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Policy Memorandum

TO: The Honorable Gavin Newsom, Governor of California

FROM: Minh D. Tran, PAI 735

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SUBJECT: Proposition 13 Reform

Purpose and Structure. The purpose of this memorandum is to propose revisions to Proposition 13. The memorandum structure describes Proposition 13's effects and current state and local government revenue sources, as well as analyzes the proposed changes' impacts and their mitigation. The reform proposals are as follows:

(1) Remove the two percent annual valuation increase limit and utilize market rate for annual assessment, with the following execution plan.
(2) Utilize a two-year announcement-to-implementation lag.
(3) Incrementally increase tax payments over a period of four years for residential properties with assessment increase of 50 percent or greater.

Overall, the policy changes continue to meet Proposition 13's original objectives and generate net increase in tax revenues through more balanced resourcing to support addressing the state's major challenges.

Proposition 13 Overview. Real property tax limit is one percent of taxable value, which is based on annual assessments that can increase property value by up to two percent in order to account for inflation. Real property includes homes and condominiums, owned or rented, commercial and industry property, vacant land, rural land, and certain personal property. Additional rates may be placed on the one percent by local governments to repay debt or outlays for which voters have voted. The market price is assessed only if a change in ownership or new construction occurs, with some exceptions. In the event that a property's value decreases upon assessment, a refund is provided (1).

Local Government Revenue Sources. Property taxes account for the largest share of local government revenue, though Proposition 13 has reduced its proportion to less than two-thirds. As a result, local governments employ sales, utility, and hotel taxes to replace the lost revenue, which has grown by 600% since 1978. Other local government methods to recover lost revenue are through fees such as developer fees. Current trends indicate slight increase in these alternative sources' share of local tax revenue (2).

State Revenue Sources and Allocation. California's General Fund budget's main revenue sources are personal income tax, retail sales and use tax, and corporation tax. Of these, personal income tax accounts for 68 percent, retail sales and use tax comprises 19 percent, and corporation tax contributes 9 percent. Personal income tax's percentage increased to 67.5 percent in 2016 compared to 52.9 percent in 2010. This increase reduced the percentage share of other revenue sources, and no estate taxes have been collected since 2001. Property tax revenues are allocated to local governments. State allocation in 2015 was 38 percent to school districts, 28 percent to counties, and cities received 18 percent. Redevelopment agencies and special districts received 12 and 8 percent, respectively (3).

Effects of Proposition 13.

Two effects of Proposition 13's limitation on value increase are variations in tax saving amounts between income levels, and variations in tax payments between neighboring properties. 2017 census data for home ownership in California showed ownership percentage increases as income level increases, and the state's Legislative Analysis Office claims that higher income households generally own properties with greater value. Therefore, the effective one percent tax rate limit results in larger amounts of savings as market value increases. Since its implementation, approximately two-thirds of Proposition 13's tax savings are received by households with incomes greater than $80,000 (2). Tax payments can also vary within a specific neighborhood. For example, under Proposition 13, a home purchased for $100,000 40 years ago would have an assessed value of $220,804 and the corresponding tax payment of $2,284. If market values increased at 3 percent annually over this time period (1 percent above Proposition 13 limit), then a new neighbor would pay $326,204 for his or her home and have $3,262 in tax payments, 47.73 percent more than the long-time neighbor. At 10, 20, and 30 years, the percentage difference in payments are 10.25 percent, 21.55 percent, and 34 percent, respectively.

Impacts on Tax Revenues.

Removing the assessed value limitation will recover lost tax revenues caused by Proposition 13. Considering single-family homes only, with which median price rose 6.9 percent in 2018 (4), the 1 percent tax rate, combined with the 2 percent increase limit, creates a 0.04 percent revenue loss for each home with ownership change in that year. Zillow Real Estate estimates California median price of $548,800 for single-family homes in 2018 (5). This implies the 2017 median price of $513,376, and the Proposition 13 authorized assessment for 2018 to be $523,644. The result is a $25,156 undervaluation for each single-family home in 2018. Applied to the 8.1 million single-family homes in the state, 1 percent of the total undervaluation is $2.038 billion. This excludes the remaining types of taxable real property of commercial and industrial, multi-family, eligible personal property, etc., of which the combined 2016 assessed total was $2.602 trillion (6).

The removal of the property tax rate limit will impact personal spending and affect retail and sales tax revenues. A study of the Italian property tax law changes in 2010 provides a possible outcome of the policy change. The study showed that affected households spent 0.05 percent less on non-durable goods and 0.43 percent less on durable goods as a result. For those whose wealth is less than one month of income, the decreases are 0.41 and 0.93 (8). In 2017, durable consumption in California was approximately 9.9 percent and nondurable accounted for 18.1 percent of all personal consumption (8). Applying the study's decreased spending response and the consumption percentages to California's 2019 budget, which estimates of $26.2 billion in sales tax revenue for 2018, the potential loss in sales and use tax revenue is $2.17 billion.

Impacts on Property Owners, Renters, and Specific-Category Individuals.

The tax limit removal produces larger impacts on owners than renters. According to the 2017 census for California, homeownership rate was 54.5 percent. Within the homeowner group, 25.8 percent have income of $50,000 or below, in 2017 inflation adjusted dollars (9). Assuming the 4.8 percent difference between property market value growth and Proposition 13's increase limit, owners will observe an additional 0.048% increase in tax payments. However, since the 1 percent tax rate is in effect, the effective tax rate remains consistent proportionate to property value.

The policy changes will create large increases in tax payments for some properties and thus the moderation mechanisms of implementation lag and phased increases are recommended to mitigate this effect. Business property turn-over rates were between 6 and 7 percent from 2012-2014, similar levels to residential properties. If this trend holds for the three most recent years, the policy change will increase tax payments for over 90 percent of current businesses and homeowners. In Los Angeles county, nearly 50 percent of residential, commercial and industrial property have not been assessed in at least 16 years (2). These properties will incur large tax payment increases. For example, the median house price in California was $211,500 in 2000, adjusted to 2000 dollars (10). Annual increase of 2 percent allowable by Proposition 13 brings assessed value in 2018 to $304,074. The difference with the market value of $548,800 then implies a tax payment increase of $2,447.

Renters in California generally have lower income than homeowners. 53.1 percent have inflation adjusted income of $50,000 or less, but will bear a smaller portion of the tax payment increase relative to owners. A 2015 California Center for Jobs and the Economy report estimated the elasticity of demand for housing at -0.74, and supply at 0.09 (11), and so renters would absorb 10.8 percent of the tax with the remaining 91.2 percent falling on landlords. This means owners are unable to completely transfer the increased payments to tenants, and would end up paying 91 cents for every dollar increase in tax payments. Renters would pay the remaining 9 cents.

The policy changes may affect labor availability and force relocation for some households. In 2017, the top ten occupations in California for employment per 1,000 jobs were in services, such as office, food, and healthcare (12). Of this group, 69.4 percent have an average annual wage less than $50,000; this subgroup also accounts for 51.14 percent of total employment in the state. Employment mobility rate in 2012 for the U.S. in services for workers under 21 was 4 percent and workers over 30 was approximately 2 percent, and decreases with age (13). The combination of low wages and difficulty in switching jobs may cause additional hardships on households that need to relocate as a result of the reforms. The proposed lag in policy change implementation serves to provide reaction time in order to mitigate these hardships.

Reform implementation will also create difficulties for elderly residents and other homeowners who rely on a low and fixed income. Propositions 60 and 90 enable those 55 and older to either transfer their base value within their county of residence or to another county, if the destination county participates in Proposition 90 (14). Revisions to these propositions are also recommended in order to prevent negating impacts to Proposition 13 reforms. One possible solution is to eliminate the ability to transfer within a county completely (Proposition 60) while reducing the sales tax on revenue resulting from the sale of the property for those 55 and older. This provides those individuals with some financial support as they relocate to a more affordable area. Proposition 90 may be retained as a voluntary reciprocal arrangement between counties, however additional analyses are necessary to determine risks of sorting from inter-district arrangements.

<u>Impacts on Public Spending and Businesses</u>.

The increase in property tax payments will lead to lower public spending preferences by voters, most notably to education as local governments allocate 38 percent of property tax revenue to education (15). Education spending may decrease by 22 percent for each percent increase in tax amount (16). Other potential decreases, shown as demand elasticities, are in parks and recreation, -0.19 to -0.92, public safety -0.19 to -1.0, public works -0.92 to -1.0 (17). The risk of lower public program spending may be mitigated through state mandated minimum requirements such as Proposition 98's requirement of the state to allocate at least 40 percent of its General Fund to K-14 education (18). Adjustments to local taxes and fees can offset the increased property tax burden and reduce the level of spending reduction. Decreasing reliance on sales tax and fees, and reducing their amounts, also lower their burden on lower income households as the majority of sales taxes are absorbed by consumers (19).

Businesses will incur increased tax expenses from the policy change. Current state business taxes are S-/ C- corporate tax: 1.5 to 3.5 percent for S, and 8.84 to 10.84 percent for C type corporations, and a combination of a minimum franchise tax and income tax. Individuals with rental properties will also face increased tax expenses through rental income and property value increase. Market value assessments of property would place the additional 0.048%, calculated previously, on business tax expenses. Consequently, the increase costs of business can cause adverse effects such as decisions to reduce employment as cost saving measures, although the increased operating expenses would also reduce taxable income.

Additional Considerations for Reform.

Proposition 13's effect of slower increase in property values relative to market value creates inequity between long-time and new neighbors in regards to tax price. It also incentivizes homeowners to not sell their homes in order to take advantage of the lower effective tax rate. The majority of Californian homes are more than 35 years old, and homeownership rates have declined steadily since 2005; down to 53.7 from 58.4 percent and is currently third lowest in the country (20).

The increased revenues from market value assessments may be directed towards current state-wide issues. The state currently faces housing shortages, particularly for low income areas with 1.5 million rental unit shortfall for very low and extremely low-income renters (20). California's current transportation infrastructure costs the state $61 billion annually from traffic delays and requires $137 billion for its 10-year maintenance backlog (21). Road and transit repairs are underfunded by $85 billion even with recent fees increases (22).

Conclusion.

The proposed Proposition 13 reforms continue to support its original objectives to provide predictable property tax payments for homeowners. The reforms also correct its unintended inequitable and regressive effects, and align with the state's progressive tax system. The accompanying proposed mitigation mechanisms are intended to reduce the risks and impacts of decreased public spending and varying tax payment increases between residents.

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a. "California's Surface Transportation Report Card 2018" American Society of Civil Engineers.
A professional organization of engineers with worldwide membership. Organization would emphasize standards for technical competence and objective analyses to maintain credibility and members.

b. "Regulation & Housing: Effects on Housing Supply, Costs & Poverty" California Center for Jobs and the Economy. May 2017.
Non-profit organization that aims to be a definitive source of information on jobs and economic trends. Would have interests in obtaining reliable data and conduct objective analyses to maintain credibility.

c. "California's Housing Future: Challenges and Opportunities" California Department of Housing and Community Development. January 2017.
State agency that supports rental and homeownership opportunities. Has main interests in the rental and homeownership environment of the state and identifying problems and possible solutions. Would have access to current data pertaining to housing.

d. "California Property Tax: An Overview" California State Board of Equalization. Publication 29. December 2018.
State agency that administers the state's property tax programs.

e. "Over 55 Base Year Value Transfer" County of Placer Assessor's Office.
Assessor Office of Placer County, California. Responsible for administering the county's property tax program, and would have accurate and current knowledge of state and local policies and procedures regarding property tax.

f. Bosler, Canyon and Nicolas Petrosky-Nadeau. "Job-to-Job Transitions in an Evolving Labor Market" *Economic Letters*. Federal Reserve Bank of San Francisco. 14 November 2016.
Publication from FRB-SF to provide economic analyses for the public. Criteria for publication in this forum would address competent research method and sound applications of theoretical and quantitative analyses.

g. *Personal Consumption Expenditures by State, Annual: California 2017*. Federal Reserve Bank of St. Louis.
FRB St. Louis is part of the Federal Reserve System. Has responsibilities and roles to support monetary policy and would have personnel, access, and objective to collect and provide accurate economic data.

h. Inman, Robert "The Fiscal Performance of Local Governments" *Current Issues in Urban Economics*, 1979.
Data table from a publication of a credible university, and author is a reputable scholar. The data results were also consistent with concepts and findings throughout PAI 735 course.

i. "Understanding the Basics of County and City Revenues" Institute for Local Government. 2013.
Non-profit organization that supports local governance and has a long working relationship with local agencies in California. Organization would aim to provide credible information to local governments to better support their communities.

j. Legislative Analyst's Office.
   i. "Common Claims About Proposition 13" September 2016.
   ii. "California's Tax System: A Visual Guide" 12 April 2018.
   iii. "The 2017-18 Budget: Transportation Funding Package" February 2017.
Office is part of California's legislature. Provides fiscal and policy advice to California's legislature. Office's interests are nonpartisan analyses of state budget and observes implementation of legislative policies.

k. Nguyen-Hoang, Duncombe & Yinger, *Education Finance and Policy*, 2014.
Publication in a scholarly journal from a credible educational institution. Publication requirements would emphasize higher standards of data quality and soundness of reasoning. Scholarly study would imply focus on objective conclusions.

l. "Financing California's Public Schools" Public Policy Institute of California.
Non-profit organization that focuses on California state policies through research. Would have the capability to determine sources of California school funding and no apparent incentive to distort statistics.

m. "2019-20 Governor's Budget Summary – Revenue Estimates" State of California Department of Finance.
California's state department of finance and advises the governor on fiscal policies. The department would have resident expertise on revenue estimates and knowledge on state program expenditures.

n. Sforza, Teri. "Where Do Your Property Taxes Go?" *The Orange County Register* 28 December 2015.
Newspaper company for California's Orange County. Main focus would be on local issues, inform the community, and would possess accurate information regarding local government's use of tax revenues.

o. Surico, Paolo and Riccardo Trezzi (2015). "Consumer Spending and Property Taxes," Finance and Economics Discussion Series 2015-057. Washington: Board of Governors of the Federal Reserve System, http://dx.doi.org/10.17016/FEDS.2015.057.
The FEDS contains working papers on economic issues of interests to the Federal Reserve and these studies would have been conducted by professionals knowledgeable in the field and capable to conduct quality research.

p. *May 2017 State Occupational Employment and Wage Estimates – California*. United States Bureau of Labor Statistics.

Federal agency responsible for measuring labor market activity in the economy. Would have the capabilities, personnel resources, and interests to collect and provide accurate information on employment information within the U.S.

q. United States Census Bureau.
   i. *Community Facts – California*.
   ii. *Historical Census of Housing Tables – Home Values*.
   National agency to provide information on its population. Possesses interests to obtain accurate and current data on communities to support national policy development.

r. Yinger, John. PAI 735 – Lesson 9. Syracuse University.
   Course material.

s. "California Home Prices & Values" *Zillow*.
   Real estate listing company nation-wide. Company's interests would be to provide accurate and updated information on home listings, and would have access to real estate data through networks or client listings.

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1. "California Property Tax: An Overview" California State Board of Equalization. Publication 29. December 2018.
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4. "2019-20 Governor's Budget Summary – Revenue Estimates" State of California Department of Finance.
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12. *May 2017 State Occupational Employment and Wage Estimates – California*. Bureau of Labor Statistics.
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