UCD Department of Agricultural Economics

WORKING PAPER SERIES

#1497

University of California, Davis
Department of Agricultural Economics

SMALL CITY RESPONSE TO LEGAL ISSUES RELATED TO PROPOSITION 13

by

Refugio I. Rochin and Karen Spatz

June 1988

Working Paper No. 88-10

Introduction

California's cities have faced complex and profound changes in their economic bases and in their relations with other governments since Proposition 13, which passed by an overwhelming majority in June 1978. Some have experienced limited growth in public employment, declining business sales, reductions in the real value of revenue and increases in public debt (Rochin, 1985). Others have grown and prospered. Some changes have been especially harsh in small cities where losses are no longer temporary effects of swings in the business cycle or housing sales, but often permanent.

Adding to local burdens are growing legal and jurisdictional constraints in the aftermath of Proposition 13. California city councils and managers have been faced with an increasing set of legal measures, especially those that impose constraints on ways to generate and spend city revenues. Today, the various challenges affecting local fiscal decisions can be divided into two broad groups: those rearranging state/local fiscal relations and those controlling the local tax base. Many of these challenges are the direct result of Proposition 13, while others have been the result of related legislation and court decisions. These issues are not always mutually exclusive nor are they consistent in their effects on local government.

A critical concern is whether or not local government officials of relatively small, remote cities are able to keep abreast of emerging laws and policies related to Proposition 13.[1] A related issue is whether or not these cities can deal adequately with increasingly complex legal matters. In this paper, we examine the results of a survey of remote small city governments designed to determine the extent to which they have been able to respond to fiscal issues such as Proposition 4, "Section 88,"

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[1]See for example the list in "California Municipal Revenue Sources Handbook," League of California Cities, January 1982, and California Senate Office of Research, 1984.

and various court decisions related to Proposition 13. Our main attempt is to see how they deal with the increasing complexity of fiscal issues.

The Survey

In 1986, 63 relatively remote cities spread throughout California were mailed a questionnaire regarding several major laws related to Proposition 13.[2] The questionnaire was addressed to City Managers and/or Mayors whose names and addresses were listed in the 1985 California Roster. The survey covered cities with a 1980 Census population of less than 10,000. In California, there are approximately 160 such cities. Given our interest in relatively remote communities, we eliminated many of the 160 cities since they are located within or near an SMSA. Our assumption was that cities near or within SMSA's would benefit more than remote cities from other city governments, nearby consultants, universities, and newspapers and would be more readily able to respond to changing fiscal issues. Of the 63 that were mailed forms, 33 responded. These are profiled in Table 1. Of the 33, most have a population of 5,000 or less. Most were classified as "rural" by the 1980 Census of Population and were General law cities as provided for by the California constitution. Two of the cities lost population and several experienced rapid population growth since the 1970 Census. The average per capita income of residents ranged from $9,425 to $3,457 in 1980 and the poverty rate ranged from 7 to 26 percent. Overall, this sample is indicative of the variety of small towns found throughout rural California.

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[2]See facsimile of questionnaire in appendix.

Table 1

Small City Profiles

City	Population (1980 Census)	Rate of Population Growth (1970 base)	1980 Income Per Capita	Percent Below Poverty Level	Percent Budget to Wages and Benefits	Percent Subventions to Revenues	General Law or Charter City
1	3,205	8	6,926	10	46	40	general law
2	7,381	34	5,271	14	--	--	general law
3	2,302	34	7,380	9	--	25	general law
4	1,201	8	6,522	15	34	3	general law
5	5,122	17	5,808	11	54	10	general law
6	6,454	22	5,632	16	60	14	general law
7	7,591	81	7,091	8	70	--	general law
8	5,019	13	6,899	12	60	9	general law
9	6,697	30	6,499	13	33	8	Charter
10	8,827	49	5,794	16	15	10	general law
11	11,488	50	5,577	14	80	--	general law
12	3,675	22	7,916	7	45	11	general law
13	4,132	30	5,609	9	16	11	general law
14	3,103	17	5,287	14	6	--	general law
15	10,341	13	6,331	12	40	11	general law
16	9,064	28	7,849	15	50	10	general law
17	3,976	38	6,396	14	75	--	general law
18	8,683	15	6,340	17	44	10	Charter
19	5,364	33	8,674	13	40	10	general law
20	9,490	24	6,431	13	46	12	general law
21	7,344	142	9,425	8	35	--	general law
22	1,276	10	7,091	11	48	40	general law
23	4,898	54	8,482	8	--	--	general law
24	6,520	-3	7,183	12	75	15	general law
25	2,879	-3	6,227	9	45	30	general law
26	1,655	5	6,348	14	45	--	general law
27	4,008	30	6,352	13	70	10	general law
28	4,777	17	7,156	9	--	--	general law
29	5,916	10	7,667	9	52	11	general law
30	6,863	32	4,195	24	70	50	general law
31	5,038	86	3,457	26	44	--	general law
32	1,705	13	7,239	9	39	10	general law
33	1,590	35	4,573	18	65	25	general law

Issues Studied

In the survey, we used a yes/no format to determine the extent to which our respondents were familiar with a particular law or issue. Space was also provided for further details. The survey focused on state and local issues, not federal, and included the Carmen decision, the Farrell decision, "Section 88" and Proposition 4, as summarized in Table 2. These issues by no means exhaust the number of fiscal issues facing local governments but were selected because of their relative importance at the time (see California Tax Foundation, April 1984, Part I: pp. 127-141).

Carmen and Farrell Issues

The two California State Supreme Court decisions, Carmen and Farrell, raised the prospects for increasing the revenue powers of local governments after the limitations imposed by the loosely worded Proposition 13 (1978). In Carmen v. Alvord (1982) the term "any indebtedness approved by voters" prior to June 6, 1978 was interpreted by local governments to cover nonbonded indebtedness such as pension plans, nonbonded payments in water contracts under the State Water Project, and voter approved taxes for paramedics, lease purchases, and libraries (see California Office of Research, pp. 80-81).

When Proposition 13 was passed it was assumed that additional tax rates could be levied only to pay the principal and interest on debt which had been approved by the voters before June 1978. However, several cities assumed that "voter approved retirement systems" would come within the meaning of "interest and redemption charges on any indebtedness approved by the voters..." and levied tax rates in excess of the 1 percent Proposition 13 rate. In addition, the manner in which local officials treated pension system costs when calculating their property tax allocations for the next fiscal year was inconsistent. Some cities received larger shares of property tax

Table 2

Summary View of Major Fiscal Issues in California, 1986

Carmen v. Alvord (1982)	Increased revenue raising powers of cities because it empowered local governments to levy property taxes in excess of the 1 percent rate to pay for interest and redemption charges for "nonbonded" voter approved, prior to June 6, 1978 debt. Nonbonded debt includes pension plans, taxes for paramedics, lease purchases, libraries, and payments for water contracts.
Current Status:	Assembly Bill 13 (AB13, Roos, July 1, 1985) permanently extends Carmen Moratorium (1983) whereby no city or county would be able to levy a "Carmen tax." However, cities and counties levying excess property tax when the Moratorium was enacted can continue to do so, but at a rate no higher than the 1982-83 rate.
City and County of San Francisco v. Farrell (1982)	Increased revenue raising powers of local governments. Cities can impose taxes to be used for general purposes if passed by majority of local governing body. A two-thirds vote of electors not required unless tax is to be used for a special purpose. "Farrell" taxes include utility users, business license, transient occupancy, and admission taxes.
Current Status:	At this time cities can still impose "Farrell" taxes. However, Senate Constitutional Amendment No. 27 (SCA 27), approved by Senate Revenue and Taxation Committee on August 21, 1985, would overturn the Farrell decision.
"Section 88" (Government Code Section 37100.5, 1982)	Increased tax levying authority of General law cities. Extended to General law cities the same tax levying authority possessed by charter cities. Empowered General law cities to levy admissions, parking, and utility users taxes. Whereas they previously had legislative authority to levy only business license, transient occupancy, and property transfer taxes.
Current Status:	Remains the same as when passed.
Proposition 4 (1979)	Limits total annual tax supported appropriations growth rate of state and local governments, effective Fiscal 1980-81, to population change and either the change in Consumer Price Index or the change in Per Capita Personal Income, whichever is "less."
Current Status:	Presently not a problem for most cities, but Proposition 4 is viewed as a future problem for cities with faster commercial or industrial growth than average population and CPI growth. Proposition 71 on June 1988 ballot to permit spending as fast as inflation or the growth of personal income, whichever is "greater."

revenues from the state because of the way they levied property tax rates to finance their pension systems. Other cities paid their pension system costs out of their general funds as with any local program. Still, a third group excluded these revenues from their base shares, but continued to levy a separate tax rate for their pension costs, in excess of the 1 percent limit.

The Carmen v. Alvord decision of 1982 interpreted Proposition 13 as permitting the levy of separate rates for pension plans. However, the range of inconsistent local bookkeeping and the paucity of information regarding the jurisdictions which actually leveled special rates for retirement system costs prompted the Legislature to place a two-year moratorium on the entire issue. All of this pointed additionally to the complex nature of Proposition 13 at the local level, calling for legal interpretations within each city attempting to finance their pension system.

The City and County of San Francisco v. Farrell (1982) decision focused on the phrase "special taxes" in Section 4 of Article XIIIA of the State Government Code. Taxes which are to be placed in the general fund to be utilized for general purposes require a simple majority vote of the governing body of the jurisdiction. However, taxes levied for a special purpose require approval by two-thirds of the electors. Under the Farrell decision, so-called "Farrell" taxes were defined in the "general" category to include: business licenses, utility users, transient occupancy, and admission taxes. Court acceptance of Farrell taxes would expand the revenue power of cities. Their rejection would make revenue measures more difficult to pass voter approval.

Provisions Involving General Law Cities

In addition to the above legal matters, are several other issues germane to Proposition 13. Here we attempted to identify the extent to which the following were dealt with by our sample of cities. Charter law cities have broad local taxing authority, limited only by their charter, various constitutional provisions and the doctrine of statewide interest. Prior to 1982, General law cities had legislative authority to levy only business licenses, transient occupancy, and property transfer taxes. However, the recently passed "Section 88," Government Code Section 37100.5 (1982), authorized General law cities to levy any tax which may be levied by charter cities. General law cities are now empowered to levy admission, parking, and utility users taxes. The Farrell decision combined with the broadened authority given to General law cities under "Section 88" now gives General law cities the opportunity to increase taxes in areas which were considered limited by Proposition 13. Since most of the cities of our study are General law, then knowledge of Section 88 provisions would be critical to future revenue decisions.

Proposition 4

Proposition 4, the Gann initiative of 1979, added Article XIIIB to the State Constitution. Proposition 4 limits a local governments' total annual appropriations effective fiscal 1980-81 to an index based on the total annual appropriations growth rate. It sets a ceiling on fiscal spending despite the changes in a city's population base and revenues. Thus, local government revenues are constrained to spending controls or limits, regardless of need, special circumstances, or thresholds of growth. Under an earlier study by Rochin, Khoii and Schmookler (1984), Proposition 4 was not a constraint faced our sample of cities. But knowledge of Proposition 4 is certainly a possible issue for the growing cities of our sample.

Other Issues

In addition to the above legal matters, are several other issues germane to Proposition 13. Here we attempted to identify the extent to which the following were dealt with by our sample of cities. Prior to Proposition 13, current service (user) charges were often subsidized from property taxes. With a decrease in property taxes, some cities have increased service charges to make programs self-supporting. This source of revenue has been growing faster than total revenues and has become a relatively major source of revenue for some cities. However, the extent to which service charges are raised varies considerably from city to city (see Mercer and Morgan, 1981). Furthermore, it is not well known how this source of revenue is used in small rural cities in general.

State subventions are currently viewed as a critical part of a cities budget. However, state subventions, which are shares of revenue earned from cigarette taxes, sales taxes, gasoline taxes, and motor vehicle license fees, depend upon the state's fiscal well-being, which has also fluctuated since passage of Proposition 13. How critical are these revenues and how unstable, is an issue we attempted to clarify.

On the cost side, local governments are squeezed by rising wages and fringe benefits. How cities control labor costs (including retirement considerations) is important to their fiscal stability. We asked questions about labor cost issues.

Another apparent issue is the fiscal relationship between counties and cities. Annexation tax exchange agreements are now difficult to agree upon due to the relatively "fixed" property tax rate. Counties and cities which share property taxes and costs are in a bind to allocate this increasingly scarce source of revenue.

Within each city, another concern is the ties of support between local government officials and local business representatives. Businesses have financial experience that can help the cities with their decision making. However, businesses tend to follow the principal of voting with their feet. If taxes rise, they leave. If taxes decline, they stay and other businesses move in. The problem with this situation is that taxes furnish public services which make cities attractive to consumers and local business. But, higher relative taxes means that businesses leave. As businesses exit, then their services and opportunities for shoppers also decline. On the other hand, lower local taxes leave lower budgets and fewer public services to maintain the conditions conducive for maintaining an attractive community. Thus, small towns are caught in a type of dilemma or Catch-22 between raising taxes and losing business.

Survey Responses

What was the small city response to these issues? How strongly did their representatives feel about the questions we asked? How much is known about the complexity of fiscal issues and related concerns? In the charts, we summarize the results of our survey. However, not every city responded to every question. In the discussion below, we include the total number of cities responding to the particular question of concern.[3]

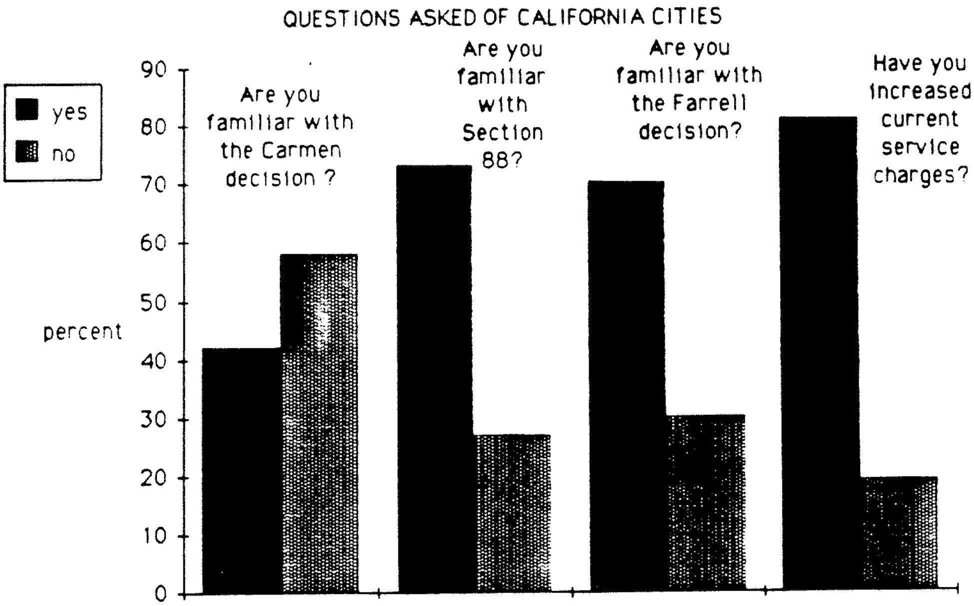
Carmen Decision - 33 responded

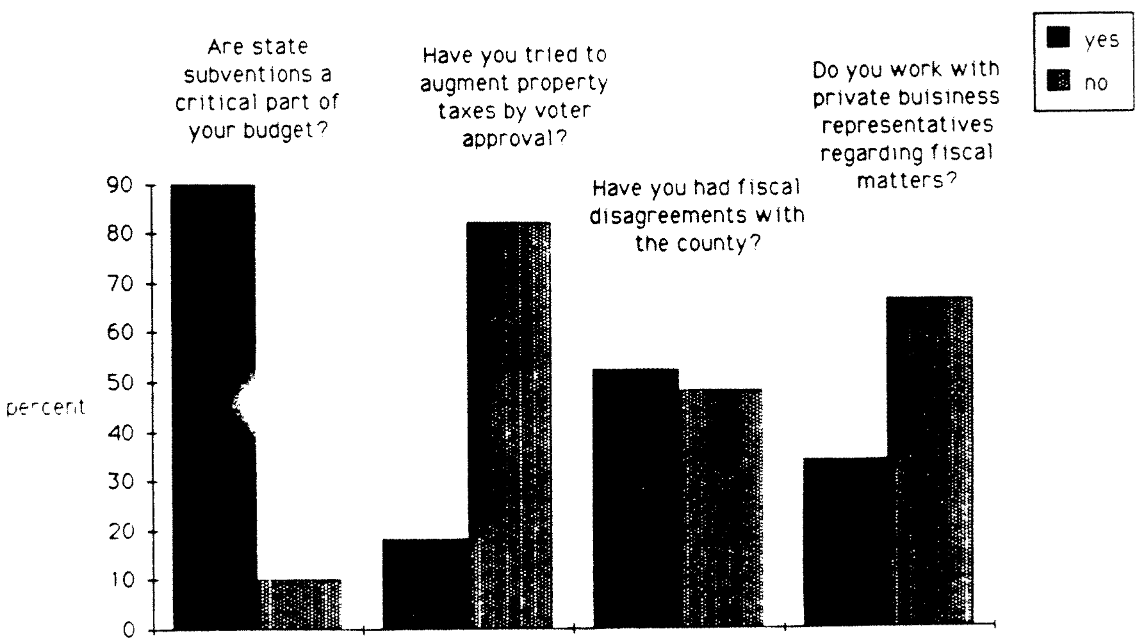
A majority of the cities were not familiar with the Carmen decision. Nineteen cities (58 percent) responded no, whereas 14 cities (42 percent) responded yes. Out of the 14 cities that answered yes only one city considered augmenting property taxes as allowed by the Carmen decision. However, the city had not levied any Carmen related tax.

Farrell Decision - 33 responded

Most cities were familiar with the Farrell decision. Twenty-three (70 percent) responded yes, whereas only 10 (30 percent) responded no. The 10 cities that were

[3]We should note that we promised confidentiality. In doing so, we know which cities returned the questionnaires, but we do not know which city official actually filled out their questionnaire.


QUESTIONS ASKED OF CALIFORNIA CITIES
yes
no
percent
Are you familiar with the Carmen decision ?
Are you familiar with Section 88?
Are you familiar with the Farrell decision?
Have you increased current service charges?
90
80
70
60
50
40
30
20
10
0


yes
no
percent
Are state subventions a critical part of your budget?
Have you tried to augment property taxes by voter approval?
Have you had fiscal disagreements with the county?
Do you work with private buisiness representatives regarding fiscal matters?
90
80
70
60
50
40
30
20
10
0

not familiar with the Farrell decision also were not familiar with the Carmen decision.

Nine of the cities familiar with the Farrell decision considered augmenting taxes as allowed by the Farrell decision but only three actually levied a new tax. One city broadened the applicability of the existing transient occupancy tax to include recreational vehicle parks. Another city levied license tax and the third city levied a public safety impact fee.

"Section 88" - 30 responded

A majority of the cities that responded to this question were familiar with "Section 88." Twenty-two (73 percent) responded yes, whereas only eight (27 percent) responded no. None of the cities have levied utility users taxes as allowed by "Section 88." One city enacted an enabling ordinance but the tax was not implemented at the time of this study.

Proposition 4 - 32 responded

All the cities except one responded no, that Proposition 4 did not pose as a limiting constraint on their appropriateness. The one city that answered yes to this question placed an override measure on their November 1985 ballot to allow spending above the limits set by Proposition 4. The voter's decision was not included in the questionnaire.

Current Service Charges - 32 responded

Twenty-six (81 percent) communities increased their current service charges while six (19 percent) did not. Over one-half (15) of the communities increased sewer service charges. One-half (13) of the cities increased water charges and seven increased planning fees. Other service fees that were increased include refuse, parks and recreation, subdivision, airport hanger and tiedowns, building and facilities, and pool fees.

State Subventions - 29 responded

Twenty-six cities (90 percent) responded yes that state subventions are a critical part of their budget. Only three cities answered no to this question. Twenty-two of the cities that answered yes, also indicated that, on average, 17 percent of their revenues came from state subventions. But there is wide variation among cities for this source of funds, ranging from 8 percent to 50 percent of revenues.

Twenty-five communities listed the subventions they depend upon the most. Twenty-two cities listed motor vehicle in lieu tax and then listed gas tax. Other state subventions that cities depend upon include cigarette tax, sales tax and transit tax.

Property Taxes Augmented by Voter Approval - 33 responded

Only six (18 percent) communities tried to augment property taxes by voter approval. The majority or 27 (82 percent) of the communities did not try to augment property taxes. Four the the cities wanted to increase property taxes to help fund policy and fire equipment and/or buildings. One city wanted to augment taxes for a swimming pool. The sixth city tried to enact a municipal services tax which did not require voter approval. This city wanted the tax approved by the voters to avoid possible repercussion such as recalls. Only one city received the required number of votes to increase property taxes for fire equipment.

Wages and Benefits - 29 responded

What percentage of the total budget goes to wages and benefits each year? The average figure for the 29 respondents was 48 percent, with a range from 6 percent to 80 percent of total budget.

Nineteen cities responded to the strategies taken to keep labor's costs in check. Eight of the cities have reduced staff size and seven have reduced or limited pay raises and benefits. One such example is a city renigging on a 7 percent raise in the last year of a two year package. Other strategies included: (1) streamlining operations; (2) allocating personnel man-hours to specific activities; (3) contracting out for services such as fire protection and building inspection; and (4) reducing fringe benefits.

Fiscal Relations with the County - 33 responded

A little over one-half (52 percent) or 17 cities has fiscal disagreements with the county. Sixteen (48 percent) cities responded no to having disagreements. Annexation tax exchanges were noted as a fiscal disagreement by five cities. The method of distributing property taxes was source of conflict for four cities and two cities had a problem in regards to redevelopment tax implementation. Other issues include sharing the costs of libraries, parks and recreation services, police dispatch, fire services, sewage treatment, and animal control. School impact fees and traffic fines were also matters of dispute.

Working with Private Business Sector - 32 responded

A majority of the cities surveyed do not work closely with private business representatives. Twenty-one (66 percent) answered no and 11 (34 percent) answered yes. Three communities worked with private business in the area of economic development. Private business representatives help in the area of financial auditing and review. Contracting out of service and street lighting are other examples of cities working together with business representatives.

General Assessment

Our overall assessment is that most small city respondents are familiar with important fiscal issues, but relatively few have tried to use a variety of measures available to them. In particular, most were familiar with the Farrell decision and "Section 88." However, the majority were not familiar with the Carmen case. Even though there was a state moratorium (AB 13, Roos) against applying Carmen, at the time, and a measure, Senate Constitutional Amendment No. 27 (SCA 27), authored by Senator John Seymour to overturn the Farrell decision, the cities surveyed did not appear to be familiar with or concerned about the measures. Only three cities out of 33 have tried a "Farrell" tax and none have tried to levy a "Carmen" tax, perhaps depriving them of valuable revenue for their pension systems. Cities would still be able to levy additional taxes as authorized by "Section 88" or by voter approval.

Proposition 4 is currently not a problem for the cities surveyed but might become increasingly important over time. Especially for cities with faster commercial or industrial growth than average population and CPI growth. However, there is a growing use of current service charges which appear to be assessed on both private developers and users of parks and recreation services. Although augmentations in user charges appear to lead to efficient allocations in cities and counties (Mercer, Morgan and Clingman, 1985) such services have not been studied in small cities.

State subventions are a critical part of revenues for the communities in our survey. This is what we expected to find. This revenue source will continue to be an important issue because state subventions can be cut back by the state as they were from 1981-82 to 1985-86. An issue that might be looked at is how cities with subventions which are close to half their revenues made up the revenue shortfall during those years.

Another resource communities do not take advantage of is working cooperatively with private business representatives. It is not evident that city officials seek business help and that private business representatives, in turn are willing to volunteer their services. These issues need to be explored.

Issues facing local governments include not just state issues but also federal issues, which were not highlighted in our study. The termination of Federal revenue sharing in 1986 and the passage of the Gramm-Rudman budget balancing law in December 1985, left federal funding uncertain for most local governments. Cities faced with reductions in these funds certainly had added financial burdens to contend with. This note only serves to add the greater complexity facing small cities for generating revenues.

Perhaps the most critical concern at this time relates to the increasingly complex set of legal measures affecting small cities. Much is happening too quickly. It is apparently difficult to keep up with changing legal issues and to sort out the options for local governments. More effective efforts are needed for communicating alternative courses of action for small cities. Hopefully, the above has served to stimulate thought, research, and action on these policies and issues.

Questionnaire

1. Are you familiar with the 1982 Carmen decision? Yes ____ No ____

2. Have you considered augmenting property taxes as allowed by the Carmen decision? Yes ____ No ____

3. If yes, was Carmen tax levied and when? Yes ____ No ____

4. Are you familiar with the 1982 Farrell decision? Yes ____ No ____

5. Have you considered augmenting taxes as allowed by the Farrell decision? Yes ____ No ____

6. If yes, were there any new taxes levied? When? Yes ____ No ____

   (If General law city, please answer questions 7 and 8)

7. Are you familiar with Government Code Section 37100.5--The "Section 88" provision regarding utility users taxes? Yes ____ No ____

8. If yes, have you used "Section 88" as a General law city? Which utility users taxes have been levied? Yes ____ No ____

9. Has Proposition 4, which defines the initial base for allowable public expenditures, posed a limiting constraint on your expenditures. If yes, please explain. Yes ____ No ____

10. Have you increased current service charges? Yes ____ No ____

11. If yes, what items? Yes ____ No ____

12. Are state subventions a critical part of your budget? Yes ____ No ____

    a. What percent of revenues? ____%

13. Which state subventions do you depend upon the most? Yes ____ No ____

14. Have you ever tried to augment property taxes by voter approval? Explain. Yes ____ No ____

    a. Did you get the required number of votes for approval?

15. Approximately what fraction of your total budget goes to wages and benefits each year? ____% Yes ____ No ____

    a. What have you done to keep labor's cost in check?

16. Have you had any fiscal disagreement with the county? If yes, explain. Yes ____ No ____

17. Do you work with private business representatives regarding fiscal matters? If yes, explain. Yes ____ No ____

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