SHIFTING GEARS: RETHINKING PROPERTY TAX SHIFT RELIEF

Is it Possible—or Desirable—to "Undo" the Tax Shift?

Summary

Debate over the property tax shifts have dominated relations between California's state and local governments for the last half-dozen years. This report provides the Legislature a framework for evaluating proposals to mitigate the shift.

- *This year, the property tax shift redirected nearly one-in-five property taxes ($3.6 billion) from local governments to schools. Mitigation measures, enacted by the state, offset more than $2.3 billion of these losses.*
- *About 12 counties and one-in-five cities appear to be "net winners" from the shifts and the mitigation measures. That is, these local governments received more funds from the mitigation measures than they lost from the property tax shift. The remaining local governments are net losers. No apparent policy basis underlays these different fiscal effects.*
- *Allocating local relief to mitigate each local government's shift losses would be difficult from a technical standpoint and would raise significant policy questions.*

We recommend the Legislature reject the notion of mitigating each local government's losses. Instead, we recommend the Legislature use any relief funds to help transform California's system of local government finance into one that reflects modern needs and preferences of local communities.

Note: This report was previously issued by our office in on February 2, 1999. This version includes some minor data revisions.

INTRODUCTION

The property tax—California's third largest tax—serves as a mainstay of finance for California's schools and local governments. The property tax provides revenues that are remarkably stable during recessions and may be used flexibly to meet local resident needs and preferences. Although generally called a "local tax," Proposition 13 and its implementation measures (particularly Chapter 282, Statutes of 1979 [AB 8, Greene]), eliminated most local authority over the tax. Not only is the base tax rate set in the State Constitution (at 1 percent), state statutes control the distribution of tax revenues among local governments. The state laws governing the allocation of property taxes are based substantially on the tax rates of local governments more than 20 years ago.

For four years in the early 1990s, the state faced annual budget gaps of $4 billion to $14 billion. To close these gaps, the Legislature and administration raised fees and taxes, cut programs, deferred costs, transferred costs to the federal government, and shifted over $3 billion of property taxes from local governments to schools. While the formulas underlying the property tax shifts were exceedingly complex, the concept was simple: shifting property taxes from local governments to schools reduced, on a dollar-for-dollar basis, the amount the state was required to spend for schools. In this way, the property tax shifts played a critical role in helping the state resolve its severe budget difficulties.

Over the last few years, the Legislature and administration have reversed—or the courts have invalidated—many of the budget gap-closing actions from the early 1990s. Despite local governments' ongoing efforts to overturn the property tax shift (in the courts, the Legislature, and the Commission on State Mandates), the property tax shifts remain in force.

Since their enactment, the property tax shifts have been an unending source of friction between state and local government. Defenders of the shifts justify the actions as the reversal of some of the state relief granted to local governments after Proposition 13. They contend that the state has mitigated most of the fiscal effect of the property tax shifts through Proposition 172 and other measures. Local government officials, on the other hand, argue that the tax shifts represent a major, unwarranted interference in local affairs. They contend that the state's Proposition 13 relief was intended to be permanent, not contingent on state fiscal fortunes and that the shift mitigation measures have been limited in amount and flexibility.

This debate over the property tax shifts shows no sign of abating. Local governments typically cite reversing the shifts as their highest legislative objective, and will soon file a lawsuit contending the shifts are a state-reimbursable mandate under Proposition 4. The property tax shift controversy also regularly winds its way into various legislative discussions, including discussions regarding the California Work Opportunity and Responsibility to Kids (CalWORKs) program, the Disproportionate Share Hospital (DSH) program, California Youth Authority fees, laws governing the formation of new cities, and the financing of trial courts. In an attempt to resolve this matter, the Governor's budget summary states that the administration intends to fully mitigate—over time—all local governments' remaining tax losses.

The purpose of this report is not to resolve the competing claims regarding the property tax shifts, or calculate how much one level of government "owes" the other. Instead, this report sets forth the factual basis of the shifts and the relief measures. Drawing on our detailed review of local government shift losses, this report explores the commonly cited approaches to "mitigating the shift" and finds that each has significant limitations.

How Much is the Shift?

The property tax shifts were enacted during two fiscal years—1992-93 and 1993-94. These shifted property taxes are commonly referred to as "ERAF" monies, after the name of the fund (the Educational Revenue Augmentation Fund) into which the property taxes are placed prior to being distributed to schools.

Figure 1 (see next page) shows the amount of the shifts, as enacted in 1992-93 and 1993-94, and their value today. At its current rate of growth, we would expect the property tax shifts to reach about $3.8 billion in the budget year.

Previous publications from our office provide extensive background on many aspects of the property tax shifts, including the statutory formulas which implemented them. Appendix 1 provides an overview of these publications.

How Much Relief is Provided?

Since the first proposal for a property tax shift, the Legislature has worked to mitigate its fiscal effect. Both the 1992-93 and 1993-94 property tax shifts were enacted in tandem with relief measures. In addition, as the

Figure 1

How Many Property Taxes Are Being Shifted?

1998-99
(In Millions)

	Shift		
	1992-93	1993-94	Value in 1998-99[a]
Counties	$585	$2,023	$2,797
Cities	240	313	537
Special districts	375	244	285
Redevelopment	200	65	—
Totals	**$1,400**	**$2,645**	**$3,619**

a The 1998-99 shift total is less than the two prior shifts combined because some components of the original shift formulas have sunsetted, were repealed, or never materialized at the amounts intended.

state's fiscal condition has improved, the Legislature has enacted additional relief measures. Because mitigation measures have been an integral part of the tax shifts, we believe any discussion of the shifts should acknowledge the relief provided.

We also note that the Governor's budget summary states that before more local relief is offered, there must be an "accounting" of the value of the relief measures and "a determination of the net effect on local governments of these various initiatives." To assist the Legislature in understanding this matter, we describe the various relief measures and estimate their value.

What Constitutes Relief?

Although there is broad agreement that mitigation measures *should* be included in a discussion of the impact of the shifts, there is considerable debate over *which* measures should be counted.

Figure 2 displays measures—enacted in 1992 or later—with the clear or implied goal of mitigating the shifts. The top section of Figure 2 displays measures that were more closely linked to the property tax shift, such as Proposition 172 and trial court reforms. The lower section of Figure 2 includes changes that, while not as closely linked to the shift, were notably influenced by the Legislature's concern about the diminished fiscal condition of local governments. For example, the Legislature's concern about county fiscal health appears to have affected its choices in

Figure 2

Relief Measures Associated With Property Tax Shifts

Measures Closely Linked to the Tax Shift

Proposition 172. Provides one-half cent in sales tax revenues annually to counties and cities. These funds ($1.9 billion in 1998-99) must be spent on public safety purposes. The funds do, however, indirectly "free up" local general purpose revenues for other purposes.

Trial Court Funding Relief. State assumed growth in trial courts costs, absorbed all trial cost in small counties, and reduced costs to other counties. Relief "frees-up" about $472 million of local government general purpose revenues in the budget year.

The Citizens Option for Public Safety (COPS) Program. $100 million statewide to cities and counties to augment front line law enforcement. Annually appropriated in the budget.

General Assistance. State granted counties authority to reduce grant levels through the "fiscal distress" (SB 1033) process; to "count" the in-kind value of medical, housing, and other assistance; and to place a time limit on employable people receiving aid. County savings are unknown, potentially $100 million or more annually.

Fines and Forfeiture Funds. Cities and counties receive a greater share of revenues from tickets issued for moving traffic violations. Funds may be used for general purposes. Relief probably exceeds $62 million annually.

Property Tax Administration Loan Program. Provides annual forgivable loans to counties for property tax administration. Counties benefit from increased property tax yields. Program authorized for several years at $60 million.

Teeter. Authorized a one-time mitigation of the property tax shift (totaling $292 million) from counties which elected to make certain changes to the distribution of delinquent property taxes.

Measures Influenced by the Tax Shift

California Work Opportunity and Responsibility to Kids (CalWORKs). Program changes and hundreds of million of dollars in new fiscal incentives, a portion of which may be available in the future for other county programs.

Disproportionate Share Hospital Program. State implemented new program to provide federal funds to county and private hospitals. Program typically provides hundreds of millions of dollars to counties annually.

County Juvenile Probation Services. State funds (approximately $200 million) for operations. Annually appropriated in the budget.

Public Library Foundation Program. State funds ($39 million) for public libraries. Annually appropriated in the budget.

Adult Protection Program. State provided $20 million in current year for an expanded county program.

developing CalWORKs (the Legislature limited county costs and provided potentially significant fiscal rewards), and the DSH Program (the Legislature reduced the amount of funds the state takes from the program). In addition, the Legislature's concern about possible program reductions led to appropriation of state funds for county probation services and local libraries.

In addition to programs such as those shown in Figure 2, the administration states that the property tax shift relief accounting should include measures benefitting local governments "over the last decade." The budget explicitly mentions the 1988 trial court funding program, and the 1991 health and welfare program realignment. In our view, including relief measures enacted *before* the property tax shifts is inappropriate because the changes were enacted for policy purposes other than shift mitigation. Moreover, should the administration wish to count preproperty tax shift actions by the state that *benefit* local government, it should also count actions during this period that *reduced* local governments fiscal capacity. No mention of these other actions is included in the budget summary.

How Much Is the Relief Worth?

From a local government perspective, the shifted property taxes represent a loss of a steadily increasing source of totally discretionary funds. None of the shift relief measures provide revenues which fully match the shifted property taxes in terms of flexibility, dependability, and growth potential. Specifically, a substantial portion of these relief funds:

- ***May Not Be Used Flexibly to Meet Local Objectives.*** Revenues from Proposition 172, the property tax administration loan program, and the Citizens Option for Public Safety (COPS) Program, for example, may only be spent on specified programs. (Funds for these programs do, however, decrease demand for local general purpose revenues for the programs.)
- ***Are Less Dependable Than the Property Tax.*** Relief from trial court reform and funding for DSH, juvenile probation services, the library foundation, and other programs may be affected by annual state budget decisions.
- ***May Not Grow as Fast as the Property Tax.*** Savings from the General Assistance (GA) program changes accrue only to counties that cut aid to the poor and do not necessarily "grow" with inflation. Similarly, funding for the COPS Program has stayed constant at $100 million for the last several years.

For these reasons, the relief funds are somewhat less "valuable" to local governments than an equal amount of property tax revenues. Many local governments contend that $1 in relief does not fully replace $1 in property taxes.

In addition to these local government concerns about the limitations of the relief funds, the state faces an even more basic problem in trying to "count" the value of the relief provided: there is virtually no detailed reporting on the amount of the shift or the value of the mitigation measures. All calculations on the value of the shift and the mitigation measures rely on dated records, voluntary unaudited reports, and statewide totals.

The LAO Estimate of Property Tax Shift Mitigation

Given the above, any selection or valuation of relief measures will be an imprecise and debatable process. Our goal in examining these measures was to select measures enacted *after* the shift that provide resources which serve as reasonable replacement for the lost property taxes. We believe three measures—Proposition 172, trial court funding, and COPS satisfy those conditions. Each of these measures:

- Provides a permanent source of revenues or, in the case of COPS, has been reviewed regularly by the Legislature and Governor and reapproved.
- Directly provides local governments with increased general purpose revenues or indirectly provide these revenues by reducing demand for general revenues.
- Offers relief that can be measured with a reasonable degree of accuracy.
- Benefits a broad array of local governments.

For added perspective, the report offers comments on the likely fiscal effect of the GA program changes and the allocation of fine and forfeiture funds. Both these relief measures meet the first two criteria above, but are much more difficult to quantify. In addition, the GA program relief principally benefits a limited number of counties. Figure 3 (see next page) details our estimates of the relief provided through these measures.

Calculating "Net" Shift

Counting the three mitigation programs discussed previously (Proposition 172, trial court funding, and COPS), we estimate that local governments are receiving over $2.3 billion in shift relief in the current year, reducing the "net harm" of the tax shift from $3.6 billion to about $1.3 bil-

Figure 3

Property Tax Shift Mitigation—How the LAO Counts Relief

- ✓ ***Proposition 172—The Public Safety Half Cent Sales Tax***. Proposition 172 will provide local governments $1.9 billion this year. Ninety-four percent is allocated to counties, the rest to cities. Proposition 172 revenues are growing at about 5 percent to 5.5 percent annually.

- ✓ ***Trial Court Funding Reform***. Our estimate assumes each county's trial court costs would have grown by 2 percent per year since 1994-95. A county's relief, therefore, is the difference between this projected level of county costs and the county's estimated actual costs. We estimate trial court relief to be $357 million in the current year and $472 million in the budget year. We note that any estimate of the benefit of trial court reform is highly dependent on the assumptions used. For example, if we had assumed that absent reform counties would have continued to pay about 60 percent of trial court costs, then our estimate of relief would be more than $100 million higher.

- ✓ ***The COPS[a] Program***. The Governor's budget reflects legislative practice over the last several years—$100 million for local law enforcement. We assume this program will continue to receive $100 million annually, with the funds allocated pursuant to current law.

- ✓ ***General Assistance***. The Legislature enacted laws allowing counties to reduce grant levels and limit time on aid. Many counties used this authority to significantly reduce program costs. County costs declined statewide by over $200 million from September 1993 through September 1997 (the latest data available at the time this report was prepared). The largest county savings accrued to counties implementing the program reductions. San Francisco, in contrast, did not implement the major changes and had virtually no savings.

- ✓ ***Fines and Forfeiture***. The 1998 trial court reform measure changed the allocation of fines collected from people who violate traffic laws. Statewide, $62 million of fine revenues were shifted to cities, and cities and counties became eligible for future increases in these revenues. During the budget debate, local government officials said that fine revenues would grow quickly because they would have more incentive to enforce traffic laws.

[a] Citizens Option for Public Safety.

lion. If the additional relief from the general assistance and fines and forfeitures changes are included, the net harm from the tax shift still exceeds $1 billion annually. We estimate that this net impact from the property tax shifts is growing modestly at a rate of about 4 percent or 5 percent per year.

Figure 4 displays our estimate of the net impact of the property tax shifts. The notable decline between 1997-98 and the current year is attributable to the benefit provided by the trial court reform measures. The small increase between the current year and 2000-01 is attributable to the faster growth rate assumed for the shifted property taxes, than for the mitigation measures. The increase would be about $48 million greater if the Governor's proposed changes to the trial court relief package are enacted.

Figure 4

Net Losses From Property Tax Shifts

(In Millions)

	1997-98	1998-99	1999-00	2000-01
Cities	$349	$369	$390	$415
Counties	955	639	583[a]	622[a]
Special districts	271	285	300	317
Totals	**$1,575**	**$1,293**	**$1,274**[a]	**$1,353**[a]

[a] These amounts would be about $48 million greater if the administration's trial court funding proposal is approved.

Difference With Administration's Approach. Because the administration indicates that it intends to consider all beneficial state-local fiscal transactions over the last decade, the administration's calculation of net impact may be lower than ours, possibly by several hundred million dollars.

A Look Behind the Numbers

To date, most discussions of the impact of the property tax shift have relied upon statewide estimates, such as displayed in Figure 4. In this section, we look behind the statewide numbers and examine the impact of the property tax shift on a local government by local government basis.

Some Winners, Some Losers

Contrary to conventional wisdom, not all local governments have lost revenues from the property tax shift and related transactions. Some instead are net "winners." That is, some cities and counties receive more revenues from the relief measures than they lose under the property tax shifts. (No special districts are net winners, but a significant number of districts were exempted from the shifts.)

As Figure 5 shows, 12 of the state's counties (comprising 23 percent of the state's population) received *more* revenues in relief than they lost in property taxes. The total net gain for these counties is about $79 million. The other 46 counties had net losses. Figure 5 shows whether these losses, examined on a per capita basis, are "small," "average," or "large." The nine counties listed in the large losses column make up more than 90 percent of county statewide losses. What does this level revenue loss mean to these nine counties? As a reference point, the counties shown in the large losses column are losing revenues at roughly the

Figure 5

Which Counties Have the Largest Net Property Tax Shift Losses?

1998-99

	Net Losses			
Net Gains	**Small**	**Average**		**Large**
Amador	Placer	Alpine	Monterey	Alameda
Butte	Riverside	Colusa	Napa	Calaveras
Del Norte	San Mateo	El Dorado	Nevada	Contra Costa
Inyo	Santa Cruz	Fresno	Sacramento	Los Angeles
Lassen	Shasta	Glenn	San Bernardino	Merced
Mariposa	Sierra	Humboldt	San Luis Obispo	Mono
Orange	Stanislaus	Imperial	Santa Barbara	San Francisco
Plumas	Tehama	Kern	Siskiyou	San Joaquin
San Benito	Tuolumne	Kings	Solano	Tulare
San Diego		Lake	Sonoma	
Santa Clara		Madera	Sutter	
Trinity		Marin	Ventura	
		Mendocino	Yolo	
		Modoc	Yuba	
+$79 Million	**-$11 Million**	**-$128 Million**		**-$579 Million**

same rate as counties commonly collect revenues from local sales taxes, local transportation taxes, utility user taxes, hotel taxes, business license taxes, benefit assessments, and property transfer taxes *combined*.

The impact of the shifts on California cities is similarly varied. While a statewide analysis was impossible due to data difficulties, we examined cities in Los Angeles County in detail. About one-in-five of the cities received more revenues from mitigation than it lost from the shifts. Sixteen cities, in contrast, had losses averaging $20 per resident. As a point of reference, such a revenue loss is equivalent to almost a 10 percent reduction in police expenditures. Based on our review of cities in other counties and given the property tax shift formulas, we would expect this variation to be very similar.

Poorer Governments Fare About the Same as Wealthier Ones

Given the great variation in fiscal impact on local governments, we looked to see if any patterns were apparent. Below, we examine whether wealthier communities fare differently than poorer communities.

To examine counties, we drew from our analysis in *Why County Revenues Vary: State Laws and Local Conditions Affecting County Finance* (please see Appendix 1 for a description of this publication). From the information in the report, we divided counties into three categories, reflecting their level of flexible revenues or "general purpose revenues." We find that counties which appear to be quite similar in terms of revenue levels frequently fall at different ends of the shift spectrum. For example, three urban counties in the average general purpose revenue category (Santa Clara, Santa Cruz, and San Mateo) have small or no net losses. Many comparable urban counties, however, have large losses (Los Angeles, Alameda, and Contra Costa). Similarly, while Butte, Merced, and Tulare all have low general purpose revenues, Butte is in the black and Merced and Tulare have large net losses. (Appendix 2 provides information on all counties.)

In reviewing this data on net shift positions, the Legislature should not assume that counties listed as "in the black" necessarily are better off than other counties. For example, even though the Legislature has authorized sufficient relief to make Butte and Orange net shift winners, these counties still have among the lowest levels of general purpose revenues per capita in the state. As we explain more fully in *Why County Revenues Vary: State Laws and Local Conditions Affecting County Finance*, various historical and local factors cause some counties to have unusually low levels of general purpose revenues.

Because we lack a method for measuring relative city or special district fiscal conditions, we were not able to perform a similar review for these governments. In the case of cities, however, we note that the distribution of net losses does not reflect the wealth of city residents. Some cities whose residents have higher per capita income have large losses (such as Beverly Hills, Palos Verdes Estates, and Manhattan Beach) while others have no net losses. Similarly, some cities whose residents have lower per capita income are net winners (such as Pico Rivera and Cudahy). Others, including Los Angeles, have sizable losses. Thus, any action to mitigate property tax shift losses would benefit some wealthier cities as well as some poorer cities.

No Regional Patterns, Except Rural Areas Generally Fare Better

In addition to looking for wealth-based variation, we examined the data to determine if there were regional differences in the shift burden. To do this, we examined aggregate net losses for *all* local governments (counties, cities, and special districts) within a county. That is, we added together all the local governments' property tax shifts and subtracted the relief. This approach helped illustrate if there were real differences among counties, or if a difference simply reflected (1) variations in governmental organization (such as San Francisco serving as both a city and a county) and (2) some counties' greater reliance upon special districts.

In general, we found that rural areas have lower overall net shift burdens. This fiscal position reflects the magnitude of the trial court relief given to these rural counties and the fact that rural communities tend to have few cities. (In general, areas without cities were less affected by the property tax shifts. This is because the formulas redirecting revenues from cities did not apply to them.)

Beyond this generalization, however, we found no discernable regional patterns. Some counties, such as Orange, have county governments that are net winners but have cities or special districts with significant losses. Overall, the highest concentration of losses were for local governments in seven counties: San Francisco, Mono, Marin, San Joaquin, Alameda, Contra Costa, and Los Angeles (listed in order of per capita losses). Residents in these counties have had their local government funding reduced by an average of $62 per resident. Revenue losses of this amount equate to roughly the cost of running all city, county, and independent libraries within the county, plus about half of all fire departments' budgets. Even within these "most affected" counties, however, there are some local governments with net gains from the property tax shift transactions. Appendix 2 presents our findings for all counties in the state.

Only a Distant Link to Proposition 13 Relief

The original property tax shift formulas reflected, to some extent, the relative benefit a local government received from the state after Proposition 13. This link to the past explains why cities incorporated after Proposition 13 incurred minimal property tax shifts in 1993-94 and why some counties had larger shifts than others.

Relief from the property tax shifts, on the other hand, has been allocated under wide ranging formulas. Proposition 172 sales taxes are distributed to local governments based on the county in which the sale occurs. Trial court relief reflects the relative size of the county and historic court funding formulas. The COPS Program funding is allocated on a population basis. As a result, the differences in net tax shift losses today bear only a distant relationship with Proposition 13 relief. In terms of counties, we find that the differences among many similar counties has little to do with Proposition 13 relief, but is attributable to differences in historic funding arrangements for trial courts and the extent of sales tax activity in the county.

Summary: Examination of Local Government Gains and Losses

Overall, the remaining impact of the property tax shift is extraordinarily varied and difficult to predict. Some local governments are actually "better off" under the property tax shift and related transactions. Some are sustaining moderate losses. Still others, shoulder large losses. These differing fiscal effects do not reflect any obvious policy rationale or patterns. Instead, they appear to be the unintentional result of "layering" one disparate statewide formula on top of another.

A New Perspective on Mitigating the Shift

Over the years, local government advocates have called for shift mitigation roughly as follows:

- The state would calculate an aggregate amount that it owes local governments.
- The state would then provide local relief equal to this sum, possibly staged over several years.
- Local relief would be provided through (1) a proportionate "baseline" reduction to all local government property tax shift liabilities, (2) a "cap" on the growth of the property tax shift, and/or (3) the state assuming some local program costs (such as general assistance or more trial court costs).

The commonly cited goal of this effort is to restore local governments' fiscal positions to about their 1991-92 levels, the year before the first shift. This restoration of funding is expected to resolve the controversy about the property tax shift and improve state-local relations.

The discussion in the Governor's budget summary reflects this conventional thinking. In our view, it has several conceptual limitations.

Conventional Approaches Will Not Achieve Expected Results

Due to the great variation in local governments' net shift losses, any general statewide formula will not achieve the goal of restoring local governments' preshift fiscal conditions. Regardless of which approach the state employed (baseline reduction, shift cap, and/or program cost reduction), some local governments would be overcompensated for the property tax shifts—and others would have significant remaining losses. Those local governments with continuing losses are unlikely to accept the claim that "on average" the state has repaid the property tax shift and the debate regarding the property tax shift would likely continue.

To illustrate, consider the effect of cutting county baseline property tax shift obligation by 10 percent. Such an action would benefit counties (and cost the state) approximately $300 million in the first year. More than $60 million of this relief, however, would be directed to counties that have net *gains* from the shift, increasing their total gains from the shift transactions to $140 million. Conversely, only about $150 million of the relief would be directed to the nine counties whose net losses total $580 million. Moreover, in some cases the baseline reduction approach provides the *same* level of relief for counties with very different net shift burdens. For example, Santa Clara County—already a net winner under the shift—would realize about the same amount of per capita relief as Contra Costa, a large net loser.

Placing a cap on the dollar amount of property taxes subject to the shift also fails to target relief to local governments with net losses. This is because a growth cap provides the greatest benefit to local governments with high shift obligations and fast property tax growth rates—not necessarily local governments with the greatest net losses. For example, if a cap had been in place last year Santa Clara County would have realized savings of $8.07 per resident, while Contra Costa County would have realized savings of $1.77 per resident. In this case, the state would have provided $9.85 per resident of local relief, but only 18 percent of it would have worked towards the goal of mitigating the shift. The rest of the funds in this example would have worked to *enlarge* the difference in the net shift position of Santa Clara and Contra Costa Counties, a factor unlikely to reduce the controversy about the property tax shift.

Finally, the fiscal effect of any program cost takeover by the state would depend on (1) the nature of the program and (2) the formula by which the state assumed costs. Our review indicates that it would be virtually impossible to create a general program cost formula that would match the unusual incidence of property tax shift burdens. For example, a state takeover of general assistance costs would greatly benefit some counties with large shift losses—Los Angeles, San Francisco, Alameda, and Contra Costa—but it would also (1) benefit many counties with no remaining losses and (2) do little to help some rural counties that have net losses but small GA caseloads.

In summary, because of this uneven fiscal landscape, any general statewide relief formula—baseline shift reduction, a cap, or a program cost buyout—will overcompensate some governments and leave others with net losses.

"Scheduling" Relief Unlikely To Achieve Intended Results

Given the difficulties of mitigating the property tax shift through a statewide formula, the Legislature could—alternatively—consider developing a local government-by-local government schedule of relief (at least for the 500-plus cities and counties in the state). Implementing shift relief from a detailed schedule would allow the Legislature to target relief with greater accuracy.

The Legislature should not underestimate, however, the significant difficulties involved in developing such a schedule of relief or in maintaining the schedule over time. For example, developing the schedule would require (1) county auditors to estimate the value of the shift for every local government in the state, an extraordinarily complicated task never before undertaken; and (2) the Legislature and administration to develop locality-by-locality estimates of the benefit of relief measures. In addition, whenever the value of the shift or a relief measure changed (due to economic fluctuations and their resultant effects on the value of the shifts and Proposition 172 revenues, or due to legislative desire to revamp a relief program, such as COPS), some local governments would argue that the value of their relief no longer equals the burden of their property tax shifts.

Scheduling relief on a jurisdiction basis would also encounter another problem—it would cost much more than expected. To illustrate, consider California's 58 counties. As Figure 6 shows (see next page), while

Figure 6

Distribution of County Net Fiscal Effect

(In Millions)

	Counties In the Black	Counties In the Red	Totals
Net shift position	$79	-$718	**-$639**
Number of counties	12	46	**58**

the net loss to counties is $639 million, it would actually cost $718 million to eliminate all the losses of the 46 counties currently "in the red."

Of course, the Legislature would reduce the cost of mitigation if it chose the controversial step of "taking back" relief from local governments that are net winners. In the case of counties, the Legislature could reduce the total cost of mitigation down to $639 million by taking back $79 million from those in the black. Such an action, however, would result in some entities transferring revenues to local governments with apparently greater access to resources. Butte County, for example, effectively would help transfer revenues to Marin. The same situation would occur with cities. If the Legislature wished to reallocate relief from cities to minimize mitigation costs, Compton and Pico Rivera would help transfer revenues to Beverly Hills. Such transfers would obviously present significant policy and practical concerns.

"Inventing" a New Formula for Local Relief Would be Very Difficult

In lieu of either a statewide formula or an entity-by-entity basis for mitigation shift losses, the Legislature could develop a new formula to provide resources to local governments. This new formula could reflect state goals and state perceptions of local government need, rather than the mathematics of the property tax shift transactions.

While such an approach may appear more practicable, we caution the Legislature against embarking down this path. Simply put, given the enormous differences among California's thousands of local governments, it would be extraordinarily difficult to gauge local needs and preferences from Sacramento. In fact, the last time the state faced a comparable task—when allocating local relief and property taxes after Proposition 13—the Legislature concluded that it could not assess local finances and preferences in a centralized fashion. Because of these difficulties, AB 8—the state's measure to implement Proposition 13 and allocate relief—largely prorated local relief based on the best expression of local needs and preferences available at the time: local taxation decisions during the years just before Proposition 13. As discussed earlier in this report, the state's current system of local finance today is still largely "locked" into this dated formula.

MOVING BEYOND THE PROPERTY TAX SHIFT DEBATE

Whether the Legislature attempts to mitigate the shift or develop some new formula for local relief, such an effort simply would put more money into the state's existing local government financing system. While these endeavors might improve state-local relations and help local governments meet some local objectives, the local government financing system would continue to have the same limitations it has today. Namely:

- State government, rather than local communities, would continue to control virtually all sources of local government revenues, including most local sales taxes, property taxes, vehicle license fees, and Proposition 172 revenues. Distribution of these funds would continue to be vulnerable to annual state fiscal actions.
- Californian's property taxes would still be distributed to local governments based on the preferences of residents living in their area more than 20 years ago. Current residents and locally elected officials would continue to lack any authority to redirect their tax revenues to meet local objectives. Thus, property taxes in a community might continue to be distributed to water districts and cemetery districts, even if current residents would prefer that their taxes pay for more city or library services.
- The assignment of program responsibilities between state and local government, and among California's many local governments, would continue to be obtuse and difficult for residents to understand. Residents would continue to have difficulty determining which level of government to hold accountable for program outcomes. California cities and counties would continue to face counterproductive incentives to shift costs to other local governments.

In summary, even if it were possible for the state to develop the perfect formula to mitigate every local government's property tax shift losses, providing such relief would not correct the flawed architecture in the state's system of local finance. In our view, such a major expenditure of state funds to mitigate the shift would be a significant missed opportunity.

What Should the Legislature Do?

Instead of aiming to mitigate the property tax shift, we recommend the Legislature think strategically about any local relief funds. Specifically, we recommend the Legislature and administration use any "shift relief" funds to transform California's system of local finance into one that reflects modern needs and preferences of local communities and that encourages governments to work together.

The summary of problems with California's local government finance system described previously is not new. Similar descriptions of the system's failings have been made by myriad legislative task groups, the California Constitution Revision Commission, and others. Many of these groups have also worked to reform the current local finance system, but none have been successful. To a large extent, these failures to effect change have occurred not because of different perceptions of the problem but due to gridlock brought about by fiscal constraints. Specifically, with thousands of local governments in California, it is impossible to make improvements without negatively affecting the fiscal condition of some. Without additional resources (temporary or permanent) to facilitate a reform effort, the number of potential "losers" under any reform proposal erodes its chances of enactment.

One significant difference this year is that the administration has indicated a willingness to direct additional resources to local governments over time. In addition, both houses of the Legislature have recently launched efforts to examine local government finance: the Speaker of the Assembly has created a Commission on State and Local Government Finance and the Senate Budget and Fiscal Review Committee has begun a series of statewide local government finance forums. Finally, the statutory sunset on the COPS Program is drawing near.

Accordingly, we recommend the Legislature reject the concept of mitigating local government shift losses, and instead, dedicate any local relief resources (including the $100 million earmarked for the COPS Program in the budget bill) to transform the state's system of local finance.

In our view, the provision of local funding should not be predicated on a calculation of what one level of government owes the other, but upon the possibility for improving California's flawed system of local government finance.

Appendix 1
Publications: Property Taxes and the Shift

Reversing the Property Tax Shifts — **April 2, 1996**
- Explains the mechanics of the shift and the formulas which implemented it.
- Discusses impact of shifts.
- Examines several proposals to mitigate the shift over time.

Property Taxes: Why Some Local Governments Get More Than Others — **August 21, 1996**
- Examines historic laws and local conditions affecting distribution of property taxes.
- Includes a detailed look at AB 8.

Property Tax Shift — **February 1997**
- Compares "baseline" shift reductions to the "cap" approach.

Improving the Incentives for Property Tax Administration — **February 1997**
- Takes a detailed look at an unexpected result of the property tax shift—diminished interest of counties in administering the tax collection system.

ERAF and the 1997-98 State Budget — **June 18, 1997**
- Provides a detailed look at options to provide a modest level of shift relief.

Major Milestones: 25 Years of the State-Local Fiscal Relationship — **December 1997**
- Provides a time line summarizing major changes in the state-local relationship.

Why County Revenues Vary: State Laws and Local Conditions Affecting County Finance — **May 7, 1998**
- Explains the formulas underlying county general revenues.
- Includes county-by-county data.

All publications are available by contacting the LAO or on our web site: **www.lao.ca.gov.**

Appendix 2

Net Shift Gains and Losses by County[a]

1998-99

			Net Shift In County	
	Population	County General Revenues	County Only	All Local Governments
Alameda	1,408,100	Medium	Large	Large
Alpine	1,200	Large	Average	Average
Amador	33,700	Large	Black	Black
Butte	201,600	Low	Black	Small
Calaveras	38,350	Medium	Large	Average
Colusa	18,550	Large	Average	Small
Contra Costa	900,700	Medium	Large	Large
Del Norte	28,900	Medium	Black	Black
El Dorado	147,600	Large	Average	Average
Fresno	786,800	Medium	Average	Average
Glenn	26,950	Medium	Average	Small
Humboldt	127,700	Medium	Average	Average
Imperial	142,100	Low	Average	Small
Inyo	18,500	Large	Black	Small
Kern	639,800	Medium	Average	Average
Kings	122,800	Low	Average	Average
Lake	55,100	Medium	Average	Average
Lassen	34,150	Medium	Black	Black
Los Angeles	9,603,300	Medium	Large	Large
Madera	114,300	Medium	Average	Average
Marin	245,900	Large	Average	Large
Mariposa	16,150	Large	Black	Black
Mendocino	86,900	Large	Average	Average
Merced	204,400	Low	Large	Average
Modoc	10,150	Large	Average	Small
Mono	10,600	Large	Large	Large
Monterey	386,200	Medium	Average	Average
Napa	123,300	Medium	Average	Average
Nevada	88,800	Medium	Average	Average

Continued

Appendix 2

(Continued)

Net Shift Gains and Losses by County[a]

1998-99

	Population	County General Revenues	Net Shift In County: County Only	Net Shift In County: All Local Governments
Orange	2,722,300	Low	Black	Small
Placer	217,900	Large	Small	Small
Plumas	20,600	Large	Black	Small
Riverside	1,441,200	Low	Small	Small
Sacramento	1,159,800	Medium	Average	Average
San Benito	46,600	Medium	Black	Small
San Bernardino	1,621,900	Low	Average	Small
San Diego	2,794,800	Medium	Black	Small
San Francisco	789,600	Large	Large	Large
San Joaquin	545,200	Medium	Large	Large
San Luis Obispo	239,000	Large	Average	Average
San Mateo	715,400	Medium	Small	Average
Santa Barbara	405,500	Medium	Average	Small
Santa Clara	1,689,900	Medium	Black	Small
Santa Cruz	250,200	Medium	Small	Average
Shasta	165,000	Medium	Small	Small
Sierra	3,360	Large	Small	Small
Siskiyou	44,700	Medium	Average	Small
Solano	383,600	Medium	Average	Average
Sonoma	437,100	Large	Average	Small
Stanislaus	427,600	Medium	Small	Small
Sutter	76,800	Medium	Average	Average
Tehama	55,400	Medium	Small	Small
Trinity	13,250	Large	Black	Black
Tulare	360,400	Low	Large	Average
Tuolumne	52,800	Large	Small	Small
Ventura	730,800	Medium	Average	Average
Yolo	156,800	Low	Average	Average
Yuba	61,400	Medium	Average	Average

[a] All data analyzed on a per capita basis.