

Waiting for the State to Get Its House in Order: The Origin of Cities' Fiscal Relationship with the State

By Betsy Strauss and Michael Coleman



Waiting for the California State Legislature to adopt a budget seems more painful each year. It's not just the lengthy budget approval process and missed deadlines, which have become fairly routine. The problem is that the state is asserting itself into city financial affairs more now than ever before, so the long wait means more uncertainty for local budgets. How did we get to this point? What factors force cities to await state legislators' fiscal decisions before we can set our own? What happened to home rule and local fiscal autonomy?

Laws passed in the last 20 years have created the present environment. The courts have eroded the constitutional home rule granted to cities in 1879. Flexibility to react to changing policy priorities has been reduced at both state and local levels.

The Foundation of Municipal Home Rule

One hundred and twenty years ago, California's leaders believed that local government would serve the citizens best if granted generous autonomy over municipal affairs. The authors of the 1879 state constitution included five provisions that specifically limited the power of the state Legislature to interfere with the affairs of cities and vested in cities extensive powers of self-government. One provision prohibits the state from imposing a tax for local

purposes, but enables the state to authorize local governments to impose them. The intention was to limit the involvement of the state in local government finances. Cities were also granted the authority to adopt a home rule charter.

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The next two revisions to the constitution, in 1896 and 1914, strengthened this home rule authority and reaffirmed the commitment to a balanced system of local and state government. These amendments freed a charter city from state legislative interference in any matter that was a "municipal affair." In 1903, in a case upholding the City of Los Angeles' business tax, the California Supreme Court stated unequivocally that local taxation is a municipal affair under Article XI section 5 of the constitution.¹ Later, in 1982, general law cities gained the authority to adopt any tax that could be adopted by a charter city.²

Building the Framework of City Government Finance

During the first half of the 20th century, the reform era took shape in California and California's professional city management became a national model. Major elements of local governance emerged such as the Subdivision Map Act, the Joint Exercise of Powers Act, and the General Plan Law. From the turn of the century onward, citizens increasingly looked to local government to address the problems associated with urbanization and provide the necessary public services. The property tax alone was insufficient to finance these new local government projects and services, so cities began to invent new types of taxes, fees and other sources of revenue.

Beginning in the 1950s, California's suburbs mushroomed. Urbanization presented new challenges for cities: better long range planning and zoning, water and waste treatment systems, roads and transportation systems, bigger and better parks and libraries. It also brought new challenges for law enforcement and fire safety. For one, the term "urban decay" began to be heard as inner cities faced new difficulties. Secondly, cities and counties built new public facilities, established new public services, and adopted new fees and taxes to finance them.

The Legislature sought on several occasions to unify and standardize some of these new taxes. In 1935, local property taxes on vehicles gave way to a state administered vehicle license fee, which was then allocated back to local governments. In 1955, the legislature passed the Bradley Burns Uniform Sales and Use Tax Act, which standardized a one-cent local sales and use tax under a unified collection and allocation system administered by the State.³

Through both Democrat and Republican administrations in the 1950s and 1960s, federal and state policy initiatives meant additional money, additional incentives and additional mandates for cities. In 1972 the state Legislature responded to the vocal concern of local government over the costs of state mandates by passing S.B. 90 (Chapter 1406) requiring the reimbursement of costs to local agencies for state mandated programs. The following year, the Legislature required cost estimates of all legislation with a financial impact on local government. In 1979, mandate reimbursement as required in S.B. 90 was added to Article XIII B of the state constitution as a part of Proposition 4. Despite these legal obligations, the Legislature continues to pass local mandates and - enabled by provisions of S.B.

¹ Ex Parte F.W. Braun (1903) 141 Cal. 204.

² Cal. Gov't Code sec 37100.5

³ Calif Constitution Art. XIII sec.29; Cal Rev & Tax Code sec 7200 et seq.

90 itself - frequently exempts the state from financial responsibility by requiring local agencies to impose fees or charges to fund the mandated program.

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Cal Fed Cracks the Foundation

Local taxation, the quintessential municipal affair, changed in 1991 with the California Supreme Court's decision in the *California Federal Savings & Loan v. Los Angeles*⁴ (Cal Fed) case. The path that led to this Supreme Court decision underscores the need for local autonomy, particularly over municipal fiscal affairs. To better understand *Cal Fed* and its significance, a brief review of California fiscal history is useful:

A Concise Chronology

In the 1920s, California began imposing a state income tax on commercial banks. Under Article XIII, section 27 of the state constitution, the bank tax is in lieu of all other state and local taxes. However, this law did not impose a state income tax on savings and loans, and did not prohibit a local tax, such as a property tax, business license tax, on savings and loans.

Charter cities imposed certain taxes, including personal property taxes, on savings and loan institutions. In an effort to maintain parity between the taxes paid by commercial banks and those paid by savings and loans, the state deducted from savings and loans' state tax bill, the amount paid to municipalities.

In 1979, the State abolished the offset and extended the bank in lieu tax to savings and loans, exempting them from all other state and local taxation. To protect cities from financial loss, the state enacted the Financial Aid to Local Agencies fund (FALA). Revenues to the fund came from a portion of the bank in lieu tax. The state distributed the money back to local governments as a way of making up for the revenue loss resulting from the restriction on local taxation.

The State stopped funding FALA in 1982, redirecting the money to the state general fund. Local governments faced the loss of a substantial revenue source without any compensation by the State (about \$110 million in today's dollars).

For more than 40 years, the City of Los Angeles, a charter city with fiscal home rule powers, had imposed a business license tax on savings and loan institutions. In 1979 when the State established the FALA, the city suspended this tax on savings and loan institutions. When the State abolished FALA in 1982, the City began to collect the tax from savings and loans again.

California Federal Savings & Loan then sued the City of Los Angeles claiming that the City's business license tax on savings and loan institutions is preempted by state legislation.

How Cal Fed Eroded Home Rule

⁴ 54 Cal.3d 1 (1991)

In *California Federal Savings & Loan v. Los Angeles*⁵, the Supreme Court struck down the imposition of the Los Angeles business license tax on savings and loans. Acknowledging the status of municipal taxation as a municipal affair, the court nevertheless determined that the state's system of taxation of financial institutions was one of statewide concern. The court concluded that the conflicting charter city measure ceased to be a municipal affair and the Legislature was not prohibited by the constitution from addressing the statewide dimensions of its own enactments.⁶ Assuming that financial institutions should be subject to a limited amount of taxation, the state decided that permitting local governments to receive a portion of these revenues through local taxation would interfere with the state's ability to raise revenues for its own purposes.⁷

The California Supreme Court's 1991 decision in *Cal Fed* changed the nature of the "municipal affairs" doctrine, eroding a charter city's ability to use its home rule authority to respond and react to actions by the state affecting municipal financial affairs.

Proposition 13 Rocks the Foundation

In 1978, California state and local government finance was sent in a new direction. Proposition 13 slashed property tax revenues by more than half. In 1979, the state reshuffled the cards in the hand it had been dealt by the voters and adopted what it felt was a permanent plan for property tax financing ("AB 8"). Made possible by a massive state general fund surplus, AB 8 caused the state general fund to shoulder a greater share of local school costs. As a result, city losses from Proposition 13 were about 28 percent less than they might have been. Nevertheless, average city property tax revenues declined 47 percent per capita (adjusted for inflation). According to the state controller, property taxes were 24 percent of total city revenues in 1975-1976. In 1995-96 they were just 7 percent.⁸

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Proposition 13 triggered a new dynamic in state and local government fiscal relations. In the years following its passage, the state Legislature and governor used the AB 8 infusion of revenue as justification to retract hundreds of millions of dollars of local revenues it controlled. Some, like the Highway Carriers Uniform Business tax were revenues once paid directly to cities, then unified for tax simplicity and equity reasons, until they were eventually taken from cities to be absorbed into the state budget. Some, like the Business Inventory Exemption Reimbursements, were state backfills for state adopted exemptions to locally imposed taxes. The exemptions remain, but most backfills have disappeared. In 1981-84 the state tapped more than \$750 million of city vehicle license fee revenues to fund state programs.

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⁵ 54 Cal.3d 1 (1991)

⁶ *California Federal Savings and Loan Association v. Los Angeles* (1991) 54 Cal.3d 1, 17

⁷ At least one commentator notes that there exists a "substantial competitive dimension" to the state/local relationship where the state and the locals pursue distinct public policy agendas with limited revenues. *Constitutional Reform in California: Making State Government More Effective and Responsive*, "State Supremacy, Local Sovereignty: Reconstructing State/Local relations Under the California Constitution" Daniel Rodriguez, Bruce E. Cain and Roger G Noll Editors (1995).

⁸ Calif State Controller, *Annual Report of Fiscal Transactions Concerning Cities*, various years

tax to 1 percent and directed that the tax be "apportioned according to law." In a 1991 court decision upholding AB8, the court noted that Proposition 13 "prevails over the preexisting taxing power of charter cities."⁹

At the time, neither the pundits nor the authors of Proposition 13 envisioned the state using this power to take local tax revenues to meet its own financial needs. But that is exactly what has been occurring since 1992 with the Education Revenue Augmentation Fund (ERAF). By shifting nearly \$4 billion of annual city, county and special district property tax revenues to local schools, the state has used Proposition 13 to strip local government of revenues to its own benefit. In Los Angeles County's 1994 challenge to the creation of the ERAF, the court characterized the fiscal relationship between local governments and schools as "fluid" and concluded that local government has no inherent power to tax: "The power is derived from the Constitution upon authorization by the Legislature."¹⁰ The ruling effectively allowed the transformation of a local tax into a state tax by vote of the Legislature.

California City Finance Today: The State Invades Our Kitchen

Cal Fed and Proposition 13 were the pivotal points in California municipal finance, not simply for their direct impacts on city revenues but because of the power over local finance they shifted from cities to the state Legislature. Since Proposition 13, the State of California has chosen to involve itself in municipal finance as never before. Cities are now more conscious of the ominous power of the State over their revenues, because the state has exercised this power repeatedly in the last 20 years.

The actions of the governor and Legislature largely have been driven by the unique forces at play on the state budget. In particular, state actions affecting city finances have their roots in: economic impacts on state revenues, constitutional spending requirements, policy choices, and caseload-driven spending.

Economic Impacts

Three sources account for 94 percent of state general fund revenues: personal income tax (50 percent), sales tax (33 percent), and bank and corporation taxes (11 percent). Each of these sources is highly sensitive to economic conditions. In addition, the amount of the state's K-14 school spending depends in part on the level of school revenues from local property taxes. As property taxes for schools lag, more money may be needed from the state general fund to maintain school financing at constitutionally guaranteed levels.

Proposition 98 Constitutionally Guaranteed School Funding

Passed by the voters of California in 1988, Proposition 98 provides K-12 schools and community colleges with a constitutionally guaranteed level of revenue. The guarantee is based on factors including enrollment growth, personal income, general fund tax revenues and prior year total funding. In 1998-99, K-14 education funding totals \$45 billion including \$26 billion from the state general fund and \$11 billion from local property taxes.¹¹

Caseload Driven Spending.

Most of state general fund expenditures are driven by caseload. School enrollment is a component of the constitutional spending requirements for education. California penal code changes, including mandatory lengthier sentences and especially the "three strikes" law (which requires longer prison terms for repeat offenders) have contributed to a 94 percent increase in prison population since 1990. The Legislative Analyst projects that through the next decade, prison population will more than double, and state corrections costs will increase at an average annual rate of about 8.7 percent. This growth is well in excess of the annual 5 to 6 percent growth in state general fund revenues that would occur under a moderate economic growth outlook during that same 10-year period, according to the Legislative Analyst's report California's Fiscal Forecast: The LAO's Economic and Revenue

⁹ *City of Ranch Cucamonga v. Mackzum* (1991) 228 Cal.App.3d 929).

¹⁰ *County of Los Angeles v. Sasaki* (1994) 23 Cal.App.4th 1442, 1454.

¹¹ Proposition 98 establishes a *minimum* level of funding for K-12 schools and community colleges. In 1998-99, the legislature appropriated funds to K-14 education in excess of the amounts required by Proposition 98.

Projections 1997-98 Through 1999-00.¹²

Tax Cuts and Other Policy Priorities

State budgetary actions are also driven by the policy priorities of the governor and Legislature. In particular, state leaders' desire for tax cuts may be more important to them than increasing or restoring local government revenues. In effect, tax cuts in recent years have been paid for by revenues shifted from cities, counties and special districts.

State actions affect city finances through mandates as well. State laws restrict the use of many city revenues; require a variety of city programs, actions and expenditures; and limit local authority in areas where the state declares a matter of statewide interest. Many of these mandates are prompted by particular interest groups who appeal to the state Legislature for reversals of local policies. Recent legislative proposals include preemption of city laws restricting leaf blowers, shopping carts, liquor stores, and cable and Internet taxation and regulation. Building interests have sought to decrease city authority to impose impact fees on new construction for schools and other public infrastructure related to the development.

During the last 20 years, cities have responded to their financial challenges – brought on by economic change and state actions - with substantial budget cuts, higher fees, and new taxes and assessments as they struggled to maintain basic municipal services for their residents. Proposition 218, which gave California voters greater control over new local taxes, assessments, and property-related fees, substantially constrains the ability of cities to increase taxes and property-related fees leaving cities more vulnerable to Legislative activity.

Is It Time To Build A New House?

Few would quarrel with the notion that cities and the state should have, and do have, distinct public policy agendas. However, the courts have awarded control over taxation to the state to carry out its public policy agenda, thereby eroding fiscal home rule authority granted under the constitution.

California voters have found it necessary to set the priorities for the state's public policy agenda - specifically the funding of K-14 education (through Proposition 98), and the punishment of criminals (through the "three strikes" law). Through Proposition 218, the voters have also assumed a greater role in establishing local taxes, assessments, and property-related fees and charges.

This reduced flexibility in setting priorities and determining how to fund priorities reduces local discretion and requires cities to wait, each year, for the state to get its house in order before they can construct their local budgets.

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¹² Legislative Analyst's Office, "California's Fiscal Forecast: The LAO's Economic and Revenue Projections 1997-98 Through 1999-00." November 20, 1997.