

# PROPERTY TAX SHIFT

## ***What Should the Legislature Consider As It Reviews Proposals to Reduce the Amount of the Property Tax Shifts?***

### ***Summary***

*Again this year, local government officials are asking the Legislature to reduce the property tax shifts of 1992-93 and 1993-94. Combined, these property tax shifts permanently redirect one-sixth of all property taxes from counties, cities and special districts to K-14 schools. These property tax shifts caused local governments to reduce many programs, and continue to strain local budgets.*

*Proposals to modify the property tax shift pose two difficult choices for the Legislature. Specifically, in order to provide any significant local relief, the Legislature would need to:*

- Reduce state program expenditures or increase state revenues.*
- Choose which local governments would receive the property taxes.*

*This write-up examines two approaches to reducing the property tax shift, and discusses alternative ways to allocate relief among local governments.*

## **INTRODUCTION**

In 1992-93 and 1993-94, in response to severe budget deficits, the Legislature and administration permanently redirected about 17 percent of California property tax revenues from counties, cities, and special districts to schools. These increased school property taxes, in turn, decreased the state's ongoing General Fund obligation for funding schools. California's overall level of K-14 school financing was not affected by this shift of tax dollars.

While these property tax shifts continue to relieve fiscal pressures on the state, the loss of property tax revenues has:

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- Caused cities, counties, and special districts to reduce a wide variety of programs.
- Strained the fiscal conditions of many local governments.

Although data summarizing the impact of the property tax shift are not available, park and recreation, library services, and programs for the indigent (including general assistance) are among the programs most adversely affected. In addition, while all local governments experienced fiscal disruption from the tax shift, many counties, some large cities, and some special districts continue to experience significant fiscal strain from the property tax losses. This strain impedes their ability to plan, respond to emergencies, and implement improvements that impose short-term costs.

### **Economic Development and Property Tax Administration Incentives Also Affected**

The shifts also exacerbated two pre-existing local government disincentives. Specifically, because cities and counties now get a smaller share of property tax revenues, they have less of an incentive to promote new business and residential land developments in their communities. For example, the average county now receives only about \$370 dollars per year in property taxes when a \$200,000 home is built, down \$660 from before the property tax shift. Some counties find this revenue level to be insufficient to pay the county's costs to provide services to new dwellings. To offset these net costs, a city or county may increase developer fees, require assessments, fail to approve a rezoning request needed to build new homes, or take other actions with the direct or indirect effect of discouraging development.

The property tax shifts also reduced counties' incentives to manage the property tax collection system in a manner that ensures all property owners pay their fair share. This is because counties now receive about 20 cents of every dollar of property taxes, yet pay more than 70 percent of the cost of property tax administration. (As we discuss more fully in a separate write-up in this part, this disincentive regarding property tax administration was evident before the property tax shift, and merits legislative attention.)

### **Legislature's Actions in 1996 and 1997**

Concerned about these consequences of the property tax shifts, last year the Legislature passed without a dissenting vote AB 2797 (Aguilar). This measure would have "frozen" the amount of property taxes local

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governments transfer to schools at the 1996-97 level, allowing local governments to keep any property tax growth over this amount. Under the state's school funding laws, schools would not be affected by this freeze. The state would have backfilled the schools' revenue losses with increased state general fund revenues.

Citing concerns about the state cost of this measure, the Governor vetoed AB 2797. In his veto message, the Governor stated that any property tax relief should come as part of a comprehensive state-local restructuring. The Governor's budget, however, does not propose any such restructuring.

Early this legislative session, Members of the Legislature introduced two bills and one constitutional measure to provide partial relief from the property tax shifts: AB 1 and ACR 4 (Aguiar) and AB 96 (Sweeney). Local governments have also indicated that a reduction to the property tax shift is among their highest priorities.

## OPTIONS FOR REVERSING THE PROPERTY TAX SHIFT

There are two commonly discussed approaches to reducing the property tax shift:

- **Freeze Shift**—placing a cap on local property tax shift amounts.
- **Baseline Reduction**—reducing the property tax shift by a fixed amount.

Below, we explain how much each approach would benefit local government (and cost the state), which local governments would benefit, and how the approach addresses the economic development and tax administration disincentives discussed above. In reviewing the two approaches, it is important to note that they are not exclusive—various combinations of the approaches are possible.

### Freeze Shift

To accomplish the property tax shift, state law requires every county auditor to deposit a portion of county, city, and special district property taxes into a countywide Educational Revenue Augmentation Fund (ERAF). The amount of property taxes diverted from any specific local government in 1992-93 and 1993-94 was set forth in statutory formulas. While the formulas are complex, a local government's property tax obligation generally reflected two factors:

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- The benefit the local government received from the state after Proposition 13, its so-called “AB 8” benefit.
- In the case of counties, the county’s receipt of Proposition 172 sales tax revenues.

(For information regarding the property tax shift amounts, please see our April 1996 policy brief, *Reversing the Property Tax Shifts*.)

Local government’s property tax shift obligations did not stay constant at these 1992-93 and 1993-94 amounts, however. Rather, every year each local government’s ERAF obligation grows as assessed value in the community grows. Growth in assessed value generally occurs due to construction of new homes or businesses, the annual two-percent increase in assessed value permitted by Proposition 13, and the recognition of higher assessed values when properties change ownership.

One approach to providing property tax shift relief is to “freeze” the amount of property taxes any local government must contribute to ERAF. For example, in AB 2797, the Legislature specified that local governments need not place into ERAF in 1997-98 or future years an amount greater than that which was deposited in 1996-97.

### **How Much Would the Freeze Shift Approach Benefit Local Government and Cost the State?**

The level of local relief provided under the freeze shift approach (and the commensurate increased state education costs) turns on the growth rate for assessed value. For 1997-98, we estimate assessed value will grow by 3.5 to 4 percent statewide. (The Department of Finance’s estimate is about the same.) Thus, if ERAF contributions were frozen at 1996-97 levels (approximately \$3.4 billion), local governments would benefit by keeping about \$130 million of property tax growth in 1997-98. As Figure 1 shows, the amount of relief under this option grows very rapidly—exceeding \$1 billion by 2002-03. This is because local governments benefit by keeping *all* the growth on a \$3.4 billion share of property taxes—and this growth compounds annually.

### **Which Communities Benefit?**

The amount of fiscal relief provided to any local government under this approach depends on two factors: the local government’s required shift amount, *and* the future assessed value growth rate in the community. The greatest relief would go to fast-growing communities with comparatively large ERAF obligations; the least to slow growing communities with small property tax shift requirements.

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**Figure 1**

**Freeze Shift: State Costs and Local Benefit Exceed \$1 Billion in Six Years**

1997-98 Through 2002-03  
(In Millions)

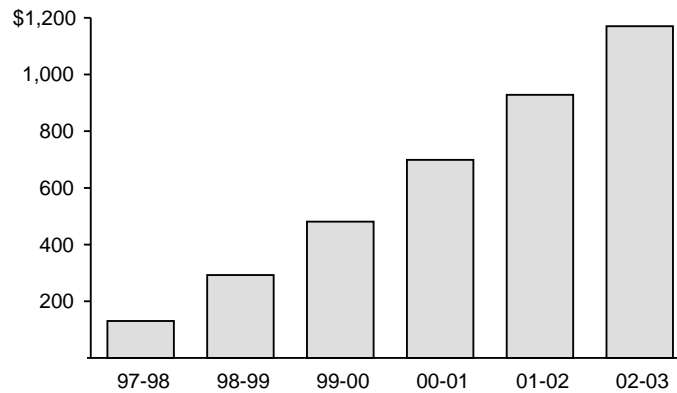


Figure 2 displays information about the local government entities that bore the largest portion of the property tax shift and thus stand to gain the most from a freeze—counties. Specifically, if the Legislature were to implement a freeze in the budget year, counties on average would realize fiscal relief of about \$3 per constituent. Individual counties, however,

**Figure 2**

**Freeze Shift: Relief Depends on Shift Amount and Growth Rate**

County	ERAF (Per Capita)	Expected County 1997-98 Growth Rate	Initial Fiscal Relief (Per Capita)
Alameda	\$103	Medium	High
Butte	37	Medium	Low
Los Angeles	95	Low	Medium
Riverside	55	Low	Low
Santa Clara	85	High	High

would realize different levels of fiscal relief, depending on the magnitude of their property tax shift obligations and their rate of assessed value growth.

For example, Alameda is likely to benefit more on a per capita basis than Los Angeles in the first year, because its ERAF obligations are higher and its growth rate is expected to be higher. Counties with lower ERAF obligations (such as Butte) would tend to receive lower benefits from a freeze shift approach, unless they have a high growth rate. Finally, while Figure 2 focuses on counties, the range of benefit from a property tax shift freeze for cities is even greater, because city ERAF obligations are even more varied.

### **Are Economic Development and Tax Administration Incentives Improved?**

A property tax shift freeze would mitigate the fiscal disincentives local governments face to approve new developments and to finance improvements to the property tax administration system. For example, under the freeze shift approach, a local government would receive significantly more property taxes from the construction of a new office building than it would under current law. (The local government, however, would continue to receive its current low share of property taxes from all *existing* developments.) While the incentives local governments face regarding land developments and tax administration still would be less than optimal, local governments' incentives would be restored to their levels prior to the property tax shift.

### **Baseline Reduction**

A second approach to providing property tax shift relief is to reduce the "base" amount of local government property tax shift obligations by a fixed amount or percentage. Local government property tax shift obligations would continue to grow under this approach. However, the shift obligations would grow from a lower base.

### **How Much Would a Baseline Reduction Benefit Local Governments and Cost the State?**

The Legislature could use a baseline reduction approach to provide large or very modest fiscal relief to local governments. Figure 3 shows the local benefit and state costs for a \$130 million baseline reduction in the budget year. (This is about the same amount of local fiscal relief as the

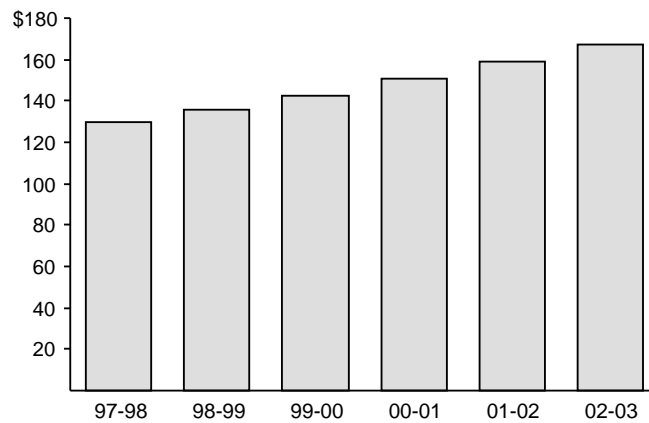
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freeze shift approach provides in its first year.) In contrast to the freeze approach, the costs and benefits of the baseline reduction approach do not escalate rapidly. After six years, local relief and state costs are less than \$170 million, whereas the freeze shift's relief/costs are over \$1 billion.

**Figure 3**

**Baseline Reduction: State Costs  
And Local Benefit Grow Modestly**

*1997-98 Through 2002-03  
(In Millions)*



**Which Communities Benefit?**

Under the baseline reduction approach, the Legislature would determine which local governments would receive fiscal relief. The Legislature could reduce the property tax shift requirement for specific local governments, or to all local governments on a proportionate basis.

**Are Economic Development and  
Tax Administration Incentives Improved?**

Modest reduction to baseline ERAF obligations would not measurably improve the incentives for local governments to promote new land developments or to invest in property tax administration. Only very large and permanent baseline reductions to local government ERAF obligations would achieve that result.

## WHAT SHOULD THE LEGISLATURE DO?

Our analysis indicates that the property tax shifts have:

- Reduced local government's ability to respond to constituent needs and preferences.
- Strained the fiscal condition of some local governments.
- Decreased local government incentives to approve new land developments and invest in property tax administration.

As a result, we believe the concept of reducing the amount of the property tax shifts merits serious consideration by the Legislature.

Ultimately, however, the decision regarding modifying the property tax shift will turn on the Legislature's perception of the relative need for state and local programs and the appropriate level of taxation. As we discuss in Part I, although the state's economy continues to grow moderately, state revenues cannot fund all the requirements of current law. Reducing the property tax shift, therefore, would require the Legislature to reduce state programs, or raise revenues.

Should the Legislature decide to provide some relief from the property tax shift, it must choose the manner in which to provide the relief and which local governments would benefit. To assist the Legislature in this regard, we offer the following observations.

### **The Freeze Approach Only Makes Sense on a Permanent Basis**

Although the freeze shift approach imposes significant future costs to the state, this approach has the advantage of correcting some of the counter-productive economic development and tax administration incentives local governments face.

Our analysis indicates, however, that this advantage does not materialize unless the freeze is implemented on a *permanent* basis. Specifically, placing a sunset provision on the freeze (which was suggested as an option in last session's debate on this issue) greatly reduces its positive benefits regarding economic development and tax collection incentives. This is because it usually takes a while for local governments to realize benefits from a change in land development policies or enhanced tax collection efforts. By the time a local government would receive additional tax revenues from these activities, the freeze on ERAF growth may have ended. In addition, implementing a freeze shift approach for a

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limited time period would be extremely difficult from an administrative standpoint.

### **Baseline Reduction Is a Better Way to Deliver Modest Relief**

If containment of costs is an important objective, the easiest way to provide property tax shift relief is through a baseline reduction. As discussed earlier, the state costs of this approach increase modestly over time. The Legislature could implement additional baseline reductions to the property tax shift in subsequent years, depending on the state's fiscal condition.

### **Deciding Which Local Governments Should Benefit Is Complex**

Ideally, all property taxes in California would be allocated among local governments in a manner that best facilitates local governments' ability to meet the needs and preferences of their residents. In considering ways to provide more property taxes to cities, counties and special districts, therefore, the Legislature is faced with the task of determining how to allocate property taxes among the many overlapping local jurisdictions serving California residents. The Legislature has three options for addressing this issue.

**Allocate the Relief Proportionally.** The Legislature could allocate any property tax shift relief in proportion to the amount of a local government's property tax shift. Such an allocation is perceived as "fair" by many because it provides relief in a manner that is commensurate with the impact of the property tax shift. On the other hand, this methodology reaffirms the property tax sharing formulas in existence before the property tax shift. As we discuss in a separate write-up in this part of the *Perspectives and Issues*, those tax sharing formulas have not been updated for nearly two decades and may not reflect the priorities or needs of the present day. Some California residents may prefer, for example, to have more property taxes allocated to their city or library special district, than a simple proportional reversal of the property tax shift would provide.

**Allocate Relief Based on Other State Formula.** Alternatively, the Legislature could allocate property tax shift relief to local governments based on some state perception of local need. For example, the Legislature could provide baseline reductions to the property tax shift obligations of fiscally distressed communities, or to cities and counties that receive particularly low shares of property taxes collected in their com-

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munity. From a practical standpoint, however, these alternative methodologies are likely to be controversial and imperfect. The state has no workable definition of local fiscal distress and low property tax shares may be appropriate for some communities (such as those that rely extensively on special districts to provide services).

***Let Communities Determine Allocation.*** A third approach would be to allow local residents to choose how to allocate the additional property taxes among the many local governments serving their community. While such an approach has not been undertaken before, the California Constitution Revision Commission included such an option in its recommendations. Specifically, the Legislature could state that local residents have the authority to direct the allocation of a certain amount or share of property taxes. The proportion of property taxes to be allocated to any specific local government would be determined by local residents in a county-wide, or sub county-wide election. Local residents could alter this property tax allocation methodology in the future with a subsequent vote.

The primary advantage of this approach is that it would represent the first time in nearly two decades that local residents had a voice in the allocation of property taxes among local governments. On the other hand, this approach would be complicated in large urban counties and is probably only practical if a significant amount of the property tax is to be placed before the voters.

### **Local Control of the Property Tax Makes Sense**

Our review indicates that local governments can best respond to local needs and priorities when they have a reasonable degree of fiscal autonomy. In addition, local residents would have a better ability to obtain the public services they want if they had some authority to reallocate property taxes among local governments. For these reasons, we think that ultimately some mechanism for allowing local control of the property tax should be developed.

## **CONCLUSION**

Proposals to reduce the property tax shift pose very difficult choices for the Legislature. Specifically, there is not likely to be “room” in the state budget to provide significant local fiscal relief, unless the Legislature reduces state program expenditures below the levels called for under current law or increases taxation. Accordingly, the Legislature must weigh the relative need for revenues and services by state government, local government, and the private sector.

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If the Legislature decides to take action to reverse part of the property tax shift, the Legislature would need to determine how to allocate this relief among the several thousand units of local government. Clearly, the simplest way to provide relief is on a proportional basis. We note, however, that such a proportional allocation may not be consistent with local residents' current needs or priorities.

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