

FAIR+EQUITABLE

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A publication of IAAO on appraisal and appraisal management, within the property assessment industry.

CALIFORNIA

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Houses line the beach along a boardwalk in Santa Monica, California

After 40 years, Prop 13 reviews are in

The verdict: It's tax stability vs. tax fairness

BY KEITH ROBISON

On June 6, 1978, 40 years ago this month, California voters passed by a 2-to-1 margin what is likely the most well-known property tax law in the United States.

Proposition 13, the populist tax revolt measure, limited commercial and residential property taxes to 1 percent of a property's value at the time of purchase and capped any increase to a maximum of 2 percent a year, no matter how much a property's market value goes up.

Also under Prop 13, if property taxes are to be increased, there has to be a vote by the property owners affected, and it must pass by a two-thirds or greater majority.

Prop 13, which is considered an untouchable political "third rail" in California, is also credited with setting off a national anti-tax revolution in the late 1970s and early 1980s.

Officially called the Jarvis-Gann Property Tax Initiative, Prop 13 was meant, its creators Howard Jarvis and Paul Gann said, to protect older homeowners from huge tax bills when they retired.

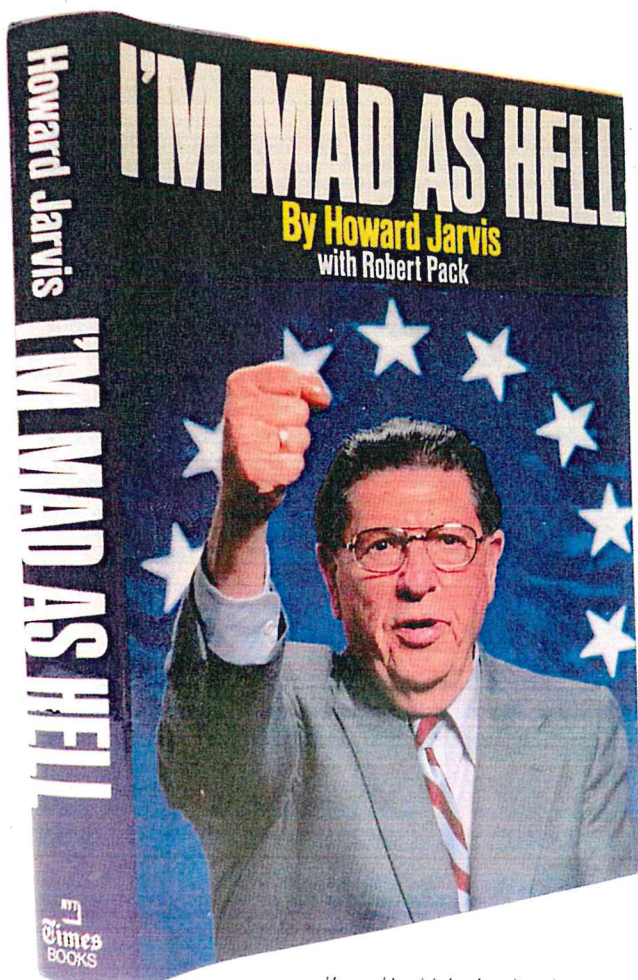
Has it worked?

Yes. Most agree the measure has done what it was created to do.

Susan Shelley is vice president of communications with the Howard Jarvis Taxpayers Association.

"Prop 13 has protected Californians from being taxed out of their own homes, which is exactly what Mr. Jarvis intended," she said. "He often said that property taxes were the most unfair form of taxation because they are assessed without regard to ability to pay.

"Proposition 13 created certainty and predictability by setting the assessed value of a property at the purchase price, and limiting the annual increase in



Howard Jarvis's book, written in 1979

the assessed value to no more than 2 percent. In one respect, however, Prop 13 did not do what Mr. Jarvis hoped, which was to restrain the growth of government."

UNINTENDED CONSEQUENCES

But others say Prop 13 created a range of unintended consequences, from creating huge disparities in tax bills among neighbors living in similar houses to disincentivizing new housing development.

An accompanying interview with Los Angeles County Assessor Jeffrey Prang (page 12) details how Prop 13 affects California assessors, what measures regarding Prop 13 are coming to the state's ballot, the pros and cons of the measure, and the debates about its fairness.

Santa Clara County Assessor Larry Stone said that before Prop 13, California and its municipalities were sitting on budget surpluses. Meanwhile, property taxes were fluctuating amid an extreme housing shortage.

California's population in the 1970s was booming, causing housing demand

to skyrocket. Also, inflation was at a historical high.

"The people in 1978, residential property owners, primarily seniors or people on a fixed income, were literally being taxed out of their homes," Stone said. "The residential property values five or six years before 1978 had dramatically increased. Many of us in local government were pushing to reduce the tax rate to not minimize, I guess, but to 'mediumize' the impact so people on limited income or seniors on a fixed income weren't taxed out."

Howard Jarvis, the man behind the Prop 13 populist movement, was an anti-tax lobbyist and a Los Angeles apartment landlord.

"He managed to work up a head of steam in the political environment, and Prop 13 passed," Stone said. "It cut property tax revenue by 50 percent overnight."

Stone said Prop 13 caused some harmful things to happen.

"No. 1, the worst thing, was the limit on annual increases across the board," he said. "In California, we have one tax rate, 1 percent. Also damaging was limiting assessment increases to 2 percent. So property values for residential and commercial/industrial have increased over the 40 years much greater than just 2 percent. Another insidious part of it established a necessary two-thirds vote to increase taxes at any level, so now all the control belongs to one-third of the voters."

Los Angeles Times reporter Liam Dillon covers California state government. He said there are two schools of thought among Californians on Prop 13.

"Property taxes in California are much lower than in other states, so Prop 13 has done that, and those who benefit

would argue that's a good thing. Given the explosion in home values in the state, folks threatened with rising taxes are able to not have that be the case anymore."

At the same time, Prop 13 completely changed the state's revenue stream.

"Prop 13 revolutionized how the state gets its money, how all the governments in the state get their money," Dillon said. "Gov. Jerry Brown has long worried about the state's reliance on income taxes, which is a much more volatile source than property taxes, which are much more stable, and much more local. As it stands, the state has to backfill all the shortfalls in school funding."

But because of California's high real estate prices, even with Prop 13's limits, the state's property tax receipts per capita are about average in the United States, ranked 21 among the 50 states, according to the Tax Foundation, a tax-policy nonprofit.

Larry Stone said another consequence of Prop 13 was the tax cap set on commercial and industrial property.

"Jarvis and Gann sold to the voters the fact that the elderly and low-income were being taxed from their homes, and they were right," Stone said.

"But the Bank of America, Safeway, and Hewlett-Packard weren't being taxed from their homes. Howard Jarvis made a lot of money off his initiative sold to the public as seniors being taxed from their homes. The savings went to all property, but their argument only focused on residential property.

"Before Prop 13, 65 percent of property tax was borne by commercial property," Stone said. "That, over 40 years, has completely flipped. Now, 35 percent is from commercial/industrial property. And that certainly doesn't turn over as rapidly has homes."

Demand is higher than supply

A report on the high cost of housing in the state by public radio station KPCC partly blamed Prop 13. Over the past 30 years, California simply hasn't built enough housing to keep up with

the number of people who live there, the report said.

According to the KPCC report, the California housing department estimates 180,000 new housing units need to be built each year to keep housing costs stable. Over the past 10 years, the state has averaged less than half of that.

So why hasn't California built enough housing to keep up with demand?

KPCC reporters found that most housing researchers agree part of the problem is Prop 13. They illustrated the issue like this:

Imagine you're a city, sitting on a huge plot of vacant land. You could zone that land for housing or for commercial use, like a hotel or a Target. Your city obviously needs more housing — prices are sky high. Easy decision, right?

No.

Prop 13 has made development decisions much more complicated. Because property taxes are capped, local governments have to rely on other revenue sources. That vacant land is much more valuable to the city's coffers if a big-box retailer goes in as opposed to a multifamily apartment building. Housing nerds call this the "fiscalization of land use."

The California Political Review, a conservative-leaning news site, listed some of what they call unintended negative consequences of Prop 13.

Local governments are missing out on billions of dollars because of a homeowners exemption to Prop 13 that allows children and grandchildren to inherit up to \$1 million in property without its having to be reassessed.

Over the past decade, the analyst with the website found that 650,000 properties, or 5 percent of properties in the state, were passed down without triggering reassessment — and many of their beneficiaries have used those properties as rentals. That trend is expected to grow as baby boomers age.

Another unintended consequence of Prop 13 is how it has added to the cost of building and owning new homes. With property tax revenue capped, local governments have imposed more sales, hotel, and utility taxes. They have looked to home builders and land developers for impact fees, a charge for bringing public services to the new development. Impact fees have been easy to impose because they don't require voter approval.

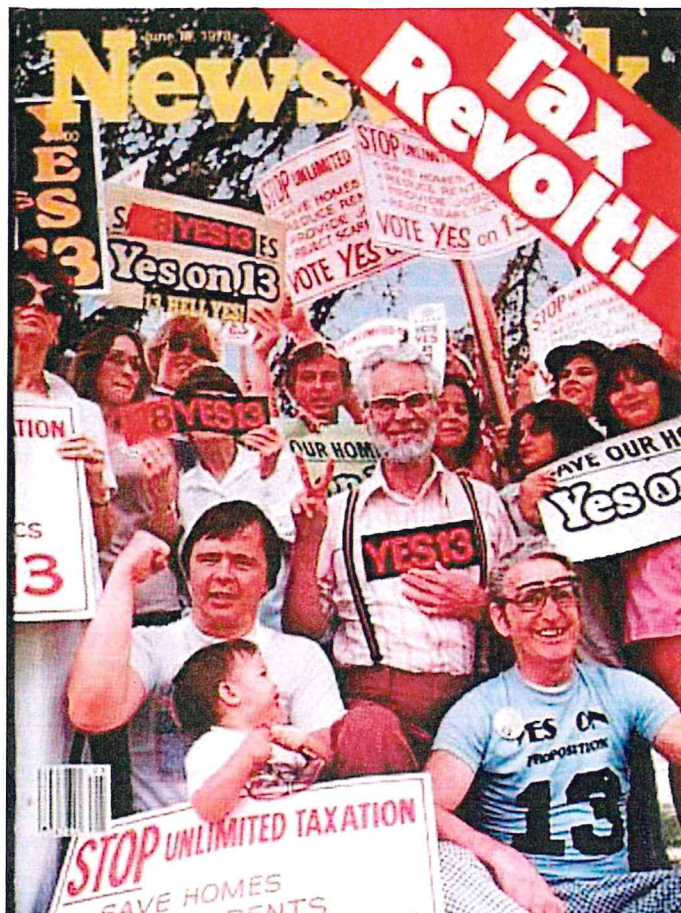
Local governments have also increased the use of Mello-Roos assessments to pay for new infrastructure, a cost that's often passed on to new homebuyers. Mello-Roos is a special tax district approved by two-thirds of voters in the district, often in a new development. The money is used to finance

everything from roads and street lights to water and sewer systems.

Nearby disparity

The provision that property can be reassessed only when it's sold has resulted in some Californians paying much more in taxes than what are imposed on similar properties in the same neighborhoods.

Billionaire Warren Buffett used his own situation to discuss aspects of Prop 13 with the *Wall Street Journal*. Back in 2003, Buffett said there was a 10-fold difference in property tax on two of



The June 1978 cover of Newsweek



"Moreover, as Proposition 13 controls the taxation of commercial property as well as residential property, the regime greatly favors the commercial enterprises of the (wealthiest), placing new businesses at a substantial disadvantage."

— U.S. Supreme Court Justice John Stevens in dissent on *Nordlinger v. Hahn* (1992)



Santa Clara County Assessor Larry Stone

his multimillion-dollar properties in Laguna Beach simply because of when he bought the houses. He also said that those property tax bills were still less than the bill on his house in Omaha, Nebraska.

Buffet added that a typical family buying a house for \$300,000 in Chico, California, would pay more in property taxes than he does.

"This family, because of Proposition 13, has been selected to subsidize me," Buffett said.

Santa Clara County Assessor Larry Stone illustrated the point with his own house in Sunnyvale, California.

"I've owned my home since 1975, in the 43 years I've owned my home, the total property tax I've paid for 43 years is about \$72,000, and that's on a 3,000-square foot house on a 10,000-square-foot lot, a single-family home. I paid \$75,000 for it in 1975. It's assessed at \$258,000 and it's worth about \$3 million now."

He said such a large discrepancy in tax bills between neighbors isn't fair.

"One person in your neighborhood can pay up to 20 times more in property taxes, but dial 911 and the police and fire come at the same speed to your house as his.

"Our kids go to the same schools, we have the same libraries, and the same streets ... but some neighbor is paying 20 times as much for the same public services.

"In my case, I have a \$258,000 assessment on a \$3 million home, which I can sell for \$3 million, buy another for \$3 million plus 5 percent, and carry my old assessment to the new house as long as I'm over 55.

"I've spent more money on tickets for sporting events than I've paid in property taxes. That's insane. You could

not devise a more unfair property tax system than we have here in California," Stone said.

Shelley, with the Jarvis taxpayers association, disagrees.

"There is no disparity between neighbors who buy their houses at the same time," she said.

"There is simply a limitation on how much the assessed value of property can rise in any one year.

"That doesn't favor the wealthy. It protects people who are not wealthy from being taxed out of their own homes by rising real estate values, an unpredictable factor over which they have no control.

"A property owner's tax liability is based on the voluntary act of purchase and is not subject to the vagaries of the real estate market."

But Paul Gann, Jarvis' partner in working for the passage of Prop 13, later acknowledged the disparity.

"My only regret is there isn't some way, and I keep looking for a way, that we can adjust this thing so my neighbor doesn't pay more property tax on the same valued piece of property than I pay," Gann told the *Los Angeles Times* in 1988.

"The reason we did that, and I can remember as if it was yesterday, was simply because you bought a home that fit within your budget."

Gann died in 1989, and Jarvis died in 1986.

A young person's punishment?

Stone said the tax revolt measure pits young against old.

"Prop 13 punishes younger people and it punishes first-time home buyers, punishing our younger folks while all us older folks enjoy the benefit."

Shelley counters that, saying the property tax cap protects first-time buyers.

"Before Proposition 13 passed, the statewide average property tax rate in California was 2.67 percent, and the assessed value rose with the market value," she said. "Prop 13 cut the tax rate on property to 1 percent. Would younger families and first-time homebuyers be better off today if the tax rate on property was 2.67 percent of the assessed value, with no limit on how high or how fast the assessed value could rise? Of course not.

"Proposition 13 protects every property owner in California from the day they close escrow. New homeowners have the certainty that their tax rate will be consistent and reliable and that their assessed value cannot rise more than 2 percent per year."

Stone said most California politicians know better than to talk about changing anything about Prop 13.

But he said he voices his opinion on the matter.

"I'm elected, and I've been talking about Prop 13 like this for 15 years," he said. "People agree with me, and they feel guilty. But not guilty enough to give up the benefit.

"They shake their heads and say, 'Yeah, it's unfair. But I like it.'"



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