Evaluation of Certain Funding and Revenue Options

Report from the Orinda Finance Advisory Committee to the Orinda City Council

November 17, 2009

This report outlines for the Orinda City Council seven types of funding sources. Five of these sources are new revenue sources which are all based on new or increased taxes. Two of these sources are not additional sources of revenue. The objective is to assist the Council in planning for the future of Orinda by presenting a balanced assessment of these sources.

The five sources that are new taxation can generally be set up to provide annual revenues or can be securitized. Please see Footnote 1 for more discussion of bonds and securitization.

All new or increased taxes require voter approval. In general, taxes for general purposes only require a majority approval and taxes assigned to a specific purpose require two thirds voter approval. A parcel tax requires 2/3's in either case. One option, the Real Estate Transfer tax, requires that Orinda first or simultaneously become a Charter City. This tax can only be used for general, not specific purposes.

Each section also estimates the effect on revenue and expenses and discusses the major pros and cons of that source.

Options for New Revenue from Taxation

These options are presented in alphabetical order.

1. Assessment Districts:

An assessment district can levy a tax, a new source of revenue. Orinda currently has 5 assessment districts.

An assessment district is not a separate government agency but rather a specifically defined area with property directly benefiting from certain public improvements and within which the special assessments are apportioned and levied according to some benefit formula approved by the legislative body. In our case that body is the City of Orinda. An assessment district is the vehicle for levying and collecting special benefit assessments.

Special benefit assessments ("special assessments") are charges levied to pay for public improvements which are imposed upon land or business within established boundaries according to the benefit received from public improvements. Special assessments are a commonly-used method of paying for the construction, reconstruction, acquisition or maintenance of public improvements. Unless a district is specifically created to levy operating revenue (e.g. a 1972 Landscaping and Lighting District) the proceeds of assessment district assessments cannot be used for operating expenses.

The most important element of an assessment is that it be levied in proportion to the special benefits received from the improvements. There may be an initial period in which each property owner can pay off the assessment in full. Financing is arranged for those who do not wish to pay off the assessment at the beginning, usually in the form of a bond. The bond term and the term of the assessment district are typically identical.

Special assessments are commonly levied for such improvements as streets, lighting and landscaping, drainage and other physical public improvements that directly benefit land. Administrative costs can be charged to the district, within limits, to cover the City's staff costs.

An assessment district is formed through the following steps. (1) A Resolution of Intention is adopted stating that the city intends to form an assessment district and a date for a public hearing is set. (2) Ballots are mailed to each property owner within the District. (3) At the end of the public hearing, the ballots are tabulated. The ballots are weighted according to the proportional financial obligation of each property within the District. If the majority of property owners vote in favor of formation, the District is formed. (4) There may be an initial period during which landowners may pay off the assessment in full. (5) Financing is arranged for those who do not wish to pay off the assessments and the assessment district constructs or acquires the proposed improvements.

An advantage of an assessment district is that it can be formed with a certain majority vote, as described above.

There are two main disadvantages. The first is that the assessment can only be used for the facilities or services of direct specific benefit to specific properties. The second disadvantage is that the process is cumbersome and requires a significant amount of staff work up front to define the district, conduct neighborhood meetings, and convince a majority of the property owners that they will benefit significantly from the improvements proposed. An approach to minimize the initial work required would be to establish a "model" for creating and setting up an assessment district that any interested neighborhoods could use.

After the considerable initial work to set up an assessment district, Orinda Finance staff estimate that annual administration costs for a district are about $2,000 if not bonded and $5,000 or more if bonded. The city contracts for this service. Some administrative costs may be included in the annual assessment. The County includes the assessment district taxes on property tax bills.

2. City Sales and Use Tax

This is a new revenue source through taxation of goods sold in Orinda and a corresponding taxation of Orinda residents' purchases delivered from outside Orinda including vehicles purchased or leased. The sales and use tax rates are identical. The term "district tax" is also used and applies to both sales and use taxes enacted by a city (which is a taxing "district.") District taxes can be used for general or specific purposes.

In California, sales tax is imposed on all sales of tangible personal property, unless specifically exempt. Sales tax is the liability of the seller who usually passes the cost on to the buyer. Sales tax is charged at the point of sale and a portion is returned to that locale. The seller remits the tax to the State Board of Equalization (BOE). The BOE remits back to local entities their share. Of the current sales tax amount of 9.25 per cent effective in Orinda, the city keeps 0.95 per cent. (Please see more details in Footnotes 2 and 3).

There are two exceptions to the above regarding which local entity receives the tax, of which one is important for Orinda. *For the sale or lease of a vehicle, vessel, or aircraft, the tax is charged and allocated to the district in which the property will be registered and not to the locale of the sale.*

In other words, if Orinda enacts a sales tax, then buyers of all vehicles, vessels, and aircraft to be registered in Orinda, but physically purchased outside of Orinda, would pay any Orinda district tax on these purchases and the money would automatically come back to Orinda. Quoting from www.californiacityfinance.com , "So if the city Jane lives in has a Sales and Use Tax, she will pay that tax if she purchases a car, even if she makes the purchase in a neighboring county that has no Sales and Use Tax."

The second exception would likely result in minimal revenue for Orinda, and is covered in Footnote 4

Three cities in Contra Costa County have 0.5 per cent district taxes: Richmond, Pinole, and El Cerrito. These cities' residents can easily shop in Alameda Co., where the district tax is 0.5 per cent above Contra Costa Co. These 3 cities thus effectively have sales tax parity with their Alameda Co. neighbors, Berkeley and Oakland. A district tax in Orinda might create a disparity with neighboring Lafayette and Moraga.

Voters must approve District Taxes. The approval margin depends upon the type of tax, general or specific, as outlined prior. Some entities have tried to circumvent the two-thirds requirement by placing majority vote general tax measures on the ballot with a companion *advisory* measure "advising" local officials how to spend the tax proceeds *without* legally dedicating the tax proceeds for the "advised" purposes. However, the taxing entity is *not legally bound* by the advisory measure.

In Orinda, each .25 per cent amount established as a District Tax would raise about $370,000 annually. Of this, about $220,000 would come from taxes on sales in Orinda and $150,000 is assumed to come from vehicle purchases (see Footnote 6). The maximum tax is limited to 1 per cent.

A City Sales Tax could reduce purchases in Orinda. Also, because a significant amount of sales in Orinda are of gasoline, fluctuations in gas prices cause variability in the local sales tax receipts.

3. Property Tax Additions

This is a new revenue source through taxation of local property owners, both residential and commercial.

Property tax is paid by property owners either as a flat rate per parcel ("parcel tax"), or as a percentage based on the value of the property ("ad valorum tax"). Both types of taxes have low administration. The County collects the tax via annual property tax bills and remits it to the taxing entity.

A. Parcel Tax: Proposition 13 capped property tax rates at 1 per cent of the "full cash value" of a parcel, and imposed an annual increase limit in the assessed value of 2 per cent. In response, local governments established a new kind of tax not based on parcel assessed value. These taxes have become known as parcel taxes.

Some parcel tax measures include annual increases in the tax amount such as for inflation. Most parcel taxes have an expiration date, but some entities, such as the Orinda Union School District, Acalanes School District, Walnut Creek School District, and the Orinda Library, have recently been able to pass a parcel tax at a fixed amount with no expiration (or "sunset"). Parcel tax proceeds can be used for any purpose and can be securitized to accelerate current cash flow. Parcel taxes always require two-thirds voter approval.

Parcel taxes are legally distinct from a special assessment, already discussed. A parcel tax is not generally required to be based on any benefit received by either the property owner or the parcel being taxed.

In Orinda, an annual parcel tax of $100 would generate about $670,000 per year. This amount would service a 30 year bond of $13.1 million at an all-in interest rate of 3.0 per cent.

Longer term residents with lower property values, especially those on relatively fixed incomes, often object to parcel taxes. An exemption to the tax based on personal income and/or on age can mitigate objections.

B. Ad Valorum Tax / General Obligation Bond: An ad valorum property tax is based on the value of the property. The tax is generally expressed as a certain mill per assessed value. (A mill is 0.1 percent, or ten basis points.) As the property assessment changes, the dollar amount of the tax would therefore change. In Orinda, as previously noted, property values have generally risen for many years. For the near term, some variability seems likely, which would cause fluctuation in tax revenues from an ad valorum tax. Fluctuation could be up or down. General obligation bonds are frequently based on ad valorum taxes.

By contrast with a parcel tax which always requires a 2/3 majority, the votes required for an ad valorum tax is only a majority for a general purpose measure. The 2/3's requirement for a specific measure still applies.

On an assumed $4.4 billion "Net Taxable Value" in Orinda, a 0.1 mill (or one basis point which is 1/100 of one per cent)) ad valorum tax would produce about $440,000 per year. This amount could service a 30 year bond of $8.6 million at an all-in interest rate of 3.0 per cent.

Newer property owners generally object to an ad valorum tax, because of their higher assessed property values.

4. **Real Estate Transfer Tax:** This is a new tax assessed against property at time of sale.

This tax can only be used for general purposes, not a specific purpose. This tax requires Charter City status, also discussed in this section.

A. Background to Real Estate Transfer tax. A real property transfer tax is a tax imposed on the "privilege" of selling or conveying real property. The tax is based upon the sales amount of the property that is transferred. Liability only happens when the property is conveyed. The property is not security for the tax. Liability for payment is on the seller. (In contrast, property taxes recur annually on a fixed date, and the sole security for the tax is the property itself.)

To date, the courts have determined that such a tax can only be enacted by a city in California if it is a Charter City and only if the tax is used for "general" purposes. Orinda is a general law city. To enact a real property tax, Orinda must therefore become a Charter City.

For the 22 Charter Cities that do impose a real property transfer tax, the tax provides on average 9 per cent of general revenues. (That figure is 12 per cent for Albany, Piedmont, Berkeley and San Mateo.) In contrast, the documentary transfer taxes collected by general law cities only provide about 2 per cent of revenues on average.

The range of tax rates is wide, as low as $2.00 per $1000 sales value (San Rafael, Santa Rosa, Petaluma), to $3.30 (Palo Alto), to $5.00 (San Mateo), to $11.50 (Albany), to $13.00 (Piedmont), and finally to $15.00 (Berkeley, Oakland). As a Charter City, Orinda would determine its own rate.

Richmond is the only city in Contra Costa County with a transfer tax. The rate is $7.00 per thousand. Richmond has experienced wide recent swings in the amount the city collects from the tax, from a high of $1,000,000 per month to a current $200,000 per month. This is likely a function of current real estate conditions, especially the rapid expansion of subdivisions, which would less affect Orinda.

If Orinda becomes a Charter City and enacts a transfer tax, the city would forfeit the portion of documentary transfer tax it now receives from the county, which is 55 cents per $ 1,000 of property sales proceeds.

Other cities with transfer taxes (Piedmont, San Mateo, Santa Rosa, Richmond) report very little administrative work to collect this tax. The tax is typically paid in escrow and remitted to the county, which then remits it to the cities. Contra Costa County charges Richmond a nominal fee. Enactment of a real property transfer tax will likely create some new administrative and/or legal costs, but based on other cities' experiences, these can be minimized if the County is used to collect the tax and exemptions to the tax match the exemptions under the documentary transfer tax.

In Orinda, a real estate transfer tax of one per cent (i.e., $10 per $1,000), would generate about $2.05 million dollars per year, net of the lost documentary transfer taxes.

Local realtors may object to this tax, fearing it will hurt their sales. But their concern is likely to be moderated if Lafayette and Moraga implement the same tax, which is under consideration in both cities. Because the tax is only paid at sale, a homeowner is not subjected to a yearly tax. The home seller is liable for the tax, but the split is sometimes negotiated among buyer, seller, and even the realtor, depending on market conditions. The tax is typically collected and remitted in the escrow process by a title company.

B. Charter City. As discussed above, only Charter Cities can enact a real estate transfer tax. A majority vote is required.

California cities are either charter or general law. The City of Orinda is a general law city. General Law cities receive their authority from the State and must follow all laws as prescribed by the Legislature. By contrast, Charter Cities are authorized in the state Constitution and reserve to themselves local control over all matters constituting "municipal affairs." Charter Cities retain greater autonomy in their day-to-day operations and are free to legislate their own form, structure and operating rules.

The main benefits of Charter City status are: (1) a community can exercise more local control over its structure and operation; (2) more flexibility in public project bidding; (3) prevailing wages do not have to be paid for some public improvement projects; and (4) the city can enact a real estate transfer tax.

A required step of becoming a Charter City is the process of creating a charter. This process can be streamlined with a simplified charter. For example, San Ramon has a simplified charter, attached as Footnote 10. Lafayette has drafted and is considering a simple charter. An ongoing disadvantage is that the process of amending a Charter document may consume time and resources.

5. Utility Users' Tax (UUT):

This is a new revenue source through taxation of local residents and/or businesses.

A city can tax the consumption of utility services, including household utilities, cable, phone, and internet services. A UUT may be a general purpose or a special tax. Voter approval is required. The most common rate is 5 per cent, but ranges up to 11 per cent. On average, the UUT provides 15 per cent of general purpose revenue in cities that levy it. The average tax rate in Contra Costa County is 8 per cent. Cities in Contra Costa County with a UUT include El Cerrito (8 per cent); Hercules (8 per cent); Pinole (8 per cent); Pleasant Hill (1 per cent); Richmond (9.5 per cent); and San Pablo (4 per cent). In addition, Piedmont, Berkeley, and Oakland all have a UUT of 7.5 per cent and Albany has one at 7.0 per cent. In Orinda, an 8 per cent rate would generate current annual revenues of about $3,970,000.

The UUT is collected by the Utility and remitted directly to the City, without State involvement. Cities must monitor for and reconcile collection. Cities must also ensure that their UUT statutes are up to date as definitions of utility services change over time, especially in the area of cell phone, wireless, cable, and internet services. A political advantage of a UUT is that both short term and longer term residents pay based on their utility usage, with no distinctions based on property assessments.

This revenue stream could possibly be securitized (Footnote 1) although the FAC has not found any precedents for securitizing a UUT. This is probably because all UUTs in California are general taxes, with just one exception. (www.californiacityfinance.com). However, two investment bankers at JP Morgan, in a 9/11/09 phone conference, said their view was that such a securitization was feasible and would depend on the details.

Non-Revenue Funding Options

A. Draw down city reserves. This is not a revenue source, but a one time use of reserve funds.

The FAC evaluated the City's reserve policy in early 2009 and recommended that the City maintain a minimum unrestricted reserve balance. On April 21, 2009, the City Council adopted Resolution 29-09 which states that: "It is the policy of the City of Orinda that the General Fund will maintain an operating reserve of the lesser of 50 per cent of its operating budget or $5 million..." In recommending this policy, the FAC evaluated the reserve policies of other cities; potential exposure to extraordinary or catastrophic events; and the large instability in State of California finances for the foreseeable future. The FAC continues to concur with this policy.

B. Improve Operating Budget Margin. This is not a revenue source. It is an expense control policy.

In 2008, the Revenue Enhancement Task Force ("RETF") reported on what it called "optimization". Essentially, the concept is that Orinda property taxes have historically grown at about 7 per cent. If growth in city expenses funded by property taxes could be held to less than this growth rate in tax revenues, than this improved "margin" could be allocated to increased road repairs. The city does not gain any new money from this. It is an issue of expense control.

The FAC view is that, absent serious services curtailment, opportunities for reducing expenses by the City are limited. As the FAC reported to the City Council in its annual report on September 15, 2009 (Footnote 7):

> *"Services are delivered in a very cost-effective way. While Orinda has grown over the years, City staffing has not....Because Orinda has managed its finances in a prudent and conservative manner, the City does not currently face the dire circumstances of many California counties and cities. Staff levels have been controlled. Benefits granted to City employees have also been controlled. Because Orinda has a defined contribution retirement plan, the City does not face an exploding and uncontrollable liability for a defined benefit pension plan as do many other California municipalities and agencies.…"*

The main challenge in achieving an improved operating margin going forward is the cost of the Police Services contract. This cost will rise substantially in the next five years, due to the defined benefit pension plan of the Contra Costa Sheriff. (Please see Footnotes 8 and 9.) Whether and how the City of Orinda can find a way to control these police contract costs is yet to be determined.

Footnotes

1. **Bonds and Securitization**. Bonds and securitization both provide a way for Orinda to receive a lump sum of cash and repay it over time. A bond is a debt instrument issued by an entity, guaranteeing payment of the original investment, plus interest, by a specified future date. The issuance of the bond creates a one time cash inflow equal to the face amount of the bond. (In general). The city repays the bond from its revenues, which can be from a dedicated source over time. Securitization is a process for creating a special type of bond backed by underlying cash flows from another asset or revenue stream. Securitization also creates a one time cash inflow which is then repaid over time by the securitized asset or revenue source. For a city, this “other asset” is typically an ongoing payment stream from an existing tax. For example, investment bankers have successfully securitized gas tax revenues for some California cities. California Communities is currently securitizing for cities the Proposition 1A borrowings by the state. If the revenue stream from a certain tax source is securitized, the city would give up being able to use for its operations the amount of annual revenue required to repay the security. Securitization thus involves a tradeoff between using revenues on an ongoing basis, and receiving a one time lump sum of cash.

2. **Sales tax amounts.** In Orinda, the current 9.25 per cent sales tax is the base rate in Contra Costa County. Of this 9.25 per cent, the state keeps 7.00 percent; the county keeps .30 per cent; BART keeps .50 per cent; the county transportation measure keeps .50 per cent; and Orinda keeps 0.95 per cent. Please note that the state technically receives 7.25%, but reimburses .25% back to cities and counties via a property tax shift. This mechanism is commonly called “The Triple Flip” and stems from certain provisions of Proposition 57 of 2004. At times, such as 2009, when statewide property tax revenues are generally falling, the state may reimburse less than this .25 per cent. This reimbursement is shown on the Orinda budget as “Sales Tax In Lieu of Sales.”

3. **“District” and “Transaction Tax”.** In the context of Sales and Use taxes, a “District” is a local entity, a county or city, that levies its own sales and use tax. “Transaction tax” is the specific term for a Sales Tax levied by a District. “District” tax refers to both Sales and Use taxes levied by a District. Retailers collect District taxes and remit them to the BOE. Retailers must generally collect District taxes in effect at the location of the sale. Please see the next footnote regarding an exception to this. On the Quarterly Sales and Use Tax Returns, resellers identify how much tax goes to each District.

4. **Sales Tax on Delivered Merchandise.** *For this footnote, assume that Orinda has enacted sales and use tax.* In general, the total tax rate in effect in a special tax district also applies to sales purchased outside but delivered or shipped into the district. For example, a purchase at Macy's and shipped to Orinda should have an Orinda sales tax added on. However, if a seller does not have a business location in the district and ships in via common carrier, then the seller is not required to collect this tax. In this case, it is the buyer's responsibility to self report the tax to the BOE. Since no major retailer has a location in Orinda and self reporting of such taxes are minimal, Orinda will receive little if any sales tax from merchandise delivered into Orinda, (except for vehicles, as explained previously and in Footnote 6.)

5. **Income tax disadvantage to individual taxpayers of sales tax vs. other local taxes.** Sales tax paid is deductible on an individual's federal income tax return only if the filer elects not to deduct state and local income taxes. This is in contrast to other local taxes, which are fully deductible on Federal Form 1040. This tax difference makes Sales and Use Tax effectively more expensive to the tax payer than the alternatives.

6. **Sales tax from new vehicles purchased and to be registered in Orinda was estimated as $150,000 annually as follows.** Assume that 17,000 Orinda residents have 12,000 cars that are replaced, on average, every 5 years. Assume the average car price is $25,000. (12,000/5) * $25,000 *.0025 = $150,000.

7. 2009 FAC Report to City Council, presented on September 15, 2009 meeting.

8. Orinda contracts for its police officers from The Contra Costa County Sheriff Department, which is covered by the Contra Costa County Employees Retirement Association (CCCERA.)

9. "The cost of shoring up Calpers, the troubled $200 billion pension fund for California public employees, will ultimately fall on the state's 38 million residents, who are already dealing with tax increases and reduced public services. The state and local governments are contractually bound to increase their payments to Calpers to help it make up for its investment losses of more than $50 billion in the fiscal year ended June 30. *" Wall Street Journal, "More Pain for State's Taxpayers, Cities", October 15, 2009, Page A4*

10. San Ramon City Charter

City Charter

CITY OF SAN RAMON

PREAMBLE

The City of San Ramon was incorporated as a general law city in 1983 by residents seeking the right to manage local affairs. The authority of general law cities has diminished as a result of increasing State mandates and involvement in local matters. In order to reclaim the local autonomy sought through incorporation and to preserve the right of the people to present grievances to the most responsive level of government, we, the citizens of San Ramon, enact this Charter.

ARTICLE 1
Acceptance of Home Rule

Except as restricted by this Charter, the City shall have all powers allowable under the Constitution of the State of California to adopt ordinances, establish rules, grant franchises, structure City government, and in every way to govern the municipal affairs of the City. Municipal affairs encompass all matters of local concern as determined by the City Council consistent with the meaning of "municipal affairs" under the constitutional, statutory, and judicially defined law of the State of California.

Nothing in this Charter is intended to restrict the City in exercising any right, power or authority granted under the general laws of the State of California. However, the provisions of this Charter shall prevail in the event of any conflict with general law.

ARTICLE II
Structure of City Government

The City shall continue to be governed by a council of five members, four Councilmembers and a Mayor, elected at large. The City Council shall appoint a City Manager and a City Attorney. The City Manager, as the chief administrative officer of the City, shall appoint all department heads other than the City Attorney. Involvement in administrative matters by the Council or by any individual Councilmember shall occur only by direction of the City Manager.

ARTICLE III
Selection of Mayor

The Mayor shall be elected by plurality at an election to be held every two years. No elected Mayor shall serve for more than four two year terms or eight years total. Duties of the elected mayor for the

City of San Ramon shall remain the same as the duties as of January 1, 2001. Compensation for the elected mayor of San Ramon shall be one hundred dollars per month more than a city Councilmember. The position of elected Mayor will become effective at the first San Ramon regular municipal election following adoption of this charter amendment where three city council seats are up for election. One of these three seats will become the elected mayor position.

ARTICLE IV
Public Contracting

The City Council, by ordinance, shall establish the procedures, including any competitive bidding requirements, to be followed by the City in awarding public contracts of any nature, including those for construction of public works.

ARTICLE V
Continuation of Existing Law

All ordinances, resolutions, rules and regulations of the City in effect as of the effective date of this Charter shall continue in effect until repealed or amended.

ARTICLE VI
Interpretation

The provisions of this Charter shall be interpreted broadly to favor the exercise of home rule. If any provision is found by a court to be invalid, the remaining provisions of the Charter shall remain in full force and effect.

Dated: November 4, 1997
Amended: November 6, 2001