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The Origin & Devolution of Local Revenue Authority

by Michael Coleman and Michael G. Colantuono

Michael Coleman is principal of Coleman Advisory Services and fiscal consultant to the League. He is the owner of CaliforniaCityFinance.com, an information resource on California local government finance. Michael G. Colantuono is a shareholder in the Los Angeles law firm of Colantuono, Levin & Rozell, APC. He serves as city attorney of Barstow and La Habra Heights and is first vice president of the League's City Attorneys Department.

As the population grows and new technology develops, the economy evolves, new needs and priorities rise, and old ones fade. The varied circumstances that arise from these factors, over time and among different localities, are an essential reason that control of municipal affairs and finance has always been a paramount concern of local governments. To respond efficiently and effectively to the needs of their customers, cities need the flexibility to change their services; they need control of their finances so revenues will cover costs and so they may reallocate resources to meet changing priorities.

But local governments in California do not have adequate control of their finances and local affairs. Over the last half-century — and especially since the adoption of Proposition 13 in 1978 — California cities and counties have lost substantial control of their major fiscal resources to fund police and other law enforcement services, fire protection, parks, libraries, schools, hospitals and public health.

Today, California's city budgets face greater risk and less stability, both economically and politically, than in the past. City revenues often don't grow commensurately with service needs, which forces increases in taxes or fees, or cuts in services. Moreover, unfunded mandates from state and federal governments and new judicial interpretations of existing statutes diminish local control over expenditures as well.

This decline of local control and stability impairs good governance, reduces efficiency, inhibits local government's ability to respond to local needs and priorities, and fosters a defensive, short-term approach among local officials. Essential decisions about what is available to spend and how money must be spent are made by higher levels of government, but political responsibility for the taxing and spending decisions remains local. The result is a lack of accountability generally, as each level of government can credibly blame another for shortcomings in desired government services. But the taxpayers are left with little understanding of how government works, much less a meaningful way to participate in our democracy and hold elected officials accountable.

In the first century of California statehood, successive constitutional amendments and legislative acts provided cities and counties with a substantial degree of home rule, including significant local fiscal authority. This was no accident: The home rule provisions of the 1879 California Constitution (our much-amended, current Constitution) were political responses to legislative decisions to hijack local budgets, often for the benefit of the then-politically dominant railroad industry.

But in the five generations since, local home rule in California has been substantially eroded. Local education is now clearly a state obligation¹. Counties, as arms of state public service, are now more dependent on state program objectives and finances. And cities, while more independent from the state than counties, also face greater fiscal constraints and vulnerability to state legislative intrusion than at any time since 1879.

A Brief History of Local Fiscal Authority

In California's early years as a state, local government authority was strictly controlled by the state government, and local affairs

were the frequent subject of meddling by the Legislature. The California Legislature displayed a deep distrust of local affairs, while local officials sought more latitude in municipal policy and public services.

Thirty years after California's admission to the union, the second (and current) state Constitution was adopted by the Constitutional Convention during a turbulent period in the state's political history. That adoption created, for the first time, substantial and meaningful home rule for California's local governments. The 1879 Constitution included five provisions limiting the power of the state Legislature to interfere with the affairs of cities and gave cities extensive powers of self-government. This Constitution prohibited the state from imposing taxes for local purposes, but enabled the state to authorize local governments to impose them.

Over the next several decades, charter city authority was extended to general law cities². In 1903, in a case upholding the City of Los Angeles' business license tax, the California Supreme Court stated unequivocally that local taxation is a municipal affair under Article XI, section 5 of the Constitution as to which local rules have control over state legislation³. Later, in 1982, the Legislature conferred on general law cities by statute the authority to adopt any tax that could be adopted by a charter city.

A 1910 ballot measure known as the "Separation of Sources Act" made the property tax a local government revenue source and established the principle of separate revenue sources for state and local governments⁴. The property tax was ideally suited to fund critical local general services, such as law enforcement, jails, fire protection, parks, libraries, schools, hospitals and public health. This concept of the property tax as the largest, most durable and essential source of local government funding would stand for 68 years, until Prop. 13 drastically altered California local government finance. Reliance on the property tax as the mainstay funding source for local government services remains the practice in most states in the nation today; California's post-Prop. 13 evolution is exceptional.

In 1914, the California Constitution was amended to provide charter cities with the authority to "make and enforce laws and regulations in respect to municipal affairs, subject only to the restrictions and limitations provided in their several charters."⁵ It established the power of charter cities to adopt their own laws with respect to municipal affairs, including flexibility in organizational and program design, latitude to regulate certain activities, and the authority to determine spending levels and priorities. But local authority in municipal affairs remained subject to state pre-emption as to matters of statewide concern. The distinctions between "municipal affairs" and "matters of statewide concern" have been the essential questions in the shifting boundary line limiting the scope of home rule.

Although cities achieved greater local fiscal authority to determine service levels and levy local taxes and charges, state fiscal rules and constraints have often dominated. In 1935, the state pre-empted the local taxation of motor vehicles as real property and established a statewide uniform value-based tax on motor vehicles, known as the "motor vehicle in-lieu tax" or Vehicle License Fee (VLF), which it then allocated to cities and counties based on their share of county population (and not, as commonly believed, on auto sales activity or the valuation of autos in their jurisdictions). In 1955, the California Legislature passed the Bradley-Burns Uniform Sales and Use Tax Act, pre-empting then-existing local sales taxes and providing for a uniform, statewide system of sales taxation and collection. The Bradley-Burns Act authorized cities to adopt local sales and use tax rates up to 1 percent of taxable sales transacted in their jurisdictions, to be administered and allocated by the state. The amounts of revenue remained intact, and the use of those revenues remained at local discretion. These changes demonstrated a balance between:

- The modern industrial economy's tendency to encourage uniform practices and procedures throughout the developing national (and now global) marketplace and to encourage state or federal regulations and standards rather than rely on differing standards responding to local needs; and
- California's continuing commitment to meaningful local control of local government finance.

Proposition 13: Taking Power and Money From Locals

Although these state actions addressed the important issues of taxpayer ease, uniformity and simplicity, they had the accompanying effect of centralizing fiscal authority with the Legislature and governor while constraining local fiscal authority. In 1978, a simple majority of California voters approved Prop. 13, seeking taxpayer relief and uniformity, but with far-reaching consequences (some unintended) for local autonomy.

Beyond its severe fiscal impacts on local governments, Prop. 13 essentially abolished any local control with regard to the property tax. Local governments still have wide latitude on the spending of the remaining revenues they receive, but the allocation of the tax is controlled by the state Legislature. In 1979–80, the Legislature used this authority to cushion the fiscal impact of Prop. 13 on local governments by sharing with them most of the state's \$5 billion surplus and the \$1 billion-plus revenue windfall it received from

higher personal income taxes due to lower taxpayer deductions for property taxes.

In addition to that fund transfer, the Legislature adopted AB 8 in 1980 to establish a system for allocating property taxes. Despite major changes in local priorities and needs, the apportionment formulas for property taxes have remained largely un-changed since then. The only significant exceptions have been additional property tax shares provided to certain non-full-service, no- and low-property tax cities; and the state's exaction of money from cities, counties and special districts during its budget problems in the early 1990s.

In spite of these efforts to cushion its impact, Prop. 13 dealt a major blow to local fiscal autonomy. As the Supreme Court noted in a 1991 decision upholding AB 8's property tax apportionment system, Prop. 13 "prevails over the pre-existing taxing power" of cities⁶. In a 1994 ruling upholding the state's shift of property tax revenues from local governments (the infamous ERAF shift), the court noted that the taxing powers of local governments are "derived from the Constitution upon authorization by the Legislature."⁷ Cities lost the authority to alter the property tax rate. The state was handed the authority to determine *de facto* local rates within the 1 percent umbrella for all taxing agencies.

There is no local authority to reallocate property tax revenue among local agencies (even those providing "city" services such as fire, parks or libraries). Local voters cannot impose a property tax rate higher than 1 percent, except for debt service on voter-approved bonds. Thus, where once a community could devote more property taxes to schools and less to public safety services while another could make the opposite choice, now all communities are constrained by taxing decisions made by leaders of a generation ago when California was a very different place socially, economically and politically.

Court decisions since Prop. 13 have further weakened local autonomy. In 1991, the California Supreme Court gave the state wider latitude to define a "matter of statewide concern" at the expense of home rule authority in fiscal affairs. In *California Federal Savings & Loan v. Los Angeles*, the court acknowledged that local taxation is generally a municipal affair, but declared the state's system of taxation of financial institutions to be a matter of statewide concern. The case involved a state statute imposing a state income tax on banks and financial institutions that prohibited other local taxes on those institutions. It did so to provide a "level playing field," because federal law permitted state taxation of federally chartered banks only if all competing financial institutions were similarly taxed (an expression of the pressure for uniformity created by a statewide or national marketplace). The court determined that permitting local governments to tax savings and loans, despite the state statute, would interfere with the state's ability to raise revenues for its own purposes and was therefore properly pre-empted as a matter of "statewide concern."⁸

This is yet another example of an instance where the courts eroded local home rule to accommodate state and federal pressure for centralized and uniform commercial rules in our increasingly national and international economy. Unlike the decisions of the 1930s and 1950s discussed above, however, this accommodation came entirely at the expense of local fiscal autonomy. Local government lost not only the revenue, but also the discretion to make choices about the benefits and burdens resulting from the presence of financial institutions within a community.

Reform Is Needed

In recent decades, local home rule in California has been substantially eroded — particularly in municipal fiscal affairs — and our state has gone from a strong home rule state to the middle of the pack. Many groups and individuals have studied the problems of California state and local government finance, and many recommendations for reform have been made. How will these ideas improve local authority and discretion and improve fiscal stability? Local government officials are in a position to support the cause of reform and encourage better understanding of the way local government services are financed today.

How the Decline in Local Discretion Has Affected Cities

The City of West Hollywood has lost more than \$1 million annually from the ERAF takeaway of the early 1990s. Our city has a very limited ability to generate new revenues. More than 70 percent of the city's current revenue is either restricted or controlled by state mandate (including revenues subject to Propositions 13, 62 and 218). With the constant threat of unilateral state revenue takeaways, managing the city's fiscal health is becoming a daunting challenge, despite our best efforts to manage our affairs in a fiscally prudent manner. — *Mayor Jeffrey Prang and Mayor Pro Tem John Duran, City of West Hollywood*

As one of the larger cities in Los Angeles County, with a population in excess of 150,000 people, Pomona has been especially hard-hit in efforts to deliver vital public services, while still acting in a fiscally prudent manner and presenting balanced budgets as required by the city charter. Since the start of property tax shifts in 1992 from cities to education (thereby reducing the state's burden

to fund these programs), Pomona's total revenue losses due to ERAF now approach \$38.5 million, with a loss of more than \$4.7 million, or 7.1 percent of our general fund budget, in the current year alone. If present estimates are realized, FY 2003–04 losses will top \$5 million for the first time since reallocations began. – *Finance Director Paula Chamberlain, City of Pomona*

The City of Novato has had to reduce its services to the public in every department by 11 percent or \$1.9 million annually as a result of the ERAF property tax shift and state-mandated programs, which divert limited resources from services like senior programs. Other programs, such as youth recreation, have been curtailed for many years to help fund the mandated programs. The state establishes programs (such as storm drain runoff compliance, currently costing \$400,000 and expected to rise another \$350,000 this year) and sets standards for compliance with no understanding of or concern for costs. The city has also had to reduce services by an additional 8 percent to manage the financial impacts of the recession. The impacts to date have included eliminating 29 positions out of a total of 220 employees, including three police officers. – *City Manager Roderick J. Wood, City of Novato*

Footnotes

1 *Serrano v. Priest*, 20 Cal. 3d 25 (1977).

2 Cities in California are either charter cities governed by the terms of voter-approved charters, or “general law” cities, governed according to the Government Code and other statutes adopted by the state Legislature. Most of the state's largest cities are charter cities and, as of this writing, 107 of the state's 477 cities are charter cities.

3 *Ex parte F.W. Braun* (1903) 141 Cal. 204.

4 J. Fred Silva and Elisa Barbour, *The State-Local Fiscal Relationship in California: A Changing Balance of Power*, Public Policy Institute of California, 1999.

5 California Constitution, Article XI, section 5.

6 *City of Rancho Cucamonga v. Mackham* (1991) 228 Cal. App. 3d 929.

7 See *County of Los Angeles v. Sasaki* (1994) 23 Cal. App. 4th 1442, 1454. The county challenged the state-imposed shifts of city, county and special district property tax revenue to Educational Revenue Augmentation Funds (ERAF). The ERAF shifts were enabled by a provision of Prop. 13 directing that the property tax be allocated “by law,” which the courts have interpreted to mean “by statute of the State Legislature.” See California Constitution, Article XIII A, section 1(a), *Amador Valley Joint Union High Sch. Dist. v. State Bd. of Equalization* (1978) 22 Cal.3d 208, 246 .

8 For a more thorough discussion of CalFed and other aspects of the state-local fiscal relationship, see Betsy Strauss and Michael Coleman, “Waiting for the State to Get Its House in Order: The Origin of Cities' Fiscal Relationship with the State,” *Western City*, November 1998.

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