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Property Taxation after the California Vote

By C. Lowell Harriss

California voters, by one of the most dramatic popular actions of recent history, have cut their property taxes by more than half. This "thundering message" against big and ever-more-expensive government also focused national attention on that standby of local finance, property taxation. This tax does need attention—and action; but before knowing what steps to take, we must answer the question, What approach to property taxation would be most in our interest and that of our children? The answer will not be a simple one.

In 1902, property taxes were somewhat under 4 percent of Net National Product. In 1978, they will be just about the same, a total of $65 billion. This comparison may seem to show little more than that our great-grandparents were also taxed on property. However, in 1902, there was no income tax, no retail sales tax, and no payroll tax—only a miscellany of minor levies and the tariff. More recently, while property tax payments have more or less kept pace with incomes, other taxes have soared, driving an ever-larger wedge between earnings and after-tax income. This has made the average taxpayer perceive property taxation as an increasing burden. In some communities, moreover, and for some families everywhere, property tax increases have far outstripped the national average.

California represented one such extreme case. A high average property tax ($64 per $1,000 of personal income in 1976 vs. a national average of $45), coupled with some large and sudden increases there, brought protests. Assessment increases outpaced the speed of general inflation. Graduated income tax rates and a high sales tax enabled the state treasury to scoop up surpluses unprecedented in American budgetary history. Officials failed to cut tax rates in order to return at least some of this inflation-caused revenue bonanza to taxpayers. Citizens were not long in making their feelings known.

The California system gave voters an opportunity to express themselves, not merely by designating one person over another to represent them in the legislature or city council but also by embedding tight limits in the state constitution. By a two-to-one majority, a ceiling rate was set at one percent (plus debt service) on full value assessment; annual increases were limited to 2 percent, less than one-third of today's inflation rate.

Keep in mind that, in California more than in most of the country, assessments on homes rather

This Issue in Brief

The overwhelming support of Proposition 13 by California voters raises serious questions about the function of property taxation in government fiscal policy. There are no easy answers.

In many ways, what happened in California was unique for a variety of reasons. However, there are a number of lessons to be learned from Proposition 13 and about the impact of inflation on property taxes.

In this article, Professor Harriss argues for retaining and strengthening the property tax, which he calls a "standby of local finance."

promptly reflect market conditions—in an environment in which house and land prices have been rising rapidly. Often, however, local officials did not use the increases in tax base to finance offsetting reductions in tax rates. Homeowners faced rising tax bills; cash income, especially for retired persons, did not always go up correspondingly. Nor, it seems, was there a sense of value received in noticeably better public services, as increases cumulated year after year, building pressure for tax relief. The Advisory Commission on Intergovernmental Relations ranks California third highest on its scale of state-local "fiscal blood pressure"—index numbers of (1) the height of taxes (1975) and (2) the size of the increase from 1964 to 1975. These pressures culminated in the passage of the Jarvis-Gann Amendment last June.

The full results of Proposition 13 will not appear at once. Only time will reveal whether new jobs develop as property owners use the addition to their disposable income; whether extensive declines will occur in state-local employment; and how much more erosion of local authority will result from expansion of state payments to replace revenues lost by the sweeping changes in real estate taxes.

Grants-in-aid Complicate Economizing

As local officials look for programs to curtail in order to meet the cutback in income, a fact not appreciated by the typical voter will force distortions of choice: The growth of Federal-state grants has created a complex "two-price" system. Some programs now cost the locality itself $100 for each $100 spent (and service received). Other programs, however, cost the locality only $75 or $50—or even less—per $100 because of state or Federal sharing in the cost. Where, to save only $50 of property tax funds, $100 or more of local spending must be cut (and services foregone)—the rest being a drop in grants received—a signal goes out, "Look elsewhere." The "meat ax" pressure to force spending reductions has weaknesses as well as merits, and there will certainly be pressure to focus on reducing those activities which are financed without matching grants from other governments.

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Some Benefits: One-shot Capital Gains

Present owners of property have voted themselves capital gain "windfalls." The reduction in property taxes will tend to raise real estate prices. Today's owners, in voting essentially permanent reductions in annual property taxes, have enlarged the stream of *net* benefits (income) to be capitalized in valuing real estate. This one-time capital gain in effect absorbs now much of the future benefit from the tax cut. In this respect, the specific results of Proposition 13 are difficult to judge because assessments (but not the tax rate) will rise after a sale. Future buyers will pay a higher price—higher by enough, in general, to offset the tax benefit. "No election will ever be lost by votes in the future," runs the conventional wisdom. And certainly California voters did not have future property owners (or voters) in mind when they rallied to the support of Proposition 13.

Lowering the tax reduces the cash required to hold on to underdeveloped land. "Speculative underutilization" becomes less expensive. Waiting for population growth and inflation to boost prices will cost less. The current offerings of land will decline—and thereby prices will be raised—because owners face lower cash pressure to sell or develop. Income tax considerations, of course, complicate individual decisions and require some caution in generalization, but the net effect on land use will be some—or much— distortion away from the direction of free-market forces.

Will the California economy get a boost from Proposition 13? Of course it will. Other things being the same, tax something, and there will be less of it (land being an exception). The 50- to 60-percent cut in taxes on man-made capital will alter favorably the "arithmetic" of construction projects in California. How much so is difficult to say. This cost reduction will interact with many other factors, including the forces tending to raise land prices. The change in prospective net returns at the margin may be more modest than impressive. But one conclusion is clear: More capital will flow where tax reduction improves the prospects for investment.

In America as a whole, few communities can expect any such reduction in property taxes. The problem for most of the 66,000 communities now imposing this tax lies in using it more wisely than they have been doing up to now.

Inflation as a Source of Problems

Sharply increased inflation in recent years compounds the problem. From World War II into the mid-1960s, inflation averaged around 2.7 percent a year (Consumer Price Index). Any resulting property tax dislocations then were a small portion of the total changes of a rapidly changing economy. In the last six years, however, the CPI has risen more than 70 points to nearly 200 (1967=100).

Today we assume a condition which would have seemed impossible through the sweep of peace-time history—inflation continuing at some multiple of a "nominal" one percent or so a year. The prospects of, say, 6 percent cumulating year after year are almost too terrifying to face. In only 10 years, the price level would go up by 79 percent.

Such inflation means that local government officials must have more dollars to perform the same functions. However, it also means that taxpayers, partly from general frustration, can become reluctant to pay more in taxes to all levels of government, year after year, for services that are not visibly better. Voters, as in California, may focus on the property tax to vent their frustration since it is close to home and subject to at least some influence.

Real estate prices, the major element of the property tax base, have been rising by more than most other prices. Local governments by bringing these property price increases on to the tax rolls can get more dollars. Officials can also reduce tax rates (and gain whatever political plaudits may be garnered by citing a rate cut) if local expenditures rise no faster than prices generally. In California, however, officials did not, in general, "permit" homeowners to escape rising real burdens through lower rates. Instead, government was enlarged and made more costly. One message from the resounding vote for Proposition 13 seems clear: "Inflation is no excuse for an expansion of government."

Inflation presents enormous difficulties for property tax administration. Robert Brown and I have discussed the problems in an article too long to summarize here.[1] Suffice it to say that, on a 5-year or other such cycle or sequential pattern, assessments will not yield defensibly acceptable valuations in times of chronic inflation when property prices tend to increase sharply and rapidly.

Underlying our system has been a tacit assumption that most real estate values will be largely stable from year to year. Local governments rely upon procedures based on this assumption: The things to be taxed will get on the tax roll. The assessor will then place a value. Much of his job will be to keep track of new construction, demolitions, land consolidations and divisions, additions and removals of machinery, changes in inventory, and so on. Over the years, of course, land prices will change; so will the worth of structures. But most changes in value for tax purposes, it has been implicitly assumed, will be gradual rather than large or sudden. Assessors' offices have not been geared to reassess annually all, or even most, of the properties on the tax roll. Despite what the state law might seem to require, reassessment on a multi-year cycle in "normal" times could serve tolerably well—say, one-fifth of parcels examined each year. Or, major reassessment at long and infrequent intervals would suffice in an imperfect world. Large inflation, however, leads to excessive inequities in such a "system."

Higher Quality Assessing Required

In today's inflationary market, even localities with the best procedures cannot get tax rolls which adequately reflect changes in real estate prices. A common procedure would now produce a tax roll which reflects in some assessments what has happened this year; 1977 values would be shown for other parts of the community; 1976 for some; 1975 for others; and so on. The resulting tax-burden inequalities are greater than has been traditionally assumed and than would ordinarily be tolerated in a world of stable prices.

If the general level of property prices is changing by several percentage points a year, a 4- or 5-year assessment cycle will produce, in two or three years, substantial inequities where full-value tax rates are as high as they are in many localities. Somehow, an *annual* tax must now reflect a frequency of value changes that could be brushed aside in the past when the tax differences seemed too small for serious concern.

The disappearance of elements that formerly provided stability calls for new procedures. So do

[1] Robert C. Brown and C. Lowell Harriss, "The Impact of Inflation on Property Taxation," in *Governmental Finance*, November 1977. Copies available from the Tax Foundation, Inc.

court decisions directing reduction of inequalities, the increasing resistance of business and individual property owners who believe themselves treated unfairly, and in some states continuing problems of school finance. Methods for more effective administration have been devised, tested, and improved upon. Techniques using computers make more nearly manageable the job of valuation on a mass scale. Enormous efforts will be needed to keep the system viable. But they are justified because of the basic merits of property taxation.

Compared with other revenue sources, property taxation has greater claim to support than generally accorded it. Not long ago, in casting up the pro's and con's, I found that the "what's good" stacked up better than is generally believed. That discussion is available upon request.[2]

Basic Merits of Property Taxation

Property taxation does much to make local government as viable, and popular choices in goverment as meaningful, as they remain. As cities, towns, counties, and school districts become increasingly subject to direction from outside, all support for "at home" decision-making ought to be preserved. The use of localities, as distinguished from state and nation, to get done some of the things we expect from collective (governmental, political) action, does continue to have merit.

Property taxation offers people in different localities an instrument by which they can make local choices significant. The property tax helps to provide freedom from being held to a level set by others who may live in areas which are quite different or who may have other values. People in one community are not forestalled by the decisions of voters elsewhere.

The once widely accepted criticism that property taxes are regressive does not survive modern economic analysis. In fact, a persuasive argument in favor of property taxation for local services can be made on grounds of equity. Especially important, it seems to me, is the fact that in effect this tax enables localities to capture some of the fruits of forces raising prices of land, including public outlays on streets, schools, sewers, and other facilities.

Fundamental Restructuring of the Tax

Finally, and probably of greatest potential, there is a real opportunity in the wake of Proposition 13 for restructuring fundamentally the way we tax property. We can reduce burdens on man-made capital and make up the revenue from higher taxes on site values, a procedure which seems to me eminently desirable on several grounds. This possibility should be part of the broader public discussion of the role of property taxation stimulated by the vote in California.

One change may be politically tempting — to reduce burdens on residential property while maintaining or even raising burdens on business and public utility property. Such moves would not only add to concealment of costs of government in the form of hidden burdens on consumers and investors. In addition, the productive portions of the economy would suffer. Building better communities will not come from boosting taxes on business.

Americans should be "up in arms"—or at least doing something—about restricting and effectively controlling the growth of government. "Revolt" seems to me too strong a term; it also seems misleading, implying as it does that a single, dramatic action will do the job. Patient, informed, continuing efforts are required. Among them will be the reform of property taxation to develop its potential as a high-quality revenue producer.

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[2] C. Lowell Harriss, "Property Taxation: What's Good and What's Bad About It," *American Journal of Economics and Sociology,* January 1974.