

Financing Cities

A status report on
California cities and
the need for serious reform.

Produced by CaliforniaCityFinance.com

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Cities . . .



■ are general purpose local governments;



■ provide essential frontline municipal services tailored to meet the unique needs of the communities they serve;



■ are funded mostly by locally enacted revenues;



■ provide land use planning and control.



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2

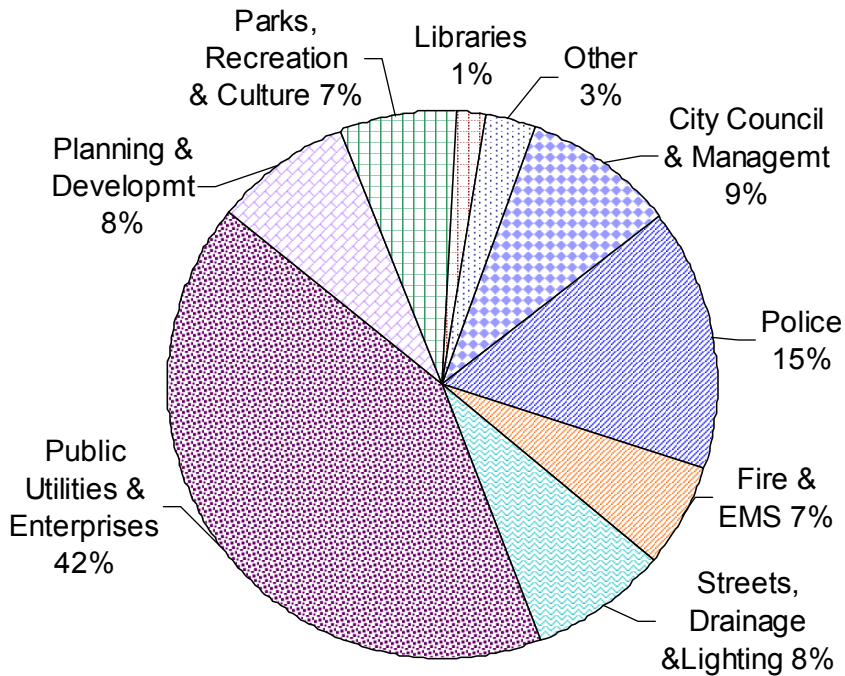
Cities are different from other government agencies.

Cities are independent. They:

- are general purpose local governments.
- provide essential frontline municipal services tailored to meet the unique needs of the communities they serve.
- are funded mostly by locally enacted revenues.
- provide land use planning and control.

Cities are independent entities not created by or for another form of government but by and for citizens and the communities in which they live. People form cities because they want local control over local public services and over the growth and development of their communities. They want services tailored to their particular needs and visions and they want greater control over how those services are performed and plans carried out.

California City Spending



3

Source: State Controller. Excludes San Francisco

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Cities are the general purpose provider of frontline community services including:

- public safety services: police, fire, etc.
- local streets, roads, transit, airports, harbors
- public utilities: solid waste, sewers, water, etc.
- parks, recreation, libraries, museums, arts.

Trends in Calif City Finance

- Decline of property tax \$
 - 15% of total city \$ in 1976
 - 8% of total city \$ in 1986
 - 7% of total city \$ in 2001 and today
- Decline of sales tax base
 - Shift to service oriented economy
 - Increasing internet and catalog retail
- Revenues more diverse & complex

4

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California city revenues have changed over the last 20 years.

•Local property tax revenue, once the backbone of city budgets is now just 7% of the average city's total revenues. Prior to Proposition 13, it was 15%.

•With the decline of this general purpose revenue, sales taxes have become more important to cities, yet we are witnessing a gradual long-term decline of sales tax base as we shift to a service oriented economy and as electronic and catalog commerce grow.

Trends in Calif City Finance

- State actions / priorities overwhelm local community interests
 - State financial needs
 - State policy priorities
- State mandates - especially utilities
 - Decline of local discretionary \$



Driving the problems cities now face has been the deteriorating relationship between local governments and the state. Not only did Proposition 13 give the state unprecedented authority over the allocation of the local property tax, but the constitutional home rule granted to cities in 1879 and strengthened in subsequent revisions of the state constitution has, over the last twenty years, been eroded by the courts and actions of the legislature and governor.

Now more than ever, city officials realize that their own policy goals and the needs of those they serve take a back seat to the state's financial needs and its policy priorities. Too often, state actions intrude on city operations without regard to local financial conditions, or local policies which have been tailored to local needs by locally elected officials and local voters. Without stable funding and reasonable home rule, cities are substantially hampered in their ability to plan their communities and services.

Trends in Calif City Finance

- Limitations on taxes, fees, etc.
 - Prop 13, Prop 62, Prop 218, AB1600.
- Greater array and cost of services.
New challenges
 - High tech, cable, transit, wireless, etc.
- Police and fire protection costs are going up, taking larger portions of budgets .

6

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Through several statewide initiatives, voters have dramatically limited the revenue options available to local government and the state. There are now numerous examples of proposed city taxes and bonds which fail, despite receiving 65% or 66% voter approval. The choices available to a city council to find the resources they need to provide municipal services are more constrained than ever. Meanwhile, as our communities urbanize and our economy and society evolves, we face growing and changing service demands. Despite this, cities have less spending flexibility to meet these needs since discretionary funding sources are dwindling while earmarked sources increase.

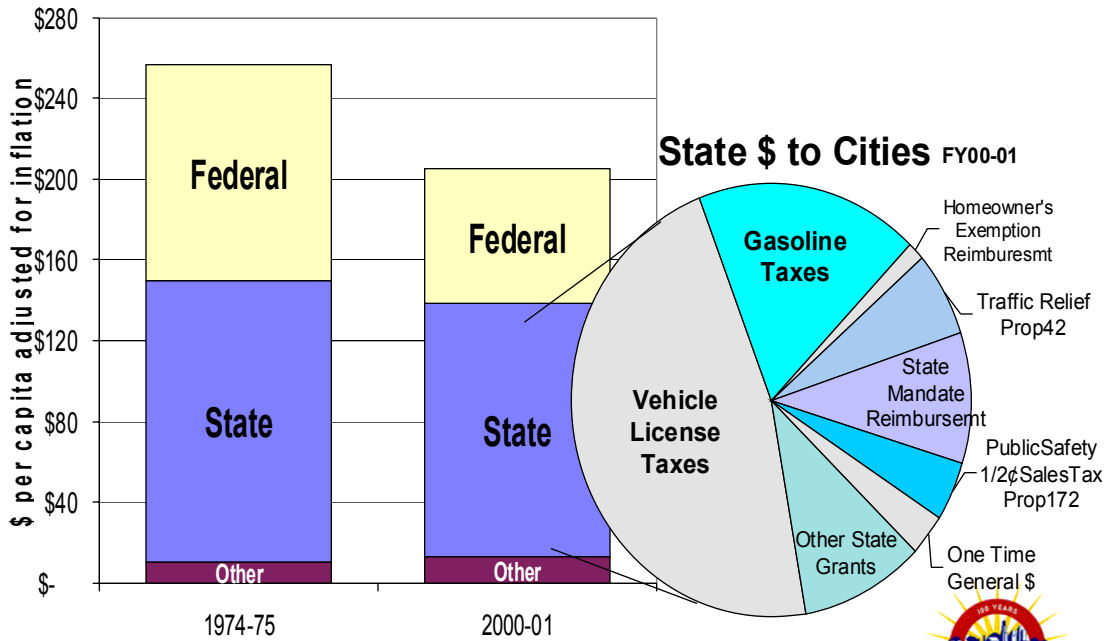
Leading Sources of California City Revenues

FY 1974-75 (pre Prop 13)	FY 1980-81 (after Prop 13)	FY 2000-01 (Recent)
1. ServiceCharges 35.2%	1. ServiceCharges 36.9%	1. ServiceCharges 42.0% ↑
2. State & Fed Aid 21.2%	2. State & Fed Aid 23.4%	2. State & Fed Aid 9.3% ↓
3. Property Tax 14.8%	3. Sales&Use Tax 11.9%	3. Sales&Use Tax 10.2%
4. Sales&UseTax 11.4%	4. Property Tax 5.8%	4. Property Tax 6.5% ↓
5. Use \$/Property 3.7%	5. Use \$/Property 3.5%	5. Use \$/Property 5.9% ↑
6. Veh.License Fee 4.1%	6. Veh.License Fee 3.1%	6. Veh.License Fee 3.8%
7. Other 9.6%	7. Other 15.5%	7. Utility User Tax 3.8% ↑
		8. Other 18.5%



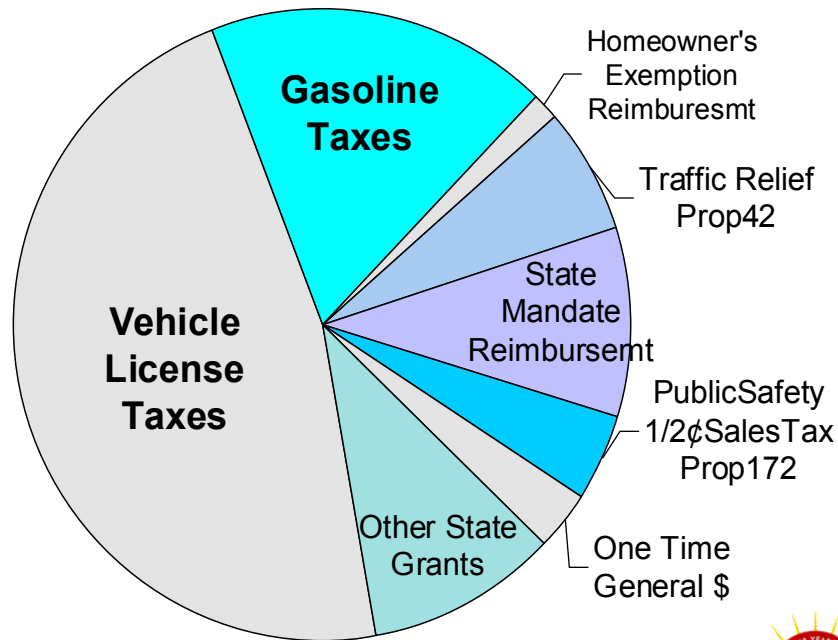
State and Federal Revenues to Cities

since 1975 per capita adjusted for inflation



Financial support from the state and federal government has declined even more dramatically. Prior to Proposition 13, federal, state, and county governments contributed 23% of all city revenues. In 2000-01, this support was just 9%.

State Revenues to Cities



9

Source: Calif State Controller, CaliforniaCityFinance.com

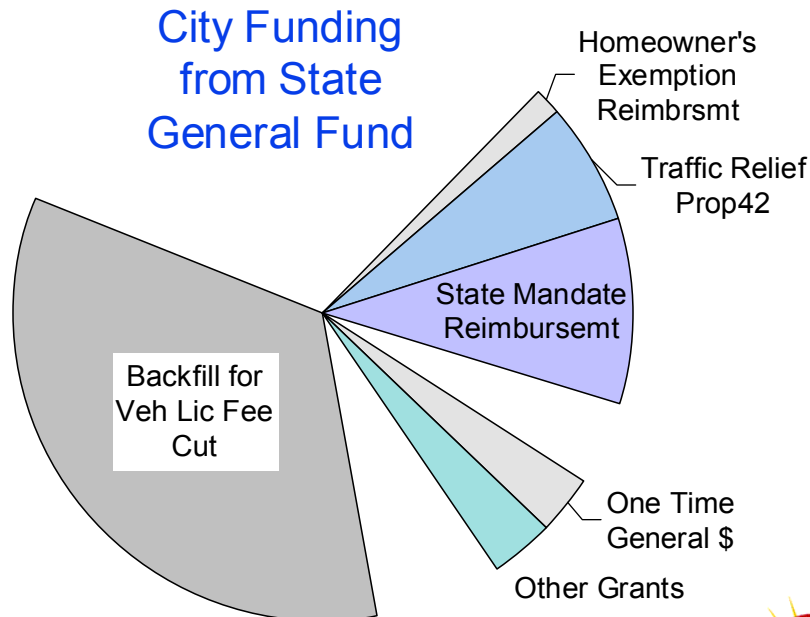
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State assistance to cities now consists primarily of

- Revenues from the Vehicle License Fee (VLF) or “car tax” which are constitutionally required to go to cities and counties,
- Reimbursement for some state mandates,
- Reimbursement for state-imposed cuts of local taxes including the VLF and the homeowners property tax exemption,
- Voter-approved Proposition 172, a ½ cent sales tax to mitigate the impact of the state imposed ERAF property tax shifts on public safety services, 96% going to counties,
- State gasoline taxes earmarked for the maintenance and construction of local streets and roads, and
- a few earmarked grants.

State Revenues to Cities



10

Source: Calif State Controller, State Budget, CaliforniaCityFinance.com

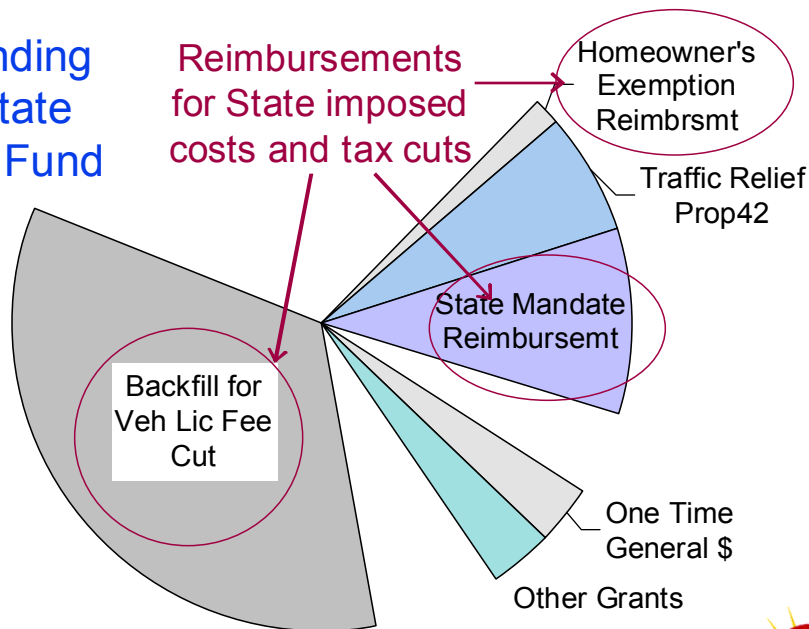
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Much of this state support is from revenues that are restricted by law to certain local uses. Because these revenues are legally unavailable to other state programs, they are segregated from the state general fund.

State Revenues to Cities

City Funding
from State
General Fund



11

Source: Calif State Controller, State Budget, CaliforniaCityFinance.com

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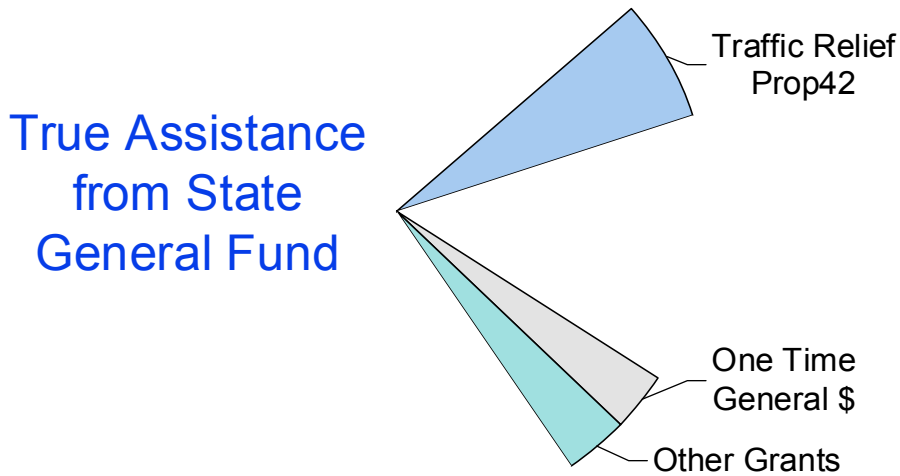


Of the state general fund money going to cities, most is

- legally required compensation to cities for the costs of state mandates, and
- compensation for state cuts of local taxes including offsets for the VLF (“car tax”) and Homeowners Property Tax Exemption.

Thus, these programs essentially fund tax relief and the costs of state laws. They do not provide true funding support of local government services.

State Revenues to Cities



12

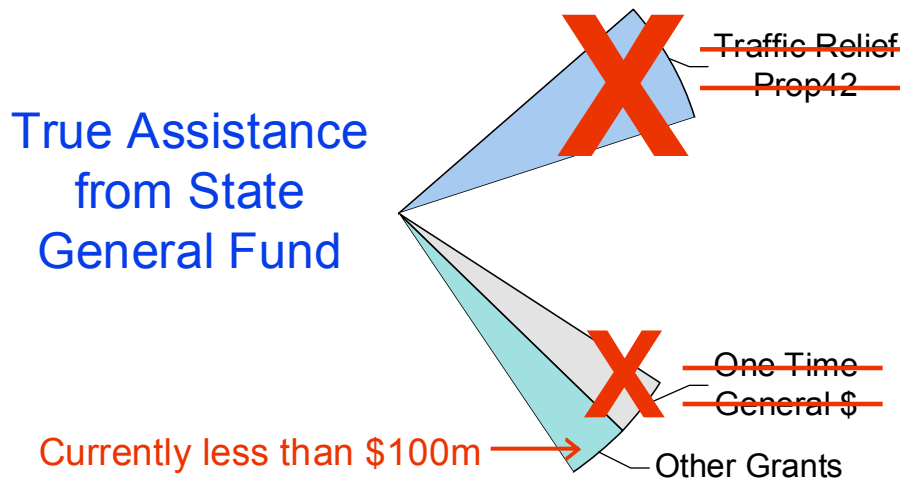
Source: Calif State Controller, State Budget, CaliforniaCityFinance.com

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True state assistance from the state general fund consists of voter adopted Proposition 42, which sends state sales tax money to local governments for streets and roads, and the Citizen's Option for Public Safety (COPS) program which provides some additional funds for law enforcement. In 1998-99 and 1999-2000, the state provided some one-time general purpose funding to local governments.

State Revenues to Cities



13

Source: Calif State Controller, State Budget, CaliforniaCityFinance.com

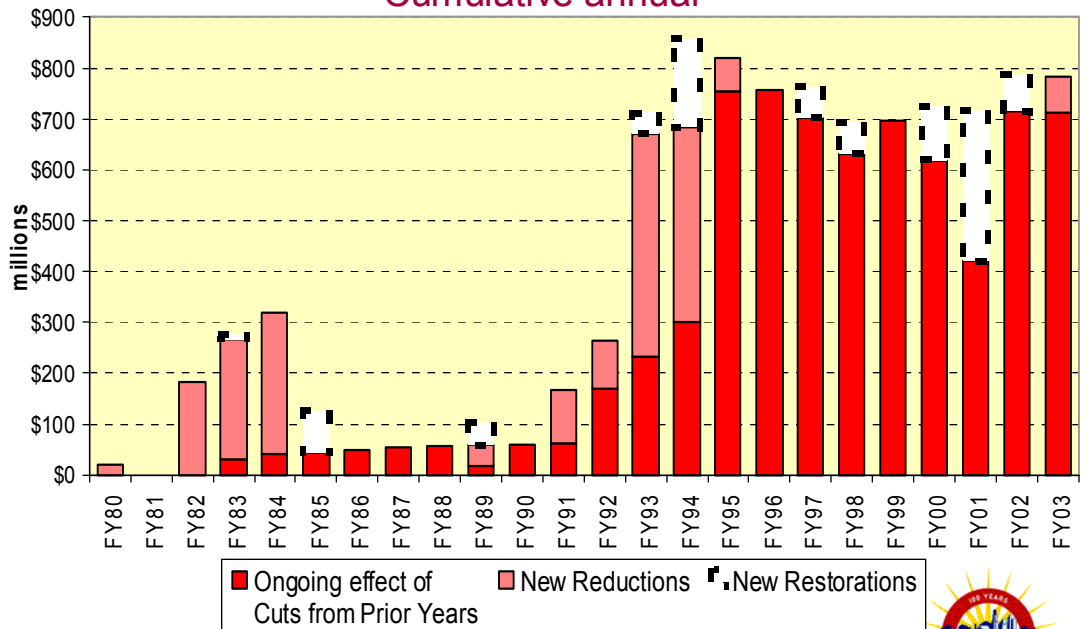
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But today, facing historic budget challenges, the state legislature has suspended Proposition 42 funding and cut nearly all general fund support to cities. In FY03-04, true financial support of cities constituted less than 1/10 of 1% of the state general fund.

State Cuts of City Revenues

Cumulative annual



14

Source: Calif State Controller, State Budgets, CaliforniaCityFinance.com

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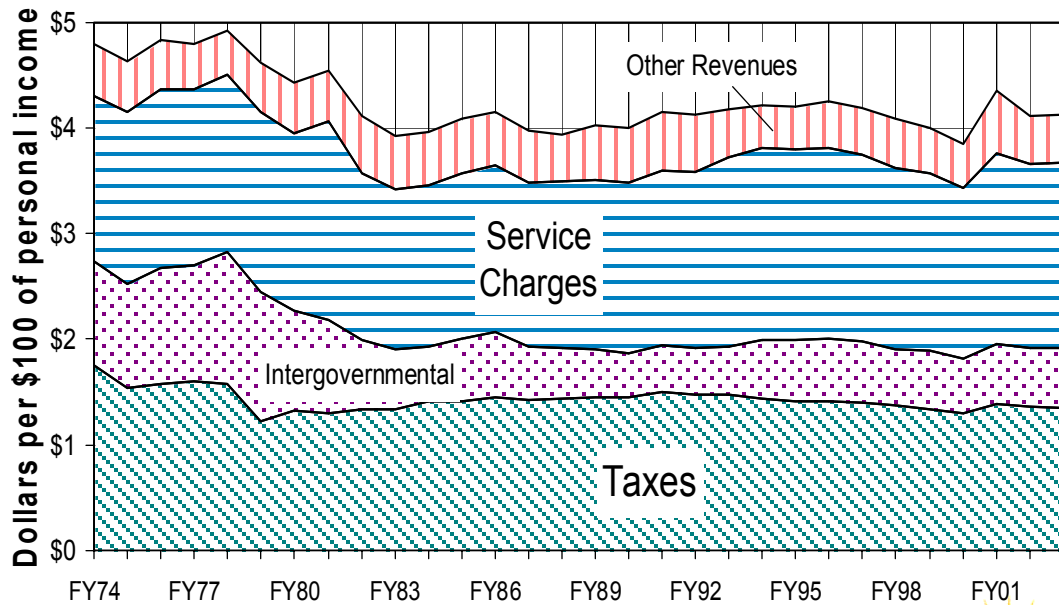
During the decline of federal financial support for cities, the state attempted, in some years, to increase its transfers to locals to mitigate the loss. However, the passage of Proposition 13 put a stop to this. In the "AB8 bail-out" following the passage of Proposition 13, the state shifted a greater portion of the dwindled local property tax base from schools to cities and counties, shifting the reliance of schools toward the state general fund. In successive years, the state responded to tight budgets by reducing most subventions to cities. In the years following Proposition 13 a variety of longstanding state subventions to cities and counties were reduced or eliminated, a loss of more than \$190 million a year to cities. During 1982 through 1984 recession years, the state temporarily cut more than \$230 million of motor vehicle in-lieu tax revenues to cities.

Since 1980, the state has eliminated and not restored local subventions including:

- Liquor License Fees
- Highway Carrier's Uniform Business Tax
- Financial Aid to Local Agencies
- Cigarette Tax
- Trailer Coach/ Mobile Home Fees
- Business Inventory Exemption Reimbursements

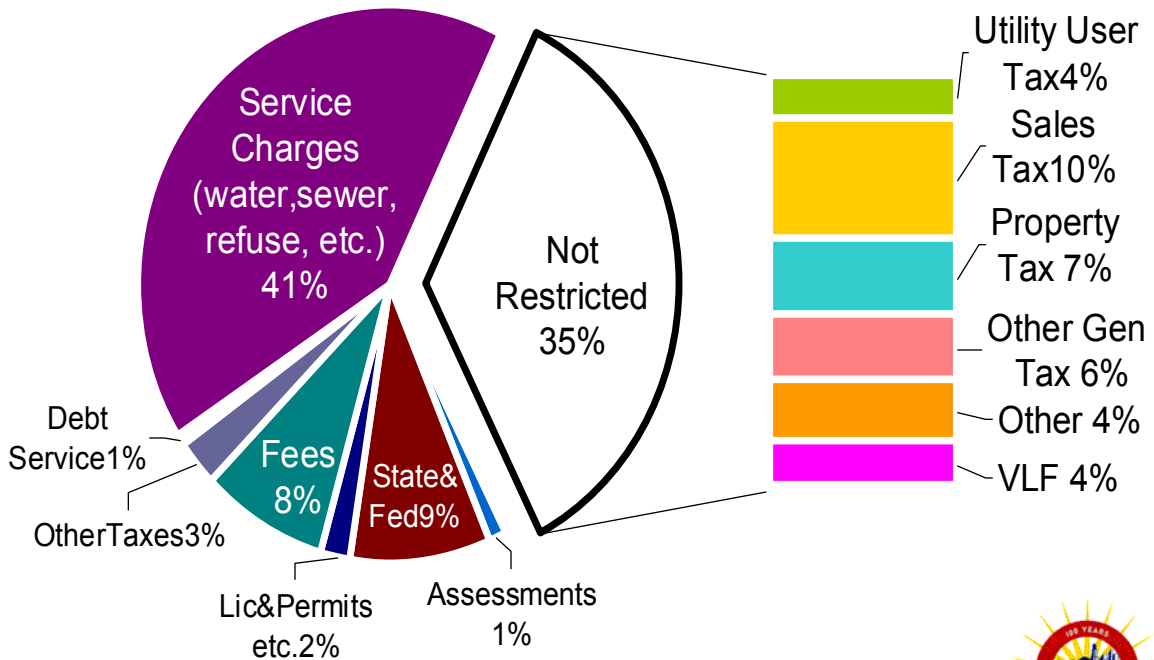
The Burden of City Gov't Has Declined

city revenues per \$100 of personal income



Cities are a better bargain today than ever. The burden of all city taxes, fees and charges fell precipitously in the years immediately after Proposition 13. It began to recover through the mid and late 1980s, but fell again in the recession years of the early 1990s. While some categories of fees and taxes have increased, the total cost burden of city government has never returned to pre-Proposition 13 levels.

California City Revenues



16

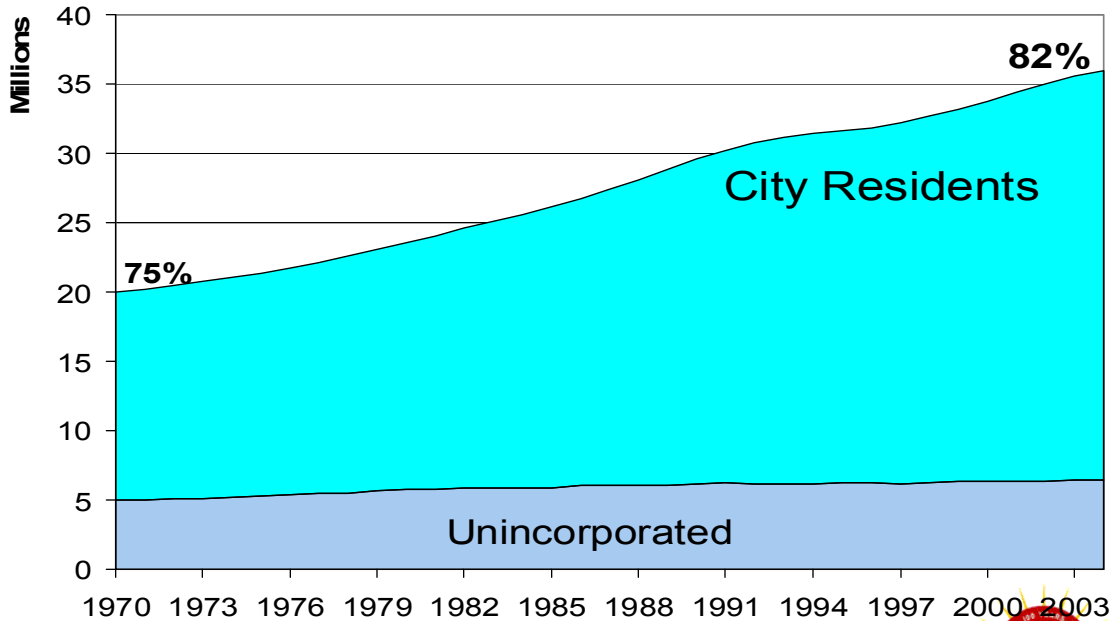
Source: Calif State Controller, CaliforniaCityFinance.com

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In the typical California city, about 2/3 of the city's revenues are restricted in use. The proportion of discretionary revenues in city budgets has declined with the demise of property and sales tax revenues and intergovernmental subventions.

California's Population Growth is in Cities



17

Source: US Census Bureau, Calif Dept of Finance

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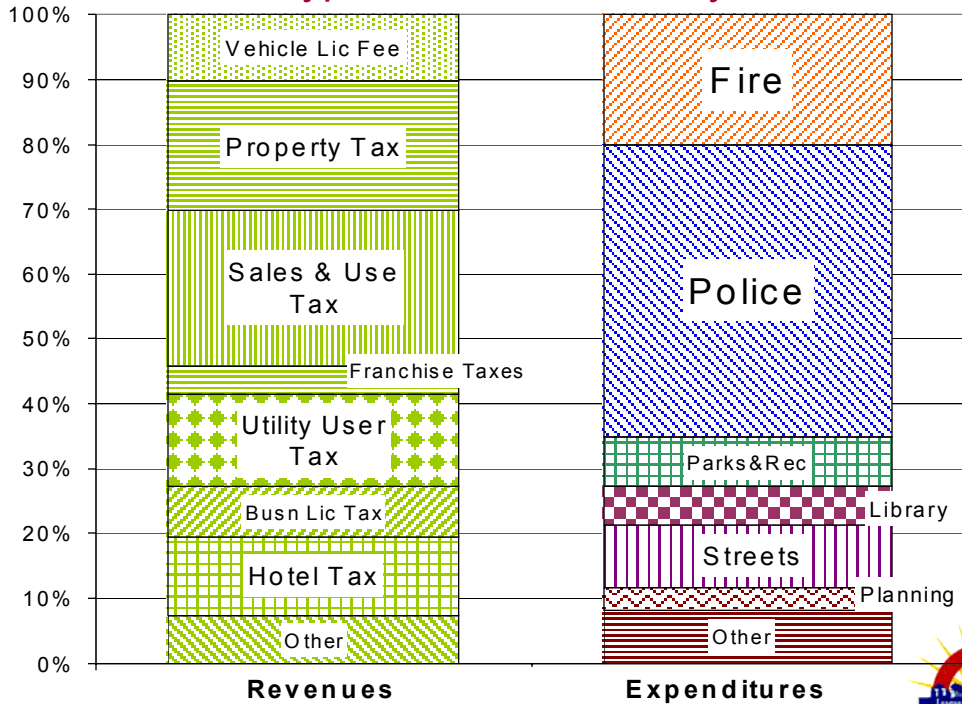
The population growth rate of cities exceeds statewide population growth, and far exceeds growth in unincorporated areas. In 1974, 75% of Californians lived in cities. Today, over 82% of Californians live in cities.

Obviously, as population grows, so does the demand for municipal services. Moreover, population growth requires cities to change their services to respond to new problems such as gangs, urban decay, urban sprawl, transportation congestion, and environmental impacts.

Cities must have the tools and resources necessary to accommodate this growth and the enormous changes it brings.

Discretionary Revenues and Spending

Typical Full Service City



18

Source: Calif State Controller, CaliforniaCityFinance.com

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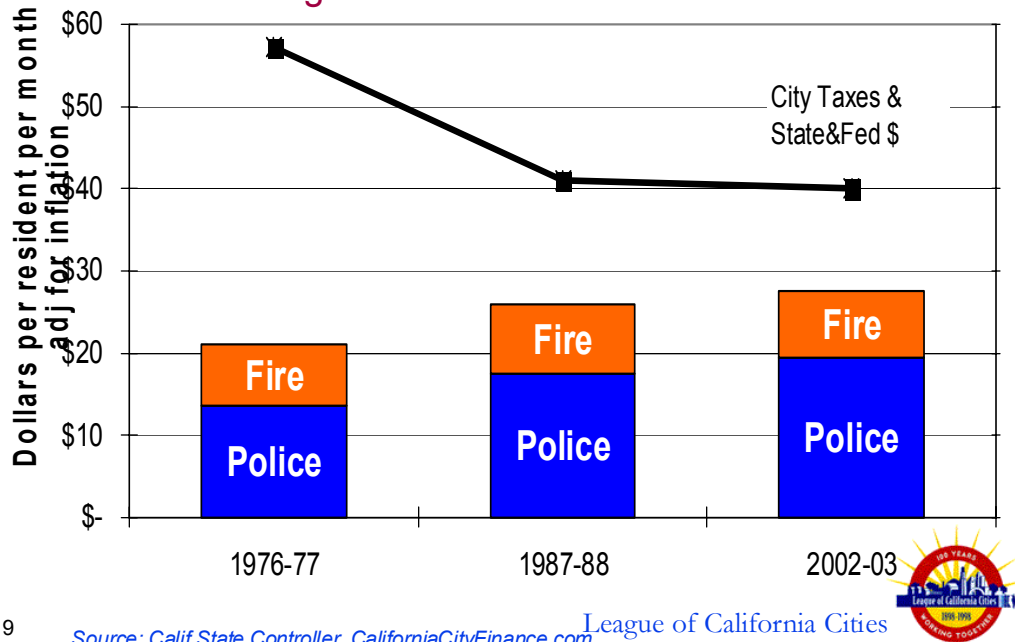


What do cities do with their unrestricted funds? More than 60% goes to public safety. This chart describes the typical **full service city**.

The numbers are a bit different for cities that are not responsible for the full range of municipal services. For example, in cities where services such as fire protection, library or parks are provided by special districts, those entities usually get property tax to do so.* That is, property tax revenue that would otherwise go to the city, instead goes directly to the special district to fund the service. This makes these cities even more dependent on other revenues - especially sales tax.

The Squeeze:

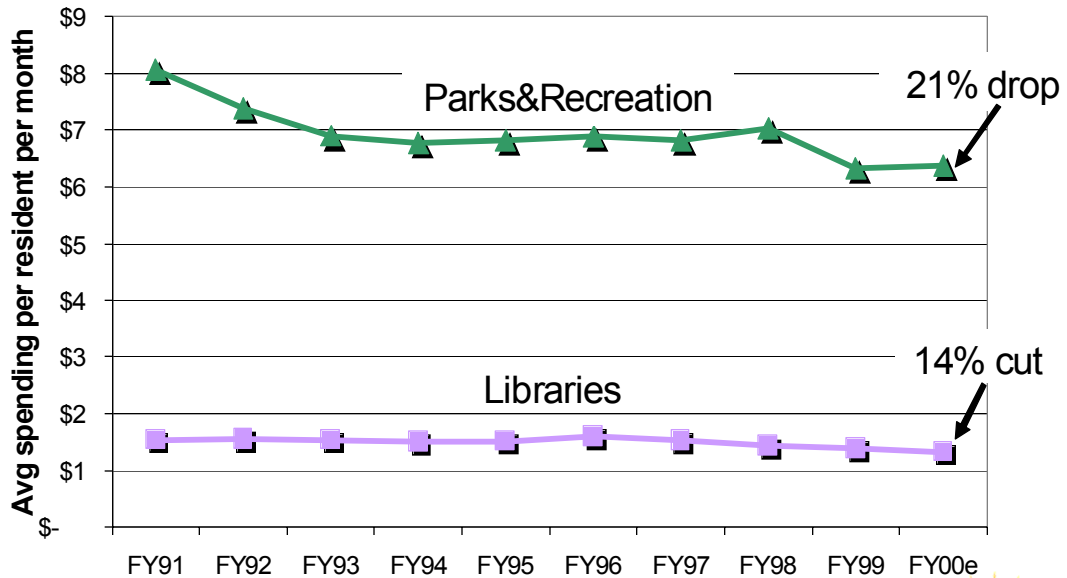
- Increasing Police & Fire Spending
- Declining Taxes & State/Federal Transfers



Cities' spending on police and fire services has grown well in excess of population growth and inflation. Because police and fire spending soak up such a substantial portion of the discretionary general fund revenue of cities, a relatively small portion of city budgets has had to bear the brunt of declining taxes and subventions. Faced with this squeeze, cities are:

- **Cutting** human services including parks, libraries, and museums.
- **Cutting** general government (property maintenance, personnel, data systems and administration).
- **Deferring maintenance** on aging infrastructures.
- **Cutting** land-use planning.
- **Relied more heavily on debt** rather than cash financing for capital improvements.
- **Cutting subsidies** to fee based programs and **raising user fees**.
- Paring down **reserves**.
- Aggressively soliciting **grants**.
- Raising **taxes** and assessments.
- Pursuing **sales tax** generators, skewing land-use decisions in the process.

Taking the Hits: Parks and Libraries



- From 1991 through 1996, spending on library services in California cities has fallen by more than 14%. Parks and recreation programs are down 21%.
- California cities with over 10,000 residents cut their planning budgets by an average of 29% from 1991 through 1999.
- On average, cities have cut street maintenance by over 11% since 1991. Big cities (with populations over 100,000) have cut street maintenance by an average 17%.

What's Wrong?

- Loss of local fiscal control and home rule: loss of accountability & responsiveness as service levels have declined
 - Decline of discretionary funding for key city services
 - Revenue instability & constraints hamper good governance
- Fragmentation of finance and governance – frozen property tax allocations - some don't make sense any more
- Disconnect between service costs and revenues in urban development imperils city services and deters balanced planning.



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Decline of Predictable, Discretionary Funding

- City revenues are not constitutionally secure, and this has led to historic losses of property taxes & state subventions
- State legislature and governor have tended toward earmarking local funding and more local mandates.
- Voters have imposed more historic limitations on local government revenue raising: Prop 13, Prop 62, Prop 218, etc.

22

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At the root of the problems with California city finance is the decline of **predictable, discretionary** funding.

City revenues are not constitutionally secure, and this has led to significant losses of property taxes, state subventions.

- Property tax was 15% of total city revenues in 1975 . . . 7% today.
- State and federal aide to cities has declined from 21% in 1974-75 to 13% today.
- Cities are losing \$740 million each year as a result of state policy changes since 1980 (net of new or restored subventions). This would fund more than 6,500 police officers, 700 fire engines or 240 libraries.
- Over the last 20 years, these state policies have cost city budgets a cumulative total of more than \$7.7 billion.

Revenue Instability & Constraints Hamper Good Governance

- Conflicts with state, counties and others have increased.
- Cities have become increasingly reliant on sales tax \$ for discretionary revenue. But the sales tax base may not have a strong future.
 - Shift to service oriented economy
 - Increasing internet and catalog retail
- Unable to predict revenue availability, city councils may defer infrastructure maintenance and development, community planning, regional cooperation, and investments that will produce long-term returns.

23

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- The inability of city councils to be secure in their revenues has increased fundamental conflicts with the state, counties (e.g., booking fees) and other governmental units. Taxpayers pay a price when government officials lack the basic trust with each other to enter into cooperative agreements.
- With the decline of two major sources of general purpose revenue (property tax and state/federal aide), sales taxes have become more important to cities. Yet we are witnessing a gradual long-term decline of sales tax base as we shift to a service oriented economy and as electronic and catalog commerce grow.

So the choices available to a city council to find the resources they need to provide municipal services are more constrained than ever. Cities have less spending flexibility: discretionary funding sources are dwindling while earmarked sources increase. Meanwhile, as our communities urbanize and our economy and society evolves, we face growing and changing service demands - and the fiscal system that has been patched together makes it difficult for cities to respond effectively.

② Fragmentation of Local Finance and Governance

- Multiple overlapping local agencies
- Old tax allocation formulas - may not be the most efficient or preferred allocation now
- Decline of general purpose government policy making authority due to fragmentation of policy and finance among too many local authorities

24

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In many California localities, municipal public service responsibilities and finances are divided up among dozens of independent local agencies. Property tax allocations are fixed based on circumstance more than two decades old. Because of this fragmentation, the general purpose government, the city, is hampered in its policy choices as to priorities, funding and service delivery. Local government is less efficient, less responsive, less accessible and less accountable to its citizens. We have:

- Multiple overlapping local agencies
- Old tax allocation formulas - may not be the most efficient or preferred allocation now
- Decline of general purpose government policy making authority

③ Cost & Revenue Disconnect in Urban Development

- Most non-retail development will not pay for itself, requiring subsidies from retail development. Economic development is impaired because housing & manufacturing don't pay for themselves.
- Property tax is most appropriate for local property-related services, but cities are unable to access sufficient amount and the frozen allocations (AB 8) no longer reflect service delivery responsibilities.
- The decline of city property tax revenue has left cities seeking other revenues.
 - Promotes aggressive sales tax consciousness
 - Housing, industrial uses often cost more in public services than they generate in tax revenues
 - In non-full service cities, much property tax revenue goes to special districts, less to the city, creating even greater dependence on other revenues, especially sales tax to fund police, parks, planning etc

25

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The decline of city property tax revenue and state/federal support means that today, housing and industrial uses often cost more in public services than they generate in tax revenues. Moreover, in cities in which some municipal services are provided and funded by special districts, much property tax revenue goes to the special districts, less to the city, creating even greater dependence on other revenues, especially sales tax to fund police, parks, planning etc.

What we have is a disconnect between the costs of services to - and the revenue that comes from urban development. As a result, cities often turn to retail development to essentially subsidize housing, industrial and office development.

Property tax is the one major revenue source which accrues from all forms of privately owned land use development. Greater property tax shares would provide a better balance between the costs and revenues of urban development - but cities no longer have rate setting powers on the property tax. We are beset with tax allocation formulas based on a snap shot of history more than twenty years past - a picture which which no longer reflects the service delivery responsibilities of today.

Other Issues in Local Gov't Finance Reform

- State mandates on local gov't limit local choice
 - Program mandates
 - Process mandates
 - Revenue use restrictions
- Calif taxpayers' federal income tax liability could be reduced by greater shift to deductible state and local taxes.
- Proposition 13 reassessment rules discourage new business.
- Sales tax growth in decline with shift to service economy, e-commerce.
- Super-majority vote requirements.



What California Cities Need:

■ Tools

- Reasonable tax & revenue options and limitations
- Adequate \$revenues with rational connection to needs/uses
- Control of all basic municipal services and the revenue to fund them

■ Independence

- Stable, reliable, revenues
- Autonomy in local affairs

