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ERAF and the 1997-98 State Budget

SUMMARY

This year, the budget conference committee and the Legislature are considering several proposals to reduce the amount of property taxes permanently shifted from cities, counties, and special districts in the early 1990s. Each of these proposals increases state costs in the budget and future years, and each raises the question of which local governments should get relief.

This policy brief examines these property tax shift relief proposals, comparing options that would cost the state greatly differing amounts. We discuss the Legislature's alternatives for allocating relief, including developing formulas that consider: Proposition 172 revenues, local population, and property tax shift obligations in previous years.

Our major recommendations to the Legislature are:

- ❖ *Fund property tax shift relief in 1997-98 at $100 million or more.*
- ❖ *Provide relief by reducing local government baseline property tax shift obligations, rather than capping the growth on the property tax shift.*
- ❖ *Distribute relief in general proportion to each local government's property tax shift burden, rather than on a population basis.*
- ❖ *Fold COPS revenues into the funds for property tax shift relief, in order to return a larger amount of property taxes and to give local governments greater ability to spend these funds to hire additional public safety personnel and make other long-term expenditure commitments.*

BACKGROUND

What Is ERAF?

In 1992-93 and 1993-94, in response to serious budgetary shortfalls, the Legislature and administration permanently redirected over $3 billion of property taxes from cities, counties, and special districts to schools and community college districts. These redirected funds reduced the state's funding obligation for K-14 school districts by a commensurate amount. (Schools and community colleges did not experience any change in their total revenues from this shift, merely a shift in the relative amounts of funding from the state's General Fund and local property taxes.)

The term "ERAF" is often used as a shorthand reference for this shift of property taxes. ERAF actually is an acronym for the fund into which redirected property taxes are deposited in each county, the Educational Revenue Augmentation Fund. In 1996-97, cities, counties, and special districts deposited about $3.4 billion of property taxes into ERAF. The amount of required ERAF contributions grows annually along with the property tax growth rate, estimated to be approximately 3 percent in the budget year.

To mitigate the ongoing impact of the 1993-94 property tax shift, the Legislature proposed and the voters approved Proposition 172. This measure provides counties and cities with a share of a half-cent of sales tax for public safety purposes.

Actions in Legislature

This Session

In the May Revision, the administration proposed reducing local government property tax shift obligations by $100 million (from $3.4 billion to $3.3 billion). The administration's proposal does *not* appear directly as an item in the budget bill. Rather, the proposal is reflected as an increase in the amount of state General Fund set-aside for school apportionments (nonbudget act Item 6110-601-0001).

Senate Provided $100 Million. The Senate approved the May Revision proposal. The Senate also took action to send the Citizen's Option for Public Safety program (COPS) to conference so that its funding ($100 million in Item 9210-101-0001) may be considered in the context of property tax shift relief.

Assembly Provided Higher Level of Relief. The Assembly approved the $100 million May Revision proposal and provided additional property tax shift relief under Item 9210-102-0001, a local government financing item. The *total* amount of relief the Assembly intended to provide in the budget bill is $280 million: $100 million in the education item and $180 million in Item 9210. (While the Assembly budget bill technically shows

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$280 million under Item 9210, the amount reflecting the Assembly's intent is $180 million).

Issues for Consideration. Proposals for property tax shift relief pose four substantive questions for the Legislature. Specifically:

- How much relief should the Legislature provide in the budget year?
- Should relief be provided in future years?
- Which local governments should get relief?
- Should the COPS program funds be consolidated with property tax shift relief?

The Legislature has broad flexibility in fashioning responses to these questions. We discuss these questions separately, below.

HOW MUCH RELIEF SHOULD THE LEGISLATURE PROVIDE IN THE BUDGET YEAR?

The property tax shift has significantly reduced many local governments' ability to provide services to their residents. This loss of general purpose revenues is particularly notable given the Supreme Court's ruling upholding Proposition 62 and the passage of Proposition 218. Both these developments make it more difficult for local governments to raise revenues for general governmental purposes. Specifically, all new local government taxes now require approval by a majority or two-thirds vote of the electorate, and local governments' ability to impose assessments and certain fees to pay for services not related to real property is limited. These restrictions on local revenue raising far exceed the restrictions the Legislature and administration face when approving state revenue increases.

As we discuss more fully in our previous publications, the property tax shift also has negatively affected local governments' incentives to approve new land developments and to administer the property tax collection system. For all of these reasons, we recommend the Legislature seriously consider providing property tax shift relief to local governments.

Determining the appropriate amount of revenues to return, if any, is a difficult policy call. Ultimately, the Legislature will need to choose between funding local government relief and other competing uses of the state's non-Proposition 98 resources, such as welfare-to-work programs, corrections, higher education, and tax relief.

Analyst's Recommendation. If the Legislature chooses to provide local government fiscal relief, we recommend that the Legislature consider the Senate's $100 million as the *minimum* amount of relief, or limit the number of local governments receiving the relief. Otherwise, a relatively small amount of relief would be distributed across several thousand local governments, yielding a negligible amount of benefit to each. We note, for example, that if the Legislature provides $100 million of property tax shift relief for all local governments, most localities will still deposit *more* revenues into ERAF in 1997-98 than they did in the current year. This is because the amount of relief would be *less* than the amount ERAF is expected to grow in the budget year.

SHOULD RELIEF BE PROVIDED IN FUTURE YEARS?

After deciding whether to provide relief to local governments in 1997-98, the Legislature will need to decide whether to continue that relief in the future, and the extent to which the relief level should grow. The Legislature has a wide range of choices regarding future ERAF relief. Each of the four major ERAF proposals currently under discussion provides an increased level of relief in future years. Each proposal, however, differs substantially in its approach, as we discuss below.

Senate and Administration's Relief Level Grows Slowly. In the May Revision, the administration proposed to permanently decrease local government's baseline ERAF obligations by $100 million. This amount of relief would grow slowly over time, along with growth in property taxes.

Assembly Bill 95 and Senate Bill 880 Provide Fast Growing Relief. AB 95 (Sweeney, Aguiar) and SB 880 (Craven), on the other hand, specify the Legislature's intent to implement two actions that provide fast growing local relief. Specifically:

- ***"Cap" or "Freeze" ERAF***. Local governments need not deposit into ERAF any amount more than they deposited in 1996-97.
- ***Provide Annual Baseline Reductions***. The amount local governments are obligated to deposit into ERAF is reduced every year, phasing out the property tax shift over ten years.

Assembly Budget Approach Did Not Specify Future Relief. The Assembly did not specify its intent as to the provision of future local government fiscal relief. In adopting the $280 million relief amount, however, there was some discussion of providing future relief in a manner similar to AB 95 and SB 880. Under this scenario, all local government ERAF obligations would be capped and baseline ERAF obligations would be reduced over a ten-year period. Instead of eliminating *all* ERAF obligations over time, however, there was also discussion of eliminating all local government's ERAF obligations *net of Proposition 172 revenues*. For

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comparison purposes, we refer to this approach as the "$280 million composite" relief option.

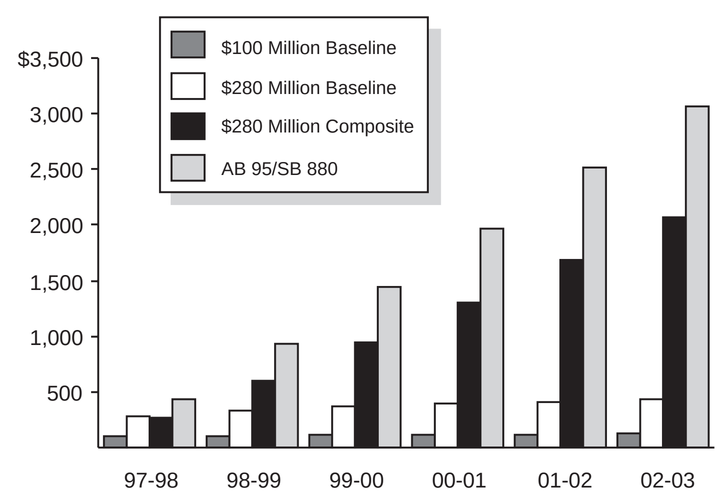
Local Relief Means State Costs. In order to provide any property tax shift relief to cities, counties, and special districts, the state must increase state funding for schools and community colleges by a commensurate amount. Figure 1 shows the future years' state cost of four relief alternatives: the Senate's $100 million baseline approach, AB 95 and SB 880, the $280 million composite, and (for comparison purposes) a $280 million baseline reduction. As the figure indicates, any alternative that includes a cap on ERAF yields rapidly escalating state costs.

Analyst's Recommendation. Over the last two decades, California's local governments have faced considerable fiscal uncertainty. Whatever approach the Legislature takes, it should be consistent with its long-term intent and fiscal capacity. If generous relief is promised in 1997-98, but suspended in future years, much of the benefit of restoring property taxes to local governments would be lost. Local governments would not have a steady stream of revenues with which to meet local priorities. Given the rapid increase in state costs of any approach that includes an ERAF cap, we recommend the Legislature consider some form of baseline reduction to ERAF instead. The Legislature could adopt a baseline reduction to ERAF this year and consider additional baseline

Figure 1

State Costs to Provide Relief: Four Alternatives

(In Millions)



reductions in future years, as revenues permit.

WHICH LOCAL GOVERNMENTS SHOULD GET RELIEF?

Any decision to provide property tax shift relief poses difficult questions as to *which* local governments should benefit. Clearly, the simplest methodology would be to specify that county auditors should reduce *all* local government ERAF obligations by one fixed percentage. Such a methodology, however, raises questions as to whether local *need* and Proposition 172 revenues should be reflected in the allocation formula, and the extent to which local governments benefit under an ERAF cap versus a baseline reduction approach. We discuss these issues below.

Should Relief Be Based on Relative Impact From Property Tax Shift or Local Need?

Most proposals to date (including the administration's, AB 95 and SB 880, and the $280 million composite) provide property tax shift relief in general proportion to each local government's losses due to the property tax shift. Some local governments, however, have suggested that the Legislature use this opportunity to correct the underlying disparities in the property tax allocation system. These governments note that some cities and counties get a small share of the property taxes collected in their communities, while others get more. In addition, others have suggested that relief be allocated on a population basis.

As we discuss more fully in *Property Taxes: Why Some Local Governments Get More Than Others* (August 1996), the current property tax allocation methodology has not been updated in nearly 20 years and is not likely to represent Californian's current needs and preferences. While we agree that an overhaul of the state's property tax allocation system is needed, we offer these cautions to considering property tax shift relief formulas intended to promote equity or address local needs.

- ***Difficult to Assess Local Government Needs From Sacramento***. California has thousands of local governments, and no common set of responsibilities. Some cities, for example, provide fire, library, and water services; others rely upon special districts or their county to provide these services. Counties have similar differences in their responsibilities. Given this variation in responsibilities, any statewide assessment of local government need will be highly imprecise.

- ***Per Capita Relief Formulas Overlook Variation in Responsibilities.*** Providing a set amount of property tax shift relief on a population basis would benefit some low-property tax cities, relative to formulas that allocate relief based on local government contributions to ERAF. This is because low property tax cities tend to have very low ERAF obligations. There is no way of knowing, however, if such a per capita relief methodology would reflect local government need or resident priorities better than a formula based on property tax shift burden.

Analyst's Recommendation. Ultimately, the only way to ensure that local property taxes are allocated to local governments in a manner that best meets local residents' needs and preferences is to transfer responsibility for allocating these tax revenues to local communities. Developing a mechanism to restore local control over property tax allocation, however, will take time. At this point, probably the most practical way for the Legislature to provide a modest amount of property tax shift relief in the budget year is through a formula that reflects relative property tax shift burdens.

Should Proposition 172

Monies Be Considered in the Formula That Allocates Relief?

In submitting its May Revision proposal, the administration indicated that it wanted the fiscal relief provided by Proposition 172 to be a factor in any formula to allocate property tax shift relief. We offer these observations on the issue.

Including Proposition 172 Affects the Allocation of Relief. Because counties receive the vast majority of Proposition 172 revenues, including Proposition 172 revenues in any relief formula reduces the share of relief counties receive. Figure 2 shows how relief would be distributed across local governments if relief were allocated based on each government's relative share of 1995-96 ERAF obligations, with and without consideration of Proposition 172 revenues.

Some Local Governments Are Net "Winners" From Proposition 172. Including Proposition 172 revenues in a property tax shift relief formula could eliminate relief to some local governments where sales tax revenues have grown quickly. For example, according to data prepared by its county auditor, Butte County's 1995-96 ERAF obligation is $7 million, while its Proposition 172 receipts are $8.2 million. Thus, Butte County has no net impact from the property tax shift. Similarly, Santa Clara and Orange Counties have only very small net ERAF obligations in the current year.

Use of Proposition 172 Funds Are Restricted. In 1993-94, Proposition 172 relieved considerable pressure on county and city budgets by providing an alternative funding source for local public safety programs. Under state law, counties and cities were required to use their Proposition 172 funds to maintain or restore public safety spending to its 1992-93 level, and then to annually increase public safety spending by the dollar growth in Proposition 172 funds. By providing new resources

Figure 2

Distribution of Property Tax Shift and Proposition 172 1995-96

	ERAF Contribution	Proposition 172 Offset	Net Shift Contribution
Counties	76%	94%	60%
Cities	15	6	24
Special Districts	8	—	16

for public safety programs, Proposition 172 revenues freed up local general purpose funds for other local needs. Accordingly, most of the Proposition 172 funds provided in 1993-94 effectively functioned as a replacement for lost general purpose property taxes. Growth in Proposition 172 revenues since 1993-94 (currently about $300 million or 22 percent of total Proposition 172 revenues), however, must be used to *increase* public safety funding. Thus, the growth in Proposition 172 revenues may not be used for general purposes.

Analyst's Comments. Given that Proposition 172's origin was as a mechanism to offset the impact of the property tax shift and protect public safety spending, it is reasonable to include at least *part* of these sales tax revenues in any formula to provide further property tax shift relief. In considering these Proposition 172 revenues, the Legislature has two major choices: use the current value of Proposition 172 ($1.6 billion), or use the 1993-94 value ($1.3 billion). The rationale for using the current value of Proposition 172 revenues is that all of these revenues are available for local programs. The rationale for considering Proposition 172's 1993-94 value is that local government's flexibility in use of the growth in Proposition 172 revenues is very limited. The decision as to which Proposition 172 base year to use affects the distribution of property tax shift relief:

- Counties receive a greater share of relief (and cities and special districts less) if an earlier base year of Proposition 172 revenues is used.

- Selecting an earlier base year provides more relief to certain counties that currently have little or no net ERAF obligations, such as Butte, Santa Clara, and Orange.

". . . most communities were reluctant to use their COPS revenues for their community's highest public safety priorities . . ."

ERAF Cap Versus ERAF Baseline Reduction

As we discuss more extensively in our *Perspectives and Issues* write-up earlier this year, the choice of a baseline reduction or a cap approach to ERAF relief affects the extent to which each local government benefits. Generally, we find that:

- A baseline reduction approach benefits *all* contributors to ERAF proportionately.
- Assuming two communities have the same amount of ERAF obligation, the cap approach benefits the *faster* growing community more.
- If communities have different ERAF obligations, the level of benefit under the cap approach depends on the *amount* of each community's ERAF obligation and its property tax *growth rate*.
- A baseline reduction approach can be adjusted to include—or exclude—Proposition 172 revenues. A cap approach is not amenable to this adjustment.

Analyst's Recommendation. For reasons of cost containment and to allow the Legislature to consider Proposition 172 revenues in the allocation of relief, we recommend that the Legislature utilize a baseline reduction approach.

Should The Legislature Consolidate COPS Funds and Property Tax Relief?

Last year, the Legislature and administration created a new local government public safety program, Citizens Option for Public Safety—COPS. Pursuant to a detailed formula, cities received $60 million of the funds appropriated and counties $40 million. Local governments are required to use these funds to increase public safety spending in their communities.

In our review of this program for this year's *Analysis of the 1997-98 Budget Bill* and during this spring, we found that most communities were reluctant to use their COPS revenues for their community's highest public safety priorities (generally hiring public safety personnel) because the funds are annually appropriated in the state's budget bill. Instead, communities tended to use the funds for one-time purchases and services. In order to provide greater certainty to local governments regarding this revenue stream, we recommended in the *Analysis* that the Legislature consider consolidating the COPS program funding and ERAF relief. The Senate acted to put COPS in conference committee to continue this discussion.

Analyst's Recommendation. We recommend the Legislature consolidate the COPS funds with ERAF relief. This would increase the amount of property taxes returned to local governments, providing a dependable stream of local revenues to local governments with which they can hire police officers and budget for other important long-term needs. The allocation of these new property taxes could be implemented based on the same statutory COPS formula, or a new formula. We further recommend that the Legislature not place restrictions on the use of newly returned property taxes, and remove the current COPS spending restrictions. Specifically, our review indicates that state spending mandates may be appropriate when the Legislature has (1) an overriding state interest in a program and (2) some reason to believe that local government would fail to act in a manner that is consistent with statewide objectives. In the case of law enforcement and public safety, however, we have no evidence that local governments or their residents undervalue these programs. Accordingly, we recommend that the Legislature give local governments discretion to use their property taxes to meet the highest priority needs in their community.

We recognize, however, that some Members of the Legislature may wish to maintain the existing COPS expenditure requirements. To that end, we propose the following alternative: consolidate COPS funds with ERAF relief, but maintain the existing spending obligation by statutorily increasing each local government's Proposition 172 minimum spending requirement. This alternative consolidates the state's two public safety spending mandates into one, but maintains the *identical* level of required public safety expenditures as required under current law.

OTHER ISSUES

In the section above, we examined the four major policy issues associated with property tax shift relief. Below, we discuss three technical issues.

Which Base Year Should Be Used? The selection of any ERAF "base" year for use in an allocation formula will be difficult because no year of ERAF data is free from one-time actions that affected the revenues. As Figure 3 shows, local governments in some counties will receive more funds if a recent year is selected, others receive more if an earlier year is selected. For example, the cities, county, and special districts within Alameda County would get more relief if the Legislature utilized 1996-97 as a base year, than they would if an earlier year were selected. In order to address these concerns, the Legislature may wish to consider using an average of several years, rather than a single base year in any allocation formula.

Getting the Numbers. Currently, the state does not require counties to

Figure 3

**Which Base Year to Use?
Share of Shift Relief Allocated to All Local Governments
Within Various Counties**

(Assumes Relief Allocated in Proportion to Net Property Tax Losses)

County	1992-93	1993-94	1994-95	1995-96	1996-97
Alameda	5.8%	6.6%	6.0%	6.3%	7.0%
Contra Costa	3.1	3.6	3.5	3.7	4.9
Los Angeles	36.8	37.6	42.7	41.9	39.0
Orange	7.2	7.0	5.8	5.6	5.5
San Diego	5.2	4.4	3.7	3.9	3.8

Source: CSAC Survey of County Auditors.

report ERAF contributions or Proposition 172 receipts by local government. As a result, any analysis of these issues pertaining to over $5 billion of tax revenues is imprecise. Should the Legislature grant property tax shift relief, we recommend that the relief be offered on the condition that counties agree to provide these data annually to the Department of Finance. Counties should be authorized to include any reporting costs as part of central property tax administration. (Property tax administration costs are paid on a proportionate basis by all property tax receiving governments, except schools and community colleges.)

Avoiding a Mandate. Depending on the complexity of the formula developed to provide property tax shift relief, county auditors could incur significant administrative costs. In order to avoid a claim for reimbursement of a state mandate, we recommend that the Legislature specify that this relief is offered on an *optional* basis, and that auditors may include these costs as part of central property tax administration.

CONCLUSION AND SUMMARY OF RECOMMENDATIONS

While property taxes are the mainstay of *local* government finance, California's Constitution vests the power to allocate property taxes with *state* government. This year, the conference committee and Legislature face several proposals to change the distribution of property taxes—shifting more revenues to cities, counties, and special districts and less to schools and community college districts. Because the state must offset fully any school and community college property tax losses, these proposals would have a significant fiscal impact on the state in the budget year and beyond.

Throughout this policy brief, we have examined the property tax shift proposals and recommended that the Legislature:

- Seriously consider funding property tax shift relief at an amount at least equal to the Senate version of the budget bill ($100 million). Should the Legislature fund property tax shift relief at less than $100 million, we recommend the Legislature limit the number of local governments receiving the relief.

- Consider a baseline reduction to ERAF this year and additional baseline reductions in future years, rather than an ERAF cap. This approach contains the state's future costs and allows the Legislature to consider Proposition 172 revenues in allocating relief.

- Provide property tax shift relief this year based on a formula that generally reflects property tax shift burden. Over the long term, we recommend the Legislature develop a mechanism to transfer the responsibility for allocating property tax revenues to local governments and their residents.

- ***Technical Issues***. Require county auditors to provide annual numbers on ERAF and Proposition 172 revenues. Offer property tax shift relief on an optional basis (to avoid a claim from county auditors for reimbursement of a state mandate).

This report was prepared by Marianne O'Malley, with contributions from Matt Newman, under the supervision of Mac Taylor.

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