

Proposition 13: Unintended Effects and Feasible Reforms

Abstract - This paper explores the causes and consequences of Proposition 13, focusing on its effects on horizontal equity among homeowners, household mobility, and the fiscal structure of state and local government. Horizontal inequities arise because a household's property tax liability depends on the purchase price of its property, not the market value. If property values rise over time, a homeowner in a recently purchased dwelling will pay more taxes than a homeowner who purchased an identical dwelling some time earlier. Proposition 13 and its implementing legislation decreased the relative importance of the property tax, transformed the property tax from a local tax into a statewide tax, and was a contributing factor in the decrease in the overall burden of state and local taxes.

In June of 1978, California voters overwhelmingly approved Proposition 13 and thus started the modern tax-limitation movement. Since then, measures restricting the taxing and spending authority of state and local governments have been implemented in dozens of states. This paper explores the causes and consequences of Proposition 13, focusing on its effects on horizontal equity among homeowners, household mobility, and the fiscal structure of state and local government.

Proposition 13 generated several changes in the California State Constitution, including the following changes in the property tax system.

- (1) The maximum tax rate was set at one percent, not including preexisting indebtedness.
- (2) The assessed value of each property was rolled back to its value in 1975–6.
- (3) For a property that is sold during a particular year, the assessed value increases with the market value, but by no more than two percent.
- (4) When a property is sold, it is reassessed at its full market value.
- (5) State and local governments are prohibited from imposing any other property taxes, sales taxes, or transactions taxes on real property.

In retrospect, the passage of Proposition 13 is not too surprising. In the late 1970s, the combination of rapidly rising

Terri A. Sexton
California State
University,
Sacramento, CA 95819

Steven M. Sheffrin
University of
California, Davis, CA
95616

Arthur O'Sullivan
Oregon State
University, Corvallis,
OR 97331

property values and stable tax rates increased property taxes as a fraction of income. The share of property taxes directly levied on homeowners increased from 34 percent in 1970 to 44 percent in 1978. The state had accumulated a surplus that would have reached \$10 billion had Proposition 13 not passed. State and local governments did not respond to rising property values and tax revenue by cutting tax rates, so voters took matters into their own hands. In doing so, they did not expect reductions in government services, but believed that government could provide the same level of services with less money. Just before the election, 38 percent of the electorate believed that state and local governments could absorb a 40 percent cut in tax revenue without cutting services.

In addition to cutting the property tax rate, Proposition 13 moderated the year-to-year changes in property tax liabilities. In the years preceding its approval, rapid increases in market values led to sticker shock when voters opened the envelopes containing their property tax bills. The large jumps in tax liabilities came without corresponding increases in taxpayers' ability to pay. This provided the motivation for the reassessment cap of two percent per year.

Another possible factor in the passage of Proposition 13 was education finance reform. Fischel (1989) has argued that court rulings requiring the state to equalize educational spending across school districts meant that local residents could no longer use the property tax to improve their schools. When educational funding was disengaged from local property taxes, the support for the property tax as a funding tool diminished, and a tax revolt involving substantial cuts in property taxes may have been inevitable.

The remainder of this paper explores the consequences of Proposition 13. The next section documents horizontal inequities generated by a property tax that is

based primarily on the original purchase price or "acquisition value" rather than market value. The third section discusses some of the distortions of economic behavior resulting from the acquisition-value tax system. The fourth section explains the effects of Proposition 13 on the fiscal structure of state and local governments. In the final section, we explore some feasible options for reforming the property tax system.

HORIZONTAL INEQUITIES FROM THE ACQUISITION-VALUE TAX

Under an acquisition-value tax system, horizontal inequities among property owners are inevitable. When a property is sold, it is assessed at market value, but if the reassessment cap (two percent in California) is less than the rate of property inflation, the assessed value will be less than the market value, and the gap between the two values will grow over time. The sale of a property triggers reassessment at its full market value, so households in identical dwellings will face different tax liabilities, with a recent mover paying higher taxes than a household who has remained in the same dwelling for some time.

The notion that horizontal equity requires equal treatment of households in dwellings of equal market value may seem reasonable, but the Supreme Court decision upholding the constitutionality of Proposition 13 suggests a different standard. In his opinion in *Nordlinger v. Hahn* (505 U.S. 1 (1992)), Justice Blackmun offered the novel argument that, by reducing the effective tax rate for long-term residents, Proposition 13 promoted "local neighborhood, preservation, and continuity." One interpretation of this argument is that two households should be considered equal for property tax purposes if they live in dwellings with the same market value *that were purchased at the same time*. In our discussion of horizontal eq-

uity, we use the broader definition of equality of circumstances, one that is independent of the time a household's dwelling was purchased.

Base Year Distribution and Disparity Ratios

In order to measure and evaluate horizontal inequities generated by Proposition 13, it is first necessary to define the notion of "base year." The base year of a property is defined as the year of the most recent sale or 1975, whichever is more recent; for a property that was in existence in 1975 and has not sold since then, the base year is 1975. The initial base year for a newly constructed property is the year in which it first appears on the property tax roll. The base year is the single most important piece of information necessary to estimate the disparities between market and assessed value; if the housing price inflation rate exceeds the reassessment cap (two percent), the older the base year, the larger the gap between market value and assessed value.

Properties can have multiple base years. If a property owner makes a substantial modification to a property—for example, adding a new wing to a house or building a new structure on a piece of land—the new part of the property will have a separate base year. Large commercial and industrial properties often have multiple base years, reflecting a series of major modifications to the property. Many residential properties will also have substantial modifications. Because it is impossible to keep track of the number of modifications for each class of properties, we made a distinction between properties with a single base year and properties with multiple base years. We term these properties "nonmodified" and "modified," respectively.

The best way to convey the difference between market value and assessed value is the "disparity ratio," defined as the ra-

tio of market value to assessed value. Although data on assessed values are available for all properties, data on market values are not. To compute the disparity ratios, we first obtained data on all properties for two consecutive years and then determined which properties sold in the second year. When a property is sold, we know its new market value (the sale price) and we also know its assessed value from the prior year. For each property sold, we can thus calculate the ratio of market value to assessed value, i.e., the disparity ratio for that property. We then separated all sales into categories based on three factors: the prior base year, the type of property, and whether the property had been modified. Within each category, we calculated the median disparity ratio for all the properties that were sold. These median disparity ratios provide a measure of property tax disparities.

Table 1 shows the distribution of base years and the corresponding disparity ratios for two counties. (Unless otherwise noted, all the data reported in this paper are from our 1995 study (O'Sullivan, Sheffrin, and Sexton, 1995a), which uses data through 1991.) Los Angeles, the largest county in California, contains about 30 percent of the market value of properties in the state. It is an urban county and was largely developed before the passage of Proposition 13. As a result of a relatively low growth rate, a relatively large fraction of properties (43 percent) had a 1975 base year. The housing market experienced rapid appreciation between 1975 and 1991, and this is reflected in relatively high disparity ratios. For example, the disparity ratio for properties with the 1975 base year was 5.19. The typical home buyer paid \$280,000 for a house in 1991 and paid \$2,800 in property taxes. In contrast, a homeowner who had owned an identical dwelling since 1975 paid only \$540 in property taxes.

The disparity ratios and base-year distribution of San Bernardino County

TABLE 1
BASE YEAR DISTRIBUTIONS AND DISPARITY RATIOS

Year	Los Angeles County Homeowners, Nonmodified		San Bernardino County Homeowners, Nonmodified	
	Base Year Distribution	Disparity Ratio	Base Year Distribution	Disparity Ratio
1975	43.2%	5.19	20.3%	3.91
1976	2.4%	4.18	1.8%	3.26
1977	2.6%	3.55	2.5%	3.01
1978	2.6%	2.90	3.1%	2.55
1979	2.7%	2.49	3.7%	1.95
1980	2.7%	2.04	3.3%	1.63
1981	1.9%	1.71	1.8%	1.46
1982	1.5%	1.68	1.9%	1.43
1983	1.5%	1.70	1.7%	1.40
1984	2.7%	1.68	2.8%	1.43
1985	3.2%	1.66	3.8%	1.43
1986	4.1%	1.62	5.0%	1.43
1987	5.5%	1.55	7.3%	1.42
1988	5.8%	1.43	8.9%	1.38
1989	6.9%	1.27	10.9%	1.34
1990	6.1%	1.12	11.6%	1.25
1991	4.4%	1.00	9.4%	1.00

Definitions:

1. Base year of a property: the year of the most recent sale or 1975, whichever is more recent.
2. Disparity ratio: the ratio of market value to assessed value.
3. Nonmodified property: a property that has not been substantially modified; it has a single base year.
4. Modified property: a property that has been substantially modified; it has at least two base years.

differ from those in Los Angeles. San Bernardino is a rapidly growing suburban county, and as a result of rapid growth in population and the housing stock between 1978 and 1991, only 20 percent of properties in the county had a 1975 base year. Although price appreciation in San Bernardino County was high by most standards, it was lower than that in Los Angeles, resulting in lower disparity ratios.

Both disparity ratios and the distribution of base years change over time. In Los Angeles County, the percentage of properties with 1975 base years decreased from 43 percent in 1992 to 30 percent in 1996, a result of natural turnover of property. The recession of the early 1990s led to a nearly 30 percent drop in property values in southern California, and the disparity ratio for properties with a 1975 base year decreased from 5.19 to less than 4.0. Thus, both natural turnover and the recession diminished property tax disparities (Sheffrin and Sexton, 1998).

Winners and Losers from the Acquisition-Value Tax System

One way to demonstrate the horizontal inequities generated by the acquisition-value system is to compute the effects of a revenue-neutral switch to market-value taxation. For a fixed tax rate, a switch to market-value taxation would increase total tax revenue because market values exceed assessed values. For revenue neutrality, the market-value tax rate must be less than the one percent rate in force under the acquisition-value system. Our computations indicate that, in 1992, the appropriate tax rate would be about 0.55 percent of current market value.

To predict the effects of a switch to market-value taxation on different types of homeowners, we matched property tax records with income tax returns (made available by the California Franchise Tax Board) for homeowners in four counties (Alameda, Los Angeles, San Bernardino, and San Mateo). We used estimates of dis-

parity ratios to estimate a market value for each homeowner, and then calculated the total market value for homeowner property and the resulting revenue-neutral property tax rate. We then computed the consequences of switching to market-value taxation.

The acquisition-value system benefits low-income homeowners at the expense of other households. With a switch from the current system to a market-value system, the typical homeowner in Los Angeles County with an annual income of \$30,000 would pay \$138 more in property taxes. In contrast, the typical homeowner with an income of \$70,000 would pay \$69 less. In Alameda County, the figures are \$213 more for the low-income homeowner and \$162 less for the high-income homeowner; in San Mateo County, the figures are \$294 more (low income) and \$105 less (high income).

Poor homeowners benefit from the acquisition-value system because they tend to move less frequently, and thus have relatively large disparity ratios and low effective tax rates. The lower mobility rates for the poor are reflected in the relatively large fraction of poor households with 1975 base years. In Alameda County, 25 percent of all nonsenior homeowners had a 1975 base year. Among the poorest

non-senior households (income less than \$20,000), the percentage with a 1975 base year was 43 percent; among nonseniors with moderate income (\$20,000 to \$40,000), the percentage was 31 percent. In contrast, only 20 percent of nonsenior homeowners with income between \$60,000 and \$80,000 had a 1975 base year.

In each income group, there is substantial variation across households in the changes in tax liabilities. Table 2 shows the results of the following exercise. For a given income group, rank the households with respect to the change in tax liability, with the household experiencing the largest *decrease* in taxes ranked first and the household experiencing the largest *increase* in taxes ranked last. Table 2 shows, for each of three different income groups, the change in taxes experienced by (1) the household in the 25th percentile (25 percent of households experience a larger decrease in taxes or a smaller increase in taxes), (2) the household in the 50th percentile (the median change in taxes), and (3) the household in the 75th percentile. The variation in the changes in tax liabilities is substantial. For middle-income homeowners in Los Angeles, a household in the 25th percentile would pay \$413 less, while a household in the 75th percentile would pay \$417 more.

TABLE 2
VARIATION IN CHANGES IN TAXES WITHIN SELECTED INCOME GROUPS

	Change in Annual Tax Liability			
	Alameda	Los Angeles	San Bernardino	San Mateo
Income = 15,000 to 20,000				
25th percentile	149	-52	-106	-14
50th percentile	373	281	31	520
75th percentile	566	495	238	794
Income = 40,000 to 45,000				
25th percentile	-418	-413	-168	-541
50th percentile	69	126	-80	126
75th percentile	465	417	136	676
Income = 80,000 to 90,000				
25th percentile	-740	-659	-272	-976
50th percentile	-315	31	-121	-356
75th percentile	439	517	178	654

Consider next the effects of tax reform on senior and nonsenior households. A revenue-neutral switch to market-value taxation would increase the average tax liability of senior households and decrease the liability of nonsenior households. In Alameda County, the typical senior homeowner would pay \$501 more in property taxes, while a nonsenior homeowner would pay \$131 less. In Los Angeles, the figures are \$503 more for seniors and \$152 less for nonseniors. Taking a simple average across the four counties, the typical senior homeowner would pay \$474 more, while the typical nonsenior would pay \$138 less. These averages obscure significant differences in tax changes within each group. For example, in Alameda County, the tax increase for the senior homeowner in the 75th percentile (ranked with respect to changes in taxes) is over twice the tax increase for the senior homeowner in the 25th percentile.

Senior homeowners would pay higher taxes under a market-value system because they are less mobile, as reflected in the relatively large fraction of senior households with a 1975 base year. In Alameda County, 82 percent of senior households have 1975 base years, compared to 25 percent of nonsenior households. In Los Angeles, 82 percent of seniors have 1975 base years, compared to 30 percent for nonseniors. On average, in the four counties we studied, senior households are about three times more likely to have 1975 base years.

Horizontal Equity and Turnover Rates

To this point, our discussion of equity has focused on contemporaneous, horizontal inequities. However, it is important to emphasize that, in the long run, differential patterns of turnover (coupled with inflation in excess of two percent) are the primary sources of inequity with regard to Proposition 13. Suppose, for example, that all property was sold precisely after

seven years. If inflation were steady but exceeded two percent, the system would appear to create inequities, since newly sold properties would be assessed at market value while properties held for nearly seven years would be underassessed relative to market value. At any point of time, there would be clear inequities in assessment. But these inequities stem from viewing the situation from a static framework. From a long-run, dynamic perspective, all property is reassessed at market value every seven years and falls below market value in the intervening years. Over this longer time frame, all purchasers face the same dynamic pattern. Our work, however, has emphasized that turnover rates are not uniform, and infrequent movers garner larger tax benefits.

Capitalization

To what extent are the tax cuts from Proposition 13 capitalized into the market values of property? In general, a decrease in the property tax rate increases the net benefits of owning property, increasing the amount that potential buyers are willing to pay for the property. This is the capitalization process: a tax cut is offset, at least in part, by an increase in the market price of housing.

Proposition 13 decreased tax liabilities in two ways. First, the maximum tax rate (one percent) was below the tax rates prevailing in most localities. Second, the use of a property's acquisition value rather than its current market value decreased the *effective* tax rate below the one percent maximum. Both of these tax cuts affected the market values of dwellings in the state.

Consider first the effects of decreasing the tax rate to one percent. Consider a world in which individuals have the option of either renting or owning and the only taxes are *ad valorem* property taxes. The rental rate is exogenous, and the supply of housing is fixed. In equilibrium, individuals will be indifferent between rent-

ing and owning, so the price of housing must be such that the sum of mortgage payments and property taxes equals the annual rental payment. For example, if the annual rental cost is \$10,000, the interest rate is ten percent, and the property tax rate is two percent, the price of housing will be \$83,333. At this price, an individual is indifferent between purchasing the house and paying interest and taxes (annual cost = 12 percent of \$83,333 or \$10,000) or simply renting. If the market-value tax rate drops to 1 percent, the price of housing will increase to \$90,909 (11 percent of this price equals the annual rental cost). To keep the household indifferent between renting and owning, a decrease in the tax rate increases the price of housing.

Consider next the effects of the adoption of an acquisition-value tax system with a reassessment cap of two percent per year. If the appreciation rate exceeds the reassessment cap, the real value of the tax decreases over time, i.e., the effective tax rate decreases over time, from one percent downward. To illustrate this phenomenon, suppose that all the features of the previous example still hold but that real tax payments fall by six percent per year (the appreciation rate of eight percent minus the reassessment cap of two percent).

To calculate the housing price that would make an individual indifferent between owning a home or renting, we must make some assumptions about household mobility. As a first step, assume that the individual remains in the home forever. This individual would obtain the maximum benefit from Proposition 13 because the real level of taxes falls each year. To calculate the equilibrium housing price, we equate the present value of rental payments to the sum of the present value of mortgage plus taxes. Using the same parameter values as in the previous example and assuming that property taxes fall six percent per year in real terms, the price of

housing that would make this individual indifferent between renting and owning increases to \$94,318, so the price of homes rises to \$94,318. The full benefits of Proposition 13 are capitalized into the housing price.

At the other extreme, suppose that each household moves every year, so they receive no benefits from the acquisition-value tax system. In this case, the acquisition-value system will have no effect on real tax liabilities and thus no effect on the willingness to pay for housing. The market value of housing will remain at \$90,909.

If individuals all change residences at some fixed intervals, the price of housing will increase to some value between \$90,909 and \$94,318. The more rapid the turnover, the lower the benefits from the acquisition-value tax and the lower the market value. With a fixed supply of housing, the price of housing still incorporates the full benefits of the tax breaks generated by the acquisition-value system.

The story changes, however, once we allow for differential mobility patterns among households. Those households that move less frequently will be willing to pay more than frequent movers for owner-occupied housing, because infrequent movers enjoy larger tax benefits. With a fixed supply of housing, the price of housing will be determined by those who are prepared to pay the most, i.e., those with the lowest turnover rates. Among those who actually purchase homes, the individual with the highest turnover rate (the marginal buyer) will be indifferent between owning and renting. For that individual, the tax benefits equal the increase in the price of housing. Individuals with lower turnover rates will enjoy net benefits from the acquisition-value system: the tax benefits will be less than the increase in the price of housing.

This simple, stylized model captures the essential inequities of an acquisition value system in a dynamic setting. Compared

to an *ad valorem* system, the winners will be those with the lowest turnover rates and the losers will be those with the highest turnover rates. If households differ in their turnover rates, only part of the benefits of the acquisition-value tax system are capitalized into the price of housing.

MOVING PENALTIES AND MOBILITY

The acquisition-value tax system penalizes firms and households when they move from one property to another. If market values increase more rapidly than the assessed values (i.e., if property values increase at a rate exceeding the reassessment cap of two percent), there will be a growing gap between the tax paid for a household's current dwelling and the tax paid that would be paid for an alternative dwelling of equal market value. A move to a different property triggers reassessment at full market value, and this moving penalty distorts the behavior of households and firms.

The moving penalty causes two sorts of inefficiencies for homeowners. First, households are less responsive to changes in economic circumstances (e.g., changes in income or family structure or changes in housing prices) that could trigger a move to a different dwelling. To realize the tax benefits of the acquisition-value system, a household will remain in a particular dwelling for a longer period, tolerating a greater mismatch between its dwelling and its ideal dwelling. The second distortion is that a household will be more inclined to modify its current dwelling rather than move to another dwelling.

How large are the inefficiencies caused by the acquisition-value tax system? Our numerical exercises suggest that the excess burden among homeowners is relatively small, in the range of \$22 to \$66 per household per year (O'Sullivan, Sexton, and Sheffrin, 1995b). The excess burden is relatively low because the state's tax rate is relatively low (below one percent of

market value), which by national standards is extremely low. A well-known proposition of public finance is that the excess burden of a tax increases with the square of the tax rate. For an acquisition-value system with a tax rate of three percent, our computed excess burden is over ten times higher than the excess burden for the California tax system.

The moving penalty also affects business property decisions. Like households, businesses will be less responsive to changes in business and property-market conditions, tolerating a bigger mismatch between desired and actual property characteristics. Businesses will also be biased toward modifying property rather than moving to another property. An added distortion is that existing businesses have a tax advantage over new ones. If a new firm purchases a property that is identical to the property owned by its competitors, the new business will pay higher property taxes because its property will be assessed at full market value, while its competitors' assessed values will be based on their acquisition values.

CHANGES IN FISCAL STRUCTURE AND GOVERNMENT RELATIONS

Proposition 13 and its implementing legislation significantly changed the fiscal structure of state and local government in California (O'Sullivan, Sexton, and Sheffrin, 1995a). It decreased the relative importance of the property tax and caused local governments to develop alternative sources of revenue. At the state level, the burden of taxes (as a fraction of personal income) decreased between 1977 and 1995, and Proposition 13 was a factor in this reduction. Proposition 13 also transformed the property tax from a local tax into a statewide tax, with the amount of revenue going to each local government determined by apportionment formulas developed by the state government.

Changes in Property Tax Revenue and the Tax Burden

Total property tax revenues in California fell from \$10.3 billion in fiscal 1977–8 to \$5.6 billion in 1978–9, a decline of more than 45 percent. All local governments suffered a decline in revenues, but counties were hit hardest, experiencing a 57 percent reduction in property tax revenues. Although total property tax revenues rose to \$19.5 billion by fiscal 1995–6, real property taxes were still 25 percent below their 1977–8 level, and real property taxes per capita were 46 percent lower.

Property tax revenues have declined in relative importance for counties, cities, and special districts. Table 3 shows the share of revenue from the property tax before Proposition 13 (1977–8) and 18 years later. For counties, the share from the property tax dropped by about two-thirds. For cities, the property tax share was cut in half. As shown in Table 4, the share of county revenue from intergovernmental transfers increased over this period, while the share of city revenue from intergovernmental transfers decreased.

Proposition 13 was a contributing factor in the decrease in the overall tax burden in California over the last 20 years. The second and third rows in Table 5 show total tax revenue and taxes as a percent-

age of personal income for 1978, 1988, and 1995. The fourth and fifth rows show statewide taxes, assessments, and regulatory fees, in total and as a fraction of personal income. In both cases, the fiscal burden—defined in terms of personal income—has decreased.

Alternative Revenue Sources

In the last 20 years, local governments have become more dependent on alternatives to the traditional property tax. In the wake of Proposition 13, local governments scrambled to raise existing fees and enact new local levies. The most common were new development fees, real estate transfer fees, business license fees, utility user fees, sewer charges, and park and recreation fees. For all California cities, the percentage of revenue from current service charges increased from 25 percent in 1977–8 to 41 percent in 1995–6. Among nonenterprise special districts (e.g., parks, libraries, police and fire protection districts), the percentage of revenue from fees increased from 7 percent in 1977–8 to 46 percent in 1995–6. City revenues from property-transfer fees more than tripled, from \$40.7 million in 1977–8 to \$168.4 million in 1995–6.

Local governments have also expanded the use of development fees and exactions. Cities and counties have the authority to

TABLE 3
SHARE OF LOCAL REVENUE FROM THE PROPERTY TAX

	1977–8	1995–6
Counties	33.2	11.6
Cities	12.4	5.6
Special districts	40.6	32.5

Source: California State Board of Equalization.

TABLE 4
SHARE OF LOCAL REVENUE FROM INTERGOVERNMENTAL TRANSFERS

	1977–8	1995–6
Counties	50.6	64.1
Cities	33.2	13.1

Source: California State Board of Equalization.

TABLE 5
TAXES AND REVENUE AS PERCENT OF PERSONAL INCOME

	1978	1988	1995
Total tax revenue (\$billion)	26.4	52.5	75.5
Tax revenue as percent of personal income	13.1	10.0	10.2
TAR: taxes, assessments, and regulatory fees (\$billion)	27.8	56.2	81.7
TAR as percent of personal income	13.8	10.6	11.0

Source: Chapman (1998).

require developers to bear the cost of infrastructure improvements through the dedication of land to public use, the construction of public improvements, or the payment of developer fees. Cities and counties often condition the approval of development projects on the provision of a variety of public facilities, including schools, freeway interchanges, libraries, parks, public transit, fire stations, low-income housing, and child care facilities. The School Facilities Act of 1986 gave school districts the authority to charge impact fees for permanent facilities.

Another financing technique that has been greatly expanded since Proposition 13 is the establishment of special assessment districts. Special assessments are charges imposed on property to pay for a public improvement of direct benefit to that property, e.g., flood control, drainage, and street lighting. The courts have held that special assessments are not subject to the one percent property tax limitation and the two-thirds approval mandated under Proposition 13. Special assessment fees collected from property owners increased more than fivefold between 1983 and 1995, from \$64.4 to \$401.4 million. The volume of outstanding benefit-assessment bonds has grown significantly since 1977–8. For cities, outstanding benefit-assessment bonds increased more than sixfold, from \$393 million in 1977–8 to \$3.0 billion in 1995–6. For counties over the same period, these bonds increased eightfold, from \$111 million to \$1.0 billion.

The Mello–Roos Community Facilities Act of 1982 gave counties, cities, and special districts the authority to establish community facilities districts within their jurisdictions. With a two-thirds approval of the district's voters (or two-thirds of landowners if there are fewer than 12 voters), local governments can issue tax-exempt bonds and levy special taxes to finance public facilities (e.g., streets, water, sewer and drainage systems, parks, schools, libraries, jails, and administrative

facilities) and to support public services (e.g., police and fire protection, library services, park and recreation services, flood, and storm services). By 1990, Mello–Roos financing totaled \$977 million.

Another attractive financing tool for cities is tax increment financing. Bonds can be issued to finance redevelopment in “blighted” areas, with the idea that the redevelopment will generate enough additional property tax revenues to service the bonds. When a redevelopment agency incurs debt for a redevelopment project, the property tax base within its boundaries is frozen and the agency is subsequently entitled to 98 percent of any tax increments within its boundaries for the life of the project. Following the implementation of Proposition 13, entire cities were designated as redevelopment districts. Some small cities designated open land as part of their redevelopment areas so that improvements could be financed to attract new developments. Since passage of Proposition 13, the number of redevelopment agencies has more than doubled, from 197 in 1977–8 to 400 in 1996–7.

In recent years, counties have relied increasingly on the use of lease-purchase plans as a method to finance capital expenditures. Under such a plan, a non-profit corporation is organized for the purpose of issuing Certificates of Participation. The proceeds are used to build a structure on land owned by a governmental agency. The corporation may arrange for conventional financing, secured by a long-term lease with the governmental agency that will use the facility. The terms of the lease are sufficient to retire the financing, and upon expiration of the lease term, the title of the facility passes to the governmental agency. Lease-purchase obligations increased almost sevenfold between 1984 and 1996, from \$1.4 to \$10.6 billion.

What are the implications of the shift away from the property tax to alternative

revenue sources? The change in the revenue mixture raises obvious questions concerning economic efficiency and equity, but as far as we know, there are no studies of the efficiency effects or the distributional consequences of the changes in the revenue mixture.

Local Government Structure and Fragmentation

There was some speculation that Proposition 13 would encourage the formation of new cities and special districts. Cities could have an incentive to “secede” from a county to raise more revenue for local public goods. Counties might have an incentive to spin off some of their functions to special districts.

There is no evidence that Proposition 13 increased the number of local governments in the state of California. As documented by Lewis (1998), the system of local government in California is less fragmented than the system in the average state. Since 1963, the number of new cities per year has dropped, and Proposition 13 did not affect this downward trend. The number of special districts has increased only slightly since 1970, with no measurable change in the trend since 1978. A standard index of local government fragmentation increased only slightly between 1972 and 1992.

Apportionment Rules

Prior to Proposition 13, each local government in the state—each county, city, school district, and special district—had the authority to determine how much property tax revenue it collected each year. Local governments could adjust the tax rate applied to properties within their boundaries. The property tax bill of an individual property owner was computed by applying the tax rates of all the local agencies serving their property. Under Proposition 13, the total tax levied on a

particular property is limited to one percent of assessed value, with the proceeds apportioned to the various local governments serving the property.

According to Section 1 of Article XIII A, the official ballot measure for Proposition 13, the proceeds of the one percent countywide property tax are to be collected by counties and “apportioned according to law” to the various districts and agencies within the county. The burden fell on the legislature to develop apportionment rules that determine how much of the smaller property tax pie would be allocated to cities, school districts, and special districts. Statewide, the property tax currently generates about \$20 billion per year and is divided as follows: school districts receive 53 percent, counties receive 18 percent, special districts receive 18 percent, and cities receive 11 percent.

The apportionment policies developed by the legislature have generated a very complex set of rules for dividing tax revenue among local governments. Initially, county property tax revenues were allocated to local agencies (cities, counties, and special districts) on the basis of their average share of countywide property taxes during the previous three years. Later, the rules were adjusted to increase the revenue going to a jurisdiction that experienced an increase in its tax base. In general, the apportionment rules have caused residents in jurisdictions that had relatively low tax rates (prior to Proposition 13) to subsidize residents in jurisdictions that had relatively high tax rates.

More recently, fiscal crises at the state level have led to changes in apportionment rules. The Educational Revenue Augmentation Fund redirects over \$3 billion of property taxes per year from cities, counties, and special districts to school districts. This allowed the state to decrease its contribution to school districts and thus mitigate state fiscal crises, but of course caused fiscal problems for cities, counties, and special districts.

In general, the implementation of Proposition 13 has converted the property tax from a local tax to a state tax (Chapman, 1998). Proposition 13 fixes the rate at one percent, and the state's apportionment rules determine how much money each local government receives. Although a local government can affect its property tax revenue through annexation, incorporation, or economic development, only a small fraction of the additional property tax revenue makes it back to the locality.

The current apportionment system is an amalgamation of many complex rules developed as short-term responses to fiscal crises at both the local and state levels. The fiscal crises were precipitated by voter referenda (Proposition 13 and other tax and expenditure limitations), judicial mandates (Serrano), and legislative actions. The result is a hodgepodge system of intergovernmental transfers and mandates that is incomprehensible to most observers.

POLICY RECOMMENDATIONS

It is clear that wholesale reform of the acquisition-value tax system implemented under Proposition 13 would not be politically feasible. A complete switch to market-value taxation would generate substantial changes in tax burdens among homeowners, with the largest tax hikes experienced by senior citizens. There are, however, two feasible changes in the treatment of residential property that would mitigate horizontal inequities and raise revenue (O'Sullivan, Sexton, and Sheffrin, 1995a).

One step would be to raise the reassessment cap from two to four percent. If the annual increase were mandated at four percent, as long as the current assessed value remained less than the market value, assessed values might eventually "catch up" to market values. This measure

would reduce some of the discrepancies between assessed and market values, reducing horizontal inequities and reducing the moving penalty. This measure would also raise a modest amount of revenue.

A second step would have a much smaller effect on revenues but would be of symbolic importance. The provision allowing property to be passed through the generations within the family without reassessment should be repealed. It is not desirable to create a dynastic class within the state, and this provision serves to dramatize the inequities built into the system. It would be best to tackle this strange feature of the tax code before the intergenerational transfer of property without reassessment becomes common practice.

We recommend more significant changes in the treatment of business property. A switch to market-value taxation would level the playing field between new and existing businesses and raise a considerable amount of revenue. A switch to market-value taxation at a rate of one percent would generate several billion dollars per year. An important component of business property is rental housing. A switch to market-value taxation would create upward pressure on rents. To mitigate some of the undesirable distributional effects of this change, the state could expand its program of income tax credits for low-income renters.

Our final recommendation is for a fresh look at the fiscal relationship between the state and local governments. The current system of intergovernmental grants and mandates is a convoluted mix of short-term quick fixes. The only apparent policy rationale for the current system is that each rule appeared to be expedient at the time it was implemented. Over time, the layering of these rules has generated a system that cannot be understood, much less defended on policy grounds. The state should develop a new system of intergov-

ernmental grants and mandates, one that recognizes the current budgetary and judicial realities and is true to the principles of fiscal federalism.

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