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Economy & Efficiency Commission Presentation

Editorial Note: Although every effort has been made to insure the accuracy of the material in this presentation, the scope of the material covered and the discussions undertaken lends itself to the possibility of minor transcription misinterpretations.

PRESENTATION BY
The Honorable Robert M. Hertzberg
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Topic: The State and Local Fiscal Mess

April 1, 2004

Chairman Philibosian introduced Mr. Hertzberg and welcomed him to the Commission.

The Scope of the Presentation

Mr. Hertzberg, commenting on the presentation, stated that he desired to discuss the existing dysfunctional relationship between the state and local governments within California, particularly at the county level, in terms of why it is happening and how it can be fixed.

History of California Budget

During its first 63 years as a state (from 1815 to 1913) California did not have a budget; the principal sources of state income were the poll tax and the state property tax. One hundred years ago state government had a similar pattern as seen in Sacramento today - no stable source of dedicated revenue upon which local governments could rely, and thus no ability to make sound funding decisions. During this time all power reverted to Sacramento, which resulted in the creation of a corrupt and dysfunctional system. In 1907 a group of reformers - "The Progressives" - decided to change the system. They implemented reforms such as non-partisan elections for local offices, the referendum, the initiative and the recall. The most important of these reforms was the Separation of Sources Doctrine, which guided the State from 1910 to 1978. This doctrine gave power in the form of the property tax to local governments as a dedicated revenue stream upon which they could rely. As a result the intense growth and development of California over this period came mostly from the local level. Since the dismantling of this law in 1978, California has seen huge dysfunctional responses in local government due to the insecurity brought on by a volatile budget and the lack of a reliable revenue stream. This has led to the fiscal mess facing California today.

The Current Role of Government and the California Budget

Although Los Angeles County has some of the largest legislative districts in the U.S., most people are not aware of its existence or purpose. Since the state controls many of the dollars that go back to local government and/or special districts, local government has developed a significant lobbying effort. It is now

necessary for local government to spend money to receive money from other governments. This results in jurisdictional turf wars and has an irrational impact upon all government. This problem is further exacerbated by term limits. As consumers of governmental services and as taxpayers, this situation should be of concern.

Over the last 25+ years, officials in local government have blamed Sacramento as the source of their problems. But, in reality, the effects of Proposition 13 resulted in the unwinding of the independence of local governments - specifically, by transferring to the State of California the ability to allocate property taxes within regions.

The Roles of Proposition 58 and the Separation of Sources Doctrine in Fixing the Budget

Proposition 58 will fix one of the two main budget issues by stabilizing the revenues of California through the creation of a reserve that is constitutionally protected. This will prevent swings in the budget and calm the political pressure to spend whenever there is an excess of money. The first of two additional items grant the Governor the authority to conduct a mid-year review of the state's cash-flow, and the second prohibits further borrowing by the State.

The other budget issue to be addressed is the dysfunctional relationship between state and local government. This could be corrected by returning to the Separation of Sources Doctrine, which would provide local government with a dedicated revenue stream.

Incentives for Local Governments

One way to unwind the instability of local governments and the demonization of Sacramento is to provide incentives to local jurisdictions. Since 1976, local government has relied on the car tax, the quarter cent sales tax, and, in some jurisdictions, a small portion of the property tax. Thus, incentives are currently in place to build businesses that result in fluctuations in revenues. In other words, the wrong kind of development has been incentivised. The focus should be on the development of communities and local services through local infill, low-income and mixed-use housing. Local government dollars have to be protected in order to avoid the current structural conflict existing among jurisdictions. The 47 sales tax cities in California have formed a lobby to work against a fix, rather than to push for reform.

Property tax is a stable, growing and reliable source of dollars which would incentivise assessed valuation as a type of growth, and would de-incentivise the kind of destructive behavior currently in existence. Two constitutional amendments are pending to implement this approach. This proposed stabilization of revenues will address the structural problem. The movement toward a model of dedicated local revenue streams will incentivise manufacturing, housing and other development that will help to build a community.

The Chart [distributed at the 4/1 Commissioner Meeting] shows how the current mix of dollars can be changed and how to change where the dollars are going without adding more. The proposal is to give to the local governments dedicated dollars.

Commissioner Questions

Commissioner Ikejiri commented on Mr. Hertzberg's recent presentation on "What's wrong with the common good" to the South Bay City Council of Governments. Commissioner Ikejiri mentioned that the Council had held a meeting with Sheriff Baca to discuss the proposed quarter cent tax increase that the City of Gardena has unanimously supported. The Council voted in favor of this resolution because they cannot look to the state or the county for money. In order to have the additional service for law enforcement, the City of Gardena, amongst others, is willing to pay the \$60/year per person tax. Commissioner Ikejiri questioned whether this tax, since it would be permanent, is for the common good, and wanted to know Mr. Hertzberg's thoughts. Mr. Hertzberg responded that he thought it was like a trap toward which, unfortunately, everyone is heading. Mr. Hertzberg has endorsed the Sheriff's proposition, but with trepidation over the dilemma of the common good vs. the momentary fix.

Commissioner Thierer suggested that there appeared to be a significant lack of credibility of the Legislature with the California public with a lack of trust culminating with last year's recall. Commissioner Thierer wanted to know if there was a way to change things in Sacramento to get the public to look at the Legislature critically and with credibility. Mr. Hertzberg replied that historical context has a lot to do with the perceptions of political figures, administrations and institutions. In order to regain the trust of the people of California, the appropriate roles of the state and local government need to be redefined. This could be accomplished by empowering officials to do more, and not to waste their power lobbying in Sacramento. With the nature of today's changing demographics and politics, it makes sense on a bi-partisan basis to devolve. Successful democracy must have a healthy tension among the three branches of government (legislative, executive and judicial) and a counterbalance of certain constitutional rights. When one of the branches has too much power, the system fails. One of the main functions of the Legislature is oversight - to ask questions and to investigate. The Legislature has currently lost its incentive and its way in terms of this role. By limiting its role and incentivising oversight, the Legislature's image will improve.

Commissioner Padilla inquired if there was any way of dedicating a revenue stream by putting into the mix the property tax and/or a percent of the income tax that a community, such as Sierra Madre, already pays. Mr. Hertzberg responded that city officials believed that Proposition 13 would enhance local government, and did not understand that Proposition 13 had this allocation provision which destroyed the Separation of Sources. The biggest problem with this suggestion is equity - it has to be insured, and the State at the end of the day has to balance it out. The goal now is to incentivise the right kind of behavior.

Commissioner Sylva asked about the impact of gaming on state and local government, specifically in terms of whether it should be broadened or decreased. Mr. Hertzberg replied that, in orders of magnitude, he did not think that there was a lot of money involved. Commissioner Sylva noted further that the Governor is currently in revenue negotiations with the Indian gaming tribes. Mr. Hertzberg stated that although there may be an impact in certain jurisdictions, considering the big picture a few billion dollars is just not a big enough number to make a major difference in the budget. The question is whether the deal will head off the initiatives on the budget.

Mr. Hertzberg went on to say that the State of California's budget is \$79 billion this year. Of that, \$15 billion is for state operations, and the rest is redistributed in other forms (i.e. to school districts, counties, other jurisdictions). We need to look ahead 10-20 years toward the immigration experience. Immigrants are driving California, and the future is in the new small businesses they bring - not in asking the big corporations who have left to come back.

Commissioner Sylva asked how the state could continue to attract and help small business, as well as local governments. Mr. Hertzberg replied that getting government off their backs would be helpful.

Commissioner Padilla requested that Mr. Hertzberg talk a little about the Governor, in order to give the Commission a sense of who he is. Mr. Hertzberg commented that he has known Governor Schwarzenegger for many years, both personally and professionally. The Governor approaches problems differently from other politicians by listening to all ideas rather than paying attention to the polls. He is very responsive, and encourages non-partisanship in his approach to problem-solving.

Commissioner Oaks asked about Mr. Hertzberg's reaction to the Governor's statement that tax increases may be inevitable. Mr. Hertzberg responded that the Governor is willing to look at all options, and his statement was perhaps a result of his thinking out loud - it was clearly not a political response. Commissioner Boonshaft added that she believes that the Governor is saying that we need to consider all of the options at this critical time, and that his approach is "out of the box" thinking.

Commissioner Petak inquired as to how much the Governor can accomplish in his remaining time in office. Mr. Hertzberg replied that he believed the Governor was moving forward at a good pace. He further feels that although Governor Schwarzenegger was elected under difficult circumstances, he has done a great deal to calm the dissent. Furthermore, he is already in the process of stabilizing the downward spiraling of the budget with the passing of the Propositions. Also, he is currently working on Workers' Compensation reform and on developing a budget that will inspire confidence, particularly in the markets. The Governor

will have to get a hold of the November ballot, particularly in regard to the gaming initiatives. Mr. Hertzberg said that he believes the Governor's upbeat, can-do attitude is infectious and will continue to inspire a real non-partisan attitude in the administration.

Commissioner Hill was concerned about the lack of affordable housing and the rising rents in Los Angeles, and the effect that this has had on the ability of even successful small business owners to enjoy a high quality of life. She wanted to know if there was a way to resolve this problem to encourage small businesses. Mr. Hertzberg replied that, first of all, the housing demand in Los Angeles is so high because the city is such a success. In other words, people are here because they know they can earn more. The economics are such that the market cannot be beaten back. However, if we do return to an incentive-based model of property taxes, city governments will put other options which currently lack incentives, such as urban and mixed-use housing, on the table.

Mr. Hertzberg went on to state that if people are encouraged to work where they live, and live where they work, Los Angeles can be revitalized. If Los Angeles is to be successful, the dynamic of the car culture has to change. Road emphasis should be on goods movement rather than commuting. The transit of goods through the airports and seaports has a huge impact on every jurisdiction. One way this impact could be lessened would be with dedicated truck lanes. This approach would help to eliminate truck congestion and long waits, thus saving millions of dollars, reducing pollution and resulting in other benefits to a community.

Commissioner Hill inquired as to Mr. Hertzberg's strategies to take this concept and make believers out of the voters. Mr. Hertzberg responded that he had a couple of ideas, but that currently he was a private citizen.

Commissioner Padilla wanted to know how to calm the fear-mongers, as good public policy often gets derailed by such people. Mr. Hertzberg replied that it is a difficult job, because politics are always personal. It is a failure of our democracy that when politics become too large and impersonal, it is easy to employ manipulation by impression management as a strategy. If you know who the fear-mongers are, you can dismiss them and move the agenda. Smaller units of government and of decision-making would alleviate this problem.

Ms. Kathryn Barger, Chief Deputy to Supervisor Antonovich, asked if Mr. Hertzberg was familiar with CSAC and the League of Cities, and wanted to know how his proposal compared to theirs. Mr. Hertzberg replied that CSAC had endorsed his proposal, but that the League had not, deciding rather to try a Legislative solution. Mr. Hertzberg clarified that his proposal favors counties, because counties are such monolithic service providers that are in unison with the State of California.

Commissioner Padilla wanted clarification regarding the redistricting that went on in Texas, and how it related to California's similar yet unrealized attempt. Mr. Hertzberg responded that the White House was concerned that the redistricting attempt would result in California getting many more Democratic seats. The White House was not willing to risk gaining any more Democratic seats; instead, they made a deal to keep the status quo. Texas had an advantage because they felt they could win as a result of their relationship with the President.

Chairman Philibosian thanked Mr. Hertzberg for taking time out his busy schedule to make this presentation to the Commission. He emphasized both his appreciation and the contribution that this information has made to the Commission's understanding of the relationship of state and county government.

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