problem," reflects many years of under maintenance and neglect of public facilities.

The concern about the condition of public facilities is not confined to California. Efforts are underway in other states and at the federal level to assess the magnitude of the infrastructure problem in the country, and to develop alternative means of financing public improvements.

Why Have Public Facilities Deteriorated?

The deterioration of public facilities can be traced mainly to (1) the reduction in funds available for *all* public purposes, and (2) decisions made by elected officials to limit funding for public works projects. Proposition 13 has sharply reduced revenues at the local level. This, coupled with public pressure to maintain existing social services, has led local government officials to postpone spending for the maintenance and construction of public facilities. Another important consequence of Proposition 13 that is relevant to the infrastructure problem is that the measure has eliminated the traditional local source of financing for public facilities improvements—general obligation bonds. Because of limits now placed on property tax rates, local governments are no longer able to sell general obligation bonds.

Reductions in state and federal aid to local governments have also contributed to the limitations on spending for public works. For example, while the federal government historically has financed 75 percent of the costs of sewage plants in California, it currently is providing virtually no funding for these facilities.

AOR Study of the Infrastructure Problem in California

Unfortunately, no reliable estimates are available which indicate how significant the infrastructure problem is in California. The Assembly Office of Research (AOR) currently is conducting an extensive study of the problem, and it hopes to produce a description of California public works and an inventory of capital replacement, repair, and rehabilitation needs. AOR plans to release its findings in the spring of 1983.

Methods Currently Available to Finance Infrastructure Improvements

In the *Analysis,* we discuss in several places issues regarding the "infrastructure" problem in California. In this section, we identify the various methods by which any needed improvements could be financed in the future.

Despite the loss of general obligation bond financing, there are a variety of financing tools which currently are available to assist localities in addressing the infrastructure problem. Some of these tools have only been developed recently, and are often referred to as "creative financing" techniques. More often than not, however, they are only variations of the traditional financing tools which have been available in the past. These traditional methods, all of which rely on tax-exempt financing, generally include special assessment bonds, revenue bonds, tax allocation bonds, and lease-revenue bonds.

Special Assessment Bonds. These bonds are sold by cities, counties, and special districts to finance public works projects, such as streets, sewers, storm drains, street lights, and sidewalks, which benefit particular properties that can be specifically identified. Assessments are then levied on the affected properties to generate the revenues needed to service the bonds. These assessments are based on the value of the benefits that each property receives, rather than on property values per se. For example, the bonds issued under the 1911 Special Assessment Bond Act are secured solely by fixed-lien assessments on property, which frees the issuing governments from any ultimate debt servicing obligations. While the volume of special assessment bonds still accounts for less than 10 percent of all nonhousing bonds issued by local agencies, the volume in absolute terms, has increased significantly in the last four years—from $14 million in 1978–79 to $87 million in 1981–82.

Assessments have several attractive features which highlight their usefulness as tools for financing public improvements. First, the courts repeatedly have ruled that assessments are not subject to either Article XIIIA of the Constitution (Proposition 13) or Article XIIIB (the so-called spending limitations). Moreover, a two-thirds vote is generally not required to levy an assessment. Finally, assessments are efficient, because the costs of the improvements are borne by those who directly benefit from them. The major disadvantage of assessments is that the limits on the purposes of assessments are unclear, particularly with respect to operation and maintenance of facilities.

Revenue Bonds. These are bonds sold by cities, counties, and special districts to pay for revenue-producing facilities, such as water and sewer systems, airports, parking facilities, and hospitals. The bonds are serviced by revenues generated from fees charged for the services provided by these services. Revenue bonds must be approved by a *majority* of the voters, and are sold competitively. Property taxes may not be pledged as revenues. The purposes for which these bonds may be used, however, are, of course, limited to revenue generating capital improvements.

Tax Allocation Bonds. These bonds are sold by redevelopment agencies to finance the acquisition of property in blighted areas, the demolition of deteriorated buildings, the relocation of existing residents and businesses, the preparation of land for redevelopment, and the provision of public improvements needed for redevelopment. Tax allocation bonds are financed and secured primarily by the "tax increment" revenues derived from a specific redevelopment project, and thus, are also sometimes referred to as tax increment bonds. Tax allocation bonds may be issued *without* voter approval.

These bonds are used extensively in California, and for a variety of projects, including shopping centers, commercial office space, and residential units. In addition, they are also used to construct public facilities needed for these redevelopment projects. For instance, one city has used tax allocation bonds to improve a freeway interchange which services a shopping mall, and another used this method to build schools and flood control facilities.

Lease-Revenue Bonds. These bonds—also called lease-purchase bonds, lease-rental bonds, or simply leasebacks—are sold by nonprofit corporations or joint powers authorities to pay for public facilities like hospitals, parking facilities, schools, and convention centers. A public agency then leases or rents the facility to provide the revenues necessary to service the bonds and to cover the operating expenses of the corporation. Normally, the lifetime of the lease or rental agreement corresponds to the maximum maturity of the bonds. The public agency finances its lease payments out of its operating budget. Once the lease or rental period has elapsed and the bonds have been repaid, the lessee normally becomes owner of the facility. In most cases, lease-revenue bonds are not voter approved.

Other Tools. There are also other new financing mechanisms, such as that authorized by the Legislature under the Mello-Roos Community Facilities Act. This measure authorizes local agencies to levy special taxes within "community facilities districts" for financing new capital construction. In addition, greater reliance can be placed on user fees or charges to generate the funds needed to finance public facilities. This may be an especially important source of financing for capital facilities in newly developed areas, where local governments may be able to increase or broaden the scope of facilities covered by fees, exactions, and other charges paid by developers. These and similar devices all have one feature in common which we believe commends them—they derive the funds needed to support capital facilities, not from general subsidies, but from fees and taxes paid by those who directly benefit.

Creative Financing Methods Inadequate—General Obligation Bonding Needed

We recommend that the Legislature present to the voters for their approval an amendment to the California Constitution that would give localities access to the general obligation bond market. Specifically, we recommend that the voters be asked to approve a constitutional amendment permitting localities to increase temporarily their property tax rates above the current 1 percent limit, for the express purpose of amortizing debt issued to finance voter-approved public facilities.

Financing methods which currently are available to local government could provide a significant portion of the funds needed for public improvements. *However,* we do not believe that the entire infrastructure problem can be solved without resort to general obligation bonds. General obligation bonds are a preferable means of financing many projects (and perhaps the only means for some) because (1) they are backed by the *full faith and credit* of the issuing agency; (2) they require approval by the voters; and (3) they generally provide for a better match between who pays and who benefits over the life of a project. Further, the use of general obligation bonds may permit some projects which could be financed under alternative financing mechanisms to be completed at lower cost, due to the superior security they offer.

Furthermore, we find no basis for precluding the use of general obligation bonds by local governments for projects which a majority of voters are willing to support. Accordingly, we recommend that the Legislature take action to give localities access to the general obligation bond market. Specifically, we recommend that voters be asked to approve a constitutional amendment permitting localities to temporarily increase property tax rates above the current 1 percent limit, for the express purpose of servicing debt issued to finance voter-approved public facilities.

V. LEGISLATIVE CONTROL OF THE BUDGET

A. COLLECTIVE BARGAINING FOR STATE EMPLOYEES

How Can the Legislature Carry Out Its Responsibilities Under the State's Collective Bargaining Laws in a Meaningful Way?

Background

In 1983–84, compensation increases for state employees will, for only the second year, be subject to determination through the collective bargaining process.

In this section, we focus primarily on the state's initial experience with collective bargaining—analyzing what happened and what can be learned from the process—in order to provide the Legislature with a framework for considering similar compensation matters in the budget year and beyond. Our *Analysis of the 1982–83 Budget Bill* (page B-44) contains a more detailed description of the bargaining process for state employees.

SEERA. The State Employer-Employee Relations Act (SEERA), Chapter 1159, Statutes of 1977, provides for a formal bilateral employee relations system for most civil service employees. Under its provisions, the Governor or his designee is required to "meet and confer in good faith"