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September 28, 2017

To: Members, Board of Directors, CALAFCO
Pamela Miller, Executive Director, CALAFCO

From: Dan Carrigg, Deputy Executive Director/Legislative Director, League of California Cities

Re: Request for CALAFCO's support for legislative efforts in 2018 Session to restore fiscal incentives (eliminated by the passage of SB 89 of 2011) that previously supported city incorporations and annexation of inhabited territory.

Summary: Since the passage of SB 89 in 2011, a budget trailer bill that swept over $200 million annually in vehicle license fees from cities – including special allocations that supported city incorporations and provided incentives for cities that annexed inhabited territory – new city formation and many potential city annexations are no longer financially viable. Over the last seven years, legislative efforts have focused on providing a fix for four recently incorporated cities in Riverside County, which were severely harmed by the passage of SB 89. A breakthrough occurred in 2017 with the passage of SB 130 that provides a financial fix for the four cities. With the issue of the four cities finally addressed, the policy discussion must resume over how to restore opportunities for new incorporations and incentives for city annexations of inhabited territory. Given the mission of Local Agency Formation Commissions (LAFCOs), CALAFCO should be part of that effort.

Solution: Introduce and support legislation in the 2018 Session that makes available the same financial fix for new incorporations and annexations that the Legislature provided to the four recently incorporated cities via the passage of SB 130.

Policy Benefits Associated With a Solution: Enabling additional city incorporations and restoring fiscal incentives to encourage city annexations of inhabited areas provides benefits to both the affected communities and advances various LAFCO policy goals. In recent years, the state has enacted laws designed to promote compact growth and reduce vehicle miles traveled and greenhouse gas emissions. All these policy objectives are advanced when new cities form or unincorporated inhabited populations are annexed and LAFCO policies guide future city boundary expansion.

- City Incorporations: The urge for cityhood and local self-government springs from the residents of a community as they seek the benefits of local democracy; it is a chance to control their destiny, improve services and quality of life. In the Sacramento area, the City of Rancho Cordova – along with neighboring cities of Citrus Heights and Elk Grove – are outstanding examples of how empowering residents with more control over their destiny can improve a community. City incorporation also advances state policies. The land-use patterns of unincorporated areas often have not been subject LAFCO review. A LAFCO's primary role is to approve boundary changes while reducing sprawl and promoting orderly development, including protecting sensitive open space and farmland. LAFCOs must review the fiscal viability of any proposed city, which then must also be approved by local voters. After a city incorporates, population densities tend to increase and future expansion of the city must be approved by LAFCO. The newly incorporated city also becomes eligible for other state and federal funding resources available for cities.

- City Annexations: Various existing LAFCO policies support and encourage the annexation of inhabited county islands and adjacent disadvantaged unincorporated areas to consolidate and improve local service delivery. Since the passage of SB 89, however, many such annexations simply do not pencil-out for cities to absorb new population and provide associated services.

Fiscal Background:

- History of the VLF and 2004 VLF-Property Tax Swap: Prior to 1998, cities had three major sources of revenue: property tax; sales tax; and vehicle license fee (VLF) revenue. VLF originated as a local property tax levied on vehicles until 1933 when the Legislature standardized collection with a statewide system. The state-collected VLF was divided among cities and counties. The city portion was allocated on a per-capita basis, such that a city that annexed an inhabited area would receive a greater share of the VLF revenue allocated among cities. A city incorporation would also receive an allocation of VLF according to their population from this city pot.[1]

  Then in 1998, during a good-budget year for the state, legislators became enamored with the idea of "cutting the car tax" from 2 percent to 0.65 percent with promises to backfill local agencies for their losses.

  That commitment lasted only briefly. As state budget difficulties returned in the early 2000's legislators questioned the backfill to local agencies and balked at the notion of allowing the triggers to be pulled which would allow VLF to be collected at its previous level of 2 percent. In 2004, this uncertainty was resolved with the VLF-Property Tax Swap that was solidified and constitutionally protected in Proposition 1A of 2004. The VLF-Property Tax Swap allowed all cities and counties in existence on that date to permanently swap dollar-for-dollar the amounts owed to them as VLF backfill for increased shares of local property tax.[2] The League advocated for the VLF-Property Tax Swap to also address future incorporations and annexations, but the fix did not make it into the final package.

  While all cities and counties in existence in 2004 were kept whole by the VLF-Property Tax Swap, the policy issue of how to address future incorporations or inhabited annexations was unresolved: unlike existing cities, there was no VLF or Property Tax in lieu of VLF provided to future incorporations or annexations. By neglecting this, the VLF-Property Tax Swap created a major impediment for future incorporations and inhabited annexations.

- AB 1602 (Laird) of 2006 provided solution for incorporations and annexations: The League worked with Assembly Member John Laird to fashion AB 1602, which addressed the lack of VLF for annexations and incorporations by providing newly incorporated cities and cities that annexed inhabited areas with permanent increased shares of the small pool of remaining city VLF. Four cities in Riverside County – Eastvale, Wildomar, Menifee and Jurupa Valley – all formed with reliance on these revenues. The incentives offered for inhabited annexations also triggered significant activity. Dozens of cities, including Fontana, San Jose, Chico, Temecula, Santa Clarita, San Ramon, Porterville, Visalia, San Bernardino, Tulare, Corcoran, Reedley, and Newport Beach annexed unincorporated areas in reliance on these revenues.

- SB 89 of 2011 sweeps all VLF revenue from recent incorporations and annexations: In 2011, during another state budget crisis, the Legislature passed SB 89 quickly with no public hearings and swept all of the remaining VLF funds as part of a budget solution. In so doing, the AB 1602 VLF-Property Tax swap patch was wiped out causing massive immediate financial losses to the four newly

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[1] County VLF allocations are not affected by city incorporations or annexations.

[2] The additional property tax is shifted from schools. Schools are held harmless with compensating funding from the state general fund.

incorporated cities and dozens of cities that had annexed inhabited areas since 2004. New incorporations and inhabited annexations have been – once again – disincentivized.

- <u>SB 130 of 2017 resolves four–city problem via amendment to the VLF-Property Tax Swap</u>: SB 130 resolves the problem created by SB 89 for the four Riverside County cities by providing those cities with shares of property tax to offset the amount of vehicle license fee revenue they would have received. SB130 essentially sets up these cities with Property Tax in Lieu of VLF just like other cities. While SB 130 does not resolve issues associated with future incorporations and annexations, it provides the legislative template to address these issues in the future.