

# Circumventing California's Proposition 13 for the Public Collection of Rent

Fred Foldvary  
Santa Clara University  
ffoldvary@scu.edu

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## Abstract

Prior to the passage of Proposition 13, local governments in California set their own property tax rates and received the revenues. California's Proposition 13, enacted in June 1978, severely limits the state's ad valorem real property tax. The measure limits the real property tax to one percent of the purchase price, and also limits the annual increase to two percent until the title is transferred. The proposition also shifted the allocation of the revenues from the counties to the state.

However, state laws and local initiatives have enabled cities and counties to circumvent the limitations of Proposition 13 to extract revenue from real estate with parcel taxes, special assessment districts, developer charges, and other charges. Real estate is also tapped privately to by homeowner association assessments, which play an increasingly important role in providing civic services. This paper analyzes the impact of Proposition 13 and examines these statewide and local measures to get around the tax limitation.

While the initial impact of Proposition 13 was a reduction in the state's fisc, increases in the sales and other taxes as well as local revenue sources have now restored the tax burden of Californians to slightly above the national average. Thus, the proposition has been largely an exercise in futility, centralizing government, greatly increasing the complexity of its public finances, and ultimately failing to constrain the size of government.

## **I. The Proposition 13 Revolution**

### **A. Historical background**

The U.S. economy experience higher inflation in the decade preceding the passage of Proposition 13. There was a great increase in the demand for tangible goods as an inflation hedge, and, due also to high population growth, recovery from the depressed economy during 1973-5, and greater regulation costs, real estate prices rose sharply in California. On the supply side, restrictions on development restricted the supply of new housing (Chapman, 1998b, p. 21). Tax levies rose in tandem, especially since the ability of county governments to gradually increase assessed valuations became blocked in 1967 with the enactment of the Petris-Knox Bill (AB80), which required assessments at 25 percent of current market value.

Taxes on many residential properties rose sharply, because these single-family dwellings had been assessed at a lower proportion of market value than commercial property (Levy and Zamolo, 1978). There was an outcry by property owners who saw their property taxes rise faster than their income after 1975, in some cases increases in tax payments as much as 60 percent for a year, although the overall tax burden was only about 2.5 percent of personal income (Chapman, 1998b, p. 13; Oakland, 1979). The fact that their real estate values rose proportionally provided little comfort as the tax had to be paid from current income.

Another contributing impetus to Proposition 13 was the California Supreme Court “Serrano decisions” (Serrano vs. Priest, 1974), which ruled that financing schools from property taxes was unconstitutional, which then led the legislature to make the financing of governmental schools independent of the property tax, reducing public support for real estate taxes (Fischel, 1995).

After the Jarvis-Gann initiative, Proposition 13, qualified for the June 1978 ballot, the state legislature put forth an alternative measure, Proposition 8, on the ballot. It would have created a split roll, limited the increase in the property tax, and increased state payments for local welfare costs, but it failed to excite the public, and failed to dislodge the victory of Proposition 13, which obtained 65 percent of the vote. Californians were in the mood for a tax revolt, attracted to the tax-cutting promise of Jarvis-Gann and also having reacted to the state budget surplus, fattened by inflated revenues from income and sales as well as property taxes.

As Chapman (1998a, p. 3) notes regarding the passage of Proposition 13, “For the first time in the state’s history, the state was put in charge of allocating the proceeds of the locally levied property tax, with the rate and base defined by the statewide initiative.”

The flaws of Proposition 13 require a comparative analysis, and land-value taxation offers a sensible basis for comparison. If California had a land-value tax (LVT) instead of the real property tax on the whole property, the impact of inflation would have been much less. Under a proper implementation, there would not have been any discrimination among various uses of land. Moreover, if most of the rent were taxed, there would not have been a speculative increase in real estate prices, as the gains from speculation would be very limited. In addition, a sensible implementation of LVT would allow the owner-occupied title holders to defer some of the tax liability during times of depressed incomes or rapidly rising rents.

Thus one consequence of Proposition 13 was to constitutionally limit an efficient source of government revenue and to block the legislature from shifting more of the tax to site values by lowering the tax rate on improvements and raising the rate on land value, as has been done in Pennsylvania and elsewhere. Since the property tax had been a major source of public revenue for local governments in California, the second consequence was to centralize public finance, to increase state income and sales taxes, and to make local governments more dependent on the state government. A third effect has been to reduce transfer mobility, since the sale of real estate raises the tax assessment up to the current market value.

Since Proposition 13 limits the increase in the property tax so long as the title is not transferred, the property tax burden has become ever more unequal, as newly acquired property can be taxed much more than long-held property. Proposition 60, adopted in 1986, lets owners aged fifty-five years or more keep their Proposition 13 assessments if they buy another house within the same county and the new residence is of equal or lower value. Proposition 90, passed in 1988, extended this grandfathered right to inter-county moves, if the origin and destination counties have a reciprocal agreement. Nevertheless, there has been a severe decrease in overall homeowner mobility.

The tax-increase limitation makes real estate ownership more profitable, which is then capitalized into higher land values. However, since selling a house and buying another within the state makes one lose the grandfathering advantage, if the transfer does not conform to the Propositions 60 and 90 provisions, there is in effect a large implicit transfer tax (the present value of the increase in future tax payments) which creates a lock-in effect. Wasi and White (2005) find that from 1970 to 2000, the average tenure length increased by six percent, holding other variables constant. Those with higher implicit tax savings had a greater tenure length; for example, a tax savings of \$2600 per year induces a 3-year increase in tenure.

“Fiscal stress” includes either an exogenous fall in revenues or an exogenous increase in the demand by the public for government services. As a change in the state’s constitution, Proposition 13 amounted to an exogenous fall in revenues. Since the state government had its own fiscal stress, even the truncated property tax became commandeered by the state government, and revenue transfers from the state were insufficient for the revenues wanted by local officials. Hence, there have been several ways that local governments have been able to circumvent the constraints of Proposition 13 to effectively tax real property. This paper describes and analyzes these methods.

## **B. The elements and legality of Proposition 13**

Proposition 13 reset the maximum real property tax rate at one percent of the market value during 1975-6, and for subsequent purchases, based on the market value of the real estate in the year purchased. So long as the property is not sold, the maximum increase in the property tax is two percent. Proposition 13 also required new state taxes to obtain a two-thirds majority in the legislature, and new special local taxes required a two-thirds approval by the voters. The proposition also prohibited any additional state or local ad valorem property tax.

Proposition 13 did not define the transfer of real estate owned by corporations and partnerships. This gap was filled by the legislature, which “determined that a change in ownership of a legal entity would be considered a change in ownership of the entity’s real estate – thereby triggering a reassessment of that property – in two situations. First, a change in ownership takes place if the original owners of the legal entity cumulatively sell more than 50 percent of the entity’s ownership shares. Second, a change in ownership occurs if any single individual or another legal entity acquires more than 50 percent ownership control of the entity”

(Brown, 2003, p. 1). The result is that property held by corporations and large partnerships pays less property tax relative to the market value of their property. The ratio of owner-occupied assessed value to total assessed value rose from 32 percent in 1979 to 38 percent in 2001 (Brown, 2003, p. 8).

Challenged in the courts as violating home rule, Proposition 13 was upheld in *Amador Valley Joint Union High School Dist. v. State Board of Equalization* [22 Cal. 3d 208 (1978)]. Opponents also argued that the different tax payments made by property owners with equally valued real estate violated equal protection, but the U.S. Supreme Court rejected this argument in *Nordlinger v. Hahn*, U.S. Cal. 1992 (Chapman, 1998b). Despite the fiscal stress and unequal tax burdens created by the measure, the U.S. Supreme Court upheld Proposition 13, in part because it allegedly contributed to “local neighborhood preservation, continuity, and stability” (Wasi and White, 2005, pp. 87-88).

### **C. Fiscal impact**

Proposition 13 immediately reduced property taxes by \$7 billion, the reduction for cities being \$800 million, for counties \$2.24 billion, for school districts \$3.54 billion, and for special districts \$460 million (Chapman, 1998b, p. 25). However, it did not permanently reduce the relative size of government or total taxation. California’s overall tax burden - \$10.96 per \$100 of personal income - is slightly above the \$10.74 average for the United States as a whole. For 2005, the total property tax revenue of the state is, in nominal dollars, \$35.4 billion compared to \$10.3 billion in 1977 (Legislative Analyst’s Office, 2006).

There has been a windfall benefit to the federal government of \$1.6 billion as the property tax is deductible from federal income taxes, and a shift from property taxes to sales taxes and other non-deducted taxes increases California’s taxes paid to the federal government (Coleman, 2006b, p. 5). About 40 percent of the benefit from Proposition 13 went to Commercial and rental properties, with 24 percent going to homeowners and the rest to the state and federal governments in increased revenues from income taxes (Coleman, 2006b, p. 6).

The immediate response of the state was a bail-out for the cities and special districts with block grants and a “buy out” of county programs and schools, the state filling in the gap in financing, funded from the state surplus. There was thus a loss of local government fiscal autonomy, the ability of local government to independently obtain and spend revenue (Chapman, 1998b). The initial legislation, SB 154, provided block grants and a distribution of the property tax. The greater role for the state was cemented by Assembly Bill 8, which restructured of the state finances.

Local government fiscal autonomy is desirable for several reasons. First, it provides greater local control and monitoring. Secondly, it provides for a greater variety of services and charges among jurisdictions, and so residents are able to “vote with their feet” (as in the Tiebout model) to select the communities that best suit their preferences. Competition among local

governments helps to limit wasteful practices.

Cities can still determine some of the tax base other the property tax, but other sources are often more limited in revenue capacity, create a greater excess burden, and are more regressive than the ad valorem real property tax. For example, utility taxes, such as on telephone, cable, and electricity usage, are based on the consumption of the utility and thus tax a greater portion of income from relatively less wealthy households.

In 1992-3, the state Educational Revenue Augmentation Fund (ERAF) policy shifted \$4 billion in property-tax revenues from local governments to school districts, replacing the state's general revenues for schooling, and thus reducing the expenditures under proposition 98, enacted in 1988 to support school spending. The average county reduction in property-tax revenue was 40 percent (Chapman, 1998b, p. 38). City property tax shares were truncated by an average of 24 percent (Coleman, 2006b, p. 18).

A shift from property to sales taxes induces a shift in the land-use policies of local governments. Since cities keep a portion of the sales tax, their coffers benefit from retail establishments. With the limited property tax, residences demand services but provide little revenue, while stores provide revenue and demand fewer services. Thus malls and car dealers are favored over manufacturing or office buildings.

The sales-tax effect is an example of what Dean Mischynski (1986) termed "the fiscalization of land use." The practice of governmental decisions on land use being based on the expected fiscal consequences long precedes Proposition 13, but it has intensified since then as local governments have sought new revenue sources or greater revenues from existing sources such as the sales tax. Other fiscalization effects include development and redevelopment, described in III below.

In May 2004, Governor Schwarzenegger proposed a swap of lost vehicle license fee revenues for an additional property tax share. The VLF tax rate before 2004 was 2 percent of the vehicle value, part of which was allocated to cities and counties. The tax rate was reduced to .65 percent, and the state made up the loss of revenues with payments to local governments from the state's general fund (Coleman, 2006a).

## **II. Other property-tax and spending propositions**

Proposition 4, the Gann initiative, was victorious in November 1979. It limits state and local government spending other than from "fees."

Proposition 62, passed in November 1986, prevents local governments from imposing general taxes unless they obtained approval from a majority of the voters, special taxes already having to be approved under Proposition 13.

Voters also approved Proposition 218, the "Right to Vote on Taxes Act," sponsored by the Howard Jarvis Taxpayers Foundation, in November 1996. This constitutional amendment strengthened and broadened the requirement for voter approval of new taxes and assessments. The proposition also specifies that voting for assessments be weighted in proportion to the assessment liabilities. Property-related fees for services other than water, sewers, and refuse must be approved by either the property owners or the electorate.

### **The failure of parcel-tax Proposition 88**

On the state ballot in November 2006, Proposition 88, the Classroom Learning and Accountability Act, sought to levy a parcel tax of \$50 on most parcels of land, with exemptions for some elderly or disabled homeowners. This measure would have added a new section to the state constitution. The \$50 amount would have been fixed, not indexed for inflation (Attorney General, and Legislative Analyst, 2006).

The funds were to provide additional governmental school funding for kindergarten through grade 12. The measure would have raised about \$450 million annually, allocated to school districts for specified education programs. The revenue would have been excluded from the minimum education funding required by the previous passage of Proposition 98. The measure failed, obtaining 23% yes votes, 77% voting no.

Although not *ad valorem*, this tax would have had some of the effect of a land tax, since the amount would have been independent of improvements. As a fixed annual charge, it would have most likely capitalized down the market value of a property.

The proposition was opposed by the California Parent-Teachers Association as creating a costly bureaucratic administration, "opening the floodgates to new parcel property tax propositions." They also objected that "Proposition 88 creates a whole new kind of statewide property tax." Currently, all parcel taxes are collected locally and are used for local services, such as improving your local schools, reducing traffic congestion, improving health care, and increasing firefighting, paramedic, and law enforcement capabilities. "The Prop. 88 property parcel tax goes to the State first." The three signatories to the argument against the measure included the President of the Howard Jarvis Taxpayers Association.

The argument against the measure stated that "Proposition 88 would impose the first statewide property tax since 1910 and would encourage other special interests to pass more and bigger property parcel taxes for their self interest causes. Opening the door to the new property parcel tax could lead to huge new property taxes, contrary to the clear intent of Proposition 13 to limit property taxes. We could see owners of small homes or mom-and-pop stores taxed out of their homes and shops."

Thus the objection from anti-property tax interests was that, however small this particular tax, it would lead to other property-based taxes whose revenues would go to the state government rather than to local governments. As the argument stated, “Proposition 88 uses a loophole to get around the two-thirds vote requirement in Proposition 13 to increase taxes. Proposition 13 requires a two-thirds voter approval to impose a local property parcel tax. Proposition 88 would impose a new statewide property parcel tax with only a simple majority vote” (Attorney General, and Legislative Analyst, 2006).

### **III. Local property taxes that circumvent Proposition 13**

Although the State of California is divided into 58 counties as the basic local governmental divisions and administrators of state programs, many other governmental units also act as local governments largely independent of the counties. In 1991 there were 466 cities, 1005 school districts, 81 transportation agencies, 381 community redevelopment agencies, and 4995 special districts (Shires and Habers, 1997, p. 7, citing the State Controller’s *Annual Reports*).

By reducing the property tax, Proposition 13 also reduced the legally tax-deductible payments to local government, replacing them with some non-deductible levies. By federal and state law, property taxes are deductible from income taxes due, but fees and benefit or special assessments are not. But the property tax statements sent by the counties typically do not separate out the tax-deductible charges. Many real estate owners deduct the entire tax bill, creating a “tax gap.” Federal law does not require local governments to report to the IRS what portion of the property tax consists of special-benefit levies.

Another real-estate related tax gap is the mortgage interest that is not tax-deductible. The IRS requires mortgage points to be deducted on a prorated basis over the full term of the loan, but many borrowers deduct the points in the year the loan is obtained. Moreover, loans spent for consumption rather than to buy or improve real estate may not qualify as tax deductible. In 2006 the staff of the nonpartisan Joint Committee on Taxation proposed new reporting rules to close these tax gaps (Harney, 2006). It would be simpler and also less discriminatory and arbitrary to make special assessments also tax deductible, so long as property taxes are deductible.

In addition to reducing legally tax-deductible payments, Proposition 13 also was somewhat self-defeating in shifting some of the tax savings to mortgage interest. A lower property tax becomes capitalized in a higher price for real estate, and the buyer then pays more interest when he borrows more to pay that higher price. Suppose a plot of land sells for \$100,000 with no property tax and the interest rate is ten percent. If he borrows the full amount, the mortgage interest is \$10,000 per year. If the rent were \$10,000 and there is a 90 percent tax on the land rent, the price of land would fall to \$10,000, and the owner would pay a tax of \$9000 (thus also 90 percent of the land value) and interest of \$1000, leaving his monthly payment the same. Thus, the removal of the \$9000 tax would replace it with \$9000 in interest. The tax cut would not reduce his monthly payment.

Local governments have used the following fiscal tools to circumvent the prohibition of ad valorem property taxes. As Chapman (1998a) states, “These other ways are usually more complex, more expensive, and typically are not discussed in public forums in ways that are intelligible to the public and elected officials. The world is full of very bright and ingenious people who delight in ways of circumventing poorly drafted initiatives. The result is a finance system that is not easy for the public to understand.”

### **1) Developers’ exactions.**

The reduction in property taxation has shifted the financing of new infrastructure from government to developers. Developers’ exactions are payments made by (exacted from) a developer for the right to undertake a project requiring governmental approval. The exactions can take the form of money, land, infrastructure, or services. Developer levies do not need voter approval.

The levies are often called “impact fees,” but they are not really voluntary user fees as are parking fees and college tuition. As noted by Altshuler and Gomez-Ibañez (1993, p. 4), the rationale for such exactions is development creates public “needs” which government then internalizes, so that, legally, these costs imposed on developers are “use fees” rather than taxes, the fee implying a direct relationship between a benefit and a charge, whereas taxes require no such relationship. However, as stated by Dresch and Sheffrin (1997b, p. 17), “The conventional economic view is that development fees and exactions are simply taxes on development.” Developer charges cannot be ad valorem; they can be based on the square footage of the development, or else lump-sum. Post-Proposition-13 California has had greatest use of developers’ exactions in the U.S. (Dresch and Sheffrin, 1997b, p. 2).

The local government that imposes the charge must specify the use of the revenues, explain how there is a reasonable relationship between the development project and the levy, and between the amount of the charge and the cost of the infrastructure. Besides cities and counties, school districts are empowered to charge developer fees, and local governments can charge school construction “fees.” The total amount of school, city, and county developer levies paid by some developers have exceeded \$9 per square foot (Chapman, 1998a, p. 14).

The revenue finances the construction of the infrastructure provided by the government. Typically, these works include water and sewer lines, streets, parks and recreational facilities. After the construction, on-going service and maintenance are financed from other sources.

If the infrastructure were part of a homeowner association, a unit owner would have a similar cost. If the benefit from homeowner-owned works is confined to the neighborhood, then the economic impact should be the same. Part of the exaction falls on the improvements, raising their cost price but also the demand due to the better neighborhood services, thus causing little or no distortions or deadweight losses. If existing houses are substitutes for the new houses, or if the benefits to the buyers are less than the exaction costs, part of the exaction falls on the developer, reducing the producer surplus, and if the developer only has normal profits which do

not fall, that portion of the incidence falls on land owners, as the developer bids less to purchase the land. The higher price for new houses also raises the price of existing houses.

However, as stated by Dresch and Sheffrin (1997b, p. v), “in some cases, development fees or exactions do not finance services that are directed solely to new residential development. They provide services to existing residents or are used to deliver services that are financed through other sources in neighboring communities.” In this case, the burden of developer exactions may fall largely on landowners as the charge becomes capitalized to some degree in a lower purchase price of the land by the developer and a lower bid price by the house buyers, relative to the case of government providing the works with other revenue sources.

Dresch and Sheffrin (1997a, 1997b) found that in eastern Contra Costa County, for every dollar of “fees,” housing prices went up by 25 cents and increased the price of exiting homes by 23 cents. The other 75c of the charge is thus borne by a lower economic profit by the developer, or else it is capitalized into a lower land value. The impact charge was entirely passed on to the buyers in the western part of the county. The eastern part was previously less developed and has recently undergone much new housing development, so demand was probably more inelastic in the western part, which also has shorter commutes.

Dresch and Sheffrin (1997b, p. v) found that “the fees imposed on new construction are significant, typically falling in the range of \$20,000 to \$30,000 per dwelling. In one community, the fees and assessments totaled 19 percent of the mean sales price.”

Dresch and Sheffrin (1997b, p. vi) add, “Excessive use of exactions creates additional risk for the market and can deter development.” Moreover (1997b, p. 24), “if landowners are not willing to sell their land at reduced prices, developers must try to either pass on the costs of exactions and development fees to consumers, absorb lower profits, or forgo development. This can explain comments sometimes heard from developers that they will ‘walk away’ from projects if the fees are too high.”

## **2) Tax increment financing**

Tax increment financing was used in California since the 1940s, but has been much more widely used since the passage of Proposition 13. About 15 percent of the state’s real estate value is in redevelopment areas, receiving 10 percent of property taxes (Legislative Analyst’s Office, 2006). The use of redevelopment debt does not require the approval of the voters. Local government, usually a city, creates a redevelopment agency, which then declares some area to be blighted (interpreted broadly, even on vacant land) and issues debt to pay for improvements. As development increases site values, the increase in property-tax revenues (the tax increment) is shared by the agency and local governments. As noted above, shopping centers are favored by cities as they later generate sales tax revenues.

Donald Shoup (1990) proposed deferred special assessment districts using parking fees,

where the expenses are paid from additional revenues from parking meters. In a parking increment finance district, the city shares revenues with a business improvement district (described below). Such financing also promotes a wider use of meters in congested times and places. In Pasadena, a city in Los Angeles county, all the curb parking revenue goes to the business improvement districts (Shoup, 2004, p. 777).

### **3) User and Property-related Fees**

Property-related “fees” are levied as incidental to property ownership and are collected with the property-tax bill. New and increased fees such as for garbage collection or sewer service require voter approval if the fee is related to the property. Fees based on usage are not restricted.

User fees have also been increased to make up for the loss of property tax revenue. Some of these are effectively rent. A parking meter charge is a payment to rent street space for parking, in addition to being a congestion charge, if it is paid when the street space is crowded. As calculated by Donald Shoup (2004, p. 771), “Converting the revenue per parking space into the revenue per front foot shows the surprising ability of curb parking to finance public improvements. If the average block has 33 parking spaces on its 1012-ft perimeter, and if each space earns \$1800 a year, the block will earn \$59,400, or \$59 a year per linear front foot. This revenue can pay to clean and repair the sidewalks, plant and trim street trees, and provide other important public services.”

College tuition fees are in part a rental paid for the benefits of using that location as students enjoy park areas and as all activities use space. True user fees are paid voluntarily for a specific good or service, and are thus exempt from tax constraints. The City of Berkeley labels some property-related charges to be “fees” which are actually taxes “imposed on parcels for services provided” (Hogan et al, 2005, p. 2).

### **4) Civic partnerships**

Local governments can become partners with private enterprise to develop projects such as shopping centers and sports stadiums, the city providing the infrastructure. In addition to providing financing or subsidies or services, the governmental side can provide favors such as a relaxation of zoning or tax abatements.

### **5) Certificates of Participation (COP)**

These are issued by a nonprofit organization established by a government. Although the organization is established by a government, the bonds are technically for the nonprofit entity, so they do not need voter approval. The holders of the bonds receive not interest but shares of the revenues, the government renting the facility from the organization. The bonds finance

infrastructure or other capital goods.

## **6) Mello-Roos**

The Mello-Roos Community Facilities Act of 1982 gave local governments the authority to finance infrastructure or services in a designated “community facilities district,” usually undeveloped (Horler, 1987). Either two-thirds of the residents or owners of two-thirds of the land area (voted on in proportion to land held) can vote to levy special taxes and issue tax-exempt bonds, which become a lien against the real estate. The homeowners are responsible for the payment of the debt, as an item in the property tax bill. The Mello-Roos payments have in some cases replaced much of the Pre-13 property tax. Mello-Roos has been widely used in areas of new and existing development to provide services to communities. “Anecdotally, there are stories of homeowners making Mello-Roos payments that are larger than their property tax payments” (Chapman, 1998a, p. 18).

## **7) Parcel taxes**

These are levied on the size of property, either of the lot or the square footage of improvements. The parcel revenue can be used for any designed purpose. While the state-wide parcel tax failed with Proposition 88, many local parcel taxes have been levied, as shown in the example below of the City of Berkeley.

## **8) Assessment districts**

Assessments are used by special districts and are used for services such as parks and streets. These revenues represent only a very small portion of overall revenues, but they grew from 0.1 percent to 0.3 percent of overall state and local revenues (Shires, 1997, p. 41). However, assessments have become very important local sources of revenues for specific services.

The legal difference between a tax and an assessment is that the purpose of a tax is for revenue, while the purpose of an assessment is to finance specific benefits, with the amount of levy proportional to the assessment (*County of Fresno v. Malmstrom*, 94 Cal. App. 3d 974, 156 Cal. Rptr. 777, 1979). Tax rates have to be uniform, while assessment amounts can vary according to the benefits received. An assessment also differs from an imposed “fee,” which is charged for the use of a commodity such as water, or to offset government burdens such as in property development.

According to *California Property Tax Information*, “By law (Prop. 13), benefit assessments cannot be based on property value. Instead, each assessment district includes a benefit formula and each parcel in the service area is assessed according to the specific benefit it receives from the services and improvements. The charge is calculated based on this formula and placed on the county property tax bill.”

New assessments require approval by the majority of the property owners in proportion to the assessment liability. The thousands of assessment districts finance benefits such as landscape development, street lighting, flood control, and sewage maintenance. They are levied with the property tax bill.

Assessment districts have been a prime means of circumventing Proposition 13. Special assessment districts are units of local government, distinct from other governmental units, that manage specific resources within defined boundaries. They are established by local governments or by voter initiative. These districts are in effect a compulsory club. The assessment revenues are intended to provide benefits such as parks to the residents and taxpayers.

As an example, in 1934, the East Bay Regional Park District in the San Francisco Bay Area was created with a nickel-per-\$100 property assessment. The district operates 53 parks with 78,000 acres, with an operating budget of over \$60 million. Another case is in Los Angeles County, where in 1992, voters approved the establishment of a district whose assessment of \$540 million is used for parks, including acquisition, security, beach restoration, tree planting, and recreational enhancements.

Benefit assessment districts assess a defined constituency and provide benefits such as roads, water, parks, and recreational facilities to those residents. Unlike special assessment districts, benefit assessment districts lack a partnership, structure, or separate governmental body with management responsibilities. As implied by the name, the districts place a levy on a property in order to provide a benefit. California's enabling legislation is the Mello-Roos debt described above. Benefit assessment districts provide the residents with a way to circumvent Proposition 13 to assessing themselves to pay for infrastructure and services.

## **9) Business Improvement Districts**

Like special assessment districts, BIDs assess real estate owners within set boundaries for additional services such as public safety, better lighting, and to keep the sidewalks clean. They establish a partnership among property owners and businesses in downtown or commercial areas to improve the business environment. In some districts, such as the Santa Cruz City Redevelopment Agency, "tenants are responsible for paying the District's assessments fees." Otherwise, the landlords may pass the assessment to the tenants' rentals, depending on the lease contract.

The formula for determining the assessment amount can be determined by the business organization that initiates the BID process, taking into account the type, size, and location of the businesses. Assessments are levied on businesses on the basis of relative benefit from the improvements and activities to be funded. They can be based on the amounts of license fees, gross revenues, or gross payrolls.

For example, four commercial districts in the City of Berkeley have special assessments

on the property tax bills to pay for improvements and beautification projects in those areas. The assessments for three of the districts (Elmwood, Telegraph, and North Shattuck) are included in the property tax bills: The assessment rates depend on the particular BID and the size and configuration of the commercial structure. The downtown Berkeley BID assessment is included on the business license renewals for those businesses within that district.

## **10) Real Estate Transfer Taxes and Documentary Transfer Tax**

A real estate transfer tax, also known as a real property transfer tax, is a local levy on the sale of real estate based on the sale price, thus in effect is an ad valorem tax for each sale of the property. Local customs and negotiations determine which party of the exchange pays the tax.

Section 11911 of the California Revenue and Taxation Code allows a county or city to adopt a documentary transfer tax to apply to transfers of real property located in the county. The tax is computed at the rate of 55 cents for each \$500 of consideration or fraction thereof, hence a rate of .11 percent. Certain types of property transfers, such as inter vivos gifts, transfers by reason of death, or proportional transfers into a partnership owned by the same individual or entity, are exempt from documentary transfer tax. A city may also adopt its own transfer tax ordinance with the tax amount fixed at one-half the rate charged by the county. The county collects the total tax in the amount recited above but turns one third the amount collected over to the city. Some cities collect transfer taxes in excess of the amounts provided in Section 11911 (California Department of Real Estate, 2000).

Proposition 13 prohibits new and additions to the transfer tax, but left the existing ones intact. As an example, the City of Berkeley has a city transfer tax of 1.5 percent, which is in addition to the Alameda County rate of .11 percent, for a total rate of 1.61 percent

## **11) Hotel taxes (transient occupancy taxes)**

The hotel or transient occupancy tax can be considered real-estate related, as a tax on the rental of a hotel room, the incidence falling mostly on nonresidents. As examples, the hotel tax rate is 14 percent in San Francisco and Los Angeles, 11 percent in Oakland, 12 percent in Berkeley.

## **12) Homeowner associations**

Sixty percent of new residential construction in California includes homeowner or residential associations which own facilities such as landscaping, parking, security (Gordon, 2004, p. v), and in some cases the streets and a community transit service (Foldvary, 2006). There are three million California homes, amounting to one fourth of the state's housing stock, in the state's 36,000 residential associations (Gordon, 2004, p. v, vi). Sometimes these are loosely referred to as "gated communities," although only about ten percent of the community association residents live within gated security.

Such associations include condominiums and housing cooperatives. Although such common interest developments substitute their own public works for those provided by government, the association assessments are not tax deductible as are property taxes, and local governments in California do not provide a tax rebate for the reduced governmental expenses. Thus a greater use of private-sector civic associations is another way to tap property values to finance local public goods (Foldvary, 2004). Total homeowner association revenues in California were \$6.3 billion in 2003 (Gordon, 2004, p. vii). Community associations also have covenants which act like zoning to govern the use of property, usually with the intent to maximize property values by preventing negative externalities.

As private-sector entities with contractual governance, community associations have no legal limitation on their assessments or services or methods of assessments. They can therefore have ad valorem charges or assessments that in effect tap the site rentals generated by the community services. They can implement what Proposition 13 forbids to local governments.

The median monthly assessment in common interest developments (i.e. residential associations) in California was \$112 in 2002, or \$1344 per year. The median for condominiums and cooperatives was \$186 per month or \$2232 per year (Gordon, 2004, p. 24). Condominiums often provide utilities such as heating, included in the assessment, which accounts for the higher amount.

#### **IV Impact on various jurisdictions**

##### **A. Counties**

The counties of California are created by and are agents of the state. One of their roles is to serve as administrators of state programs. Another role is to directly govern the unincorporated portions of the county, providing services similar to those of municipalities. Counties are also responsible for administering elections and the real property tax. Some of the services required by the state are not fully paid for by the state government.

The revenues of the counties, having been cut by more than half by Proposition 13, were replaced by revenues from the state. Real per-capita state aid rose by 75 percent. The property tax proportion fell from 33 percent to 12 percent of county revenues (Chapman, 1998a, p. 6). On the spending side, there has been a decline in "general government expenditures." The relative reduction in federal revenues has also been offset by other revenue sources. The reduction in local tax autonomy has resulted in only 20 percent of county revenues being controllable (Chapman, 1998b, p. 41). Real per capita county revenues declined in some counties, including Los Angeles, but rose in others.

##### **B. Cities**

Proposition 13 restructured but did not reduce city revenues. By 1995-96, the property tax had fell behind other major sources of revenues for cities, falling from 16 percent of revenues in 1977 to 8 percent in 1995 and also in 2001, less than sales tax revenues (Chapman, 1998a, p. 8, Coleman, 2006b, p. 11). City user fees and service charges increased in importance since 1978, and in 2004 they generated 40 percent of city revenues. In 2004, state and federal transfers provided ten percent of city revenues (Coleman, 2006b, p. 11). Real per capita city revenues increased by nine percent from 1978 to 1994 (Chapman, 1998b, p. 43). California cities have thus been able to maintain their fiscal autonomy.

On the spending side, cities in California, like the Counties, reduced the share going to “general government” to 7 percent in 1995 in contrast to 13 percent in 1977, although it is not clear whether this represents an improvement in efficiency or a loss of service (including longer delays for permits). The portion going to libraries and parks fell from ten to six percent, but the portion allocated to the police was about the same (Chapman, 1998a, p. 9).

### ***Case study, City of Berkeley***

Alameda County’s 2003 Secured Tax Roll lists 28,293 Berkeley parcels. Excluding the underwater area at the Marina, the total lot square footage for all parcels was approximately 241,074,170 sq ft. according to the City’s Land Management database (Hogan et al, 2005, p. 2).

Residential uses make up 55.4% of the lot area, with commercial and industrial uses 12.3%, and governmental use 28.7%. Properties held by the City, City agencies, and other government agencies (including the University of California) are exempt from tax and assessment levies, although some fees such as the Clean Storm Water fee apply to all real estate, including city property. Nonprofit organizations are generally exempt from the county property tax, and the City extends this exemption to most of its own taxes (not for street lighting and for Clean Storm Water), in effect extending to them a subsidy, as the users of these properties benefit from city services. Some \$1.2 million could be gained by the City and \$.8 million could be gained by the Berkeley Unified School District (BUSD) if special taxes were assessed on non-governmental exempt properties (Hogan et al, 2005, p. 9). The State of California does not require cities to grant such exemptions. Exempt properties include hospitals, the YMCA, religious colleges and seminaries, and foundations.

City levies are categorized into special taxes (used for a specified purpose), assessments and fees. The special taxes are for City Landscape/Parks, City Library Services, Paramedic Supplement, Physically Disabled, and CFD1 Disaster Fire (financed by Mello Roos bonds approved by the voters to acquire a mobile disaster fire protection system). The special taxes on property levied by Alameda county and its cities and districts are collected as one billing from the property owner.

A typical house in Berkeley can serve as an example of the charges. The property was purchased in 1979. The land is valued by the country at \$120,630 and the improvements at

\$26,975, for a total of \$147,605. The homeowners exemption of \$7000 is subtracted from the total for a tax base of \$140605. The bill for 2006-2007 includes the following ad valorem charges:

Taxing agency	Tax rate (percent)		Tax amount
Countywide tax	1.0000		\$1406.05
Berkeley debt service	0.0525		\$ 73.81
Berkeley Unified School District	0.1352		\$ 190.10
Community College District	0.0272		\$ 38.24
Bay Area Rapid Transit	0.0050		\$ 7.03
East Bay Regional Park District	0.0085		\$ 11.95
EBMUD Special District 1	0.0068		\$ 9.56
total	1.2352		\$ 1736.74

(EBMUD is the East Bay Municipal Utility District that provides water.)

The debt service charges increase the effective tax rate to 1.2352% from the base rate of 1%. Added to these ad valorem payments are the following “fixed charges” and “special assessments.” The special parcel taxes are based on a square footage of 1786. CSA is the County Service Area. Some assessments are per unit, based on the type of property. The only charge based on lot size is the Clean Storm Water fee.

City landscaping and parks	\$186.28 (special parcel tax)
City library services	\$257.18 (special parcel tax)
Berkeley School Tax	\$230.58 (special parcel tax)
School maintenance	\$ 92.34 (special parcel tax)
School 2004 Measure B	\$176.64 (special parcel tax)
AC Transit Measure BB	\$ 48.00 (special parcel tax)
Physically Disabled	\$ 18.58 (special parcel tax)
Paramedic supplement	\$ 49.66 (special parcel tax)
City Street Lighting	\$ 19.28 (assessment)
City refuse collection	\$541.68 (fee)
Mosquito abatement	\$ 1.74 (special tax; based on units)
CSA Paramedic	\$ 24.96 (assessment; based on units)
CSA lead abatement	\$ 10.00 (assessment; based on units)
CSA Vector control	\$ 5.92 (County service area)
CFD1 Disaster Fire	\$ 22.34 (special tax and Mello Roos)
EBMUD Wetweather	\$ 58.80 (fee, based on units)
EBRP Park Safety	\$ 12.00 (excise tax, per unit)
Clean Storm Water	\$ 31.26 (fee based on lot square footage)
Total	\$1736.74
The total property tax bill is	\$3529.42.

The total in special parcel taxes is \$1040.62.

The tax bill is payable in two equal installments, in the fall (November 1) and the spring (April 10). There is a delinquent penalty of ten percent plus \$10 after the due date. There are low-income refunds available on the following taxes and fees: Library, Parks Landscape, Clean Storm Water, Mello Roos (Fire Protection), BUSD Taxes, Sewer (EBMUD), as well as the Cable Services (Utility Users Tax).

The total tax amount divided by the assessed tax value is  $\$3529.42/\$140605 = 2.51$  percent. The market value of the property is about \$750,000, thus  $\$3529.42/\$750000 = .47\%$ , thus the tax rate relative to market value is about one-half percent, since the assessment value has risen at a maximum rate of two percent per year from the rolled-back base of \$81,488 in 1975-76 (calculated as \$147605 divided by 1.02 raised to the power of 30).

We can see here two effects. First, local governments, including the county, city, school and other districts, have continuously added special assessments and taxes to the state base, increasing the tax rate on assessed value from 1.2352% (state rate plus debt services) to 2.51%, thus doubling the tax rate. But the limitation on the annual countywide tax rate of two percent annually has lowered the rate based on market value to less than half of what a new owner would pay.

A new owner would pay the ad valorem tax of 1.2352 percent of \$750,000, or \$9264 plus the fixed and special charges of \$1792.68 for a total of \$11056.68, effectively 1.47 percent of market value. Estimating the building value at \$100,000 and the land at \$650,000, the tax rate based on site value would be about 1.7 percent.

### **C. School districts**

The Serrano court cases, begun in 1968 and concluded in the 1980s, ruled that the property tax was wrongfully unequal as a source of funds for school districts. The cases mandated a financing plan that was not based on the property tax. An alternative approach could have been a more equal distribution of property tax revenues. The cases made the state government become more involved in school finance. After the passage of Proposition 13, school districts have received a portion of the property tax as well as other financing from the state budget based on General Fund revenues, state population, personal income, local property taxes, and K-12 average daily attendance (Chapman, 1998a, p. 16)

School districts are in effect a special-purpose jurisdiction of government apart from cities and counties. They have the power to levy special real property taxes, subject to a two-thirds voter approval, so long as the tax is not ad valorem.

### ***Case study, City of Berkeley***

Like the City of Berkeley, the Berkeley Unified School District, whose boundary coincides with the city, levies real estate taxes on the square footage of improvements. There is an exemption from the school tax for property owned and occupied by low-income homeowners older than 64 years; the income qualification is based on that of the City of Berkeley.

The Berkeley school tax was set to expire in 2007, and was put to the voters in November 2006 for renewal as Measure A, the “Berkeley Public Schools Educational Excellence Act of 2006.” As stated in the measure’s resolution, “California Constitution, Article XIII A, section 4 and Government Code section 50075 et seq. authorize the District, upon approval of 2/3rds of the electorate, to levy qualified special taxes on property in the District for the purposes of providing quality educational programs in the District” (Resolution 05-87, 2006).

The Berkeley school tax is collected together with the county property tax in the same bill. It is subject to the same penalties and interest rates for late payments as the ad valorem tax. The measure states, “The tax shall be levied on the Square Footage of all Improvements, including all Buildings and Structures, on Parcels of taxable real property in the District, except where the Improvements are otherwise exempt from taxation” (BUSD, Resolution 05-87, 2006, Section 4).

As to the tax rate, “The tax levied shall be at the rate of 22.80 cents per square foot on all Improvements on Residential Parcels, 34.36 cents per square foot on all Improvements on Commercial, Industrial, and Institutional Parcels, and \$50 per parcel on Unimproved Parcels.” The tax rate is subject to annual cost-of-living adjustments. An exemption may be granted to low-income senior citizens.

The resolution and ballot arguments did not explain why the levy is on improvements and not on lot sizes. The special taxes and assessments of the City of Berkeley are also on the square footage of improvements, thus all these property taxes share the same base. The renewal repeated the previous tax base. At forums to discuss the local ballot measures, those who promoted Measure A provided no explanation of why square footage was chosen; it was something to which they had given no thought. The choice of tax base, whether on improvements or land, did not seem to matter to the voters, as the debate was focused on the expenditure side.

The split roll with a higher tax rate on commercial real estate somewhat reflects the higher property values of nonresidential land, and also the lack of voting power of the owners who live elsewhere, although they can have influence by contributing to campaigns.

The \$50 tax on unimproved parcels at least obtains some revenue from vacant lots, and amounts to 219 square feet (a square with a 15 foot side) for a residential lot at 22.80 cents per square foot, thus taxing vacant lots more lightly than developed lots. A rationale for not basing the tax on the lot size may be that empty lots generate no income, but this is precisely the economic rationale for taxing such lots, so that they are induced to become developed and

contribute real estate services. There may also be an anti-development bias in basing the taxes on improvements rather than lots.

## **VII Conclusion**

Proposition 13 has increased the complexity and inequalities of property taxes in California. It has created disparities between the tax rates for residential and commercial real estate and among properties within each of these categories. A study by the California Tax Reform Association (2004) found “consistent evidence in the major counties that an increasing percentage of the local property tax burden has shifted to homeowners” and that “huge disparities exist across the state among substantially similar properties, and [that] these disparities are likely to increase in the years ahead if Proposition 13, as it applies to commercial properties” (p. 5).

Since the economic impact of taxes depends on the marginal tax rate, and new owners pay the highest marginal rates, the lower tax rate on those with older titles has a perverse economic effect. Furthermore, since lower tax rates become capitalized into higher land values, and since new developments pay various extra charges, the impact of slashed rates is largely nullified for new real-estate investments.

As stated by Shires, Ellwood and Sprague (1998, p. 7), “the institutional framework created by California has rendered the state’s public finance framework almost incomprehensible.” The complex mix of property-based government revenue gets around the restrictions of Proposition 13, but few taxpayers can understand how they are being charged and what the charges pay for. It would have been much simpler and less costly to exempt buildings and other improvements from the property tax and simply levy a charge based on the current market value of land.

The defeat of Proposition 88, which would have levied a state-wide parcel tax on land and could have opened the way to a greater use of property-related taxes, shows that Proposition 13 still has strong support. There is another way, however, to restore the relative simplicity and effectiveness of ad valorem payments and even land-value-based payments. A greater use of homeowner associations, and the conversion of existing neighborhoods to community associations (as practiced in St. Louis) would also shift the financing of the public goods from government to the associations (Foldvary, 1994).

There is no movement to do this now, but it could be a politically viable option in the future as the limitations and inequities caused by Proposition 13 become more severe over time, and we observe new communities with homeowner associations better able to finance their civic goods than older communities. As contractual private-sector communities not shackled by Proposition 13 and other tax law, the associations could replace many of the existing taxes, assessments, and fees with a simple assessment based on the property value or the site value. Given the strong opposition to repealing Proposition 13, the privatization of civic works could be

the most feasible way to simplify the public finances of California while also shifting from taxes with excess burdens to efficient benefit-based assessments.

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