The property tax is among the oldest forms of taxation in America, dating back to the colonial period. Prior to 1912 in California, property taxes constituted the largest single source of revenue to the State budget. In 1900, 89% of California state taxes were derived from ad valorem property taxes.

But a major change came with the great depression, which so depressed property tax revenues, it forced the state to seek other forms of revenue - diversification if you will - namely the sales and income taxes. Since 1933, the property tax has been a local tax, levied, collected and used by local governments (including schools). In 1930 78% of all city revenues were derived from property tax revenues.

Before the great change in 1978, property tax was the largest source of revenue for most cities. There were, even then, some communities that were sales tax magnates who could set their property tax rates low, especially if their property values were high. But cities (specifically city councils) had the authority to examine the public service needs of their constituents, consider revenue projections from their finance staffs, consider what the community would be willing to pay, and increase or decrease the property tax rate accordingly.

But Proposition 13 changed all that.
Compared to other local tax revenues the property tax is one of the most stable, reliable and growing sources cities have. This graph shows the deep drop after Prop 13 - even with the state’s shift of a portion of its budget surplus to cushion the local impacts. But look at the next ten years: steady growth exceeding the growth in city population - even after adjusting for inflation. Of course in the early 1990s we hit a recession and most importantly - the ERAF shifts.
### Leading Sources of Calif City Revenues

<table>
<thead>
<tr>
<th>Source</th>
<th>FY 1974-75 (pre Prop 13)</th>
<th>FY 1978-79 (after Prop 13)</th>
<th>FY 1997-98 (Recent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Service Charges</td>
<td>35.2%</td>
<td>1. Service Charges</td>
<td>36.9%</td>
</tr>
<tr>
<td>2. Intergovernm'l</td>
<td>21.2%</td>
<td>2. Intergovernm'l</td>
<td>26.5%</td>
</tr>
<tr>
<td>4. Sales&amp;UseTax</td>
<td>11.4%</td>
<td>4. OtherGen'r'lTaxes</td>
<td>6.2%</td>
</tr>
<tr>
<td>5. OtherGen'r'lTaxes</td>
<td>4.5%</td>
<td>5. Property Tax</td>
<td>5.8%</td>
</tr>
<tr>
<td>6. Use $/Property</td>
<td>3.7%</td>
<td>6. Use $ Property</td>
<td>3.5%</td>
</tr>
<tr>
<td>8. Other</td>
<td>13.7%</td>
<td>8. Other</td>
<td>15.5%</td>
</tr>
</tbody>
</table>

The importance of the property tax to cities has declined since Proposition 13 and ERAF. City revenues today are far more diverse and complex. They are more restricted with less discretion for city decision makers. Moreover, the decline of this important, broad-based revenue source has had serious public policy effects.
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.
Proposition 13 - nuts & bolts

1. Limits property tax rate to 1% of full market value,

2. Caps the increase in property value at 2% with reassessment at full market value only upon change of ownership,

3. Rolls back property values for tax purposes to 1975-76 levels,

4. Requires 2/3 voter approval to raise “special taxes,”

5. Requires any bill to increase state revenues to be approved by 2/3 vote of each house of the state legislature,

6. Transferred the authority for allocating property tax revenues from local government to the state.
Proposition 13 - effects

- Elderly and Low Income Homeowners’ tax burden lowered
- Disparate treatment of similarly situated properties
- Local government property tax revenues cut by 60%
- Revenue windfalls: State $1 billion, Federal $1.6 billion

Local government property tax revenues now depend on:
- pre-Prop 13 tax rate relative to others
- assessed valuation
- differences in service responsibility
- redevelopment
- Tax rates / shares out of sync with service demands
Proposition 13 - effects

- Greater reliance on state general fund for county and school funding (especially)
  - commensurate shift of power
- Cities and counties raised user fees and local taxes
  - variety/complexity of municipal revenue
- State authority to allocate local prop tax
- “Fiscalization of land use”
In 1992-93 and 1993-94, facing massive deficits in the state budget, the Legislature and Governor transferred nearly $4 billion of property tax revenue from cities, counties and special districts to K-14 schools, allowing the state to reduce its general fund spending on education. Cities and counties, who depend substantially on sales tax and property tax revenues for discretionary income, were already experiencing the same recessionary effects as the state. These property tax shifts, using a mechanism called the “Educational Revenue Augmentation Fund” (ERAF), continue today growing on average at about 3% each year, and contribute to healthy state revenues.

The Legislative Analyst recommends “that the Legislature consider mechanisms for reversing all or a portion of the tax shifts . . .” noting that “the property tax shifts have: 1) Reduced local government’s ability to respond to constituent needs and preferences, 2) Strained the fiscal condition of some local governments, [and] 3) Decreased local government incentives to approve new land developments and invest in property tax administration.”

With the exception of less than ten (10) cities who - due to their lesser service responsibilities - receive no property tax revenues, all cities lost money from ERAF.
In 1993, a measure to extend an existing one-half cent portion of the sales tax was approved by the state’s voters. The purpose of Proposition 172 was to mitigate the impact of ERAF shifts on city and county public safety programs. As implemented, Proposition 172:

- distributes 94% of its benefits to counties
- restores 56% of county losses due to the property tax shift, but just 17% of city losses
- is accompanied by a “maintenance of effort” requirement preventing the reduction of public safety program spending from prior years.

Cities and counties argue that Proposition 172 is a lousy reparation for ERAF. First, for most cities, Proposition 172 provides insignificant money compared to their property tax revenue loss. Second, Proposition 172 dollars come with spending restrictions unlike general purpose property tax revenue, which allows local communities to set their own priorities free of dictates from Sacramento. Finally, Proposition 172 dollars are sales tax revenues, allocated on a skewed formula. As such they do not adequately parallel the added service costs of new development as property tax does. Thus, the trade of property tax for sales tax money from Proposition 172 worsens a local government finance system that encourages inefficient land use decisions which do not meet overall healthy community and economic development goals.
Some Pitfalls in Looking at Prop Tax Allocations

Apples & Oranges #1: County Unincorporated Areas Differ

- proportion that is incorporated varies
- in unincorporated areas counties provide “city” services and get more P.T. share

♫ For each county, we should look at the share in the incorporated area and unincorporated area separately

A common error among observers of local government finance is to compare county shares of total local property tax revenues. But counties differ significantly. A starting place for a fair comparison is to compare 1) county property tax shares within their incorporated regions, and 2) county property tax shares within each county’s unincorporated area.
Some Pitfalls in Looking at Prop Tax Allocations

Apples & Oranges #2: City Service Responsibilities Differ

- Less than 1/3 are “full service” (but they serve a majority of the state’s population)
  - 28% aren’t responsible for fire,
  - 63% aren’t responsible for library
- This is the most significant factor in explaining the differences among city property tax shares

When comparing city shares, examine the full share going to all “city services” including amounts going to fire, library, and parks / recreation districts.

Should all cities be receiving the same share of local property tax revenues? All cities are not created equally. The obvious size/population differences aside, cities differ in what they do - in the services for which they are financially responsible. This has nothing to do with whether a city chooses to contract out a service or not. It concerns financial responsibility: does the city have to pay for the service?

Some facts:
- Less than 1/3 of California cities are “full service” (but they serve a majority of the state’s population)
  As used here, “full service city” means a city that is financially responsible for the full set of basic tax-dependent municipal services within its jurisdiction including police, fire, park&rec, library, streets and land use planning.
- 28% aren’t responsible for fire (the service is provided by a special district),
- 63% aren’t responsible for library (service provided by a district)
This chart shows the discretionary revenues and spending of a full service cities - So it excludes earmarked revenues such as fees for service and the services they pay for. Basically this general fund - excluding any fee supported services that may be in there.

>> In most full service cities, the cost of providing fire service alone eats up the entire property tax revenues of the city and more.

So in a partial service city, one that's not responsible for fire service, any property tax revenue they get is essentially money ahead compared to their full service neighbor.

This difference in service responsibility is the most significant factor in explaining the differences among city property tax shares. Take this into account and many of the “disparities” disappear.
The numbers are a bit different for cities that are not responsible for the full range of municipal services.

Note the much lower property tax revenue and consequently greater dependence on other revenues, especially sales tax. On the other side though we have fewer expenditure demands, less than 35% are responsible for fire and less than 25% are responsible for library service.
Property Tax Shares Vary With Service Responsibility

Allocations in L.A. County Cities

In cities that . . .

- full service
  - City
  - Schools
  - ERAF
  - County

- provide fire, not library
  - City
  - Library District
  - Schools
  - ERAF
  - County

- provide library, not fire
  - City
  - Fire District
  - Schools
  - ERAF
  - County

- don't provide fire or library
  - City
  - Fire District
  - Library District
  - Schools
  - ERAF
  - County

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

Source: LA County Auditor, Coleman Advisory Services

This shows the average AB8 property tax allocations in LA County when we group cities by service responsibility - and you can see the significant differences.

The city of Covina is a full service city responsible for library, police, etc. - and fire. It gets less than 15% of the 1% property tax in its community. It is a full service city. Across the county, in a partial-service city, the LA Consolidated Fire Protection District gets 17% of the property tax share, just for providing fire service. Add to that the 7% the partial service city gets and 2% that goes to the Library District - and you have over 26% going to the same collection of services that get less than 15% in Covina.
Looking at Prop Tax Allocations . . .

**Pitfall #3: Differences in P.T. Share Don’t Necessarily = “Inequity”**

- service demands differ (e.g., urban v rural, coastal v inland, income levels, land use, etc.)

- Assessed Values differ: for some communities with high AVs, a low property tax rate generates adequate revenues.

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The Problem is Not So much that Rates Differ

... it’s that they are based on a 20+ year old snapshot

Proposition 13 took away local control of the rate, so communities can no longer affect their property tax revenues in response to differences in property values, service demands, and willingness to pay.

The problem for most of these “partial service” cities is not so much one of a lack of money or of inequity, it’s a problem of a distorted financing system that doesn’t encourage balanced land use planning - a system beset by fragmented local governance. The problem is not that rates differ it’s that they are based on a 20+ year old snapshot. A side effect of Proposition 13 is that it took away local control of the rate, so communities can no longer affect their property tax revenues in response to differences in property values, service demands, and willingness to pay.
Good Governance Requires

- the ability to set priorities across a broad spectrum of needs
- the ability to coordinate programs for efficient service delivery
- the ability to fund these programs adequately with revenues which are rationally tied to the program, and
- the ability to change priorities, funding allocations, and service delivery methods as circumstances change.

Our local elected officials are hampered in their efforts to provide efficient, responsive local public services by a complex fragmentation of local services and finances. In many communities numerous overlapping special districts split responsibilities with the city and county. Tax allocations may be out of step with current priorities, but no one has the local authority to change things.

Good local governance requires:
- the ability to set priorities across a broad spectrum of needs
- the ability to coordinate programs for efficient service delivery
- the ability to fund these programs adequately with revenues which are rationally tied to the program, and
- the ability to change priorities, funding allocations, and service delivery methods as circumstances change.
But we have . . . 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

California cities are generally well governed. But 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 in these cases is less efficient, less responsive, less accessible and less accountable to its citizens than it could be.

As a result of this fragmentation, partial service cities
- Cannot re-allocate resources in later years as the community changes, as new challenges arise, and as needs and priorities change.
- Face greater financial risk with a palette of revenues that are more sensitive to fluctuations in the economy (e.g. sales tax) as well as intergovernmental actions. (e.g. VLF)
- Rely on revenues that are insensitive to changes in the community. That is, city revenues are less responsive to changing service costs from growth and change in the community.
- Lose the authority to ensure that their residents are receiving equitable service levels from independent special districts relative to costs.

As a result, local finance and governance in these communities has become balkanized.
Distorted Fiscal Incentives

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 partial-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

This fragmentation is a key contributor to the "fiscalization of land use" problem. Partial service cities may not have as many responsibilities but they face such a strange structure of revenues with their very low property tax shares. They are compelled to seek sales tax generators, to go after additional local taxes - because that’s the only way they can cover the costs of new development - especially housing, office and manufacturing.
Fixing Property Tax System is Central to Reforming Local Governance and Finance

1. **Realign local government responsibilities and finances along rational lines.** Assign responsibilities & property tax $ for all local services (except schools) to cities or counties.

2. **Shift a greater share of property taxes to cities & counties** in exchange for:
   - subventions the state is paying to cities (e.g., VLF backfill, etc.)
   - a portion of local sales tax revenues

3. **Reverse the property tax shift**
   - first, with allocations to bring cities & counties up to an equity base line
   - second, to increase city and county property tax shares in proportion to ERAF loss

4. **Provide constitutional protection for local taxes & fees** including the property tax, sales tax, and locally approved taxes.

Reforming the local property tax is central to the reform of California’s state and local governance system. To begin with, these reforms should:

1. **Realign local government responsibilities and finances** along rational lines. Assign responsibility and accompanying property tax revenues for all local services to cities or counties. Cities and counties may delegate services to special districts under contract. Non-enterprise special districts are often the most efficient way to provide a local service, but they should do so under contract with a city or a county, not as an independent, inaccessible taxing entity. Consolidating local government finance and service responsibility into general purpose cities will improve accountability and local government responsiveness to changing needs.

2. **Shift a greater share of property taxes to cities** in exchange for:
   - subventions the state is paying to cities as backfill for the car-tax reduction
   - a portion of local sales tax revenues

   This can be accomplished on a dollar-for-dollar basis so as not to harm individual agencies. In the long term, this provides a more stable revenue stream for local communities and improves the incentives for balanced land use development.

3. **Reverse the property tax shift**
   - first, with allocations to bring cities and counties up to an equity base line
   - second, to increase city and county property tax shares in proportion to ERAF loss

4. **Provide constitutional protection for local taxes and fees** including the property tax, sales tax, and locally approved taxes.

The current discussions of state and local government finance reform offer taxpayers an opportunity to get behind some long-needed reform of government finance. Meaningful change must deal with the excessive fragmentation of local governance and property tax allocations. Improving the structure of local finance will improve the efficiency and effectiveness of our public services, our land use planning, and our ability to make sensible decisions that respond to a changing society.