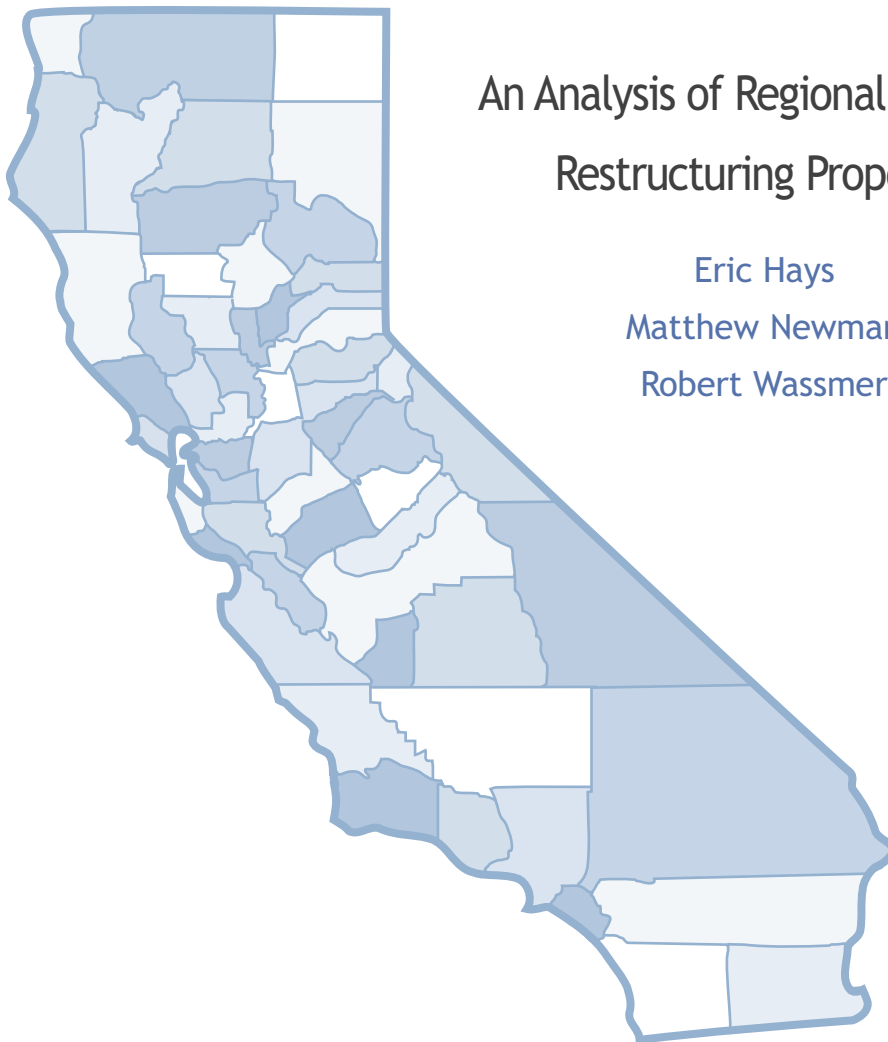


CICG

commission report

November 2001



An Analysis of Regional Revenue Restructuring Proposals

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Executive Summary

The California Speaker's Commission on Regionalism has sought means of promoting better regional collaboration and improved regional planning and public policy decision-making. A critical element of any such strategy will be the development of fiscal mechanisms to finance infrastructure and other investments and the crafting of fiscal incentives to promote improved regional responses to the public policy challenges confronting California.

This paper outlines the results of the California Institute for County Government's (CICG) analysis of a series of proposals for revenue sharing or reallocation under consideration by the Commission. The proposals are all designed to change the set of fiscal incentives that local governments currently face in order to promote improved land use decision-making and encourage regional responses to public policy challenges.

The Commission asked CICG to evaluate two broad classes of revenue restructuring options:

1. swapping a portion of the growth in sales tax revenues for increased property taxes, and
2. allocating a portion of the sales tax growth according to a per capita, income-based or other locally determined formula.

Our analysis of these restructuring proposals yielded five important conclusions:

First, each of these restructuring arrangements would reduce the reliance of local governments on the sales tax. Reducing the relative importance of the sales tax will in turn help to reduce the current "fiscalization" of land use decisions, in which local governments seek out those development projects likely to generate the greatest amounts of increased sales tax revenues. The result of these fiscal incentives is often a continued decentralization of retail activity, as newer suburbs attract retail activity at the expense of older, central urban areas.

Second, beyond simply reducing the reliance on situs-based sales taxes, each of the options considered by

the commission would offer positive incentives to local governments by increasing an alternative revenue source.

The property for sales tax swap proposal would increase the amount of property taxes received by local governments, and in so doing increase the incentive to approve property tax generating land uses such as housing. This type of swap proposal would be of most benefit to those entities that have relatively fast growing property tax bases.

The incentives created by an alternative sales tax allocation formula would depend on the specific formula adopted. This formula could be tailored to create incentives designed to address a specific regional need or public policy objective. For example, a performance or policy-based allocation methodology could be developed in which revenues would be distributed to those jurisdictions that met specific performance criteria such as developing low-income housing or protecting open space. At the request of the Commission, CICG evaluated the results of population-based and an income-based allocation methodologies. These methods seek to allocate a portion of sales tax revenues according to the needs of the local entities, rather than based on where retail transactions occurred.

Third, while each of these proposals would act, on average, to improve local fiscal incentives, application of a single formula across the state's more than 500 cities and counties ensures imperfection. Under each of the formulas analyzed, cases emerged in which wealthy communities were rewarded at the expense of poor ones, or fast growing entities were benefited at the expense of their slower growing neighbors. Furthermore, a proposal that appears to work well in one region may not work as well in another. In fact, one of the conclusions of our analysis is that no uniform, statewide revenue restructuring formula is likely to achieve all of the desired results. The only way to prevent unwanted outcomes is for each region to tailor these general proposals to meet the specific needs of that community.

Fourth, it is certainly the case that these proposals will be viewed through the lens of current economic

conditions. That is, the characteristics of our recent past experience will inevitably color the consideration of these prospective proposals. For example, the sales tax has recently been growing more rapidly than the property tax. This stands in contrast to the longer-term historical trend in which property taxes have grown more quickly. As a result, proposals that swap sales taxes for property taxes may look undesirable today, but may look much better a year from now, if property taxes continue growing even as a slowing economy reduces sales tax growth.

Fifth, creating a new revenue source for regional purposes may be more feasible than reallocating an existing revenue source. Simply put, consideration of any proposal to reallocate existing revenues must confront the reality that some jurisdictions will, at least in the short term, do better than others. That is, any proposal to reshuffle existing revenues will create perceived “winners and losers.” The proposals analyzed in this paper all apply only to revenue growth, so that no jurisdiction would actually experience a reduction in revenues. Instead, the proposals would result in some jurisdictions receiving more revenue growth relative to others. Nevertheless, though the region as a whole can expect to benefit from reduced competition for retail development, improved cooperation among local entities, availability of resources to finance regional projects, and other benefits, the political difficulty of implementing any such proposal cannot be ignored.

In order to avoid these political obstacles while accomplishing the goals of financing regional projects and improving cooperation among local entities, the Commission may wish to recommend the development of a new revenue source. These new revenues could come from a variety of areas, and could be allocated for any set of regional purposes, from infrastructure investment to workforce development to preservation of open space.

Finally, the specific proposals analyzed are intended to be illustrative, rather than serve as recommendations of the Commission or CICG. These proposals represent broad classes of reallocation formulas: swapping one revenue source for another,

or allocating a revenue source according to a different formula. Many alternative swaps or reallocation formulas are possible. The analysis of these proposals is intended to allow regions throughout the state to examine what a specific proposal would mean *for that region* and to serve as a starting point for discussion of regional fiscal solutions. To facilitate the analysis of the restructuring proposals, CICG developed a very flexible simulation model that can illustrate the effects of a wide range of restructuring proposals beyond those specifically discussed in this report.

Introduction

The Speaker's Commission on Regionalism has sought means of promoting better regional collaboration and improved regional planning and public policy decision-making. A critical element of any such regional strategy will be the development of fiscal mechanisms to finance infrastructure and other investments and the enactment of fiscal incentives designed to promote improved regional responses to the public policy challenges confronting California.

The current system for financing local governments does not adequately address a fundamental aspect of modern California: the regional nature of economic and geographic regions. In other words, local governments are organized and financed as discrete entities - cities and counties - without regard for the fact that economic activity, environmental impacts of development, and people themselves don't necessarily fit into these jurisdictional boundaries. Instead, these forces of modern California are regional in scope. As the Public Policy Institute of California's Fred Silva has pointed out, "regions are defined in economic and geographic terms without governance or fiscal powers to match."¹ As a result, local governments frequently make decisions without regard for the regional implications of those decisions. In many cases, the impacts of these projects spill over into neighboring jurisdictions. For example, construction of a new mall may increase sales tax revenue for one jurisdiction while reducing revenue for a nearby jurisdiction as retail activity is transferred from one location to another within the same region. Similarly, a new mall may generate benefits in excess of costs for the entity that receives the sales tax revenues but may generate few benefits for a neighboring jurisdiction that may still face increased costs as a result of the new development, for example from increased traffic.

Currently, there are few public policies able to manage this development process. Put another way by Elisa Barbour and Michael Teitz, writing in a report for the Commission, "the crux of the regional planning problem is how to develop coordinated policies to address problems that are regional in scope in the absence of general-purpose governments operating at a regional scale."²

One of the clearest and most discussed manifestations of this "every jurisdiction for itself" system has been the increased "fiscalization" of land use decisions. While land use decisions have always been based on fiscal incentives to a certain extent, the current system of fiscal constraints on local governments in California has led to a growing sense that land use decisions are being made primarily based on the amount of sales tax that a proposed development project is likely to produce. With sales tax generating capacity as a principal consideration, the likely impact on a neighboring jurisdiction – to say nothing of the region as a whole – is given relatively little attention in the planning process.

Without regional governance structures, and given the presence of fiscal incentives that promote sales tax generating projects to the detriment of many others, changing the set of fiscal incentive that local governments face may be an appropriate response to consider.

With these considerations in mind, the Commission has decided to evaluate various means of reallocating existing revenue sources, sharing revenue growth, or developing entirely new revenue sources in an effort to improve fiscal incentives and promote improved regional policy making.

Restructuring Proposals

Using the options outlined for the Commission by Fred Silva as a guide, the California Institute for County Government (CICG) through the California State University Faculty Fellows Program was asked to model and evaluate the potential impact of three revenue sharing or reallocation proposals.³ Each of the three would reallocate growth in existing revenue sources, either by swapping growth in one revenue source (sales taxes) for growth in another (property taxes), or by sharing the growth in sales taxes within a region according to a specific formula based on population or income.

Specifically, CICG developed a computer-based model to demonstrate the effects of three proposals:

1. swapping a portion of the growth in sales tax revenues for increased property taxes,
2. allocating a portion of the sales tax growth on a per capita basis as opposed to a situs basis, and
3. allocating a portion of the sales tax growth according to an income-based distribution formula.

Each of these proposals would serve to reduce the reliance of local governments on the sales tax and, in so doing, diminish the incentives for “fiscalization” of land use decisions.

These proposals represent broad classes of reallocation formulas: swapping one revenue source for another, or allocating a revenue source according to a different formula. Many alternative swaps or reallocation formulas are possible. For example, the specific proposals analyzed apply only to the growth in sales tax revenue, not to the sales tax revenue base. The sales tax base could also be swapped or reallocated (with a correspondingly larger improvement in fiscal incentives). Nevertheless, we have modeled the effects of swapping a portion of the growth only out of an awareness that many local jurisdictions have already made budget decisions based on expectations that the current level of revenues will continue. That is, the idea is to encourage future changes in policy without penalizing past policy decisions based on historic revenue distribution systems.

Clearly, alternative allocation formulas could be developed. Sales tax growth could be allocated, for example, according to poverty rates, or other measures of need. An allocation formula that took account of a local entity’s performance on a specified criteria, such as how well the entity had done in building low income housing, could also be developed.

Analysis of the Proposals

Each revenue sharing proposal would benefit a slightly different group of local entities. Swapping some of the growth in sales tax for additional property taxes would be of most benefit to those entities that have relatively fast growing property tax bases. Sharing sales tax growth on a per capita basis would benefit those entities that currently receive relatively small amounts of sales taxes per capita. And sharing sales tax growth according to average income would be of most benefit to those entities with relatively low average per capita incomes.

In order to evaluate the specific effects of each of the restructuring proposals, CICG developed a series of simulation models designed to illustrate the impact of the proposals on each local jurisdiction in the state. The models were designed to be highly flexible, so that policy makers can easily see the effects of a different set of assumptions or a modification to the specific proposals evaluated. For example, the simulation models are capable of demonstrating the effects of swapping a varying amount of the growth in sales taxes, from zero to 100%. In addition, local governments can be grouped into regions according to any definition of a region selected by the user. To illustrate the specific effects of these proposals, we chose sample values for the models’ adjustable parameters, including regional definitions and amount of sales tax revenue that is shared.

For purposes of this report, we evaluated the effects of sharing 50% of the sales tax growth and divided the state into regions based on the current definitions used by the state’s councils of governments.⁴ The effects of each proposal were then simulated for an actual three year historical period, from 1995 through 1998 (the most recent year for which revenue data are available). By using an actual historical period we are able to compare the impact of the revenue sharing or restructuring proposals with what in fact occurred in each jurisdiction. In addition, while our results apply statewide, we selected one area – the six county Sacramento region – to demonstrate the effects of each proposal in more detail.⁵ The Sacramento region, consists of the counties of Sacramento, Placer,

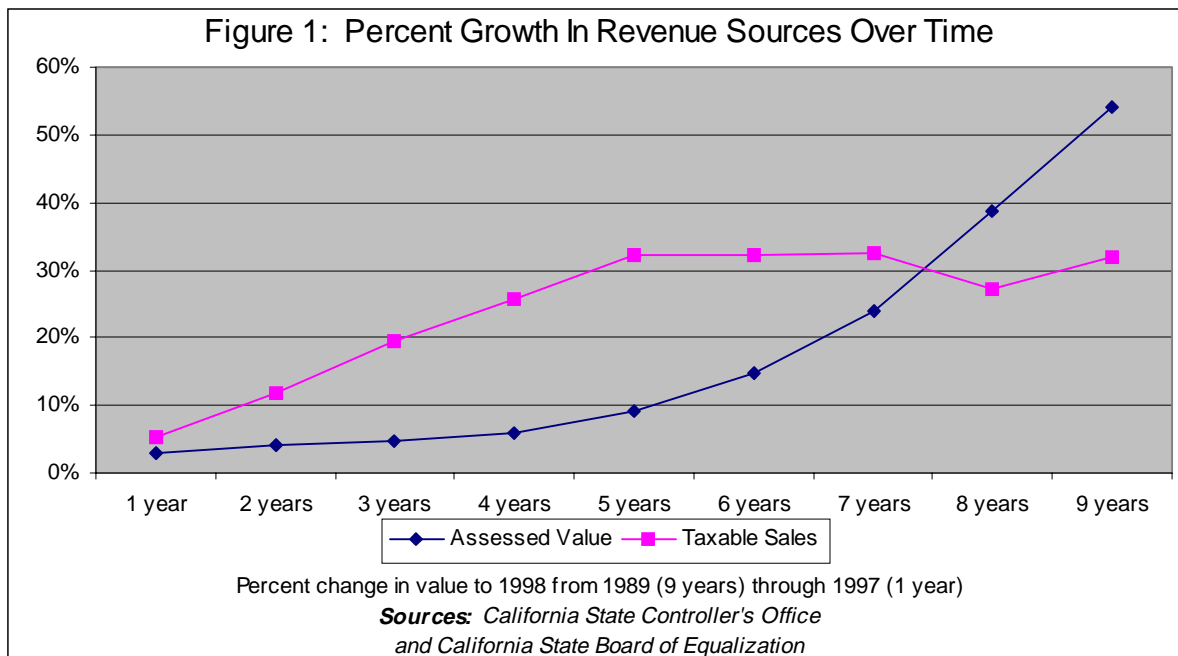
El Dorado, Yolo, Sutter, and Yuba, and the twenty cities within those counties (Citrus Heights was excluded because it was not an entity during the entire study period).⁶ The relevant data was collected on a fiscal year basis.⁷

Model 1: Sales Tax for Property Tax Swap

This first proposal would swap half of the growth in sales taxes in each jurisdiction for an equal amount of property tax. Under the proposal, the state’s share of the sales tax is increased and the school or Educational Revenue Augmentation Fund (ERAF) share of the property tax decreased, with the additional

property taxes going to cities and counties. (The lost school property taxes would be made up with additional state general fund revenues, so there would be no impact on school revenues.) The reduced sales tax and increased property tax bases would each grow at the respective underlying growth rates.

This model is not “revenue neutral” from the perspective of the region. To the extent that sales taxes grow more rapidly than property taxes, the state would benefit while the local entities in the region would be hurt. When property tax growth exceeds sales tax growth, local entities would receive additional revenues while the state would need to make up the shortfall.



Historically, growth in property tax revenues has outstripped growth in sales taxes. Figure 1 shows the growth in taxable sales and assessed values to 1998. As the figure indicates, during the seven years leading to 1998, sales tax growth exceeded property tax growth. Going back further in time, however, it can be seen that the long-term growth in property taxes has substantially exceeded the long term growth in sales taxes.

For the recent three-year period that we analyzed from 1995 through 1998 (corresponding to years 1 through 3 in Figure 1), sales tax growth outpaces property tax growth. While assessed property value, the basis for calculating the property tax, increased statewide by 5%, taxable sales, the basis for calculating sales tax, increased 19%. (Note that, because of periodic changes in tax policy, tax revenue from either source is not solely dependent on the underlying base values, taxable sales or assessed value.)

Because sales tax revenue grew faster than property tax revenue during the period we analyzed, local governments would have lost money to the state under this revenue swapping proposal during this period. For example, the Sacramento region would have lost nearly \$3.5 million to the state between 1995 and 1998. In our statewide model for the three years 1995-1998, only 5 of the 37 regions had net gains; the other 32 regions lost revenue to the state.

This effect is period specific, and relates to the different recovery rates for property values and retail sales after the recession of the early 1990's. Specifically, taxable sales tend to decline faster and farther than assessed values during periods of slow economic growth. Assessed values, meanwhile, tend to be relatively stable during downturns. Were this revenue sharing proposal applied to a different time period, the results would likely show an influx of revenue to local entities from the State. For example, though data are not yet available for modeling purposes, it is likely the case that sales tax revenues have begun to slow significantly, while assessed values continue to climb throughout most areas of the state. Were this proposal applied on a prospective basis, it is likely that most regions would benefit from increased revenues.

Under this proposal local government entities that experience rapid growth in the sales tax base face moderate (in the context of overall revenues) reductions in revenues relative to the current tax regime, while entities with relatively slow growing sales tax bases (as compared with their respective property tax bases) receive modest gains. For example, in the Sacramento region, cities such as Folsom, Lincoln, Loomis, and Wheatland and the counties of Sutter and Yuba, all of which had sales tax revenue

gains of at least 30% during the study period, experience revenue reductions. Meanwhile the cities of Auburn, Marysville, Placerville, Rocklin, South Lake Tahoe, and the counties of El Dorado, Placer, and Sacramento, all of whom had sales tax revenue growth of less than 10%, show revenue increases under the proposal.

While this proposal would serve to improve local fiscal incentives by reducing the reliance on the sales tax and offers the potential for providing fiscal relief to local entities, it does not serve to equalize disparities in the level of per capita sales tax revenues (which some have suggested is an important goal for improving regional cooperation). For example, the per capita sales tax revenue in 1998 in our example region ranged from \$23 per year to \$308 per year, with an average value of \$113. Of the 13 local government entities that received lower revenues under this proposal relative to the current tax regime, only five actually had above average per capita sales tax revenue; meanwhile, half of the entities that had above average per capita sales tax revenues would actually receive an increase in revenues under this model. This effect is caused by applying the model only to the growth in sales tax revenue, rather than to the base (for reasons described above), and by not using population as a factor for allocating revenues in the proposal.

The results of the sales tax for property tax swap for the Sacramento region are shown in Table 1. Base year revenues are actual revenues received by each local entity in that year and are not affected by the model. The unadjusted and adjusted columns refer to the amounts received by each local entity under current law and the restructuring proposal respectively.⁸

Characteristics of Sales Tax for Property Tax Swap:

- Reduces reliance on the sales tax, thereby reducing the incentive to seek out sales tax generating land uses.
- Over long periods of time, the property tax tends to grow faster than the sales tax, so local governments tend to benefit, with the state paying for the cost of the differential growth rates.
- Helps entities with relatively fast growing property tax bases.
- Hurts entities with relatively fast growing sales tax bases.

Table 1: Sales Tax for Property Tax Swap in the Sacramento Region

Individual Entity's Revenues From Sales Tax and Property Tax								
	Base Year 1995	Unadjusted 1996	Adjusted 1996	Unadjusted 1997	Adjusted 1997	Unadjusted 1998	Adjusted 1998	3 Year Gain/ (Loss)
REGION TOTAL	431,855,498	450,283,857	449,978,190	461,448,474	459,093,608	470,192,013	469,421,745	-3,430,801
AUBURN	3,432,392	3,349,620	3,302,282	2,874,540	3,164,666	3,436,532	3,393,426	199,682
COLFAX	493,761	508,237	550,973	519,665	558,792	575,560	587,346	93,649
DAVIS	6,986,665	7,407,147	7,378,918	7,928,190	7,750,018	8,086,729	7,964,379	-328,751
EL DORADO CO.	28,608,269	28,959,060	29,345,977	30,361,375	30,684,134	31,648,051	31,785,843	847,468
FOLSOM	10,602,919	10,370,537	9,743,293	11,792,652	10,859,712	14,616,130	13,553,940	-2,622,374
GALT	1,253,482	1,337,838	1,334,369	1,250,188	1,281,980	1,362,844	1,358,517	23,996
ISLETON	138,360	134,801	135,245	162,070	161,764	162,070	161,764	-168
LINCOLN	847,031	837,873	855,982	954,412	943,820	1,054,091	1,023,989	-22,585
LIVE OAK	318,493	333,573	340,025	345,208	342,589	367,210	369,051	5,673
LOOMIS	617,518	627,914	631,515	768,809	697,941	875,519	763,567	-179,219
MARYSVILLE	2,567,610	2,753,131	2,803,188	2,541,271	2,606,135	2,381,854	2,487,178	220,246
PLACER CO.	40,656,249	42,661,478	42,901,050	44,706,786	44,966,973	46,227,637	46,696,952	969,074
PLACERVILLE	2,097,202	2,397,186	2,590,600	2,123,421	2,580,571	2,123,421	2,580,571	1,107,713
ROCKLIN	4,082,743	4,300,724	4,328,606	4,446,088	4,355,368	4,540,767	4,616,615	13,009
ROSEVILLE	18,887,752	20,561,203	21,106,550	22,206,405	22,042,994	24,747,509	24,074,046	-291,528
SACRAMENTO	80,721,726	85,836,159	83,437,145	86,146,829	83,132,296	87,875,300	84,792,921	-8,495,926
SACRAMENTO CO.	169,145,265	175,322,580	176,973,338	176,653,740	177,769,621	173,017,456	177,224,668	6,973,851
SO. LAKE TAHOE	6,138,311	6,295,058	6,230,104	6,693,783	6,773,080	5,928,986	5,928,913	14,270
SUTTER CO.	8,486,335	8,912,064	8,799,229	9,455,180	9,240,258	9,594,479	9,348,022	-574,214
W. SACRAMENTO	11,667,795	12,182,182	11,988,206	12,201,999	12,011,203	12,466,271	12,219,951	-631,093
WHEATLAND	96,799	121,199	112,157	138,335	117,028	137,593	116,698	-51,244
WINTERS	578,493	576,093	570,304	606,138	589,218	611,904	592,907	-41,706
WOODLAND	9,371,220	9,846,596	9,820,563	10,069,837	10,098,689	10,648,206	10,686,240	40,853
YOLO CO.	10,298,248	10,541,506	10,577,127	12,232,537	12,248,593	13,132,234	13,118,378	37,821
YUBA CITY	7,534,411	7,565,233	7,597,363	7,886,210	7,883,914	8,077,395	7,722,088	-325,473
YUBA CO.	6,226,449	6,544,865	6,524,082	6,382,806	6,232,253	6,496,265	6,253,775	-413,826

Model 2: Reallocate Sales Tax Growth on a Per Capita Basis

This proposal would reallocate half of the growth in sales taxes on a per capita basis, with the remaining sales taxes allocated on a situs basis, as in current law.

Because more local government services (revenue demand) are provided to people than to retailers, it may make sense to consider population in the distribution of sales tax revenue rather than just the location of retailers. However, there are special revenue needs for retail heavy areas, such as increased roadway demand, waste removal needs, and police and fire protection.⁹ Thus a balance between population and situs based distribution of sales tax revenue is desirable. Our computer-based model allows users to select any ratio of regional vs. situs based distribution desired; the examples in this written report we selected a 50% split.

As with the other models, reducing the situs based sales tax revenue reduces the incentive for retail sales development, but including population in the model might also increase incentive to encourage housing development.¹⁰

This proposal is “revenue neutral” from a statewide perspective because taxes are simply reallocated among local government entities within a region, thus no region gains or loses money to the state. In our example region, 18 of 26 local government entities receive more revenue under model two versus model one, however this advantage may be reversed during

a period of time when property tax revenues increase faster than sales tax revenues.

There would be some legal hurdles to such a distribution method, however, there are a variety of solutions available to lawmakers to navigate these obstacles. One benefit of the shared sales tax revenue pool is that it creates, for the first time, a regional revenue pool. Under the current model the entire amount of the pool is distributed to local entities, but it would be possible to retain a portion of the pool for use for regional expenditures. Another benefit is that under this proposal all entities in the region would benefit from new sales tax producing businesses, thereby reducing the potential for conflicts among local entities and encouraging a mutual effort towards long-term growth.

This second model’s inclusion of population as a factor in allocating revenues allows it to do a better job of equalizing disparities in the amount of per capita sales taxes that each entity received. However, because only a portion of the growth in sales taxes is allocated according to population, some portion of these disparities would remain, at least for the near term, even under this proposal. For example, in the Sacramento region, of the 14 entities that receive less revenue than they would under current law, 8 had higher than average per capita sales tax revenues; of the 12 entities that received revenues in excess of what they would have received under current law, 9 had lower than average per capita sales tax revenues. Thus this proposal does serve to equalize disparities in per capita sales tax allocations, at least to some extent.

Characteristics of a Population Based Sales Tax Allocation:

- Reduces reliance on the sales tax, thereby reducing the incentive to seek out sale tax generating land uses.
- All entities in the region benefit from new sales tax producing businesses, thereby reducing the potential for conflicts among local entities and encouraging long-term growth.
- Helps entities with relatively low sales tax growth rates or low sales taxes per person.
- Hurts entities with relatively fast growing sales tax bases or relatively high sales tax revenues per person.

Table 2: Reallocate Sales Tax Growth on a Per Capita Basis in the Sacramento Region

Individual Entity's Revenues From Sales Tax								
	Base Year 1995	Unadjusted 1996	Adjusted 1996	Unadjusted 1997	Adjusted 1997	Unadjusted 1998	Adjusted 1998	5 Year Gain/ (Loss)
REGION TOTAL	175,129,232	183,550,760	183,550,760	189,426,427	189,426,427	190,678,613	190,678,613	0
AUBURN	2,085,130	2,072,009	2,105,918	1,517,637	1,849,633	2,176,885	2,245,324	434,344
COLFAX	395,338	389,891	396,078	400,491	404,204	456,075	432,396	-13,779
DAVIS	2,689,919	2,886,529	2,913,381	3,265,524	3,197,550	3,263,993	3,221,588	-83,527
EL DORADO CO.	5,055,201	4,480,093	5,036,590	4,842,631	5,438,636	5,382,814	5,774,783	1,544,471
FOLSOM	3,735,003	4,465,723	4,199,485	5,338,470	4,684,995	6,513,477	5,204,021	-2,229,169
GALT	471,687	507,757	526,505	432,297	521,174	522,147	576,117	161,595
ISLETON	65,646	63,491	66,551	77,232	75,086	77,232	75,385	-933
LINCOLN	446,884	424,943	454,962	514,293	516,620	584,309	552,833	869
LIVE OAK	108,400	105,021	119,310	121,141	137,869	123,066	140,846	48,796
LOOMIS	266,754	267,154	281,345	412,554	365,333	498,995	403,209	-128,817
MARYSVILLE	1,823,590	1,926,342	1,904,583	1,767,563	1,849,586	1,630,459	1,784,037	213,842
PLACER CO.	7,588,809	7,573,392	7,802,274	7,921,617	8,153,511	7,871,930	8,169,425	758,271
PLACERVILLE	2,068,111	2,358,568	2,234,358	2,081,683	2,121,383	2,081,683	2,124,604	-41,588
ROCKLIN	2,134,453	2,221,803	2,242,498	2,408,821	2,388,895	2,308,265	2,358,313	50,817
ROSEVILLE	12,913,310	13,712,426	13,455,699	15,272,792	14,340,410	17,308,849	15,318,735	-3,179,223
SACRAMENTO	39,823,602	44,777,727	43,220,947	45,520,670	44,302,340	46,441,000	44,941,843	-4,274,266
SACRAMENTO CO.	70,216,513	70,849,902	72,161,914	72,025,375	73,691,638	66,944,489	71,404,739	7,438,526
SO. LAKE TAHOE	2,814,533	2,956,747	2,940,695	2,987,203	2,996,842	2,719,867	2,876,842	150,561
SUTTER CO.	1,402,888	1,661,630	1,615,736	1,910,078	1,798,233	1,979,665	1,843,385	-294,019
W. SACRAMENTO	6,489,074	6,947,343	6,790,221	6,955,644	6,850,888	7,150,382	6,955,675	-456,585
WHEATLAND	40,351	61,068	55,343	80,386	66,939	79,695	67,476	-31,391
WINTERS	150,835	158,769	167,103	182,661	188,674	186,991	192,532	19,887
WOODLAND	5,054,520	5,334,905	5,297,776	5,406,065	5,416,083	5,709,855	5,581,392	-155,574
YOLO CO.	1,221,321	1,187,377	1,254,149	1,423,056	1,414,045	1,578,967	1,493,987	-27,218
YUBA CITY	4,845,273	4,842,159	4,924,805	5,073,157	5,105,570	5,442,558	5,300,613	-26,886
YUBA CO.	1,222,087	1,317,991	1,382,537	1,487,386	1,550,290	1,644,965	1,638,511	120,995

Model 3: Reallocate Sales Tax Growth on an “Equity” Basis

This model reallocates half of the growth in sales taxes according to a formula based both on population and on the median income for a local entity, with the other half of the sales taxes allocated on a situs basis. Along with other changes to the current tax regime, with this model wealthier entities would receive less revenue and poorer entities more revenue under the formula.

The argument for the second proposal over the first proposal was that, since revenue use was more closely tied to population than to the number of retail establishments, it made sense to consider population in the distribution of revenue. This proposal takes that argument one step further. Many local government services are targeted to or heavily utilized by lower income people. This proposal uses the formula underlying model two as a foundation, allocating a percent of growth in sales tax revenues according to population. In addition, a portion of the growth in sales tax revenues is allocated based on the median income in each local jurisdiction.

This proposal overcomes what might be perceived as a flaw in the earlier models. All of the models transfer some sales tax revenue to those local government entities that have had slow growth of sales tax revenue – and this includes wealthy residential communities that have restricted all forms of commercial development to preserve a certain quality of life. Such restrictions on commercial development should certainly be allowed, but policy makers may not wish to reward such a choice with additional revenues at the expense of poorer neighboring communities. The population based model is particularly vulnerable on this point. As Lewis and Barbour put it, “switching toward a more population-based system would seem to have the perverse effect of rewarding high-status communities for their ‘not in my backyard’ approach to commercial development.”¹¹ A good example from the Sacramento region of this flaw and its remedy under Proposal 3 is Rocklin, a city with the second highest median income and a low sales tax revenue growth rate as well as low sales tax revenue per capita. Under Proposal 1, Rocklin would receive \$13,009 more than it would have under the current regime. Under Proposal 2, Rocklin would receive an extra \$50,817. But under Proposal 3, Rocklin would receive \$5,294 less than it would have under the current tax distribution method.

Characteristics of an Equity Based Sales Tax Allocation:

- Reduces reliance on the sales tax, thereby reducing the incentive to seek out sales tax generating land uses.
- All entities in the region benefit from new sales tax producing businesses, thereby reducing the potential for conflicts among local entities.
- Helps entities with relatively low median incomes, low sales tax growth rates, or low sales taxes per person.
- Hurts entities with relatively fast growing sales tax bases, sales taxes per person, or high incomes.

Table 3: Reallocate Sales Tax Growth on an "Equity" Basis in the Sacramento Region

Individual Entity's Revenues From Sales Tax								
	Base Year 1995	Unadjusted 1996	Adjusted 1996	Unadjusted 1997	Adjusted 1997	Unadjusted 1998	Adjusted 1998	5 Year Gain/ (Loss)
REGION TOTAL	175,129,232	183,550,760	183,550,760	189,426,427	189,426,427	190,678,613	190,678,613	0
AUBURN	2,085,130	2,072,009	2,134,599	1,517,637	1,897,781	2,176,885	2,298,792	564,641
COLFAX	395,338	389,891	522,672	400,491	621,375	456,075	672,410	570,001
DAVIS	2,689,919	2,886,529	2,911,295	3,265,524	3,188,256	3,263,993	3,210,831	-105,664
EL DORADO CO.	5,055,201	4,480,093	4,936,515	4,842,631	5,258,641	5,382,814	5,571,249	1,060,867
FOLSOM	3,735,003	4,465,723	4,164,452	5,338,470	4,617,955	6,513,477	5,127,758	-2,407,506
GALT	471,687	507,757	557,594	432,297	572,196	522,147	632,142	299,732
ISLETON	65,646	63,491	181,841	77,232	272,940	77,232	294,050	530,875
LINCOLN	446,884	424,943	503,068	514,293	598,116	584,309	643,006	220,645
LIVE OAK	108,400	105,021	451,109	121,141	706,798	123,066	769,686	1,578,365
LOOMIS	266,754	267,154	301,070	412,554	398,680	498,995	440,260	-38,693
MARYSVILLE	1,823,590	1,926,342	2,038,300	1,767,563	2,078,612	1,630,459	2,037,749	830,298
PLACER CO.	7,588,809	7,573,392	7,719,566	7,921,617	8,002,310	7,871,930	8,003,131	358,068
PLACERVILLE	2,068,111	2,358,568	2,350,186	2,081,683	2,319,285	2,081,683	2,343,668	491,206
ROCKLIN	2,134,453	2,221,803	2,232,761	2,408,821	2,367,883	2,308,265	2,332,951	-5,294
ROSEVILLE	12,913,310	13,712,426	13,407,485	15,272,792	14,245,193	17,308,849	15,207,475	-3,433,914
SACRAMENTO	39,823,602	44,777,727	42,827,014	45,520,670	43,590,622	46,441,000	44,137,889	-6,183,872
SACRAMENTO CO.	70,216,513	70,849,902	71,391,554	72,025,375	72,480,501	66,944,489	70,090,756	4,143,044
SO. LAKE TAHOE	2,814,533	2,956,747	3,001,547	2,987,203	3,100,394	2,719,867	2,991,430	429,555
SUTTER CO.	1,402,888	1,661,630	1,648,498	1,910,078	1,850,416	1,979,665	1,901,419	-151,040
W. SACRAMENTO	6,489,074	6,947,343	6,871,578	6,955,644	6,988,032	7,150,382	7,108,631	-85,129
WHEATLAND	40,351	61,068	131,852	80,386	198,154	79,695	212,505	321,362
WINTERS	150,835	158,769	208,911	182,661	259,893	186,991	271,453	211,836
WOODLAND	5,054,520	5,334,905	5,292,898	5,406,065	5,402,810	5,709,855	5,567,340	-187,777
YOLO CO.	1,221,321	1,187,377	1,290,867	1,423,056	1,474,740	1,578,967	1,562,078	138,285
YUBA CITY	4,845,273	4,842,159	4,998,592	5,073,157	5,228,684	5,442,558	5,437,091	306,493
YUBA CO.	1,222,087	1,317,991	1,474,937	1,487,386	1,706,158	1,644,965	1,812,863	543,616

Conclusions and Policy Options

Choosing a Restructuring Proposal

Development of regional financing mechanisms and improved local fiscal incentives will be fundamental to any effort aimed at creating regional responses to important public policy challenges. The three revenue reallocation proposals analyzed here would all serve to improve the fiscal incentives faced by individual local entities throughout the state. Each would reduce the reliance of local governments on sales taxes, and thereby decrease the incentive for approval of development projects aimed at generating sales tax revenues. The sales tax for property tax swap proposal has the added benefit of creating a mechanism for providing local entities with fiscal relief, at least to the extent that property tax revenues grow more rapidly than sales tax revenues. Proposals two and three would encourage local governments to support economic development wherever it occurs within a region by giving all local entities a stake in the sales taxes generated by new development within that region.

Each proposal would have different effects in different regions across the state. For example, regions with relatively fast growing property tax bases may prefer the sales tax for property tax swap proposal. One conclusion of this analysis is, therefore, that no single, statewide reallocation formula is likely to work effectively across the entire state. Instead, each region should consider which formula, if any, best meets the needs and goals of that region. Specific revenue sources and models of distribution could be decided on a region-by-region basis, allowing for solutions more tailored to each region, rather than using one statewide formula. The computer-based models that are the foundation of this report would be useful in selecting appropriate regional models; workshops demonstrating the use of the models could be presented to stakeholders within each region to see if a consensus can be reached on an appropriate regional revenue allocation alternative for each region.

Long-term Benefits of Regional Public Finance Policies

Over the long-term, public policies that encourage better regional decision-making, reduce competition for tax revenues, and provide more equal distribution of tax revenues have the potential to increase economic prosperity and improve quality of life for residents. Because the behavioral responses of specific local entities to a change in revenue allocation are somewhat uncertain and may take several years to manifest themselves, we were not able to model the likely dynamic effects of these three proposals. Nevertheless, these benefits can be anticipated to occur, and should be incorporated into any discussion of whether or how to more effectively reallocate revenues to local governments. Future work to identify the likely long-term economic effects of a specific proposal could aid local policy makers as they evaluate competing proposals.

Potential Pitfalls

In evaluating these revenue reallocation proposals, it is important to consider the potential pitfalls associated with each. All three proposals, if adopted statewide, would have the effect of continuing the reliance of local government entities on the state rather than promoting increased local autonomy. Also, under any of the three proposed reallocation formulas, some local entities would receive more revenue than they would under the current allocation method while other entities would receive less, at least in the short term. Absent a clear demonstration of long-term benefits to the region, those entities that receive less revenue under a particular proposal are likely to vigorously oppose any change.

Furthermore, the “winners” and “losers” from any given proposal may not always be what policy makers intend. For example, while a proposal to reallocate sales taxes on a per capita basis may aid entities where sales tax revenues have been slow to develop in spite of local economic development efforts, such a

proposal may also inadvertently aid entities that have purposefully avoided retail development. Such entities are often wealthier communities that policy makers may not wish to reward with additional resources.

Developing a means of compensating (at least some of the) “losers” and identifying long-term benefits of any proposal will be important if any change is to be successfully adopted.

Creating a New Regional Revenue Source

Though each of the proposals analyzed in this report offers the potential for benefits to California’s regions, each also brings with it potential pitfalls and challenges, notably including the likely political difficulties in attempting to adopt a specific proposal. A policy that created a new revenue source for regional purposes could avoid much of the potential conflict between winners and losers under a reallocation plan. Any new revenues could be allocated according to a pre-determined formula, or allocated by a regional decision-making body such as a COG.

There are a wide range of potential revenue raising options available, although each would require a state law change and/or a vote of the local electorate for implementation. Some options for new revenue sources include the following:

1. Increase the sales tax rate
2. Expand the sales tax to cover services
3. Establish a local income tax
4. Implement a regional development fee
5. Establish a regional tipplers tax
6. Create a regional hotel tax add-on
7. Create a regional tax on rental cars
8. Create a regional real property transfer tax
9. Establish a regional parcel tax

Development of a regional revenue source would provide a source of funding for important regional projects, such as economic development, protection of open space, infrastructure investments, or transit improvements. It is worth noting, however, that these revenue raising options would not change the current set of land use incentives faced by local governments. Future research to identify the most feasible revenue raising options and analyze the likely fiscal and economic impacts of these options would provide another valuable tool to regional policy makers.

Appendix 1: Details of the Sacramento Region

The table below contains details of the current sales tax distributions in the Sacramento region.

Select Characteristics of Sacramento Region Entities

Place	1995 sales and use taxes (\$)	1998 sales and use taxes (\$)	Percent change 1995 to 1998	1995 per capita sales and use taxes (\$)	1998 per capita sales and use taxes (\$)	Percent change 1995 to 1998	Rank median income
AUBURN	2,085,130	2,176,885	4%	187	187	0%	7
COLFAX	395,338	456,075	15%	276	308	11%	23
DAVIS	2,689,919	3,263,993	21%	52	60	15%	13
EL DORADO COUNTY	5,055,201	5,382,814	6%	46	46	2%	6
FOLSOM	3,735,003	6,513,477	74%	94	145	54%	1
GALT	471,687	522,147	11%	32	32	0%	11
ISLETON	65,646	77,232	18%	79	93	18%	20
LINCOLN	446,884	584,309	31%	57	70	23%	12
LIVE OAK	108,400	123,066	14%	21	23	8%	26
LOOMIS	266,754	498,995	87%	45	82	83%	4
MARYSVILLE	1,823,590	1,630,459	-11%	146	134	-8%	24
PLACER COUNTY	7,588,809	7,871,930	4%	83	83	-1%	5
PLACERVILLE	2,068,111	2,081,683	1%	236	233	-1%	22
ROCKLIN	2,134,453	2,308,265	8%	83	78	-5%	2
ROSEVILLE	12,913,310	17,308,849	34%	229	257	13%	3
SACRAMENTO	39,823,602	46,441,000	17%	104	115	11%	15
SACRAMENTO COUNTY	70,216,513	66,944,489	-5%	104	111	6%	8
SOUTH LAKE TAHOE	2,814,533	2,719,867	-3%	122	118	-3%	18
SUTTER COUNTY	1,402,888	1,979,665	41%	41	55	34%	16
WEST SACRAMENTO	6,489,074	7,150,382	10%	217	237	9%	21
WHEATLAND	40,351	79,695	98%	21	41	98%	17
WINTERS	150,835	186,991	24%	30	36	18%	10
WOODLAND	5,054,520	5,709,855	13%	120	128	7%	9
YOLO COUNTY	1,221,321	1,578,967	29%	59	75	27%	14
YUBA CITY	4,845,273	5,442,558	12%	145	156	8%	19
YUBA COUNTY	1,222,087	1,644,965	35%	26	35	38%	25

Appendix 2:

The equations that define each of the models examined follow, where A = sales tax revenue, B = shift percent, C = population, D = percent of shift based on income, E = 1989 median income, F = the adjustment factor, G = property tax revenue, i = local entities, and t = years:

Model 1:

$$A_{it+1} = A_{it} + B(A_{it+1} - A_{it})$$

$$G_{it+1} = (G_{it} + (1-B)(A_{it+1} - A_{it})) \left(\frac{G_{it+1} - G_{it}}{G_{it}} + 1 \right)$$

Model 2:

$$A_{it+1} = A_{it} + B(A_{it+1} - A_{it}) + (1-B)(A_{t+1} - A_t)(C_{it} / C_t)$$

Model 3:

$$A_{it+1} = A_{it} + B(A_{it+1} - A_{it}) + (1-B)(A_{t+1} - A_t)D(C_{it} / C_t) + (1-B)(A_{t+1} - A_t)(1-D) \left(\frac{1/E_i^F}{\sum \frac{1}{E_{i...n}^F}} \right)$$

Endnotes

¹ Silva, J. Fred , “Local Finance Reform From a Regional Perspective,” p. 2.

² Barbour, Elisa and Teitz, Michael, “ A Framework for Collaborative Regional Decision-Making.” Prepared for the Speaker’s Commission on Regionalism, May 2001.

³ See J. Fred Silva “Local Finance Reform from a Regional Perspective,” 2001, for further discussion of the various revenue restructuring proposals evaluated by the Commission.

⁴ Any set of regional definitions can be accommodated by the model. The definitions selected were chosen in consultation with the SCOR.

⁵ Results from any region in the state can be produced and evaluated from the model developed.

⁶ See Appendix 1 for more information about the Sacramento region.

⁷ Throughout this report we refer to each fiscal year by its end year, thus 1998 refers to the fiscal year July 1997 through June 1998.

⁸ These same column definitions apply to Tables 2 and 3.

⁹ See Lewis and Barbour, “California Cities and the Local Sales Tax,” Public Policy Inst. of Cal.: 1999, pp. 113-115.

¹⁰ Ibid.

¹¹ Ibid.

About CICG

The California Institute for County Government is an independent research organization dedicated to improving county government in California through research and analysis. CICG is a joint program of the California State Association of Counties, the California State University system, and California State University, Sacramento. CICG conducts empirical research projects in a broad range of public policy areas relevant to county government in California. The institute also maintains a database of local government financial, economic, and demographic statistics, which provides researchers, county officials, and state-level policy makers with access to accurate, reliable data for use in research, public policy analysis, and decision making.

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