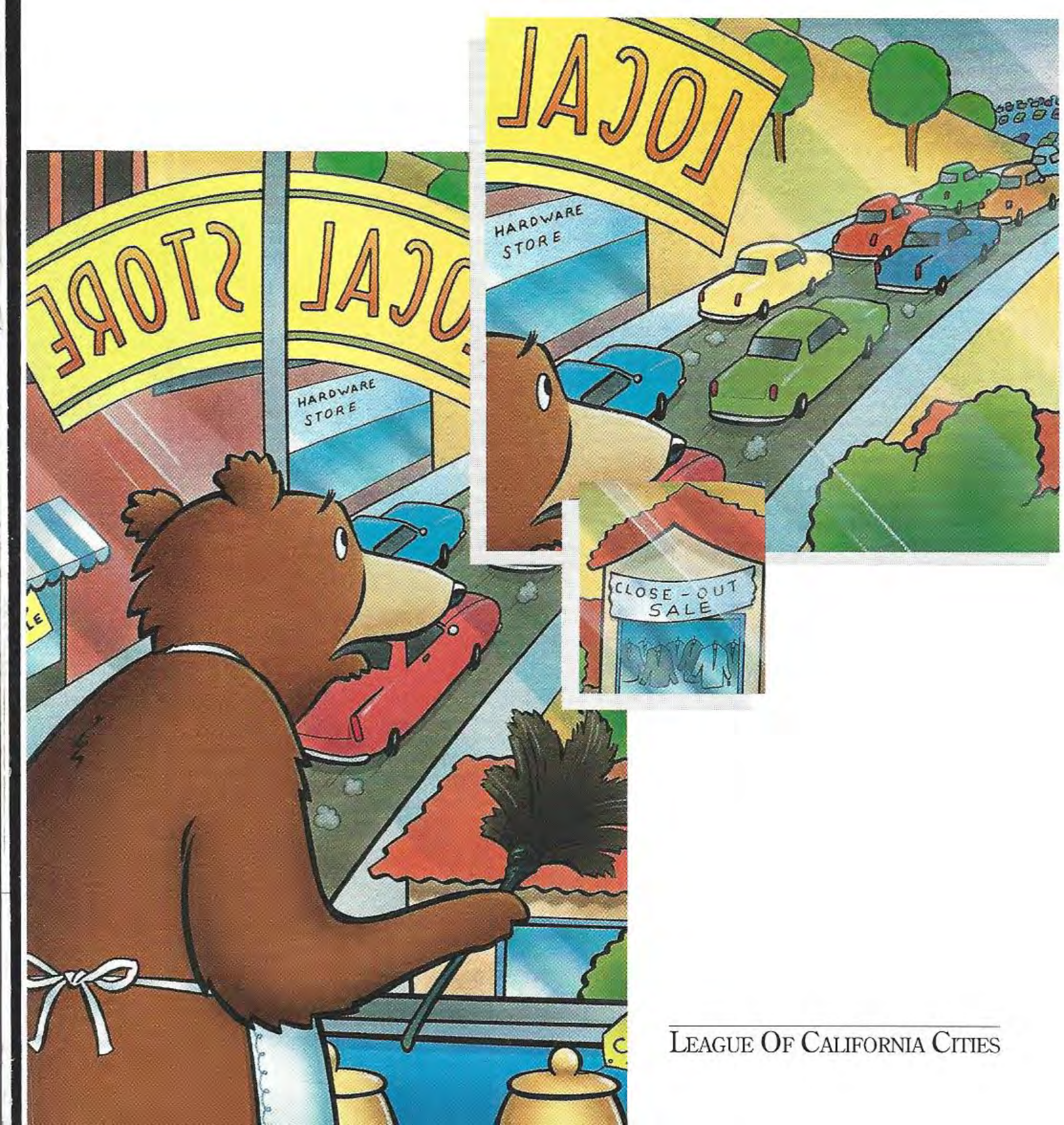
UNDERSTANDING SALES TAX ISSUES FOR CITIES

by Bill Statler



The issue of sales tax revenues in California cities raises many questions: How are they imposed? What kinds of "sales" are actually subject to this tax? How are the tax revenues shared between various levels of government? How are they collected and distributed? What factors most affect the amount of revenue collected? And what are the future prospects for this revenue source?

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But the first question to answer is: Why is it important for city officials to ask these questions? The answer can be taken directly from Willie Sutton, who replied when asked why he robbed banks, "Because that's where the money is."

For most California cities, sales tax revenues are the single largest source of general purpose revenue, and they have been since Proposition 13. As summarized by the chart below, sales tax revenues for cities totaled over $2.4 billion in 1993–94, accounting for 26 percent of all city general revenues statewide; this share is 30 percent greater than the number two revenue source — property taxes — which accounted for 20 percent of general revenues.

In short, cities throughout California, regardless of size or location, are critically dependent on sales tax revenues in funding key general purpose services such as police, fire, streets, parks and recreation.

What Transactions Are Subject to the Sales Tax?

There are two distinct components to what is commonly referred to as the "sales tax":

Sales Tax

While this is technically imposed on California retailers for the privilege of selling tangible personal property, it is generally accepted that retailers pass the sales tax directly on to their customers. Because it is a tax on the sale of personal property, there are a number of sales transactions that are excluded from this tax, including real property, food for home consumption, prescription medicine, utilities and most services.

Use Tax

This is imposed on the use of tangible personal property purchased from an out-of-state retailer for use in California. Originally focused on large purchases by businesses from out-of-state suppliers, the use tax concept has taken on greater importance due to increased home shopping via catalog, cable television and the Internet.

How Are Sales Tax Revenues Distributed Statewide?

In 1994–95, the State Board of Equalization collected over $23.4 billion in sales tax revenues, which included:

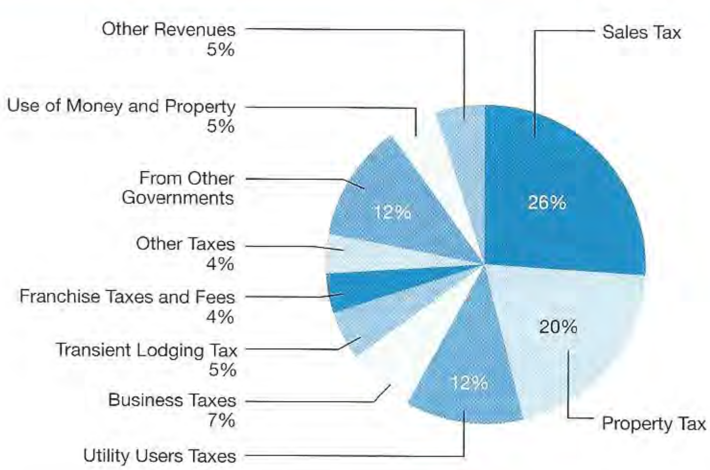
- $2.9 billion in local sales and use taxes on behalf of 58 counties and 469 cities;
- $1.94 billion for special districts; and
- $743 million for county transportation purposes.

Statewide, the 7.25 percent sales tax rate comprises the following:

- 6 percent for the state general fund, including 5 percent for general purposes and 1 percent for special purposes, of which 0.5 percent is for public safety purposes as approved under Prop. 172;
- 1 percent levy for cities and counties; and
- 0.25 percent for county transportation.

In addition to these statewide components, 21 counties impose an additional sales tax rate for a variety of purposes, including transportation, open space and hospitals. This results in sales tax rates ranging from 7.25 percent to 8.5 percent, depending on the county.

1993–94 Top Ten City General Revenues



Source: State Controller's Office, Annual Report of Financial Transactions Concerning Cities of California, Fiscal Year 1993–94

A Brief History of Sales Tax in California

California first enacted a statewide sales tax in 1933 in response to a dramatic decline in property values (and related revenues) as a result of the Great Depression. The initial rate was set at 2 1/2 percent, and revenues were used solely to fund state operations. By 1946, a number of cities had enacted their own local sales tax. While this seemed a simple idea at first, it soon became apparent that setting, administering and collecting this tax on a city-by-city basis was a very complex undertaking, which resulted in lower collections than expected. Ultimately, this led to the passage of legislation in 1955 establishing a uniform, statewide system for administering and collecting local sales taxes: the Bradley-Burns Uniform Sales and Use Tax Law.

Under this system, the collection of local sales taxes by the state is not automatic. Each city and county must adopt their own local tax (in strict conformance with the provisions of the Bradley-Burns law). By 1967, every city and county had imposed a local sales tax. This meant that for the first time, the local sales tax rate — and the procedures for collecting it — were the same throughout the state.

The Local Sales Tax Today

More than 40 years later, the basic components of this legislation are still in effect today:

- Under a uniform system of rules set by the state, cities and counties may impose a local sales tax of 1 percent. Because it is the local agency's own tax, revenues are principally allocated on a *situs* basis; that is, revenues are based on sales within the city limits (or in the case of counties, in the unincorporated area).
- The state (through the Board of Equalization) collects these revenues on behalf of cities and counties along with its own sales tax

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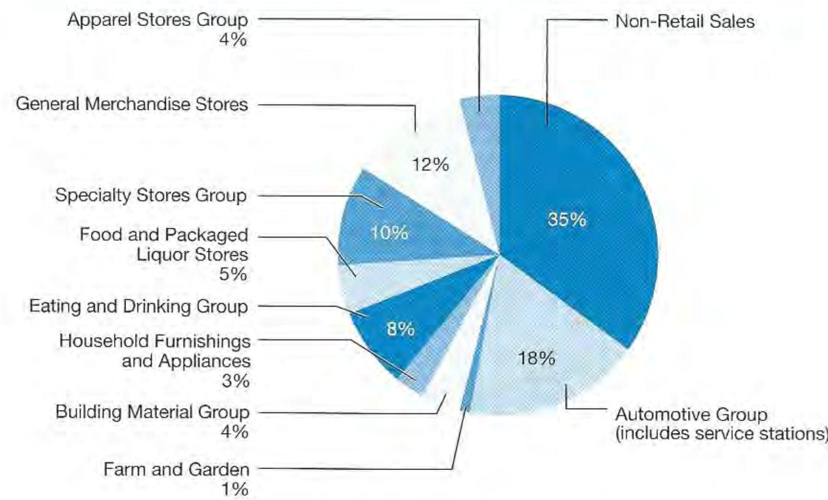
revenues. It is important to note that while local sales taxes are collected for cities by the state, these are not "shared" revenues similar to gas tax subventions. Although the state sets all the rules, this is the city's own tax under existing law.

- Revenues are remitted monthly to cities based on estimates made by the state. Each quarter, the state reconciles the advances paid with actual revenues for the preceding quarter. This means two things for cities as they monitor sales tax revenues: 1) monthly revenue amounts are meaningless — only quarterly data from the state is potentially useful; and 2) monitoring up-to-date sales tax trends is difficult because this information is always a quarter behind. For example, revenues for the Christmas quarter (which is typically the most important one) will not be known until the end of March, at the earliest. Due to timing, reporting and misallocation problems with the raw data, care should be taken in reviewing sales tax trends based on this quarterly information.
- Not all local sales tax revenues are allocated on a *situs* basis. In some cases, the state has determined that it is too difficult to keep track of sales based on location, and for these types of purchases they have established "pools" at the county and state level. Revenues from the pools are allocated based on the proportionate share that each city or county represents of *situs* sales. Allocations from the pool can range from 5 to 20 percent of a city's total sales revenues, so it is important to have a clear grasp of what specific types of transactions are in the pool and how a city might be affected. Common pool revenues include sales taxes on vehicle sales between individuals and construction materials delivered onsite.

There are a number of arcane but potentially important revenues in these pools. For example, the City of San Luis Obispo receives "pool" sales tax revenues from the Diablo Canyon nuclear power plant (which is not in the city limits) for as much as $970,000 a year, depending on their refueling schedule, or about 15 percent of the city's annual sales tax revenues.

1995 Taxable Sales Statewide by Business



Source: State Board of Equalization, Taxable Sales in California, 1995

Factors That Determine Sales Tax Revenues

Statewide Factors

The key factor determining sales tax revenues is the strength of taxable spending by consumers and businesses. As cities have experienced over the past several years, this close linkage to the performance of the economy can make sales tax a highly volatile revenue source. Key performance factors are highlighted by the summary of taxable sales statewide in 1995 by type of business above.

This chart reinforces what most public officials intuitively know: automobile-related sales are the number one source of sales tax revenues. What may not be so obvious, however, is the importance of "non-retail" sales tax revenues, which account for about 35 percent of taxable sales.

What makes up non-retail sales taxes? For the most part, they are business-to-business sales that typically do not occur in retail stores but in business and industrial parks. For example, in San Luis Obispo one of the largest sales tax producers is a computer forms company that prints billing stock for a number of major companies nationwide. These sales are subject to sales tax.

This means that in identifying strategies for improving sales tax revenues, cities should not overlook the opportunities that may exist in their business and industrial parks. These revenues can compare favorably with a power retail center or auto mall and may be less subject to economic downturns and competitive pressures from nearby communities. Also, these types of businesses rarely compete with the existing retail base.

Local Factors

While economic factors play the dominant role in determining sales tax revenues at a statewide level, there are three other key factors that determine sales tax revenues at the local level: location, location, location. Because local sales taxes are received on a *situs* basis, where the transaction occurs is as important to a city as whether it occurred at all. From a purely fiscal perspective, a strong recovery in automobile, general merchandise and consumer electronic sales (or computer billing forms) won't matter much to a city that does not have these kinds of outlets to begin with.

Monitoring Sales Tax Revenues

Collecting the right amount of revenue under the very complex sales tax system is the state's responsibility and, fortunately, it has a vested interest in doing this well. With $16.7 billion projected for 1996–97, sales taxes account for 34 percent of the state's general fund revenues, second only to personal income taxes. However, the state does not have the same level of interest in accurately keeping track of where sales are made — which, of course, is of singular interest to cities.

Additionally, while the state maintains extensive electronic databases on city sales tax revenues, the resources required to develop and support local systems to meaningfully use this information in tracking trends are unattainable by most cities.

For this reason, many cities have contracted with firms specializing in sales tax revenue management. Their services can ensure that revenues are correctly allocated to the city, identify reporting errors or aberrations, and monitor trends by business type and geographic area within the city. Regardless of whether monitoring is performed by in-house staff or through contract services, it is essential that cities invest adequate resources in understanding the factors that underlie their most important revenue source and ensure that all of the revenues due to them are, in fact, received.

Future Prospects for Sales Tax Revenues

For the past 40 years, sales tax revenues have served as an essential (although not perfect) revenue source in funding city services. However, as the graph below reveals, revenues from sales tax as well as property tax have dropped significantly from 20 years ago.

Three trends are emerging that will require fundamental rethinking about this revenue source as the next millennium approaches:

1. *Change to a service-based economy.* When the sales tax was first put in place, expenditures on services accounted for about 39 percent of all spending; by 1990, this increased to about 54 percent. This trend towards a more service-based economy is continuing. As recently as 1980, taxable sales were about 52 percent of personal income; by 1995, this was down to about 40 percent. Even if this lower level of spending on taxable items stabilizes, the reality is that, relative to income, the sales tax base has shrunk by about 25 percent in the last 15 years. But in reviewing recent efforts, the outlook for expanding the sales tax base is not reassuring. All of the modest changes made in 1991 to extend the sales tax to include candy, newspapers and aircraft jet fuel have been subsequently repealed.
2. *Changes in shopping habits.* The impact of home shopping through catalog, cable television and Internet sales has only begun to be felt. Most of these sales are not in California. As these new methods become more prevalent forms of purchasing taxable goods, the sales tax base will shrink even further unless new ways are found of capturing these lost revenues. Realistically, builders and users of the information highway will strongly resist this.
3. *Fiscalization of land use and cannibalization of neighbors.* Like Willie Sutton who robbed banks because that's where the money was, cities and counties are robbing each other for the same reason. In a post-Proposition 218 era where new revenues are going to be even more difficult to find (let alone put in place), sales tax takes on even greater im-

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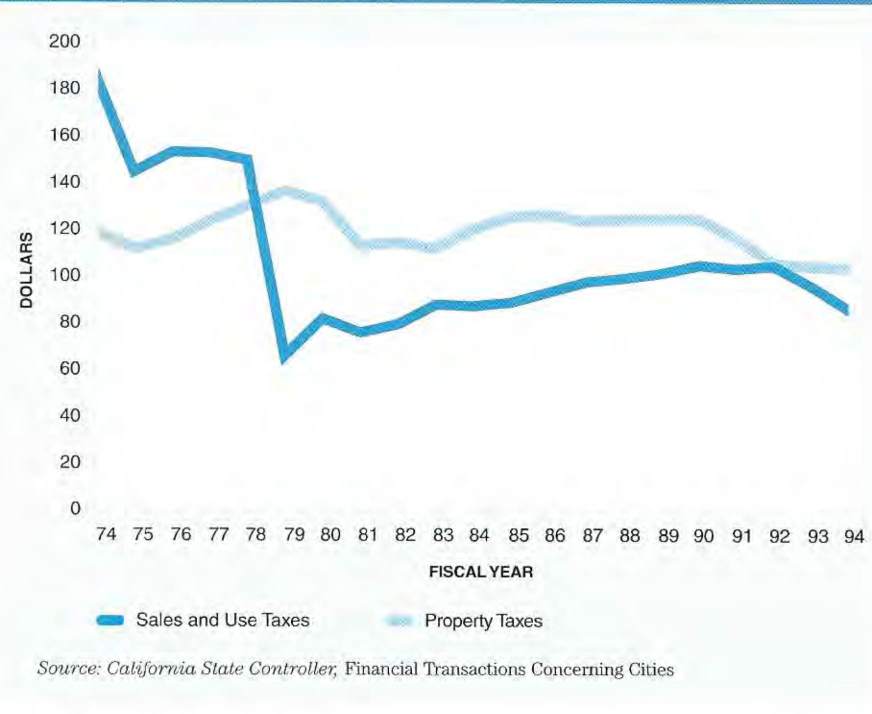
California City Tax Revenue Per Capita, Adjusted for Inflation to 1997



Source: California State Controller, Financial Transactions Concerning Cities portance for many cities. This can mean struggling to attract a new major sales tax generator (probably from a nearby city) or struggling to keep one (who is probably being wooed away by a nearby city).

The tragedy of all this — especially when cities agree to provide major financial incentives to retain or attract major sales tax producers — is that it is a zero sum game. At any point in time, there is only so much aggregate demand in a region for the consumption of taxable goods. Attracting or retaining a new auto dealer does not change the economics of the region, but it can certainly change the fiscal situation of the city where the auto dealer locates. Relationships with counties are also strained by this focus on where sales tax generators are located, especially in annexation negotiations.

In summary, this is not a new issue. The "rightness" of allocating local sales tax revenue on a *situs* basis has been discussed extensively for years. What is changing, however, is the continued deterioration of other revenues and the increased reliance on this already very important revenue source.

Where to From Here?

The three emerging trends highlighted above are not new. However, a number of serious proposals are currently under consideration that might actually result in some fundamental changes.

First, while more will need to be done, changes are already being made at the state level to better address catalog and other out-of-state sales. Secondly, there are new, serious discussions about expanding the sales tax base to include services. While this may need to be phased in and will probably have to be "revenue neutral" when implemented (by reducing the sales tax rate), in the long term this diversified tax base would result in a more stable situation for the state as well as cities and counties. Thirdly, there is interest in looking at the way sales taxes are allocated. One example is the recent proposal from the City of Covina to shift 1 percent of the state's 5 percent sales tax rate to cities and counties. This proposal spurred SB 1310, authored by Senator Ross Johnson. A two-year bill, SB 1310 was held in the Senate Revenue and Taxation Committee and is not eligible to be heard again until January 1998.

Finally, there are renewed efforts to change federal law, which inhibits the collection of sales and use taxes on transactions made through mail order catalogs, the Internet and cable television.

Summary

Local sales tax has been around for more than 40 years and is likely to be around for another 40. But if it is going to continue to play a critical funding role (and what is the likely alternative if it does not?), it will need to change to meet the needs of radically different economic and political circumstances from when the sales tax was first adopted.