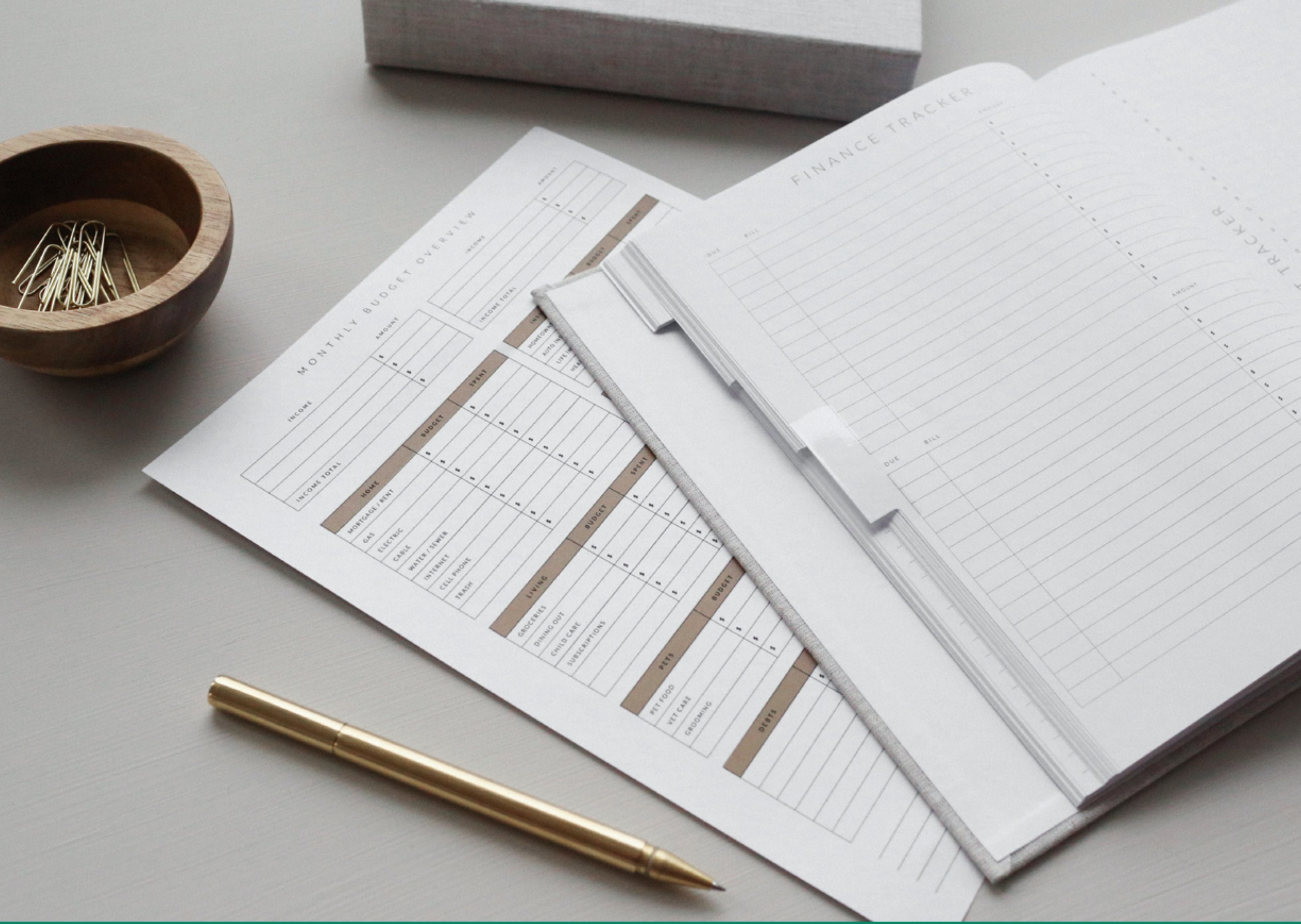

The Planning Commissioner Handbook

Chapter 11

Fiscal Issues

INSTITUTE FOR LOCAL GOVERNMENT℠

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The Fiscal-Planning Link

Land use planning is fundamentally linked to the cost of providing public services and infrastructure. Take, for example, a general plan goal to develop a network of greenways and bike paths. Reaching this goal typically involves adding open space dedication requirements as conditions of approval for tentative map applications or negotiating for such space in development agreements.

While a network of greenways and bike paths is an admirable goal for the land use planner, the financial analyst will ask how will the paths and greenways be managed? Who will pay for construction? How will they be policed? Where will funding for lighting, landscaping, restrooms and other facilities come from? How frequently will the paths need to be maintained?

It is not the job of a planning commissioner to conduct a detailed financial analysis of each project. Staff will often highlight these issues in the staff report. However, the relationship between local fiscal needs and overall land use planning goals is part of the decision-making calculus. If you weigh fiscal goals too heavily, for example, you risk sacrificing other worthwhile goals, like air and water quality, affordable housing and transportation mobility.

Overview of the State-Local Fiscal System

Successful local governance is closely tied to rational local finances and financial management. Unfortunately, since the adoption of Proposition 13 in 1978, California's fiscal system has limited local agencies' control over their finances. Proposition 13 replaced local agencies' authority to raise local property taxes with a countywide one percent rate. Later, Propositions 62 and 218 further limited local authority to impose other taxes and certain types of fees. While these measures have reduced the tax burden on homeowners, they also have made it difficult for local agencies to generate sufficient revenues to cover the cost of services.

Proposition 13 also had an unexpected (at least from the perspective of local agencies) side effect: it put the state in greater control of how local property taxes are distributed among cities, counties, special districts and schools. The result has been that state government has redistributed property taxes to meet its own needs at critical times. For example, when the state faced a severe budget deficit in 1992, it met its legal obligation to fund schools by diverting specified amounts of local property taxes into an "educational revenue augmentation fund" (ERAF) in each county.[1] In other words, the state shifted the property tax distribution to balance its own budget. Although intended as a temporary emergency measure to reduce the state's burden for funding public schools, as of 2021, the tax shift remains in effect.

The problem for local agencies is that housing generally does not generate enough property tax revenue to cover the cost of the services it requires. This is due to the limitation on both the property tax rate and changes in assessed value. Moreover, greater proportions of local budgets are increasingly composed of restricted revenues that are earmarked for specific purposes by the state or local voters. Discretionary revenue—the primary source of funds for police, fire, parks and libraries (among other services)—is harder to come by, making it difficult for local agencies to make adjustments to their budgets as circumstances change.

Currently, about two-thirds of revenues in most jurisdictions are restricted to specific purposes. For example, service charges (like water and garbage charges) pay for a particular service. Similarly, some departments like community development are enterprise organizations and derive most, if not all, of their funding from planning fees collected. Local taxes (property, sales and use, utility user and others) comprise most of the remaining unrestricted "general revenues" that may be used for local priorities or new programs.[2]

The result of these trends is that local agencies often do not receive sufficient revenue to meet service demands. To compensate, some local agencies have adopted development strategies that focus on attracting sales tax generators—like large retail establishments and auto malls—to increase their discretionary revenues.[3] Many observers believe that dependence on sales taxes creates an incentive for local agencies to favor retail development over housing and other land use choices. The argument is that this "fiscalization" of land use decisions forces some agencies to put revenue generation ahead of other community and regional priorities.[4]

As important as sales tax has become, its long-term importance is in doubt. Economists predict a gradual loss of sales tax revenue resulting from the transition of consumption patterns from goods to services and growth in untaxed catalog and internet sales.[5]

1 Proposition 98, adopted by the voters in 1988, requires an amount equal to a specified percentage of the state's general fund be transferred to K-12 schools.

2 Paul G. Lewis & J. Fred Silva, Growth Challenges and Local Government Finance: A Primer for the Sacramento Valley, (September 2001) (available at www.ppic.org), at 5; Michael Coleman, A Primer on California City Finance, (November 2002), at 6.

3 Michael Coleman, City Budget Impacts of Land Development: The Roots of Fiscalization, (December 2002) (available at www.californiacityfinance.com).

4 Lewis & Silva, at 8.

5 Donald Bruce & William F. Fox, Sales and Local Tax Revenue Losses from E-Commerce: Updated Estimates, (September 2001) (see www.statestudies.org); Paul G. Lewis and Elisa Barbour, California Cities and the Local Sales Tax, (July 1999), at 21 (available online at www.ppic.org/content/pubs/R_799PLR.pdf).

Propositions That Limit Local Fiscal Options

Since the late 1970s, a series of statewide initiatives have steadily eroded local control over tax and fee revenue, including:

- **Proposition 13.** Proposition 13 limits the maximum amount of any tax that is based on the value of real property. It also requires two-thirds voter approval for special taxes.[6]
- **Proposition 62.** Proposition 62 requires majority voter approval for general taxes.[7] It also prohibits local transaction taxes or sales taxes on the sale of real property within a city, county or district.[8] Local agencies may collect property transfer taxes.
- **Proposition 218.** Passed in 1996, Proposition 218 moved the majority voter approval requirement for general taxes to the state constitution. It also made other changes in the law relating to taxes and property-related fees and assessments.[9]

6 See Cal. Const. art. XIIIA, §§ 1(a) and 4.

7 See Cal. Gov't Code §§ 53720 and following.

8 See Cal. Gov't Code § 53725.

9 See Cal. Const. arts. XIIIC and XIIIB.

State-Controlled Revenues

A large portion of most local agency budgets is derived from four taxes that are collected at the state or county level and distributed to local agencies according to state-legislated formulas:

- **Property Tax.** The property tax is an ad valorem (value-based) tax imposed on real (and tangible personal) property. The tax is capped at 1 percent of the property's assessed value during the 1975-76 baseline year and may not be raised by more than 2 percent per year. Property can be reassessed when it is sold or when improvements are made. The revenues are collected by counties and allocated among cities, counties, school districts and special districts. The tax is allocated based upon the taxing agency's tax rate prior to the adoption of Proposition 13. Redevelopment agencies receive a large part of the incremental growth in the property tax within redevelopment areas.[10]

  State law that governs the annexation of property requires an agreement between a city and county regarding the disposition of property taxes generated by the affected properties. Although this agreement may be reached on a project-by-project basis, in many instances cities and counties enter into "master tax sharing agreements" in order to streamline annexation proceedings.

- **Sales and Use Tax.** The sales tax is imposed on retailers for the privilege of selling tangible personal property in California. The use tax is like the sales tax except that it is imposed on the user of a product purchased out of state and delivered for use in California. Although the basic sales tax rate is 7.25 percent, the tax actually comprises state sales and use tax and a local sales and use tax. The local sales and use tax (most often 1 percent) goes to the "site" of the sale, which is the city or county in which the sale occurs. In some areas, voters have approved an extra quarter or half of one percent for transit purposes, open space or libraries.[11]

- **Motor Vehicle License Fee.** The motor vehicle license fee (VLF—sometimes called the car tax) is the state's personal property tax on vehicles and is dedicated in the state constitution to cities and counties. VLF funds are an important source of general fund revenue, providing 16 percent of general revenues to the average city budget and often as much as 24 percent. The VLF is collected by the state Department of Motor Vehicles and allocated to cities and counties based on population.[12]

- **Gas Tax.** The state imposes an 18-cent per gallon tax on gasoline for research, planning, construction, improvement and maintenance of public streets, highways and mass transit. A portion of this amount is distributed to local agencies based on population and another portion is distributed to counties based on the number of registered vehicles. Smaller amounts are apportioned for specific purposes, like snow removal and bicycle transportation.[13] In addition, counties receive a substantial amount of revenue from federal and state sources related to social services, health care and other services that they provide.

10 Cal. Health & Safety Code § 33607.5.

11 California State Board of Equalization, California City and County Sales and Use Tax Rates, (October 2003) (available at www.boe.ca.gov).

12 Michael Coleman, VLF Facts: A Primer on the Motor Vehicle In-Lieu Tax, the Car Tax Cut and Backfill, (March 2004) (available at www.californiacityfinance.com).

13 Cal. Sts. & High. Code §§ 2106, 2107.

Locally Controlled Taxes

Local agencies may impose additional taxes that are subject to the voter approval requirements included in Proposition 218. Such taxes are classified as either "general" or "special." A "general tax" may be used for any public purpose—the funds are fully discretionary and may be deposited into the general fund. A majority vote of the electorate is required to impose, increase or extend a general tax.

On the other hand, a "special tax" is a tax imposed for a specific purpose. For example, many county transportation authorities impose an additional half of one percent to the local sales tax rate that is specifically designated for transportation projects. A two-thirds majority of voters is required to add, increase or extend a tax for a specific purpose. There are a variety of commonly imposed local taxes, including:

- **Parcel Tax.** A special non-ad valorem (non-value based) tax on parcels of property generally based on either a flat per-parcel rate or a variable rate depending on the size, use or number of units on the parcel. This is also known as a supplemental assessment. Parcel taxes require two-thirds voter approval and are imposed for any number of purposes, including funding police and fire services, neighborhood improvement and revitalization and open space protection.[14]

- **Sales Tax.** Additional transaction and use taxes may be imposed by a city or countywide special district with voter approval (majority for general purposes, two-thirds for specific purposes) up to a maximum set by state law. These measures typically add a certain amount—like a cent or a fraction of a cent—to the sales tax rate. They may be imposed as a general tax, but are often imposed for a specific purpose—like to fund transportation, health care, education or open space programs.[15] There is a special sales tax for public safety that is distributed to cities through the county.[16]

- **Business License Tax.** A fee charged on the issuance of a business license, usually levied as a general tax. The amount of the tax is often based on the number of employees or gross sales.

- **Transient Occupancy Tax (TOT).** A tax charged on the rental of a room for less than 30 days in a hotel, inn or other lodging facility. Rates range from four to fifteen percent of the cost of the lodging. In nearly all cases, these are adopted as general taxes. Some agencies, however, make a point of budgeting the funds for tourism or business development-related programs. In those jurisdictions with a TOT, it provides seven percent of general revenues on average and often as much as 17 percent.

- **Utility User Tax (UUT).** A tax levied on the users of various utilities, like telephones, electricity, gas, water or cable television. Utility user rates vary from one to eleven percent. For those jurisdictions that impose the UUT, it provides an average of 15 percent of general revenue and often as much as 22 percent.

- **Document Transfer Tax.** An excise tax on the transfer of interests in real estate. Counties are authorized to tax at a rate of 55 cents per $500 of the property value. Cities may impose the tax at one half of this amount, which is credited to the payment of the county tax.

14 See Cal. Const. art. XIIID, § 3.

15 See for example Cal. Rev. & Tax. Code §§ 7285, 7288.1.

16 See Michael Coleman, Proposition 172 Facts: A Primer on the Public Safety Augmentation Fund, (December 2003) (available at www.californiacityfinance.com).

Locally Raised Fees

A fee is a charge imposed for a service or facility provided directly to an individual or to mitigate the impacts of an activity on the community. Fees fall into four general categories:

- User fees charged for using a service such as garbage collection.
- Development fees charged to mitigate against the impacts of development.
- Regulatory fees charged to support the regulation of specific activities or industries. Examples include fees charged to alcoholic beverage sale licensees to address public nuisances associated with those sales, or landfill assessments to reduce illegal waste disposal.
- Property-related fees.

Fee revenues must be deposited into a specific fund that is dedicated to the purpose for which the fee is imposed. A fee may not exceed the estimated cost (including overhead or administration costs) of providing the service. For example, when a local agency provides water and sewer service, the rate that it may charge must be based on a calculation of the actual costs of providing the service to residents.

Proposition 218 created a special subset of fees called "property-related fees." These are fees that are imposed as an "incident of property ownership." In other words, the mere ownership of property is the basis for imposing the fee. Proposition 218 procedural requirements apply to all property-related fees, making them more difficult to enact. To impose a property-related fee, the agency must first hold a public hearing. At the hearing, a majority of affected owners can stop the fee by filing written protests. If no protest is filed, the agency must still conduct an election unless the fee is imposed for sewer, water or refuse collection services. Otherwise, a majority vote of the property owners of the property subject to the fee, or at the option of the agency, a two-thirds vote of the general electorate, is required to impose the fee.

Local Benefit Assessments

Benefit assessments are charges for public improvements or services that provide a specific benefit to property within a predetermined area. Each parcel or business in the area is charged according to the benefit received from the improvement. California has a number of laws that permit the establishment of benefit assessment districts. Some allow for bond financing; others levy assessments.

A property can only be subject to a benefit assessment if it is specially benefited by the improvements to be financed. Properties that are generally benefited may not be charged. For example, if the purpose of the assessment is to landscape a center median, only those properties likely to benefit by fronting the street with the center median could be included in the assessment district. Claiming that all properties in a community would benefit based upon beautification of the community would merely be evidence of a general benefit.

An engineer's report must be prepared to determine which properties will be specially benefited by improvements. The engineer's report includes a description of the improvements to be financed, cost estimates of the improvements and an assessment diagram mapping the district's boundaries, zones and parcels. The report identifies the method of allocating the annual assessments to each parcel and the proposed maximum annual assessment per parcel to pay administration or registration costs. Different classes of properties pay different assessment amounts, calculated in proportion to the special benefit received.[17]

A new assessment requires the approval of a majority of the property owners who return mailed ballots through an assessment ballot proceeding. Voting is weighed in accordance with the amount of the assessment.[18] Local agencies implementing new assessments in pre-existing neighborhoods have to conduct a great deal of community outreach. Creating assessments in new developments is often easier when the developer of a large tract agrees to create the assessment district before subdividing the property. Once created, the assessment applies to all new lots and homes built or created within the assessment district. A lighting and maintenance district (LMD) is an example of a benefit assessment district.

17 Cal. Const. art. XIIID, § 2.

18 A list of cities that have conducted assessment ballot proceedings is available online at www.cacities.org (search keyword "Proposition 218"). The ballots are weighted according to the dollar value of their proposed assessments (the equivalent of one vote per dollar). Thus, the vote of a landowner whose lot has an assessed value of $50,000 counts twice as much as the vote of a landowner with a $25,000 lot.

Local Debt Financing Tools

Local agencies may issue bonds and other debt instruments to finance improvements and services. Debt financing enables costs to be spread over time and is needed when the cost of a project exceeds revenues available during the acquisition or construction period. Terms of repayment vary but usually do not exceed the life of the project. A variety of debt financing tools are available:

- **Community Facility Taxes.** The Mello-Roos Community Facilities Act[19] authorizes local agencies to impose a special tax to finance public facilities, infrastructure and public services. The tax must be authorized by a two-thirds vote of the registered voters living within the district. If fewer than 12 voters live within the district, approval requires a two-thirds vote of the district's landowners. The difficulty of meeting the two-thirds vote requirement generally limits the availability of Mello-Roos to large undeveloped parcels with less than 12 registered voters.

- **Infrastructure Financing Districts (IFDs).** This mechanism[20] allows cities and counties to finance infrastructure improvements that are consistent with their general plan. Infrastructure financing resembles redevelopment tax increment financing in that an increase in tax revenues beyond a base level goes to the IFD, which itself requires a fairly complex procedure for establishment, including approval by two-thirds of the district electorate. An IFD differs from a redevelopment district in that any competing agencies that receive tax funds must agree to the passing over of the tax increment to the IFD and the IFD does not have the power of eminent domain. There is also no blight requirement to establish an IFD. Once established, an IFD can issue bonds backed by the tax increment revenue.

- **Enhanced Infrastructure Financing Districts (EIFDs).** EIFDs are established by a city or county to define an area in which improvement or rehabilitation of community infrastructure is a priority. EIFD activities are primarily funded through a property tax increment within the EIFD area. EIFDs must receive consent from other taxing entities including applicable cities, counties or special districts. EIFD creation is also subject to public review. In addition to tax increment funding EIFDs are able to use revenues dedicated by a taxing authority to the EIFD or loans from a city, county or special district. With 55% voter approval, the district may also issue bonds.

- **Community Revitalization and Investment Authorities (CRIA).** CRIAs are intended to replace some functions of the dissolved redevelopment authorities, the CRIAs offer municipalities an opportunity to capture additional tax revenues for the revitalization of neighborhoods. The authorities can be formed in two ways. First, a municipality can create an authority and establish an authority board with five members, two of which must be residents or workers in the CRIA plan area. Second, a city, county and special district can create an authority by entering into a joint powers agreement. Again, the board of five members must include two members from the community. CRIAs will have expansive revitalization authority. Their key funding mechanism will be similar to that of redevelopment agencies. CRIAs will be able to receive the tax increment on increased property taxes in a subject area with consent from taxing entities including the city, county and special districts. Twenty-five percent of revenue from the tax increment must be allocated to Low- and Moderate-Income Housing Fund.

- **General Obligation Bonds.** General obligation bonds are essentially IOUs issued by public entities to finance large projects. General obligation bonds are backed by property tax revenue, which is used to repay the bond over a twenty- to thirty-year period. Increasing the property tax to repay the debt requires two-thirds voter approval and may only be done to acquire or improve real property.[21] Since investors perceive property taxes as being less risky than the security

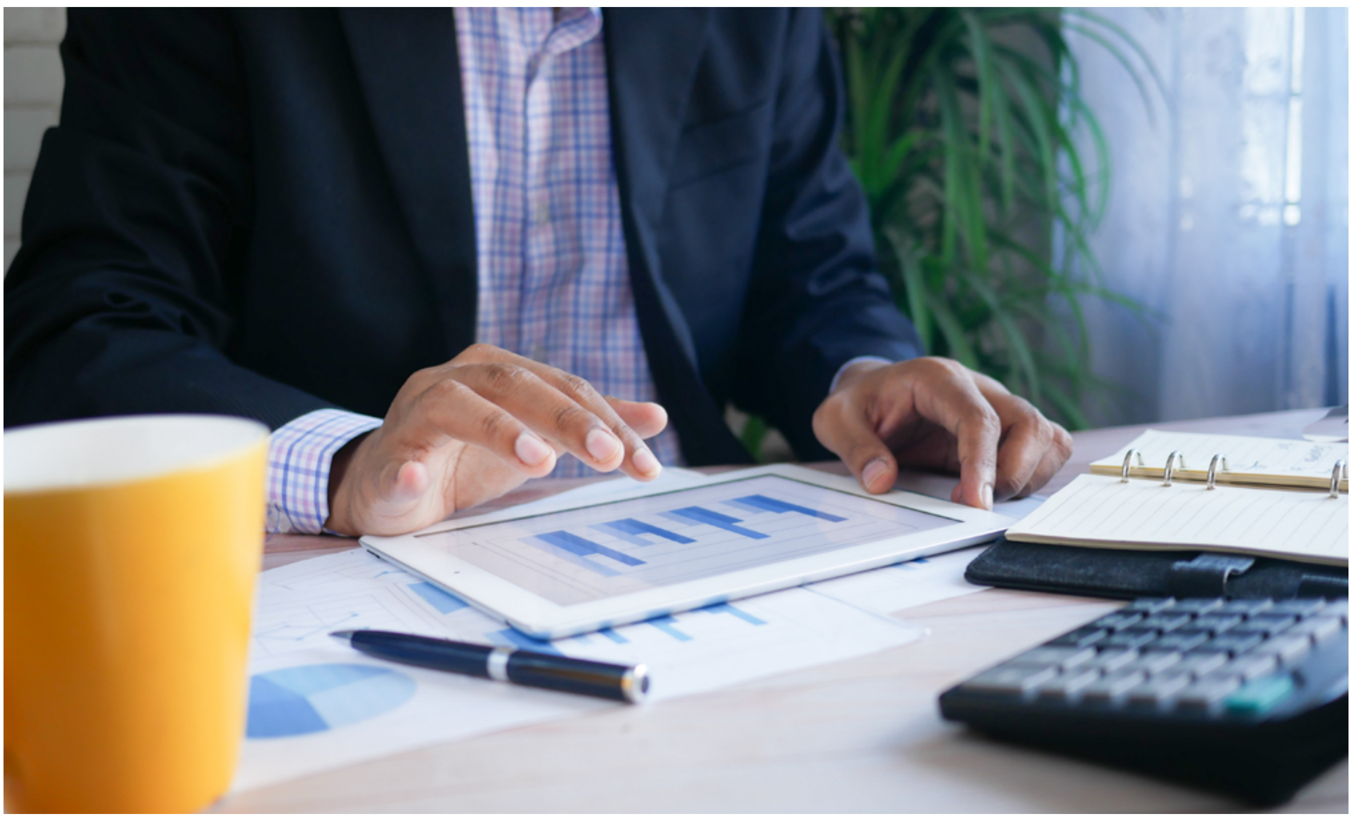
19 Cal. Gov't Code §§ 53311 and following.

20 Cal. Gov't Code §§ 53395-53397.11.

21 Cal. Const. art. XIIIA, § 1(b).

for other types of indebtedness, general obligation bonds may be issued at relatively low interest rates. Bonds provide a means for getting money up front to fund a project. They also distribute the cost over time. On the other hand, interest costs raise the overall amount that the agency will pay.

- **Lease-Purchase Agreements.** Lease-purchase agreements work when local agencies might otherwise be prevented from incurring debt to purchase an asset.[22] Under a lease-purchase agreement, the agency leases the asset for a period of years with the option to purchase the land or improvement at the end of the lease.[23] The amount of the lease is equivalent to the principal and interest that would be paid if the transaction were financed as a loan. Certificates of participation (COPs) are a variation of this tool. These enable a group of investors, or a publicly created financing authority, to acquire an asset and lease it to a public agency. The investors then transfer the right to receive payments to a trustee, who redistributes the lease payments on a proportional basis.



22 See Cal. Const. art. XVI, § 18. Local agencies are constitutionally prohibited from borrowing an amount of money in excess of the amount that can be repaid in a year's time. Lease purchase, certificates of participation and other special funding mechanisms are exceptions to this rule.

23 See City of Los Angeles v. Offner, 19 Cal. 2d 483 (1942); Dean v. Kuchel, 35 Cal. 2d 444 (1950).

Accounting and Types of Funds

Most local agencies have developed detailed accounting procedures in order to assure that funds are spent according to their intended purpose. Where the money comes from often determines how it may be spent. For example, a local agency cannot use funds raised to provide affordable housing to build a library. To keep these different sources of funds straight, local agencies typically use accounting methods that designate different funds. There are five general classifications:

- **General Funds.** Funds that are not required to be accounted for in any other fund. The funds are fully discretionary, meaning the governing body can spend them as it sees fit.
- **Enterprise Funds.** Funds from self-supporting activities that provide services on a user-charge basis. Examples include water, wastewater treatment, garbage collection, parking, golf courses and marinas.
- **Special Revenue Funds.** Funds designated for specific sources or that have specific limitations on use according to law. Examples include affordable housing mitigation fees and special purpose parcel taxes.
- **Internal Service Funds.** Funds used to account for services—like accounting or vehicle maintenance— that are provided internally from department to department. The use of such funds is a budgeting tool to help track and balance costs across various budget categories.
- **Reserve Funds.** General or special purpose funds that are set aside for future use or harder economic times.

Keeping track of where local agency revenues come from and how they can be used is helpful to understanding the overall fiscal picture of the community. Over time, discretionary revenue as a percentage of the entire budget for California cities and counties has decreased. This sometimes creates a situation where there may be surplus funds in one account at the same time that another fund is in serious deficit. However, if the funds in the account with the surplus are dedicated, they may not be transferred to cover the shortfall.

Fiscal Implications

The long-term fiscal consequences are often part of the consideration when deciding to approve large projects. New development brings in new residents, employees, and uses that will demand local services, such as law enforcement, fire protection, parks, libraries, sewer and water service. Anticipating and evaluating the associated fiscal impacts of new development helps local agencies ensure that they do not extend infrastructure in a way that becomes too much of an economic burden for their community to bear. In addition, such analysis helps formulate new funding strategies for facilities and infrastructure and revitalization.

A fiscal impact analysis can also be used to compare the fiscal costs of alternative approaches to a development. If a project is not fiscally sustainable but meets community planning goals, the analysis may suggest the need for additional revenues—like development fees or special benefit assessments—to cover costs related to the development, such as for water service, transportation and public safety.

A typical fiscal impact analysis includes a number of assumptions about how your community will grow, how property values will change and how much tax revenue will be generated by the development. It also requires an estimate of a baseline scenario or an assumed future without the development to allow for a comparison of fiscal conditions with and without development.

Here is a simplified version of how the numbers in a fiscal impact analysis are derived:

- **The Increased Demand for Services is Quantified.** The changes that will be caused by the proposal are quantified by measurable units, like jobs created, housing units built or square footage of retail.
- **The General Cost of Services is Estimated.** The type and amount of services is identified. An estimate of the cost of providing this amount of service is made. Estimating the cost, however, is often difficult given the "lumpy" nature of services—like sewer—that may have little or no incremental cost until capacity is reached. To provide another example, the police may have sufficient capacity to handle one development, but may be forced to hire additional staff if the same development were proposed again. Staff will often make estimates to take these difficulties into account.
- **The Cost of Serving the New Development is Calculated.** This can be expressed as either a per unit cost or a total cost for the development.
- **New Revenues Generated by the Project are Estimated.** The likely per unit revenues to be derived from the project, like property taxes, development fees, license fees and other revenues is calculated.
- **Projected Costs and Revenues are Compared.** The estimated revenues and costs and determine net fiscal impact is compared. A positive number suggests that the projected revenues are sufficient to cover costs.

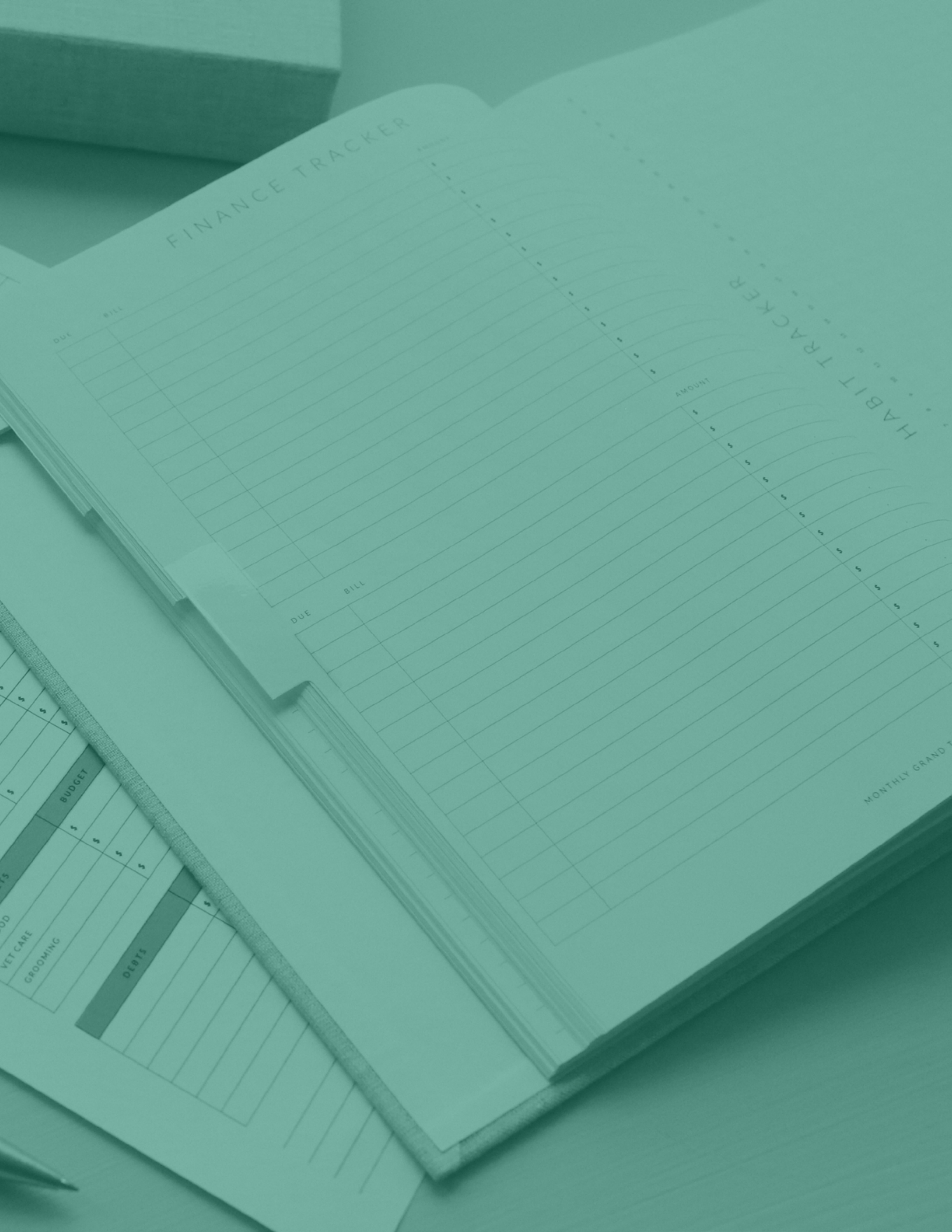
It is worth repeating that a fiscal impact analysis provides a rough estimate at best. As noted above, the analysis is built on a number of assumptions. Another major limitation is that the analysis does not capture the interactions among land uses. For example, a retail development may show a net positive in terms of comparing probable revenues with the cost of services for that property, but it may also unexpectedly reduce sales tax revenues from neighboring businesses. A further weakness is that the analysis only considers the impacts for the deciding agency. The development may have impacts on neighboring jurisdictions that are not included. Finally, the analysis often does not account for cumulative impacts. For example, where a single development may only have a slight negative effect on a particular service, a series of similar developments may change the nature of the community and significantly impact revenues or expenditures.

Accordingly, a fiscal impact analysis is just a planning tool. It helps project the budgetary consequences and responsibilities of developing the community. As a planning commissioner, you should use the tool with the proverbial grain of salt and remember to balance the fiscal analysis with other community goals, like affordable housing and environmental protection. In the long run, a community needs a balance of uses— housing, retail, commercial, educational, parks and open space—to be healthy, and seeking only revenue-maximizing projects will not help achieve this balance.

Thinking Fiscally

The following questions are designed to help you determine what the fiscal impact of a project may be:

- Will service quality — like police or fire response time — be affected?
- Will new sources of revenue need to be identified to sustain the project?
- Are the costs that are being generated one-time costs or will they be ongoing?
- Do regulatory fees cover the ongoing costs?
- To what extent will development affect the budgets of other local agencies — like schools or special districts?
- Does the intended use of the new development (like number of workers or residents per household) match the underlying numbers used in the model?
- For businesses, will new employees be relocating to the community or commuting?
- Will new services be necessary?
- Will additional staff be required?
- Do the estimates reflect a typical year or do they need to be adjusted?
- Is there sufficient capacity to serve the development? What about the next development?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