



# *CITY COUNCIL AGENDA REPORT*

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MEETING DATE: AUGUST 2, 2004

ITEM NUMBER:

**SUBJECT: CONSIDERATION OF POTENTIAL NEW REVENUE SOURCES**

**DATE: JULY 26, 2004**

**FROM: FINANCE DEPARTMENT/ADMINISTRATION**

**PRESENTATION BY: MARC R. PUCKETT, DIRECTOR OF FINANCE**

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## **RECOMMENDED ACTION:**

Provide direction to staff regarding potential new revenue sources.

## **BACKGROUND:**

Staff presented a report regarding consideration of potential new revenue sources at a Council Study Session. Included in the study session presentation were other potential new revenue sources for Council's consideration and review. These additional potential new revenue sources were the Fire-Med subscription fee and the local sales tax provided for under SB 566. After presentation to Council at the study session, the matter was to be brought forward to Council at a future Council meeting for further consideration.

At the April 12, 2004, City Council meeting, Council indicated that they were interested in considering the Sanitation Franchise Fee, Fire-Med Subscription Fee, Business License Tax and Transient Occupancy Tax further. Staff was directed to meet with stakeholders and bring this matter back to Council for further consideration at the July 6, 2004, Council meeting.

At the July 6, 2004, City Council meeting, Council directed staff to proceed with implementation of the Fire-Med Subscription Fee program using the "private" model and took no action on the Business License Tax, Sanitation Franchise Fee and Transient Occupancy Tax.

Subsequently, Council member Scheafer requested that the matter be placed on the August 2, 2004, City Council agenda for further consideration.

## **ANALYSIS:**

The Business License Tax, Sanitation Franchise Fee and Transient Occupancy Tax are summarized herein. For each of the potential new revenue sources discussed herein, a description of the revenue source, taxing authority, overview of the fee, and estimated revenue collections are included.

Any increase in the business license tax or transient occupancy tax would require a vote of the people. Whether the ballot measure requires a simple majority (50% + 1 vote) or a super majority (two-thirds of those voting in the affirmative) depends upon the ballot language and whether the question is placed upon the ballot as a general tax increase or a special tax increase. In making these determinations, there are a number of decisions that Council must make to place the matter before the voters. These issues were discussed at length with Council and thoroughly detailed by the City Manager in his July 7, 2000, memo to Council preceding the placement of the Transient Occupancy Tax question on the November, 2000, ballot. A copy of the City Manager's memo is attached (Attachment 1) and referenced herein with respect to the requirements of placing a ballot measure before the voters.

On page two of the memo, the City Manager discusses the five decisions that Council must make and the four ways that the ballot measure may appear before the voters on the ballot. These same decisions apply to each of the potential new revenue sources discussed herein requiring voter approval prior to implementation. The attachments to the City Manager's memo from the City Attorney's Office and the Finance department further delineate matters that need to be considered with respect to placing a ballot measure before the voters.

The attachment to the City Manager's memo from the City Attorney's Office has been revised and updated on July 8, 2004. Pursuant to these revisions, and most significantly, placement of a general tax question on the ballot requires a two-thirds affirmative vote by City Council. The general tax question must also be on the ballot at a "regularly scheduled general election" at which Council Members are elected. Placement of a special tax question on the ballot would require only a majority affirmative vote by City Council and could be placed on the ballot on any election date permitted by state law, including calling a special election.

It is suggested that these requirements be reviewed in detail with respect to issues concerning placement of a ballot measure before the voters as a general tax increase or a specific tax increase.

According to the Deputy City Clerk, cost estimates for placing a "stand-alone" local ballot measure before the voters is approximately \$95,000 to \$100,000. Costs for placing a local ballot measure on a "consolidated" ballot are currently estimated at approximately \$25,000 to \$32,000.

### **Business License Tax:**

**Description:** The Business License Tax is a general tax on businesses for the privilege of conducting business within the City. As a general tax, use of revenues derived from the issuance of business licenses is unrestricted.

**Authority:** The authority to levy this tax is granted pursuant to the Government Code, sections 37101, et seq.

**Overview:** The Business License Tax is a type of excise tax imposed on businesses for the privilege of conducting business within the City. The tax is most commonly based on gross receipts or levied at a flat rate, but is sometimes based on the quantity of goods produced, number of employees, number of vehicles, square footage of the businesses or some combination of factors. Rates are set at each City's discretion but may not be discriminatory or confiscatory.

Cities may levy this tax for both regulatory and revenue-raising purposes. However, regulatory fees may only be levied to cover the costs of regulation.

Any increase in the Business License Tax will require voter approval. The current Business License Tax rate of a maximum of \$200 regardless of gross receipts has remained unchanged for over 20 years.

Based upon the last available survey approximately five years ago, over 440 cities (93 percent of all cities) collect a business license tax as a general tax. Some of those that do not collect a business license tax, collect a business license fee based on cost recovery for licensing and processing or for other services provided.

During the last fiscal year ended June 30, 2003, the Business License Tax revenue collections equaled approximately \$854,000. The business license tax is not now a major revenue stream for the City. However, for many cities, it is a major revenue stream. A copy of the business license tax survey prepared and included in the Budget Study Session Workbook is attached (Attachment 2).

As noted in the survey, 27 out of 34 cities (80%) in Orange County levy a business license tax. Of those that levy a business license tax, 16 cities have variable rate structures and nine cities collect more revenue than Costa Mesa. Further, 24 of the 27 cities that levy a business license tax impose a tax structure that is higher, and in most cases significantly higher, than Costa Mesa.

If desirable, in order for Costa Mesa to generate a significant increase in business license taxes, the City would need to move to a fee based on a fixed percentage of gross receipts, say for example, between .4% and .8%. A fee based on a fixed percentage of sales such as this would maintain uniformity and equity for all businesses, small and large alike. Pursuant to the Government Code, rates are set at each City's discretion but may not be discriminatory or confiscatory.

With a tiered fee structure, businesses falling within the lower portion of the "range" would effectively pay more in tax on a proportional basis to gross sales than those businesses at the upper end of the range.

The business license tax and proposed rate structures for an increase were discussed with the president of the Chamber of Commerce, Mr. Ed Fawcett, separately, at a staff level meeting with Mr. Fawcett and representatives of the Chamber Board and with the Chamber as a whole at a breakfast meeting at which the City Manager gave the keynote address. Mr. Fawcett expressed his understanding of the City's need to consider new revenue sources in light of the economic climate, the condition of the City's budget and the State budget deficit condition. As such, he prepared and proposed a continuation of the tiered rate structure with upward adjustments made to each of the rates and the banding of each range. He has indicated that he supports and would advocate for increases in the business license tax as outlined in his proposed fee schedule if the City Council chooses to pursue an increase. The increase that he has proposed would approximately double the current business license tax, although it should be noted that due to the "hard cap" on the current rate structure, the City's business license tax would remain as one of the lowest known in the state of those cities that levy this tax and will remain among the lowest business license tax in the state even if the tax is doubled.

Mr. Fawcett and other members of the Chamber expressed their support of a proposed business license tax structure that would effectively double the current fee if the City Council believes an increase is justified. Also, they indicated that if a fee structure were proposed that would increase the business license tax beyond double what they are now paying, they may not be supportive of such an increase and would appreciate the opportunity to discuss the matter further with the City Council and staff.

Also, per his estimates, he believes that the increases in the ranges as he has proposed (Attachment 3) will result in an increase in business license tax revenue of approximately \$1 million. These estimates were based upon a review of the sales for the Top 20 business categories in the quarterly sales tax reports over the last four quarters. Gross receipts information for all businesses is not readily available in such a format that would allow staff to accurately estimate the revenue collections based upon Mr. Fawcett's proposed business license tax schedule. However, it should be noted that staff did review his methodology and it does appear reasonable.

### **Transient Occupancy Tax:**

**Description:** The Transient Occupancy Tax is a general tax imposed on occupants for the privilege of occupying room(s) in a hotel, motel, or inn. Use of the revenues are unrestricted. However, some cities budget a portion of the revenues for tourism and business development purposes. Costa Mesa levys a 2% Business Improvement Assessment for the benefit of the Costa Mesa Convention and Visitors Bureau to assist that organization in promoting tourism travel to the area. The current TOT rate of 6% has remained unchanged for over 22 years.

**Authority:** The authority to levy this tax is promulgated from the State Government Revenue and Taxation Code being sections 7280 and 7281.

**Overview:** Cities may impose the transient occupancy tax on persons staying 30 days or less in a room(s) in a hotel, motel, inn, tourist home, non-membership campground or other lodging facility. Cities may also levy a tax on the privilege of renting a mobile home located outside a mobile home park, unless such occupancy is for more than 30 days or unless the tenant is an employee of the owner.

According to a survey by the League of Cities, rates throughout the state ranged from 4 to 18 percent. The average rate was 9.6% with 10% being most typical. Nearly two-thirds (65.7 percent) of cities reported using their revenue for general fund purposes.

Currently, more than 80 percent of cities collect a transient occupancy tax. Those that do not collect a transient occupancy tax reported that there were no significant number of hotel rooms for rent in their communities.

Although Costa Mesa has one of the higher concentrations of available hotel rooms in the county, the transient occupancy tax levied is the lowest in the County. A copy of the transient occupancy tax survey of Orange County cities prepared and included in the Budget Study Session Workbook is attached (Attachment 4). Per the survey, the rates in the County ranged from 6% to 15%. The most common rate in the County is 10%. Costa Mesa's rate of 6% is the lowest in the County although the city has one of the highest concentrations of hotel rooms.

As an ancillary note, it is also highlighted in the survey that the City does not assess or collect a utility users tax.

During the current fiscal year, it is estimated that the City will collect \$3.8 million in transient occupancy taxes. This revenue estimate is \$800,000 less than the actual revenue collections for fiscal year 2000-2001. Transient Occupancy Taxes, while finally on the upswing again, have not returned to the level of revenue collections prior to the 9-11 event.

Based upon a revenue estimate of \$4 million, each 1% increase in the transient occupancy tax would generate approximately \$665,000. A 2% increase in the Transient Occupancy Tax would generate approximately \$1,330,000.

Benefits of considering an increase in the Transient Occupancy Tax include placement of a portion of the tax burden to provide city services on transient visitors to the community. Residents benefit from this spreading of the costs of services over a larger tax base including those visiting the community, therefore lowering the cost of services to residents.

Staff has met with representatives of the Costa Mesa Convention and Visitors Bureau (CMCVB) which is comprised of the General Managers of the seven largest hotels in the City. The transient occupancy tax rate was discussed in relationship to other cities with a large base of hotel rooms and the TOT rate charged in those cities. CMCVB members agreed that the City's rate is low by comparison. It was also mentioned that the most common rate charged in the County is 10% with the tax ranging from 6% (Costa Mesa) to as high as 15% for the City of Anaheim. While opinions varied among the Hotel General Managers, strong concerns were expressed about the potential impact of any increase in the TOT on hotel occupancies.

Subsequent to the meeting with representatives of the CMCVB, the attached response was submitted for the City Council's consideration. In summary, the CMCVB suggests that any increase by the City be limited to no more than 2% with up to a ½ percent returned to the CMCVB for tourism and promotion. If such an increase is considered for submission to the voters, it is strongly suggested that any increase in revenue to the CMCBC be considered as part of the annual Business Improvement Assessment and not as part of any increase in the TOT.

It was further discussed that if this proposal were to move forward to a future ballot, the ballot question would be a general tax question.

### **Sanitation Franchise Fee:**

**Description:** The Sanitation Franchise Fee is a fee that may be imposed upon exclusive or non-exclusive franchisees for the purposed of residential and commercial solid waste handling services within the City. Generally, a franchise fee is a fee paid to a municipality from a franchisee for "rental" or "toll" for the use of city streets and rights-of-way. Use of revenues generated from a Sanitation Franchise Fee are unrestricted and may be used for any purpose.

**Authority:** The authority to enter into such franchise agreements is found within the Public Resources Code sections 49520 through 49523. Further, adoption of a Sanitation Franchise Fee Ordinance would be necessary to set forth specific requirements for prospective franchisees.

**Overview:** Of the 34 cities in Orange County, 31 have Sanitation Franchise Fees. The franchise agreements may be on either an exclusive or non-exclusive basis.

The City is proposing a non-exclusive franchise agreement. Such franchise agreements allow the trash haulers to set their own rates without any controls by the City, thus preserving their free market system. Further, a non-exclusive franchise fee would provide for a means of monitoring the waste hauler rates to determine if in fact, waste hauler rates in Costa Mesa were indeed higher or lower than other communities with Sanitation Franchise Fees. A Sanitation Franchise Fee may be imposed upon residential, commercial and industrial waste haulers.

As noted in the attached survey (attachment 5), it is estimated that the Sanitation Franchise Fee may generate approximately \$500,000 to \$1.5 million in new revenues to the City based upon what level the City would set the franchise fee at. Also, with respect to the waste haulers, the fee ranges from 1% to 12.8% countywide with 7% being the most common rate. In some cases, the rate is split with different rates charged for residential and industrial/commercial customers' waste with rates for the industrial/commercial customers being set at a higher level than the residential rate.

Staff would propose, based on the County average, that a non-exclusive franchise fee rate of 7% for residential and 7% for commercial/industrial customers be considered if it is Council's desire to move forward with this proposal. This fee structure would generate approximately \$1 million.

Staff has also met with the waste haulers currently working in the city and reviewed the proposed franchise fee. The proposed fee structure is in-line with the franchise fee assessed in most Orange County cities. The waste haulers understood the reasons why such a fee is being considered at this time and expressed a willingness to cooperate with the City on a possible increase if tied to an increase in the length of the existing permit for refuse collection. At present, the City limits permits to an annual renewal.

One of the three potential new revenue sources (the Sanitation Franchise Fee) may increase the financial contribution of residents to fund the level of service delivery currently provided. The potential increased cost to residents for the Sanitation Franchise Fee would be around \$28-30 annually per household. The Sanitation Franchise Fee may or may not be ultimately passed on to residents. The fee would be assessed as a franchise fee against the waste haulers and would only be paid by residents if passed through as a rate increase by the waste haulers to their customers. Since this fee is already in place in almost all cities throughout the county, the waste haulers current rate structure may already have considered this fee since it is not evident that there is any identifiable difference in rates paid in Costa Mesa versus other cities in the County.

The Transient Occupancy Tax and the Business License Tax both would require that a ballot measure be placed before the voters. There will most likely be no direct impact on residents of Costa Mesa if these fees were increased. The Business License Tax would generate approximately \$1 million if doubled while still remaining among the lowest such tax in the state. The TOT would generate approximately \$1.3 million if increased by 2% from 6% to 8%.

The Sanitation Franchise Fee would generate approximately \$1 to 1.5 million in new revenue based upon how the fee is structured if implemented.

### **CONCLUSION:**

There are several options presented herein and available to the City to generate new revenues to meet the variety of community needs for which the revenues could be justifiably approved.

From the standpoint of taxation, the City is very accommodative to business. The current Business License Tax rate of a maximum of \$200 regardless of gross receipts has remained unchanged for over 20 years and is the lowest in the County and among the lowest in the state. As noted in the survey, 27 out of 34 cities (80%) in Orange County levy a business license tax. Of those that levy a business license tax, 16 cities have variable rate structures and nine cities collect much more revenue than Costa Mesa even though their commercial base of business is smaller. Further, 24 of the 27 cities that levy a business license tax impose a tax structure that is higher, and in most cases significantly higher, than Costa Mesa.

The Transient Occupancy Tax rate of 6% has remained unchanged for over 22 years and is the lowest in the County and among the lowest in the state. Although Costa Mesa has one of the higher concentrations of available hotel rooms in the county, the transient occupancy tax levied is the lowest in the County. Additionally, the City is one of only a very few cities in the County that returns a share of the TOT (in the case of Costa Mesa, this is done by way of the BID assessment) to local hotels for tourism and promotion. For FY 2003-04, this amounted to approximately \$1.0 million. The current average TOT in Orange County is 10.5%.

At present, 31 of 34 cities in Orange County currently assess a Sanitation Franchise Fee. The City is one of three cities in the County that do not assess a Sanitation Franchise Fee. Based on the County average, staff would propose that a rate of 5% for residential and 7% for commercial/industrial customers be considered if it is Council's desire to move forward with this proposal. This fee structure would generate approximately \$1 million in new revenues.

The franchise agreements may be on either an exclusive or non-exclusive basis. The City is proposing a non-exclusive franchise agreement. Such franchise agreements allow the trash haulers to set their own rates without any controls by the City, thus preserving their free market system. Such franchise agreements allow the trash haulers to set their own rates without any controls by the City, thus preserving their free market system. A non-exclusive franchise fee would also provide for a means of monitoring the waste hauler rates to determine, if in fact, waste hauler rates in Costa Mesa were indeed higher or lower than other communities with Sanitation Franchise Fees.

Over the course of the past few fiscal years, the City's expenditures have exceeded its revenues. This circumstance has required that the City draw from fund balance and other sources to balance the annual operating budget. As staff has advised, the practice of utilizing fund balance is deemed prudent on a very short-term basis but ultimately will create a continuing and serious impact on the operating budget and the provision of service delivery if not addressed. There are three primary means to address the budgetary shortfall:

1. Reduce Operating Expenses
2. Reduce or Eliminate Programs & Services
3. Increase Revenues

The City Council, public and staff have focused a good deal of attention on the first two means noted above to close the “gap” between revenues and expenditures. For the past 4 fiscal years, the gap has remained at approximately \$3.5 to \$4 million per year. While efforts have been made to reduce various operating expenditures, these savings have largely been offset by substantial increases in employee retirement costs along with the continuing and increasing loss of revenue to the State of California. In terms of the reduction or elimination of programs and services, the City Council was presented with an extensive listing of all services and programs as part of the FY 2004-05 budget adoption. While some reductions in the operating budget were achieved through a review of programs and services and still others are under consideration, it is clear that the gap is unlikely to be closed substantially by this process. With the preceding in mind, the remaining element not considered to date is that of increasing revenues.

Prior to staff’s meetings with the various interests such as the Chamber of Commerce, hotel managers and the refuse industry, a good amount of consideration was given to the “objective” of increased revenues. Was the objective to close the gap or simply raise existing and new revenues to some “average” of Orange County cities irrespective of revenue generation? On the later subject, staff recognized that Costa Mesa residents generally are not supportive of “average services” but have very high expectations. Likewise, the City has chosen not to compensate its employees as “average” among all cities in Orange County but at the higher end of the compensation range based on surrounding communities. Recognition was also given to the fact that the economy does show signs of emerging from a multi-year downturn and that local revenues will likely reflect this increased prosperity. Unfortunately, offsetting the benefits of the economic upturn is the continuing instability of the State of California and its adverse impacts on local government.

Taking into account all of the preceding, staff suggests a course of action that will bring the subject revenues more into line with the rest of Orange County to the level needed to close the gap. Given improvements in the economy and the opportunity of the electorate in November 2004 to discontinue the practices of the State of California in terms of continually taking local revenues, the City should be able to meet normal operating expenditures with some modest room for growth. But this does not appear to be sufficient to close the continuing gap created in large part by past actions of the State.

As such, it is suggested that all three revenue sources be considered for implementation at a modest level at the earliest available opportunity so that the City remains competitive and does not place an undue burden on any one sector of the community.

Another point of consideration for the City Council – if it chooses to go forward with one or more of the revenues discussed in this report – is the matter of when to proceed? While largely a policy matter, City Management has given the subject careful consideration and offers the following for Council’s consideration.

Of the three subject revenue sources, two revenues (TOT, Business License) require submission to the electorate while the Sanitation Franchise fee may be acted on by the City Council. The next opportunity for placement of a general tax question before the voters would be November, 2006. Please see the attached report from the Deputy City Clerk, revised by the acting City Attorney, that clarifies the timing for placement of matters on the ballot and other circumstances that may effect voter consideration. Taking into account the discussion with the various interest groups most directly affected by the revenue proposals, available dates for consideration by the voters, the experience of other cities throughout the State in terms of requesting revenue increases, uncertainty with the State of California and the need to address the City's budget gap, City Management would suggest the following:

1. Implement the Refuse Franchise fee at this time. Direct staff to work with the various interest groups on the structure of this new revenue and return to the City Council within 120 days for action.
2. Direct staff to bring the Transient Occupancy Tax and Business License Tax back for reconsideration at a future Council meeting and continue working with the Chamber of Commerce and the Costa Mesa Visitor and Conference Bureau in structuring proposals to be submitted to the electorate at the general election date in 2006. This effort should address not only the structure of the revenue increase but also a commitment for support and public education as to the need for the revenue increase.

The preceding suggestions would allow the City to begin addressing the budget gap now from the revenue side of the equation. Unless circumstances change significantly between now and fiscal year 2005-06, the City will find it substantially more difficult to meet its operating budget requirements. That will likely leave only reductions and programs and services as the means available to balance the operating budget.

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Allan L. Roeder  
City Manager

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Marc R. Puckett  
Director of Finance

- Attachment 1: [TOT Agenda Report regarding Ballot Measure](#)  
Attachment 2: [Business License Survey](#)  
Attachment 3: [Business License Fees](#)  
Attachment 4: [Transient Occupancy Tax & Utility Use Tax Survey](#)  
Attachment 5: [Sanitation Franchise Fee Survey](#)  
Attachment 6: [Letter from CMCVB Board](#)  
Attachment 7: [Possible Special Election Dates Memo dated June 23, 2004](#)

Copy to: Department Directors