Finance and Budget Commission Comments on City Tax Options for 2018
January 5, 2017

Introduction

A 2016-18 goal~~s~~ adopted by the City Council (Goal 1, Objective 1A) included a decision to "queue up a parks maintenance tax discussion with enough time to consider all options prior to the expiration of the tax in June of 2018." Accordingly, in alignment with this goal, the Finance and Budget Commission supported a Revenue Subcommittee work plan that including looking at how the current parcel tax is structured and whether changes should be considered.

Attached to these comments please find two position statements adopted by this commission in late 2015 that provided feedback to the council on a proposed utility users tax and outlined some more general guidelines the commission believed should apply to any future tax measures. Consistent with those two position statements, FBC has not at this time endorsed any tax increase measure and recommends that approval of higher taxes in the future be tied to a detailed scoping statement for use of tax proceeds, measurable metrics to define the successful use of funds, and other steps to increase accountability in the use of the new funding.

Accordingly, our purpose here is not to recommend a single preferred approach, but to stimulate a broad and early discussion of some key issues the City Council may wish to consider as it begins the process of shaping the June 2018 tax decisions. The language of the 2016-18 goal adopted by the council clearly suggests that it wishes to explore options beyond a simple renewal of the existing $49 parks maintenance tax in its current form and in its current amount (which voters have renewed four times so far). Our findings are summarized in the box below.

Summary of Findings

Policymakers should explore five key issues:

1. The magnitude of a tax measure. An analytical assessment of the city's overall General Fund condition should be the primary factor used to determine the size of a new tax proposal.
2. What type of tax proposal should be offered. A two-part package for June 2018 with a parcel tax for new money for streets and roads and a sugary beverage tax could help balance the risk of voter rejection of a parcel tax requiring a two-thirds vote against the opportunity to more fully meet the city's critical infrastructure needs.
3. Ensuring any new tax revenues are used as promised. A tax package could be accompanied by council actions providing reasonable assurances to voters that the new revenues would be spent as proposed.
4. Providing greater equity in the distribution of the tax burden. State law allows other forms of property-related special taxes that might be fairer to many taxpayers than the current tax structure. More limited changes are also possible to improve tax fairness.
5. Whether tax rates should be adjusted automatically to grow over time to keep up with growth in infrastructure maintenance costs. Tax rates could be adjusted for inflation.

Analysis

1. *What magnitude of tax solution is needed? An analytical assessment of the city's overall General Fund condition should be the primary factor used to determine the size of a new tax proposal. This memo describes a logical process and some factors to consider in such an analysis.*

It has been apparent for some time to FBC and City Council members that, even with recent improvements in the city's financial condition, the city's current revenue and cost structure may provide insufficient long-term resources to meet all its obligations. The main concern is for the General Fund, which supports a broad array of important services valued by its citizens. We now know that pension contributions for the city will escalate significantly in the next few years, and analyses conducted by city-paid consultants has documented that significant additional resources are also needed to maintain basic parks and buildings infrastructure.

This concern has prompted efforts by the city to find and implement additional efficiency measures and new revenues from non-tax sources, such as from the lease or sale of surplus city assets. It appears highly likely, however, that an increase in taxes will also be needed to fully address these fiscal challenges. But what amount of additional funding will be needed has not been fully analyzed.

The additional tax revenues needed to fix our infrastructure cannot be considered in isolation. Expenditures for infrastructure tend to be deferred in lean times to preserve funding for ongoing services, including police and fire protection. Some voters will also want to be sure that the city truly has a funding shortfall before they will be willing to dig into their own pockets to provide additional revenues to City Hall. To answer such concerns, the analysis proposed here would examine how the General Fund would fare for at least the duration of a proposed tax measure that includes a "sunset" provision. If a permanent tax measure is the preferred approach, such an analysis should assess the condition of the General Fund for at least ten years, in keeping with the city's most recent practices for making long-term budget forecasts.

Technically, the parcel tax measure that is up for renewal in 2018 does not generate money for the General Fund. It goes to a special fund, since it is derived from a special tax. However, these revenues are largely used today to offset the amount of General Fund monies that would otherwise be needed for the support for the Parks and Community Services Department. That means an analysis of the condition of the General Fund in the future is an important factor in assessing what size of a parcel tax measure ~~is~~ *may be* needed in 2018.

The FBC is already working to achieve a greater understanding of the "big picture" for the General Fund in the long term. The council may soon have available for its use the long-term budget projection model that the FBC subcommittee of Commissioners Williams and Miller has been developing in consultation with city staff and our intern Bob Fung. The model, as now contemplated, would allow city policymakers to choose among various revenue and expenditure scenarios, recognize now-unfunded liabilities that are not now recognized in long-term budget projections, and to identify the funding gap that remains.

As this new tool is fine-tuned, the council may wish to consider the following approach for assessing the long-term General Fund condition and estimating the monies needed from a parcel tax to meet our infrastructure needs:

-- *Using a mid-range projection of revenues rather than a worst-case or a best-case scenario.* This could involve, for example, using long-range sales and property tax revenue growth rates more in keeping with the city's historical revenue performance rather than more conservative assumptions. Also, such an analysis will probably require an assumption regarding whether a partial or full renewal of Measure O occurs in 2020, when the sales tax measure would otherwise expire, since this will overlap with the time period a new parcel tax would be in effect.

-- *Developing a more realistic estimate of the growth in city costs over the projection period.* For example, the council may wish to include in its calculations an estimate of the growth in city payroll costs that is consistent with City Council negotiating goals or that reflects the city's actual experiences in growth in city payroll costs in recent years. The most recent city budget projections, which assume no payroll growth over the next decade, almost certainly understate the actual costs the city will experience over time. The long-term estimates for OPEB costs are also likely understated, based on publicly released analyses prepared for CalPERS of the current investment return environment.

-- *Recognizing that the funding gap identified in the model would not be filled with new taxes alone.* The analysis of tax revenue needs could account for the additional revenues the city anticipates it will receive from any hotel projects it has approved and from other economic development projects it foresees. The city could assume some level of ongoing financial help from UC Davis to mitigate the impacts of the new long-range plan the campus is now preparing. The city may also wish to set dollar targets for the achievement of governmental efficiencies as well as from the generation of new non-tax revenues, such as from the leveraging of surplus city assets.

These assumptions, which are consistent with city policies and goals, would collectively reduce the additional revenues needed from higher taxes to more realistic and achievable levels and represent a more balanced approach to dealing with the city's fiscal problems. Once the need for new taxes has been assessed, public opinion surveys may be warranted to determine if Davis citizens would be likely to support the identified amount of revenues. However, it is important that the process start with an analysis of revenue needs, not with what the public is willing to vote for.

2. *What type of tax measure should be placed on this ballot? A two-part package for June 2018 with a parcel tax with new money for roads and bike paths maintenance and a sugary beverage tax for parks maintenance could help balance the risk of voter rejection of new parcel tax requiring two-thirds approval against the opportunity to more fully meet the city's critical infrastructure needs.*

One of the critical issues facing the council is this: Should the existing parcel tax be renewed, should some other type of tax be adopted, or should some combination of new tax measures be adopted to address the city's infrastructure problems?

The council considered, but rejected in 2015 for various reasons, the concept of establishing a utility users tax, which as proposed would have been a general tax subject to majority voter approval. Recent voter approval of a sales tax increase, and the fact that an entire penny of sales tax revenues for the city is at risk unless renewed in 2020, makes further additional city hikes in the sales tax unlikely at this time.

The council has voiced continued interest in renewing and increasing, for one public purpose or another, the existing parcel tax for parks. Such a parcel tax measure would be subject to two-thirds voter approval, which poll data a couple years ago suggested could be challenging to obtain. That poll data also suggested that some proposed uses of tax funding, some as for roads and bike paths and parks, were more likely to generate public support than others. By its nature, a special tax such as a parcel tax provides greater assurance to the public that it would be spent on the specific purposes promised to voters, because the use of those tax proceeds is legally limited to its stated purposes.

Under the state Constitution, a parcel tax, as a property-related tax, cannot be presented to voters as a general tax and therefore must be subject to two-thirds voter approval no matter what ballot it appears on. Other types of tax measures, such as a tax on sugary beverages presented to the council by public health advocates, could be crafted either as a general or a special tax measure, depending upon when they were presented to voters. Any general tax measures would have to go on the June 2018 ballot.

In picking and choosing among such alternatives, the council must consider some difficult trade-offs. Pursuit of some form of a majority-vote tax measure ostensibly makes a ballot measure easier to pass. But that approach simultaneously opens the door to greater voter opposition and criticism because use of the new tax monies is for the general benefit of the city and legally cannot be limited to particular programs and projects.

Another difficult trade-off: a parcel tax measure, though possibly more difficult to pass, would likely generate more new revenue to meet the city's infrastructure needs (a $1.4 million net gain from a doubling of the existing $49 parcel tax to $2.8 million more from a tripling of the tax to about $150). A sugary beverage tax configured as some other cities have adopted at one cent per ounce would likely generate $800,000 to $1 million annually. Moreover, because this is a novel tax that is intended to discourage consumer purchases of sugary beverages, the stability of these revenues is less certain and could decline in future years (similar to the way state revenues from tobacco taxes have historically declined along with the prevalence of smoking).

There is no one magic solution to resolving these dilemmas. Here is one approach, meant to stimulate public discussion, about how to shape a June 2018 tax package *that* could balance these kinds of risks:

Place two separate tax measures before voters in June 2018.

The first ballot measure would be a special tax measure to increase the parcel tax. The first $49 collected per parcel would continue to go for park maintenance and related purposes, much as it does now. However, any additional amounts (another $49 if, say, the total amount of the tax was to be doubled) would be devoted to street and road and bike path maintenance.

This blending of the two types of public works projects appears to be consistent with the provision of state law authorizing the current parcel tax [Government Code Section 53313(d)]. That state law says such tax monies may be used for "maintenance and lighting of parks, parkways, *streets, roads,* and open space." (Emphasis added.) Notably, bike paths may be funded under the existing city parcel tax law. Municipal Code Section 15.14.030 (see the definition of "public improvements") states that monies may be used to install and repair "public lighting, landscaping, parks, public areas, recreational facilities, open space, and *bike trails*." (Emphasis added.) So, no change in city ballot language would be needed to allow funding from the new tax for bike paths.

The second ballot measure would be a general tax measure to institute a tax on sugary beverages at the penny per ounce level modeled in some key respects after similar measure adopted in Berkeley, San Francisco, and Oakland. Revenues from the City of Davis version of the tax would be used to rehabilitate parks and recreation infrastructure, although, as a general tax, such a commitment would not be legally binding.

This approach assumes that various new city programs proposed by previous advocates of the tax would not be funded from this new revenue source, with a focus instead on supporting city parks programs. This approach would be consistent, however, with the policy aim of encouraging youth and adult activities that reduce obesity. As discussed later in this analysis, there are steps the city could take to provide reasonable reassurances to voters that the monies would be spent as intended.

The stakes would be high for any measure to increase parcel tax revenues. A "no" vote on any ballot measure to increase city revenues for infrastructure would not only prevent a tax increase from taking effect – it would also cause the loss of the $1.4 million annually in existing revenue now collected to support parks maintenance from the original $49 parcel tax.

For this reasons, the approach outlined above balances the opportunity to obtain greater resources to deal with the city's infrastructure problems against the risks that voter rejection of a parcel tax increase would leave the city with even less resources than it had before for such purposes. If voters rejected the two-thirds parcel tax measure proposed in this memorandum, the sugary beverage tax measure, which would require only a majority vote for approval and thus be more likely to pass, would provide a sort of fiscal insurance policy that would partly offset the potential loss for parks. Instead of a loss of $1.4 million for parks, new revenues from a sugary beverage tax could limit that to a net loss of a more manageable $400,000. In theory, the sugary beverage tax could be put on the ballot as a special tax also requiring a two-thirds vote, but that would significantly diminish its chances of enactment. Notably, the four North California cities that enacted a sugary beverage tax – Albany, Berkeley, Oakland, and San Francisco – all adopted it as a general tax subject to majority voter approval rather than as a special tax requiring two-thirds approval.

If both proposed City of Davis tax measures won voter approval, the city would maximize its opportunity to fix its streets and roads, bike paths, and parks with the new resources approved by the voters. In that event, the city would have the combined revenues from the parcel and sugary beverage taxes available.

There are ways this proposal could be improved as well as alternative approaches to a tax package that warrant consideration. For example, the city could consider putting two separate parcel taxes on the ballot – one for parks and one for roads – in addition to a measure for a sugary beverage tax (although that approach carries its own significant risks of overwhelming voters with three separate tax measures). Whatever approach they ultimately choose, city policymakers should consider crafting a tax package that balances the opportunities for gaining needed revenue for infrastructure against the risks that voters will reject a parcel tax increase bearing a challenging two-thirds vote requirement.

3. *How could a tax package ensure that any new funding it generates is used in keeping with promises made to voters? The package could be accompanied by council actions providing reasonable assurances to voters that the new revenues would be spent as proposed.*

The two attached FBC resolutions from late 2015 spell out in greater detail several mechanisms that could be used to strengthen the bond of trust between policymakers and the voters over a tax package. (See Page 2, Section 6 of the November 2, 2015 FBC position statement as well as points 1, 5 and 6 of the December 14, 2015 motion.) The options identified by the FBC, in no particular order, include:

-- Adoption of so-called “maintenance of effort” requirements intended to ensure that new resources provided from a tax measure are used to expand maintenance and carry out capital improvements, rather than to allow a redirection of existing resources budgeted for these items to other purposes.

-- Development of a widely published written plan in advance of the election explaining how the proceeds of a new tax measure would be spent.

-- Formal annual review of city government expenditures after the fact to ensure that funding from new taxes is spent in keeping with that written plan.

-- Placement of a "sunset" or time limit on the duration of the tax measure as has been occurring for the park tax for some time.

Policymakers may wish to consider these provisions regardless of whether special or general taxes are placed on the ballot. They could prevent misunderstandings before the election that could endanger the passage of tax measures and avoid problematic disputes after the election regarding how the new resources are to be used.

For example, simply increasing the size of the parks maintenance tax, and continuing the current practice of using these monies to take the place of General Fund support that would otherwise be required for the Parks and Community Services Department, could lead to difficult questions about which city expenditures would be the "real" beneficiaries of the new tax revenue. Displacing more park support costs with new tax monies would effectively leave new uncommitted funds available for any purpose. A detailed expenditure plan, imposition of a maintenance of effort requirement, and other steps outlined here could help avoid such controversies by clearly identifying and verifying the specific infrastructure projects for which new tax proceeds would be used.

Such provisions could be integrated into the language of a ballot measure or in accompanying council resolutions or ordinances that did not appear on the ballot.

4. *Could a tax package be crafted in a way that provides fairer taxation of the Davis community? State law appears to allow other forms of property-related special taxes that might be fairer to many taxpayers than the current parcel tax structure. More limited changes are also possible to improve tax fairness.*

Section 15.14 of the Municipal Code details how the park maintenance tax is apportioned. Under the city law, a tax of $49 is levied on "single-family residences," defined in the measure as containing less than five residential units on a single parcel. Multifamily residential housing, defined as having five or more residential units on a single parcel, pay $49 per unit.

The tax is levied differently on other types of property. Group living homes pay $20 per resident; commercial property owners pay $40 for each 1,000 square feet of building space, up to a cap of 10,000 square feet (or $400); industrial property owners pay $12.80 per employee up to a maximum of 30 employees (or $384); while day care providers pay $14.30 per 1,000 square feet of building space, up to a cap of 10,000 square feet (or $143).

As it crafts a new tax measure, city policymakers may wish to consider two main approaches to reforming the way this tax is imposed in Davis.

<u>First, the distribution of the tax burden using the current parcel-based tax structure could be modified to make it more fair.</u>

As noted above, owners of up to five units of housing on a single parcel of land pay $49 under the current parcel tax structure. Arguably, the current structure of the park maintenance tax places most of its tax burden on owners of one-unit residences (mostly homeowners) while providing tax advantages to property owners operating rentals and “mini-dorms” of less than five units. Students residing at multiple-unit properties might make heavier use of the city park system than a family living in a one-unit home, but that entire four-unit complex would nonetheless be taxed at the same $49 rate paid by such a homeowner family.

The current parcel tax structure similarly provides a tax advantage to larger commercial and industrial property owners to the disadvantage of small business property owners. For example, the property owner of a very large industrial operation, with 150 employees, currently pays the same exact parcel tax as a company with only 30 employees. The cap in tax liability results in considerable savings for employers who have large numbers of employees.

City policymakers could modify or eliminate part or all of the caps on levies for commercial and industrial property owners. They could also revise the provision in the law that allows up to five residential units to be deemed “single-family residential.” This and other proposed tax changes would likely increase the revenues that a parcel tax would generate for the city’s infrastructure needs. Accordingly, city policymakers may wish to examine what fiscal impact such changes may have.

In considering such changes, policymakers should also consider what unintended negative effects such changes may have, including their potential to discourage growth in businesses and rental housing. However, it seems unlikely that the relatively small amounts of additional payments that might result from revisions of the parcel tax would affect the investment decisions made by the owners of such properties, which usually involve much larger financing and taxation factors.

<u>A second approach to reforming the existing parcel tax would be to consider more basic changes to the tax structure of a new ballot measure.</u>

One longstanding concern is that owners of large luxury homes pay the same $49 parcel tax levy as owners of much smaller homes. The park maintenance tax, in this respect, is a regressive tax, given that higher-income families ordinarily are the ones able to afford larger homes.

However, state law does not require that such special property-related taxes be imposed on such a simple per parcel basis. Rather, the Constitution requires that such taxes be imposed in a uniform manner. One additional restriction is that the basis of the levy cannot tied to the value of the parcel. (Proposition 13 of course generally limits such *ad valorem* taxes). But those constraints still leave many other valid alternatives to imposing equal tax amounts for each parcel one owns within a city.

As the California Tax Foundation (CalTax) discussed in a September 2014 report, *Piecing Together California's Parcel Taxes*, other local jurisdictions apportion special taxes relating to property in a variety of ways. The includes basing taxes on the square footage of buildings on a parcel, the square footage of the lot, the linear length of frontage on streets and roads, or even the calculation of more complex "single-family equivalent" units intended to provide a fairer distribution of taxes among residential and non-residential properties.

As the CalTax report notes, some important technical issues pertain to some of these apportionment methods. For example, while data on the square footage of lots is usually accurate, data on the size of building improvements is often less reliable. However, it should be noted, the City of Davis already uses some of these other measures to levy other types of fees and charges. For example, the existing Municipal Service Tax and the Public Safety Tax are levied based on the parcel size and number of dwelling units for residential parcels, and on the parcel size and structure size for commercial customers. This means that the city would likely have the data in hand it would need to shift to a different tax structure for the parks maintenance tax using these types of apportionment factors if it chose to do so.

Nothing would prohibit the city (with voter approval) from setting tax rates under a newly restructured ballot proposal so that they would generate the same amount of money as the existing parks maintenance tax. But the rates could also be set at a level to collect greater revenue to the city for infrastructure projects than the per-parcel tax that is levied now.

The CalTax report suggests that the simpler and uniform an approach a city takes to apportioning taxes, the more likely it would meet state Constitutional requirements governing property-related special taxes. Policymakers should consult with the city attorney on this and related legal issues to ensure any ballot measure would survive any legal challenges.

The overall distributional effects of such a change to the city's tax structure warrants careful study. City data on the distribution of tax revenues generated from other city fees and taxes could be used to model what would happen if the parks maintenance tax were apportioned on a similar basis. For example, the city could review what share of Public Safety Tax revenues come from apartment complexes and commercial properties and compare that with the proportion of revenues being received from those same classes of properties under the existing park maintenance tax structure.

Any change in the tax structure will automatically create some "winners" and "losers," which is why tax reform is often so difficult to enact. Some small homes close to central Davis, for example, may be occupied by residents with higher personal incomes who would not be burdened by paying the same parcel taxes as families living in larger homes on the outskirts of town. The correlation of home size and incomes in Davis should be studied to determine if such an approach to tax reform would be equitable.

Another important factor to consider is how the proceeds of a tax increase would be used. It may make sense to create a new tax structure to reflect changes in who would effectively benefit from the revenues generated by the tax.

For example, the current parks maintenance tax structure probably imposes more of a tax burden on single-family homeowners than on owners of commercial and industrial property. This could be considered fair, in that families living in those homes are probably more likely to use city park facilities than industrial workers. If, however, the tax package *was* revised to use its proceeds to improve streets and roads, a different distribution of the tax burden may be warranted since many local businesses depend as heavily as homeowners on good roads. In that event, shifting to a new tax structure that imposes a greater share of the tax burden on local businesses could be equitable.

5. *How can city policymakers ensure that revenues from a new tax measure grow in keeping in inflation in infrastructure maintenance costs? A tax package could include provisions that automatically adjust tax rates for inflation.*

The current parcel tax rate is a flat amount that remains unchanged over time. A new park maintenance tax could be modified to allow the tax rate to be adjusted each year to be more in keeping with growth in city infrastructure costs. For example, the new tax measure could allow up to 2 percent growth per year in keeping with the rules for *ad valorem* taxes imposed under Proposition 13. Inclusion of an automatic inflation adjustment mechanism – perhaps one that could be suspended by a vote of the City Council in recessionary periods to avoid hardships – would assist the city in keeping up with the growing costs of maintaining its infrastructure.

On the other hand, inclusion of such a provision could also bring objections that, over time, the inflationary adjustments would make the tax more burdensome. These concerns could make a tax increase measure harder to pass.

Summary. There are many other details policymakers may wish to consider as they formulate their approach a 2018 parcel tax measure. For example, the council may wish to consider exactly what duration should apply to any new tax proposal and whether it wishes to consider going to the voters for approval at a time other than June 2018, when the current tax expires.

But in our view the council would do well to focus initially on the key components of any new tax measure that are outlined here, then examine narrower issues at a later point. Resolution of these larger issues will, in many instances, almost automatically determine the outcome of these narrower decisions. For example, if the council wishes to adopt a general tax, it would have to occur in June 2018. For these reasons, we urge the council to consider the approach outlined above.

Attachments