A Perspective on County Fiscal Constraints

What Are the Underlying Factors Limiting Counties' Ability to Respond to Fiscal Problems and Effectively Administer Both State and Local Programs?

Summary

One of the most difficult problems which governments at all levels face is determining the proper level and mix of services to provide. In order to accommodate the needs and preferences of constituents, locally elected officials must have the ability to govern their own fiscal affairs. Each elected body must be able to alter the level of both revenues and expenditures to accommodate voters in their community.

The current system in California fails to provide this flexibility to counties. County officials are constrained both in their ability to allocate resources according to local preferences and to raise revenues to pay for desired programs. As a result, counties are limited in their ability to provide the appropriate type and level of services to residents, respond to fiscal crises, and effectively administer both state and local programs.

This piece provides an overview of the fiscal constraints counties face. These constraints hinder county administration of many programs in which the state has considerable interest—including health, welfare, criminal justice, and property tax collection. These fiscal constraints also impair county ability to provide local programs—law enforcement, libraries, and parks—in a manner which meets the preferences of local residents.

As the Legislature considers proposals for local government reform put forth by the Governor, the California Constitution Revision Commission, or the counties themselves, an understanding of the county fiscal condition will help inform the policy debate.

INTRODUCTION

Fiscal distress among California's counties has been a chronic public policy problem in the state for nearly two decades. The Legislature has responded to this challenge with a variety of proposals and solutions. Yet the problem persists. Following the property tax shifts of 1992-93 and 1993-94, the recent California Supreme Court decision upholding Proposition 62, the bankruptcy of one county (Orange), and the major budget shortfalls of many others, it is an appropriate time to take another look at the basic fiscal structure of California's counties and the relationship of the counties to the state.

The state has a fundamental interest in the fiscal health of counties. Counties provide many health, welfare, and criminal justice programs in which the state has a vital interest. Yet counties lack the fiscal flexibility to respond to local needs and preferences and to effectively administer programs on behalf of the state.

This piece provides an overview of the fiscal constraints counties face. An understanding of these constraints is vital to the development of a productive state-county relationship. As the Legislature considers proposals for reform put forth by the Governor, the California Constitution Revision Commission, or the counties themselves, an understanding of the county fiscal condition will help to inform the policy debate.

THE STATE'S SYSTEM OF GOVERNMENT

A system of state and local governments allows for flexibility and variation with respect to the type and amount of government services provided to residents. In some areas, local residents may choose to fund libraries at the expense of parks and recreation. Another community may choose to invest in social services such as public or mental health programs while public safety may be a priority elsewhere. With regional variation and flexibility, residents and businesses can migrate to the region that provides the desired type and level of government services. Similarly, as preferences change, local voters' desire for more or less of a given government service can be accommodated.

This local variability must be balanced by larger statewide concerns. In some cases, there is an overriding state interest in achieving uniformity within a program. For example, the state may wish to provide uniform access to justice through the courts. In other cases, regional variation in service levels may create unacceptable economic incentives for migration. For example, wide variation in the level of funding for welfare programs may result in migration of recipient populations among the counties. Finally, certain programs may have benefits that are not restricted geographically. For example, certain public health programs that reduce the presence of communicable disease are of statewide interest. In these cases, the state's interest may override the desire for local discretion. Together, however, the system of state and local governments helps to ensure that residents of the state are receiving both the type and level of services which they desire.

To accommodate this flexibility, each level of government must have the ability to govern its own fiscal affairs. Each elected body must be able to alter the level of both revenues and expenditures in their community to accommodate the needs and preferences of voters in that jurisdiction. The current system in California fails to provide this fiscal flexibility to county governments. Local officials are constrained in their ability to provide those services desired by residents and to allocate county resources according to their best use.

The County Role in California's Governance System

Under the current system in California, counties play a dual role in providing services to residents. Counties act as both a local government entity and as an agent of the state. As a local government entity, counties are responsible for providing municipal services to the unincorporated areas within the county. Such municipal services include public safety, parks and recreation, libraries, and public works programs such as road construction and maintenance. Many counties also operate enterprise programs which charge fees to users of their services and are organized like businesses. Typical enterprise programs include airports, hospitals, and solid waste disposal.

As agents of the state, counties are responsible for administering many of the state's health, welfare, and criminal justice programs, such as Aid to Families With Dependent Children (AFDC), mental health, public health, trial courts, and probation. Counties also provide general assistance (GA) and health care for the indigent in their communities. Because counties are obligated by statute to provide these programs, they are referred to as state-required programs.

As both a local government entity and an administrative arm of the state, county governments experience an inherent tension as they seek to accommodate their dual role. County officials are accountable to local voters and must provide locally desired services. Yet they must also provide services of statewide concern. In seeking to provide both local services and state-required programs, county officials face significant fiscal constraints on their ability to allocate resources according to local preferences and on their ability to raise revenues to pay for these programs. We discuss these constraints in greater detail below.

COUNTIES HAVE LIMITED CONTROL OVER EXPENDITURES

As an administrative arm of the state, counties provide a large number of state-required programs. Most of a county's budget is allocated to paying for these programs. In general, counties have limited ability to alter the level of expenditures for state-required programs. Practically speaking, local discretionary programs are financed with county resources remaining after state requirements are met.

County Budgets Reflect State Policy Choices. As shown in Figure 1, counties face significant constraints on their ability to allocate resources according to local preferences. Counties must fully fund state requirements for health, welfare, social services, and courts before they can allocate resources for local discretionary programs. State contributions generally cover only part of the cost of providing a state-required program. For example, the state currently pays approximately 37 percent of the cost of the trial courts, with the counties paying the remaining 63 percent. Counties must make up the difference between the state's contribution for a program and the required funding level with county general purpose revenues.

Maintenance-of-Effort and County Match Requirements Limit Flexibility. In some cases, counties are further constrained by maintenance-of-effort (MOE) restrictions, which require counties to maintain a certain level of funding for a program or department. Currently, the state imposes MOE requirements on county spending for health, mental health, libraries, highways, and public safety programs, among others. The state also imposes "county match" requirements in which counties must contribute a share of their own resources to receive state funds. These requirements limit the ability of county officials to allocate county general purpose revenues according to local preferences.

Limited Ability to Control Costs in State-Required Programs. Counties can exert some influence over program costs through decisions regarding program administration, access to services, and service levels. However, the ability of counties to determine eligibility and service levels varies from program to program and from county to county. For example, counties have extremely limited control over expenditures in AFDC because the state and federal governments establish eligibility criteria and grant levels, while caseloads vary with economic and demographic factors. Counties have more control over expenditures for

Figure 1

Factors Limiting County Fiscal Flexibility—Expenditures

- ✔ **Majority of county expenditures controlled by state**
- ✔ **Flexibility to allocate own-source revenues limited by maintenance-of-effort and county match requirements**
- ✔ **Limited ability to control costs for state-required programs**
- ✔ **Cost increases for state-required programs decrease available resources for local purposes**

criminal justice programs. County decisions regarding law enforcement can have an impact on the costs for administration of the courts and correctional facilities. By choosing to enforce certain laws more or less vigorously, counties have some ability to control the flow of individuals through the court system. However, counties have almost no control over the number of civil cases filed in courts or the number of people arrested and placed into county jails by city police departments.

Local Programs Squeezed. Counties must finance local discretionary programs with resources remaining after all state requirements have been met. With little ability to raise new revenues, increases in costs for state-required programs necessarily result in decreases in county discretionary programs. The result is that locally collected revenue is often allocated for state-required uses while local preferences and needs may go unmet.

COUNTY REVENUES CONSTRAINED BY STATUTE AND CONSTITUTION

In addition to constraints on the ability of county officials to make expenditures according to local preferences, counties face constitutional and statutory restrictions on their ability to raise revenues to fund both state-required and county discretionary programs. As shown in

Figure 2, counties have little control over the property tax, generally cannot raise taxes without a vote of the people, are limited by statute in the types of taxes which they can levy, and cannot control the level of intergovernmental transfers.

Figure 2

Factors Limiting County Fiscal Flexibility—Revenues

Limited control over largest revenue source, the property tax

- Tax rate controlled by Proposition 13.
- Tax allocation controlled by state.

Limited ability to raise new revenues

- Popular vote required for tax increases.
- State controls types of taxes that can be imposed.
- Limited tax base in the unincorporated areas.

Majority of revenues come from intergovernmental transfers

- Level of transfers determined by state and federal budget processes.
- Annual variation in level of transfers impedes effective long-term planning.

Little Control Over the Property Tax

The property tax is the largest source of county general purpose revenue. Prior to the passage of Proposition 13, counties were able to annually adjust the local property tax rate to accommodate changes in demands for both state and local services. However, Proposition 13 limited the property tax *rate* to a maximum of 1 percent of assessed value and *annual increases* in assessed value to 2 percent.

In addition to the constitutional limits placed on the property tax rate and assessed value growth, under Proposition 13 the state determines the allocation of the property tax collected in the county among the various local entities. Each year, the Legislature and the Governor can alter the relative share of the property tax going to an individual local entity. For example, in 1992-93 and 1993-94, the Legislature modified the allocation of the property tax and shifted approximately $2.5 billion in property tax revenues from counties to schools. This revenue loss was partially mitigated by Proposition 172, which provides a one-half cent sales tax for public safety purposes. The allocation of these sales tax revenues is also determined by statute.

Limited Ability to Raise New Revenues

Counties have limited ability to increase existing taxes or raise new revenues. Propositions 13 and 62 limit the ability of counties to raise taxes without a vote of the people. Proposition 13 requires a two-thirds vote of the people to raise *special* taxes (taxes for specific purposes), while Proposition 62, recently upheld by the California Supreme Court, requires a majority vote of the people to raise *general* taxes. With voting requirements for most types of revenue increases, the level of county revenues is largely determined by local voters.

County Revenue Raising Authority Controlled by the State. As an administrative arm of the state, counties have only that revenue raising authority explicitly granted by the Legislature and the Constitution. Taxing authority for county versions of such revenue generating measures as cigarette taxes, tippler's taxes, or local income taxes has not been granted under state law. And while legislation (Ch 466/90 [SB 2557, Maddy]) now affords counties the ability to levy certain taxes formerly restricted to cities (such as utility users' taxes and business license fees), counties lack a strong revenue base on which to levy such new taxes. Under state law, these taxes can only be levied on residents and businesses in the unincorporated areas within a county. In most counties, the majority of the population, and therefore of the tax base, lives in incorporated cities.

Intergovernmental Transfers Limit Local Fiscal Flexibility

While the largest county general-purpose revenue source is the property tax, the largest single revenue source is intergovernmental transfers from the state and federal governments. In 1993-94 (the most recent year for which data are available), more than 50 percent of county revenues in California came from such transfers. These revenues are typically tied to a specific program and can only be allocated for the stated purpose. In addition, state and federal budget processes determine the level of funding, which can vary from year to year. As a result, county officials often cannot engage in effective longer-term planning.

IMPLICATIONS OF LIMITED COUNTY FISCAL FLEXIBILITY

Increased Potential for Fiscal Crisis

Lacking adequate control over both expenditures and revenues, counties experience the ongoing risk of fiscal crisis. State policy changes, reductions in a revenue source, or increases in demands for services can produce a county budget deficit. With the overwhelming majority of county resources allocated to required program uses each year, any significant variation in either the costs associated with providing required programs or the revenues available to fund those programs can create a budgetary imbalance.

For example, last year's budget problems in Los Angeles County were in part a result of reductions in both state and federal transfers for health programs and the 1992-93 and 1993-94 property tax shifts to schools. These same property tax shifts placed increased fiscal pressure on Orange County officials, and may have inadvertently created pressure for increased interest earnings and, in so doing, contributed to the recent Orange County bankruptcy. In Merced County, the property tax shift resulted in an ongoing annual loss of approximately $14 million in local revenues. This amount represents more than 50 percent of Merced's preproperty tax shift allocation and constitutes a 25 percent reduction in the revenues available for general purposes. The loss of these revenues forced the county to make significant reductions in its local discretionary programs. Other counties have experienced similar fiscal difficulties.

Impaired Ability to Perform State-Required Functions

Beyond this potential for fiscal crisis, the lack of local fiscal flexibility and stability has impaired the ability of counties to effectively provide many programs of vital interest to the state.

Property Tax Administration System Weakened by Fiscal Distress. Counties are responsible for the assessment of property and the collection of property taxes. However, counties bear a disproportionate share of the costs of administering the property tax system. While counties can charge cities and special districts for the costs associated with assessing property and collecting property taxes, schools receive their share of property taxes without paying the costs of administration. With increasing budgetary pressures, assessors' offices have experienced cuts along with other county departments. Operating with reduced staffing levels, many assessors' offices have been unable to keep up with regular additions to the property tax roll. Many newly constructed properties, additions or modifications to existing properties, and transfers of ownership have gone untaxed. These backlogs reduce the amount of revenue collected, which affects not only local governments but also the state (because schools receive more than 50 percent of the property taxes collected and any shortfall in property taxes going to schools generally must be made up by the state). Beyond this temporary reduction in revenue, a failure to maintain the property tax administration system can result in diminished faith in the fairness and equity of the property tax, which accounts for approximately $20 billion in revenues statewide each year.

Lack of Flexibility Prevents Effective Functioning of Criminal Justice Programs. In the wake of tougher sentencing laws, including "Three Strikes," county jails have become increasingly overcrowded. In fact, 28 counties in the state are operating under maximum capacity limits imposed by federal courts. The population of inmates awaiting trial has increased as court backlogs (also exacerbated by the new sentencing laws) have produced longer waiting periods for trials. As a result, many county sheriffs have been forced to release those arrested on less serious charges at the time of booking, while many sentenced inmates are released before completion of their sentences. Similarly, many district attorneys have significantly reduced their prosecution of misdemeanors and low-level felonies. County fiscal distress has also been reflected in more limited court budgets. Many courts now face considerable backlogs and have been forced to reallocate resources devoted to civil cases for use instead in criminal cases. Courtroom security is an issue of concern in many jurisdictions; however, local fiscal conditions often prohibit the implementation of security measures.

State Requirements Prevent Allocation of Resources According to Their Best Use

The current financing structure for many state-required programs subverts local preferences and can result in inefficient allocation of county resources. For example, state law requires counties to provide GA to the indigent. In many counties, the requirement to provide GA means that county discretionary programs must be reduced.

The state requirement to provide GA not only necessitates a reduction in local programs, it can also result in the inefficient allocation of the resources devoted to the GA program. Counties generally have limited discretion over who receives GA, while the level of assistance is primarily determined by the Legislature and court interpretations of the law. Greater discretion over GA would allow county officials to use these resources more efficiently, in accordance with local preferences. For example, if given greater discretion in implementing GA, counties might choose to provide larger grants to a smaller group of the indigent (such as the elderly or the unemployable). In many such state-required programs, there is not an effective mechanism to ensure that the resources committed are used as efficiently as possible. (We discuss the state requirement to provide GA in the following piece.)

CONCLUSION

One of the most difficult problems which governments at all levels confront is determining the appropriate level and mix of services to provide. Unlike a competitive market in which consumers express a desire for a given product by purchasing more of that good at a given price, most public sector goods and services cannot be purchased or priced according to market conditions. Determining the proper level and mix of services to provide is the job of elected officials. While some goods and services need to be provided at the state level, many can be provided at the local level. Local elected officials are in the best position to assess local preferences and local needs for services. This division of responsibilities allows for the protection of state interests while offering the greatest opportunity for local variation in the level and mix of services provided.

Yet California's counties have limited control over their own financial affairs. Both the level of expenditures and the level of revenues are determined largely by forces beyond the control of county officials. State policy choices govern the majority of county expenditures while constitutional and statutory provisions limit counties' ability to raise revenues. As a result, counties are constrained in their ability to respond to fiscal crises, provide the desired type and level of services to county residents, and effectively and efficiently administer both state-required and local discretionary programs.

The state has a vital interest in ensuring the fiscal viability and effectiveness of county government. This is because counties provide a broad range of services of interest to the state. To address this fundamental problem of county fiscal flexibility requires a major restructuring of county finances and the state-county relationship. Without a long-term solution, county fiscal distress will continue.

The 1996-97 Governor's Budget contains a range of proposals that affect the counties. These proposals should be evaluated in terms of how they would help—or hinder—progress toward developing a long-term solution to the county fiscal problem. The following piece discusses three budget proposals in the context of their impact on county fiscal flexibility and the state-county relationship.