I’ve been asked to discuss Proposition 13 and to critique some of the various proposals that would tax commercial property differently than residential property– the so-called split roll issue. But to understand Prop 13 and judge it as either good or bad we must first look at the very nature of property taxes.

Property taxes, at least as we understand them in America, had their basis in feudal England when, as in all of civilization, land meant wealth. Now, in 21st century America, land still means wealth, but not in the same manner as it did back then. Apple & Intel corporations own real estate, but the land is not the basis of their prodigious wealth.

Property taxes are wealth taxes. The incidence of any wealth tax is not a financial transaction like receiving a paycheck, dividend, realizing a capital gain or a sales transaction. The incidence is the mere possession of one form of wealth – real estate – on a single day – called the lien date – of the calendar year: In California, the lien date is January 1st.

If California were creating a tax structure from scratch – a tax structure to finance both state and local needs – would we even have a property tax?
That's a great question. Given its archaic nature, we might abandon it entirely and rely more heavily on consumption taxes including taxes on services. Or even a value added tax. We might elect – for our income tax – to flatten out the rates.

But let's assume that, because of either history, habit or political inertia, we decide to retain a wealth tax on property. The next question would be, do we want to do what most other states do and base the tax liability on current value or is there a better way to do it? The way Proposition 13 does it.

Now, Prop 13 has always had its critics. It is blamed, of course, for the decimation of our schools. But critics have no answer to the fact that we are now spending 30% more on a per student, inflation adjusted basis than we were just prior to Prop 13 enactment, a time when there is broad agreement that California schools were top notch. The fact is, it is not for lack of revenue that our quality of education has suffered, but it is due to other factors.

And it's not just schools. There is a running joke in our office with our top 10 list. A list of various evils and ills blamed on Prop 13 by the media and various Prop 13 detractors: These include, the acquittal of OJ, the murder of Polly Klaus, obesity in children and a shrinking pool of choral singers.

Let's lay to rest the notion that Proposition 13 has starved local government of revenue. The fact is that the increase in property tax revenue coming into local government has far exceeded population and inflation. And
while California now has the highest income tax rate and sales tax rate in America, we remain in the top third (14th out of 50) in per capita property tax collections. In short, we are not a low property tax state.

Prop 13 is criticized for what some believe to be an “inherent flaw.” Because Proposition 13 uses acquisition value (usually the purchase price) as a basis of taxation and not current market value, it is possible for owners of identical side-by-side properties to have significantly different tax bills. In short, the system generally favors those who have owned their property for longer periods of time.

But this criticism flows from a mind-set so accustomed to market-value-based taxation that no thought is given to the original policies of Proposition 13 which are, in fact, being advanced today.

To understand why Proposition 13 is fair one must understand how it works. Proposition 13 limits property taxes by both limiting the maximum rate (1%) and, more importantly, by limiting increases in assessed valuation (2% annually). With the latter provision, it is easy to see how a property’s current market value can greatly exceed its taxable value over the span of just a few years.

As we all know, the difference between a property’s actual value and its taxable value disappears when the property changes hands because then county assessors reassess the property to market value. Thus, recent
purchasers derive no immediate benefit from the limitation on annual increases in taxable value.

So is Proposition 13 fair, even to recent property owners? Yes. It treats equally those who purchase property of similar value at the same time. Unlike any other tax system in the country, it provides absolute certainty to homeowners and businesses as to what their tax bills will be in all future years. It prevents property owners’ tax liability from the vagaries of the real estate market – something over which they had no control. Instead, the amount of property tax liability will depend almost exclusively on the voluntary act of purchase.

The California Supreme Court recognized Proposition 13’s inherent fairness shortly after its adoption by the voters in saying “an acquisition value system...may operate on a fairer basis that a current value approach.”

Critics might concede that Proposition 13 provides absolute tax certainty and yet still assert that the system is flawed because owners of similar property may be paying different tax amounts. (We call this the “nosy neighbor” complaint). The response to this is that it should be no concern whatsoever to a new resident what his neighbor’s tax is as long as his or her own tax is reasonable. The absolute cap of 1% imposed by Proposition 13 makes everyone’s tax reasonable.
Critics also complain that owners of similar properties are paying different amounts for the same public services. However, this is no more unfair that the traditional method of taxation under which owners of more valuable property pay more for the same services. Indeed, some public services – like police protection -- are inversely correlated with the value of property. This entire argument ignores the nature of taxes. If we were that concerned with proportionality between the amount of tax and the level of service, we would resort to a system of nothing but user fees. Because proportionality between tax liability and services has never been an attribute of property taxes, it is unfair to level this charge against Proposition 13 alone.

Now, there is another huge advantage to Proposition 13 that has only recently manifested itself. That is, the extraordinary stabilizing effect it has on local government revenues. Indeed, it is this feature of Proposition 13 that likely saved California from complete economic meltdown during the recent recession.

Volatility of revenue is one of California's biggest fiscal problems. We are so overly reliant on a handful of wealthy individuals that in boom times revenues come pouring in but in recessionary times, the drop is severe. Indeed, volatility of revenue is such a large problem that Governor Schwarzenegger created the California Commission for the 21st Century Economy, aka, the Parsky Commission, to come up with solutions.
Regrettably, while there was a broad consensus that there was a volatility problem, the commissioners could not agree on what to do about it.

During the Commission’s hearing process, the Legislative Analyst produced a chart showing the volatility of California’s tax revenues. That chart depicted a great deal of volatility in income taxes, some volatility in sales taxes and extraordinary stability in the property tax stream. Indeed, in 2008 and 2009 we had declines in income taxes, sales taxes and declines in market value of property but increases in property tax collections. Why? All that equity which, in the aggregate could not be taxed because of the 2% limitation, provided a huge cushion to local governments. So, for local governments, it was like jumping out of a first story window, not the sixth floor. Indeed, even when market values of property were declining rapidly in California, many counties continued to see year over year increases in revenue. Local government officials, especially assessors, will tell you that California would have been in a world of hurt without Proposition 13 during the recession.

Let me spend just a moment talking about split roll – the proposals that would remove Proposition 13 tax limits for commercial properties. First, let’s note that Proposition 13 did not create a loophole for business properties. California has always – at least since 1850 – taxed property at the same rate. Proposition 13 didn’t change that. Second, we often hear that, during the
campaign in 1978, the fact that Proposition 13 protections would be extended to business properties wasn't presented to the voters. Not true. The opponents hammered those arguments throughout the campaign and, specifically, in the official ballot pamphlet itself.

During the Proposition 13 campaign, it was predicted that, over time, homeowners would pay an increasing percentage of the total property tax revenue because residential properties change hands more frequently than commercial properties and thus would be taxed closer to market value. But for many years the percentages remained relatively static. Only more recently has there been an uptick in the percentage of property taxes paid by homeowners. According to the LAO, the total assessed value of owner-occupied homes was at an all time low of 32% in 1986 to a high of 39% in 2005. But that percentage shrunk back to 36% in 2011.

Why does even matter? I would submit to you that it does not. Merely because commercial properties may now being contributing a smaller slice of the property tax pie does not necessarily mean they are getting a break at the expense of homeowners. Consider a small town with only a handful of businesses. If one of those businesses closes, then the residential share, when stated as a percentage of total property tax revenue, will go up. And if all the businesses close – because of a burdensome tax and regulatory climate – then
homeowners will reflect 100% of the assessed valuation. This is hardly a tax break for businesses which were bankrupted or driven out of state.

More importantly, the supporters of split roll are themselves split on the issue whether income producing residential properties – apartments – would be included in the definition of “commercial.” If they are, this would have an even more profound impact on California’s economy and, of course, housing costs.

Finally, a study by Stephen Frates and Michael Shires at Pepperdine University’s Davenport Institute, showed devastating impact of increased property taxes on jobs and small businesses. It showed that by increasing property taxes on businesses by $6 billion, it would result in $71.8 billion in reduced economic output and nearly 400,000 fewer jobs over the first five years of the tax increase. And those impacts would grow over time.

Now, let’s talk politics: are we going to get a split roll? We already have one bill proposal by Assemblyman Tom Ammiano so we know that there is at least some political pressure for altering Prop 13. Keep in mind that these proposals can come in three different forms.

First, a constitutional amendment to Prop 13 could authorize a higher tax rate on commercial property. Instead of the one percent cap, the current rate, it could be moved up to whatever the proponents designate. However, since a constitutional amendment would be required to effectuate this change, it
would have to be initiated either as a proposed Senate Constitutional Amendment (SCA) or Assembly Constitutional Amendment (ACA) and secure a two-thirds vote in each house. Alternatively, the spending interests – mostly organized labor organizations – could secure the signatures necessary to place such a proposal on the ballot. Indeed, that is the far more realistic threat right now.

Second, via the same means just described to amend the constitution or perhaps by statute – there could be a change in the law relating to “change of ownership.” There are few definitional guidelines in Prop 13 itself as to what constitutes “change of ownership.” Thus, especially with a two-thirds Democrat majority in both houses, the fear of the business community is the passage of legislation that would include certain corporate real estate transactions as “changes of ownership” which currently are not so defined. The alteration of “change of ownership rules” is widely opposed, not only by business interests, but also by most county assessors who see it as a huge administrative nightmare. This method of “splitting the roll” is favored by the California Tax Reform Association (Lenny Goldberg) and other assorted left leaning organizations allied with public sector labor.

Third, and potentially more dangerous, a de facto split roll can be imposed via parcel taxes. This requires a bit of explanation.
The California Constitution requires that all property be taxed “according to value.” But the courts, regrettably, have found that additional taxes on property can be imposed as qualifying “special taxes” under Proposition 13 as long as they are not imposed as a percentage of value. Many parcel taxes are imposed on an entirely flat basis. A typical parcel tax would be $79 annually on every parcel in a school district to pay for education programs. The negative policy implications of parcel taxes ( regressivity, etc.) are readily apparent.

First, these taxes impose a uniform levy -- the young couple in a starter home, the elderly couple in a bungalow and a multimillionaire in a mansion, all pay the same amount. There is no restriction on the dollar amount of these taxes that exceed Proposition 13’s limits, or on the number of such proposals that can be placed on the ballot. For homeowners, there is no greater threat to homeownership than this highly regressive form of taxation.

The threat to the business community is when parcel taxes are imposed, not on an entirely flat rate basis, but in different amounts depending on the use of the property. For example, in order to limit opposition from voting homeowners to a parcel tax proposal, a school district might put forward a modest flat rate $29 per parcel for single family residential properties but, at the same time, hit commercial properties with a $1,200 levy or, potentially worse, a high cost per square foot.
Despite the fact that the majority party now has a two-thirds supermajority in each house, we are hopeful that moderates and perhaps the Governor himself will deter some of the more radical proposals to gut Prop 13. But that will not stop the interests for whom no amount of tax revenue is enough from qualifying an initiative to weaken or even repeal Proposition 13. Given the passage of Proposition 30, itself a $50 billion tax hike, we think these interests – mostly public sector labor groups – have simply had their appetites whetted. For that reason, those in the private sector, particularly those in the business of commercial real estate, had best prepare for political battle in 2014.

Finally, we are often asked why HJTA is taking a lead position in the fight against split roll. While it is true that most of our members are homeowners whose primary interest in preserving Proposition 13 is to prevent them from being taxed out of their homes, HJTA counts among our members a substantial number of businesses who support our mission. Many of these are owners of apartment buildings who would be devastated – as would their tenants – if they were to lose Proposition 13 protections.

Second, in the words of Founding Father Benjamin Franklin, we can either hang together or hang separately. It is vitally important, in our view, that all property owners step up to preserve Prop 13 for everyone. For if we lose Prop 13 for businesses today, it will be far easier for our adversaries to
come after homeowners tomorrow. Prop 13’s enemies have made it clear that they will not rest until Prop 13 is destroyed in its entirety.

Our mission is to ensure that that never happens. Thank you.

HJTA Brochures & website.

Q & A.