

UNIT 5:

HOW DO WE PAY FOR GOVERNMENT SERVICES

YOU GET WHAT YOU PAY FOR

City manager Larry Jackson told the city council Tuesday that the state's revenue shortfall will likely mean a drop in city revenues that could approach 20 percent.

"I am not certain we can avoid cutting meat and bone out of the city budget this year," Jackson said.

Last year's budget crisis led to a round of cuts that included slashing library hours in half, charging admission to all city parks and play fields, deferring needed street and sewer system repairs, and a freeze on new hires in all city departments, including the police and fire departments.

The council's reaction to the report was mixed.

"I, for one, am ready to take a look at ways we can raise some new revenues," said Council Member Lorene Picone. "My constituents tell me public safety is their number one priority, and I think we have to look at expanding our police department, not cutting it still more."

Council Member Bill Yee said he would never support any new taxes. "I didn't get elected to raise people's taxes," he said. "There are plenty of places where we can cut out some waste and inefficiency."

The council, having already rejected new taxes on hotel rooms and tickets to sporting events, ordered city staff to identify city services for which fees could be charged.

"We can't afford to pick up everybody's lawn clippings for free anymore," said Council Member Than Nguyen from the Old Town area. "If people want that service, they're going to have to pay for it."

HOW LOCAL GOVERNMENTS COVER THEIR COSTS

The average citizen and the student of local government will agree on one thing: How local government is financed can seem complicated. Services are paid for in different ways, by different people, at different times.


If local governments were like any other business, they would produce their products and then sell their products at the highest price the market would bear in order to yield the maximum amount of profit. But much of what our local governments do for us does not follow this model. It is not the intent of local government to make a profit. Most local services are mandatory, not optional. Many services are not paid for by those who use them, but by the public-at-large. Public schools, for example, are

NEW WORDS

The following are new words students will read in this text:

Ad Valorem
Assessed Value
Deficit
Franchise
Franchise Tax
General Fund
Operating Budget

CONTACT US:

 (916) 658-8208

 www.ca-ilg.org

open to all children, regardless of their family's income, and state law requires that all children attend some kind of school through age 18. Also, as a matter of public health, garbage collection services are legally mandated by most communities. And what would happen if you only paid for fire protection or law enforcement services when you needed them?

Because local governments provide a variety of services, the way they are paid for can vary widely. Just as each community provides different services and "feels" different to live in, cities, counties and special districts are funded in many different and complex ways. Much of this complexity can be traced back to two factors: local traditions and propositions.

HISTORICAL BACKGROUND

Local Traditions

Paying for local services, like providing those services, has evolved in different ways in different locales over many years. For example, some cities send residents a bill for picking up the garbage; other cities do not, but instead they are paid for out of general tax revenues.

Propositions 13 and 218

California voters in 1978 adopted a constitutional amendment freezing property tax rates at one percent of the property's assessed value in 1976. Although Proposition 13 gave tax relief to homeowners, in effect, the largest single source of tax income for California local governments was cut in half. Any property that has changed hands since 1976 has been valued at its actual sale price. Homes that are new or partially remodeled are valued using a formula based on square footage and the date of completion.

Proposition 13 also shifted control over local property taxes to the state legislature. At the time, the state enjoyed a substantial budget surplus, part of what motivated the so-called tax revolt that led to the passage of Proposition 13. The legislature initially used this surplus to mitigate the effects of Proposition 13 on local governments. However, in the 1990s, when the state faced an economic downturn and budget shortfalls, the legislature used its authority to divert property taxes away from local governments to backfill state funding of schools and community colleges. This diversion of about 20 percent of local property tax revenue is known as the Educational Revenue Augmentation Fund or ERAF and it continues to this day.

In 1996, voters passed Proposition 218, another significant restriction on local government funding. Proposition 218 placed limits on the property related fees local agencies can set. Property related fees include fees for services such as residential water delivery and wastewater disposal. Local governments cannot set a fee that is greater than the cost of providing the service to the property. New or increased fees are subject to procedural requirements, including majority protests, created by Proposition 218. Fees may also be reduced or repealed by a popular vote.

Ballot initiatives like Proposition 13 and 218, and legislative actions such as ERAF have rendered most local governments more dependent on taxes collected at the state level. The most important state taxes are the personal income tax, sales tax, and business tax. By and large, these taxes are established by state law and cannot be adjusted locally unless there is a vote by the community.

Prior to Proposition 13, local governments determined the need for services and then set their local property tax rates to meet those needs. Today things have turned around: instead of fitting taxes to public needs, a local government more likely will adjust its services to fit its revenues.

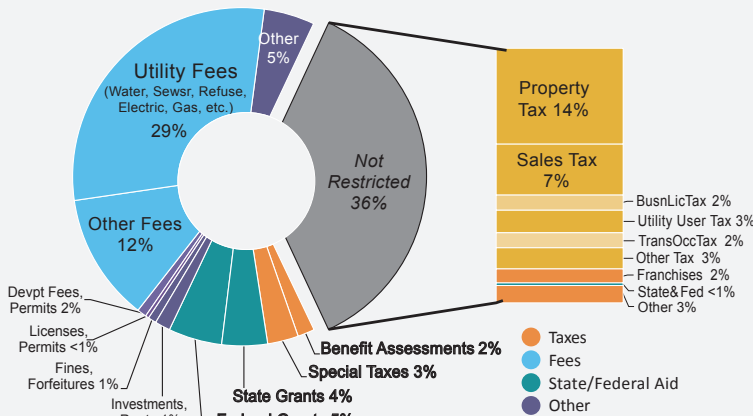
The revenues received by cities, counties, special districts and school districts may be divided predominantly into two types:

1. Fees collected for specific services, commonly referred to as enterprise funds
2. Taxes which are placed into a **general fund** and budgeted, commonly referred to as non-enterprise funds or governmental funds

**SHOW ME THE MONEY:
Typical Revenues and Expenditures for Cities, Counties and Special Districts**

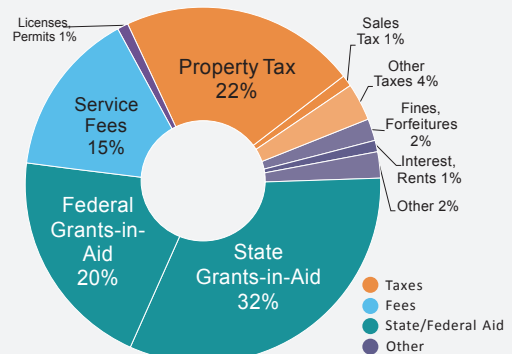
Displayed below are charts showing typical revenue and expenditures for cities, counties and special districts. Revenues sources for local government include federal and state grants, property taxes, user charges and fees and other taxes.

California City Revenues



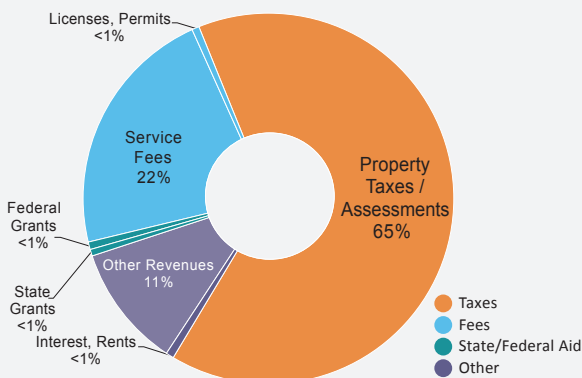
This is a statewide mash-up of city revenues. Individual cities vary.
Source: Author's computations from data from California State Controller 2014-15.
Does not include the City/County of San Francisco.

California County Revenues



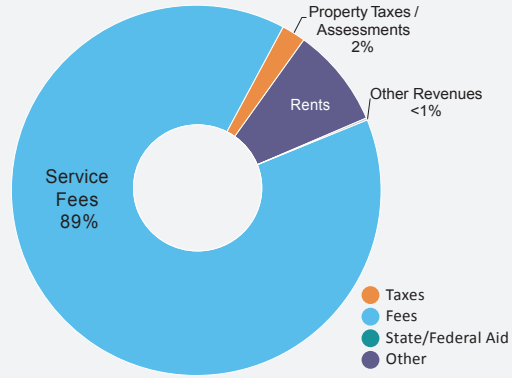
Source: Author's computations from data from California State Controller 2014-15.
Includes the County/City of San Francisco.

**California Special District Revenues
Typical District (fire) Providing Non-Enterprise Services**



Source: Author's computations from data from California State Controller 2014-15.

**California Special District Revenues
Typical District (water) Providing Enterprise Services**



Source: Author's computations from data from California State Controller 2014-15.

PROPERTY TAXES

Traditionally, the tax on real property, land, and the permanent structures built on it was the backbone of local government finance. In theory, services connected to property, such as police protection, garbage collection, or local schools, would be paid for with a tax on property. Supervisors, city councils, school boards and special district boards determined their budgets for the coming year and then set the tax rate to meet those expenses. Every piece of property was “assessed” by the county assessor, who assigned a taxable value to it. Each local agency set its own tax rate that applied to the property. If one person owned more property than a neighbor, or if that property was considered to be more valuable, he or she would receive a higher tax bill than the neighbor.

That all changed in California in 1978 when voters approved Proposition 13, limiting the property tax to one percent of the “assessed value” of property as of 1975, and to one percent of a property’s actual sale price for properties that change hands after 1975. Unless the property is sold, assessed value increases are limited to two percent per year of the 1975 value.

As a result, recent home buyers generally pay much higher property taxes than people who bought their homes 40 or more years ago. For example, two identical houses, next to each other in the same neighborhood, could have radically different tax bills if the first was purchased for \$50,000 in 1978, and the second was purchased for \$250,000 in 1992. The first house started with a property tax of \$500; by 1992, the two percent annual increase would have raised the tax to about \$660. The second house, although identical in every way, would pay \$2,500 in 1992, or almost four times as much as the house that hadn’t sold since 1978.

The disparity in property taxes charged to new homebuyers is exacerbated by another ballot initiative, Proposition 58 passed in 1986. Proposition 58 allows parents to transfer a residence to their children without it being reassessed for property tax purposes, even if the children choose to rent the residence out or operate a business from the home, rather than live in it. This means that a parcel may never be reassessed, so long as it continues to be passed along. What are the implications in terms of revenue for local services? Does this policy place a higher burden upon new homebuyers, immigrants, or foster children? Should our state support the ability of its citizens to keep property in the family and for parents to leave a legacy for their children?

Another consequence of Proposition 13 is a growing disparity over time between the assessment of residential property and commercial or business property. Similar

to the concept of a family that passes along a home for multiple generations as an inheritance, many businesses that own property are able to retain majority ownership of that property for decades. This is because, unlike people, business can live forever. As a result, some commercial property may never be reassessed. Over time, what is the effect on the collection of local revenue? If a new comic book store opens up across the street from a long-standing comic book store, should the new store be required to pay a higher property tax rate? Is it important for businesses to have a predictable tax rate from year to year that is not subject to large spikes?

In addition to its limit on property taxes, Proposition 13 also requires that any special tax win approval by a two-thirds majority of the voters, instead of the traditional simple majority of 50 percent plus one. Special taxes are charged to property owners on a per property or “parcel” basis whereas traditional property taxes are charged based on value, known as **ad valorem**. A two-thirds majority has proven very difficult to achieve. Even Proposition 13 did not win by a two-thirds majority and new taxes have been rare since 1978.

Proposition 13 expressly forbids new taxes based on the relative value of property. A subsequent ballot initiative did permit one exception: Local governments may place a tax on the value of property to pay for bonds for certain construction projects, but these bonds and taxes must also be approved by a two-thirds majority. Such bonds are called general obligation bonds. This threshold was lowered to 55 percent for school districts by Proposition 39 in 2000.

The Sales Tax

A sales tax is collected on the sale of all items except groceries, prescription drugs, diapers, feminine hygiene products and some services. Because of the limits and restriction on property taxes placed into the state constitution by Proposition 13 in 1978, the sales tax has become a very important tax for cities and counties. The Department of Tax and Fee Administration collects the sales tax and then returns a portion to the city or county where the sale was generated.

Because the location of the sale determines who gets the revenue, cities and counties tend to compete with each other and among themselves for the right to receive the local portion of the sales tax.

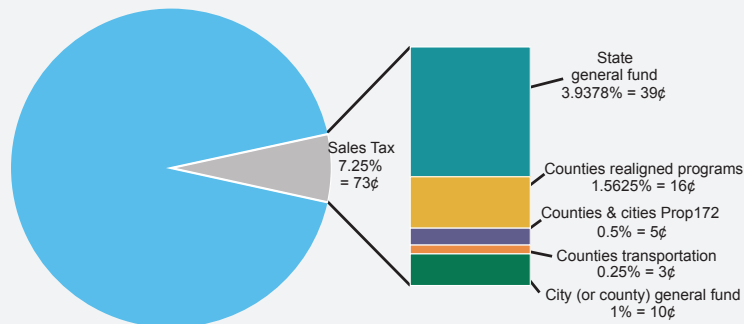
County governments may oppose the formation of a city because they do not wish to lose the sales tax receipts generated within the boundaries of the proposed city.

Cities and counties will do what they can to encourage an automobile dealer or the developer of a shopping center to locate in their jurisdiction, because the retail sales would have a big effect on the funding of the local government

As of April 1, 2019, Californians pay between 7.25 and 10.5 percent sales tax depending on the county. The sales tax you pay at the store is made up of several components:

- **The state sales tax rate in California currently is six percent.** Of that, 0.5 percent was passed as part of the state’s budget for 1991-92, aimed at overcoming a very large drop in state revenues and a potential budget **deficit**. A measure on the November, 1993, ballot to maintain the 6 percent sales tax was approved by the electorate. Despite more recent budgetary deficits, the state has not since changed the sales tax rate.
- **The “uniform” local sales tax.** Since 1967 a standard 1.25 percent sales tax has been imposed in all counties. Every city and county in the unincorporated area receives 1 percent based on the level of retail sales occurring within its boundaries. The remaining 0.25 percent is allocated to the county transportation fund for mass transit and highway programs.
- **Optional local sales taxes.** As of 2019, 34 of California’s 58 counties levy at least one additional, optional sales tax. In many of these counties, an optional sales tax is for transportation projects. Four counties collect optional sales taxes for general or other specific purposes. State law limits optional sales taxes to 3 percent, which would amount to a total sales tax of 10.5 percent. Only the City of Santa Fe Springs, in Los Angeles County has reached this limit.

**PURCHASE POWER:
How much of a sales tax goes to state and local governments?**



Rates effective January 1, 2017 after the expiration of the 0.25% Proposition 30 temporary rate. In addition to the base, statewide rate of 7.25 percent, local voters may authorize additional “transactions and use tax” rates. These additional rates raise the total effective rate to as much as 9.75% in some locations.

HOW TAXES FOR CITIES, COUNTIES, SCHOOLS, AND THE STATE OF CALIFORNIA ARE APPROVED

	TAX- General	TAX- Parcel or Special (earmarked)	G.O. BOND (w/tax)	Fee / fine / rent
City / County	Majority voter approval	Two-thirds voter approval	Two-thirds voter approval	Majority of the governing board*
Special District	n/a	Two-thirds voter approval	Two-thirds voter approval	Majority of the governing board*
K-14 School	n/a	Two-thirds voter approval (parcel tax)	55% voter approval**	Majority of the governing board*
State	For any law that will increase the taxes of any taxpayer, two-thirds of each house of the Legislature – or approval of majority of statewide voters.		Statewide majority voter approval	Majority of each house

* Additional procedures apply for property related fees.

** Per Proposition 39 (2000), maximum tax rate limits and other conditions apply for a 55% threshold school bond or threshold is two-thirds.

LICENSES AND PERMITS

Cities and counties collect fees in the form of licenses and permits from special users of general government services. Most cities and counties issue business licenses for businesses operating within their jurisdictions on the theory that the city incurs many costs as a result of commercial activity. Services needed may include additional traffic signals, wider streets and increased police patrols. The business license is a means by which companies can contribute toward the cost to the city of providing these necessary services.

Other permits and licenses are issued to reimburse the city for costs incurred in regulating various activities. These include filing fees charged for processing zoning changes, engineering fees charged for processing a subdivision map and permit fees collected for building construction. Pet licenses and bicycle licenses are also common.

How much can a city, for example, charge for a building permit? If the city needs the money, why not charge a lot? Other than political considerations, there was little to prevent a city or county from doing just that before Proposition 13. However, Proposition 13's restrictions on new taxes also prompted a new look at municipal fee structures.

Some local governments did attempt to boost their fees to make up for lost revenues, but those increases were over turned in the courts. As a general rule, local governments were not permitted to raise their fees beyond the cost of providing the services which the specific fee supported. To raise fees any higher would be the equivalent of a new tax, and that would require a two-thirds vote of the people.

However, fees could be raised to recover the actual costs of the services, and in many cases they were. In general, local governments became much more careful about accounting for their costs. Building permit fees, for example, were tied more directly to the city's actual cost of processing the fees, conducting the inspections, and enforcing the building code. Developers, when they came in with zoning change proposals or subdivision maps, could be charged for their share of the cost of running the entire planning department. In most cases, fees were raised, because in the past, governments had not recovered the actual costs of services.

Court fines and forfeitures

Fifty percent of fines and forfeitures for law violations occurring within the city are remitted to the city. The remaining 50 percent goes to the state general fund to help fund the courts which are administered by the county. Cities do administer and receive all parking citations within the city limits.

Service Charges

Most local governments derive a considerable amount of revenue from charges for such services as trash collection, fee-based recreation programs, use of facilities and copies of records or maps. Examples of services where local agency charge a fees, include:

- Weeding vacant lots,
- Sheltering animals,
- Filing subdivision maps,
- Playing on golf courses, and
- Docking boats in municipal harbors.

As with permits and licenses, tight budgets create pressures to raise the fees for local services. Again, the guiding rule has been to limit the fee to the true cost of the service.

REVENUES COLLECTED BY THE STATE

More than 500 individual local governments collect taxes in California across 58 counties. With so many cities, towns, villages and counties, the state is in a better position to more efficiently levy and collect taxes on behalf of these public agencies. These revenues are called state "subventions." Two of the most important are:

- **Motor Vehicle "In Lieu" Fees.** These fees are paid by owners of cars and trucks for vehicle license plates. The state collects and returns money to cities and counties after administrative costs have been deducted. These motor vehicle fees are levied by the state "in lieu of" the personal property tax that local government used to levy and collect. The state can administer this tax more efficiently because the Department of Motor Vehicles must register all vehicles for regulatory purposes anyway. Cities and counties get the money because local governments provide most of the facilities used by autos.

- **Gasoline Tax.** The state collects taxes on vehicle fuels (gasoline and diesel) and a percentage is returned to cities and counties to be spent on construction and maintenance of arterial streets and roads that serve as the collector system for state highways.

Utility Franchises

Privately owned public utilities like telephone, natural gas, electric utilities and internet providers normally pay a franchise tax calculated as a percentage of their annual sales within the city. They pay the franchise tax in exchange for the exclusive right to serve the citizens in that area, while using the public rights-of-way such as public streets and property to carry out their business. Because they pay a franchise tax, utilities are usually excluded from the requirement that they pay for a business license.

Operation of Utilities

Nearly 60 percent of the cities in the state operate city-owned water utilities. About 20 operate a city-owned electric power distribution system, and a few distribute gas. About 60 cities, and most counties, operate airports, bus systems, harbors or hospitals. These “proprietary functions” of local governments are usually managed separately, with their own financial accounting and records.

Independent special districts carry out these functions throughout other parts of the state, with about 340 water districts serving California. Sewer and water recycling services are provided by approximately 100 sanitation or sanitary districts. Many Californians also receive water, sewer or electricity services from one of about 90 irrigation districts, five municipal utility districts and 50 public utility districts. Many of the state’s approximately 320 community services districts provide water or sewer services.

California is served by 10 airport districts, nearly 20 transit districts, a dozen port and harbor districts and nearly 80 healthcare districts.

In addition to local governments, corporations known as investor-owned utilities provide most of California’s electricity services and some of its water services. These utilities are granted monopolies by the state and regulated by the California Public Utilities Commission. Unlike local governments, investor owned utilities earn a profit. Their board of directors is chosen by private investors rather than elected by voters living in the community the utility serves.

BENEFIT ASSESSMENT DISTRICTS

Laws passed in the 20th century allow a government to form a “benefit assessment” district to provide a needed service. The district can charge its costs directly to those whose property benefits from it. For example, a benefit assessment district could be formed to build dams for flood protection, and all property owners within the protection zone would be assessed to pay for it. Benefit assessment districts have also been used for street lighting, street construction and other infrastructure.

More recently, tight budgets have given some local governments an incentive to create benefit assessment districts for improvements that have already been made. For example, a neighborhood may already have street lights or city parks, but a city council could establish a benefit assessment district to pay for the maintenance and operation of these facilities that had previously come out of the general tax fund. By asking property owners to pay these costs, the general fund can be freed up for other uses.

OTHER SOURCES

Some cities and counties, because of their unusual circumstances, rely on less customary sources of revenue. Among the revenue sources used by some cities and counties:

- An admissions tax charged on tickets to racetracks or other large amusement facilities and events.
- A hotel/motel tax charged on the room rental bills of those staying in local hotels.
- A utility tax collected on the bills paid by customers of such utilities as the electricity, gas or cable television companies serving the community.

SCHOOL FINANCE

The major source of funding today for education in California for grades kindergarten through community college is the state general fund. In the 2018-19 school year, the state general fund accounted for 58% of K-12 funding. Property taxes and other local revenue sources account for about 32% and federal funds account for 9%. One of the consequences of Proposition 13 was increasing the role of state funding in K-14 education.

In 2013, California revamped its school funding formula, implementing the Local Control Funding Formula (LCFF). Under LCFF, California moved away from a complex system of 50 funding categories to a formula that directs funding to schools and districts that serve high-need students. Districts receive a base amount tied to their Average Daily Attendance (ADA), defined as the average number of students either in school or validly absent each day. Districts then receive a 20% supplement for each high-need student, defined as students learning English, in poverty, and/or foster care. Districts with high concentrations of high-need students receive extra funding.

As of 2015, state support for school operations averaged a just over \$10,000 per student. Adjusted for the high cost-of-living in California, K-12 funding ranks 41st of the 50 states. In addition to the LCFF funds for school operation, schools may also receive the following funds:

- **Developer fees** may be charged per square foot of new construction in a community to help pay for new construction and temporary housing of students in “portable” classrooms. This helps school districts with growing population serve the increased number of students. In addition to schools, cities, counties and special districts also charge development fees on new projects.

- **The California State Lottery** was established in the mid-1980s. Today, the lottery accounts for less than one percent of the **operating budgets** of California public schools.
- **Categorical programs** have been created at the state and local levels to provide funding for specific purposes such as special education or college readiness. By law, such funds cannot be used for any other purpose.

PROPOSITION 98

California voters passed a constitutional amendment to protect the level of funding of the state’s public school system in 1988. The measure, “Proposition 98”, guarantees schools a certain percentage of the state budget or the same level as the previous year with adjustments for inflation and enrollment growth. While education spending has not kept up with inflation in recent years, funding for schools has not been reduced at the same level as other state and local functions.