

Proposition 13 and its Aftermath

*By Anita A. Summers**

In the first phase of the great tax reform flurry that began sweeping across the country last year, the banner headlines went to California's Proposition 13. Now they're going to a state-initiated Constitutional amendment to limit the Federal budget; and many states are on the lookout for ways to respond to tax protests in their own capitals. Clearly, the accelerated pressure to reform reflects a general discontent.

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While proposals for tax capping at the Federal level introduce a complex of issues connected with the use of Federal fiscal policy for economic stabilization, issues are far from being resolved even at the state and local level. Proposition 13 and several of its progeny reflect a confusion of the objectives of budget capping with those of fiscal reform. Restraining the size of government (and its associated tax burden), reducing government inefficiency, and reforming state and local taxes are distinct objectives. Each of them has an agenda that is appropriate to it alone and not to the others. But Proposition 13 and its variants have failed to keep them separate.

In practice, the size of state and local budgets will not be controlled best by any one constitutional or legislative action, and the fairness of the property tax will not be improved simply by lowering it. Responsible

reformers who share the concerns of the taxpayers will want to consider many measures.

WHAT UNDERLIES THE CURRENT DISCONTENT?

Why have the past few years seen so much concern with reform of state and local government fiscal affairs? In part because growth rates of real income have been declining while the tax burden has been increasing. This combination of trends has focused attention on the total tax burden, on efficiency in government, and on the incidence of the major taxes. More particularly, it has led to protests against having government spend as large a portion of total income as it does and against the very visible property tax.

Income, Taxes, and Big Government.

Recent assaults on the size of government and the level of taxation undoubtedly reflect the squeeze on family budgets. Real personal disposable income increased about 50 percent from 1957 to 1967 but only about 32 percent from 1967 to 1977. People have perceived and reacted to this shift in trends but without fully appreciating that it arises from different factors. The slower growth of real income in recent years reflects a combination of escalating inflation, a substantial number of recession years, and sluggish growth in productivity.

Against this background of slow growth in real income, the more rapid real tax growth—51 percent from 1957 to 1967 and 38 percent from 1967 to 1977—stands out sharply. This tax growth reflects several factors. First, the United States has become increasingly concerned about social justice since World War II. Legislation and major court decisions, for example, reflect the increased emphasis on income redistribution as a policy criterion in the public sector. And this emphasis has translated into growth in Social Security, unemployment compensation, welfare, medical care, education, and many other income transfers and public services—or, in

other words, into growth in government expenditures, which are supported from tax revenues. Second, those who want certain government expenditures can lobby more easily than those who want lower taxes: those who want ramps for the handicapped on street corners, for example, can coalesce to lobby for the budget allocation, but those who don't want to pay the, say, 10 cents extra in taxes needed to finance these accommodations, are too diffused to resist them effectively. Third, government decisionmaking, which in principle is based on cost-benefit calculations, often underestimates the cost of new programs.¹ And fourth, rewards in the public sector tend to favor those who manage larger entities over those who produce more services with less resource input.

For all these reasons, government expenditures, and the taxes associated with them, have expanded. As the growth in real income has declined, the protest against this expansion has become more urgent.

Distaste for the Property Tax. A good deal of protest lights on the very visible property tax. In a period of rapidly rising property values, the property tax is a conspicuous target. The rising property value is not very visible (unless the property is sold), but the rise in the property tax bill has to be faced every year. Moreover, though the property tax has diminished from about 80 percent of all state and local taxes at the turn of the century to about 45 percent in the 1960s and about 35 percent now, it remains a major tax in the United States. Out of every \$1 thousand of personal income, \$123 goes to state and local taxes, \$45 of which is paid in property taxes. The property tax is a perennial target.

¹The reason is that there's a downward bias on the cost side: the efficiency losses involved in engaging in an activity in a noncompetitive market are not included in the calculations. For a fuller discussion of this issue see Anthony M. Rufolo, "Upward Biases in Government Spending?" *Business Review*, Federal Reserve Bank of Philadelphia, November/December 1978, pp. 15-23.

Public finance texts criticize it, the urban poor rail against it, Center City businessmen condemn it, and those who have retired on fixed incomes abhor it. Why so much criticism?

In a nonagricultural economy such as ours, *the property tax does not closely reflect the value of public services received by the property owner* (there is no evident relation of the value of fire protection services to the value of property, for example); and *the value of property is not a very good indicator of the owner's ability to pay*. A match-up of tax payments with value of services and ability to pay is a standard criterion for a good tax. So the property tax might appropriately be faulted on these grounds.

The property tax has been attacked also for its *regressivity*—its tendency to take a smaller percentage of income from those whose incomes are higher. And it can be regressive, but not for the reasons traditionally cited.

Until recently, people argued that since an increase in the property tax increases the cost of housing, and since lower income persons spend a larger portion of their income on housing, the burden of the property tax is heavier on them. In recent years, however, economists have become more sophisticated at tracking through the real incidence of taxes.² They now recognize more fully that taxes may not fall only on homeowners who write checks to the tax collector and that, in the case of the property tax, part of the burden will be borne by all those who own interest-earning capital. Since the rich own more such capital than the poor, the tax incidence has some progressive portion. And, further, when economists look at the ratio of the value of housing to lifetime income, rather than to a single year's income, they find that this ratio is about the same for all

²An excellent presentation of current perspectives on the property tax is given in Henry J. Aaron, *Who Pays the Property Tax? A New View* (Washington: Brookings Institution, 1975).

income groups. While there is more evidence still to be gathered on the incidence of the property tax, the notion that the property tax is regressive seems highly questionable—provided, of course, that it's administered properly.

The property tax, however, generally is not administered properly.³ In most places, *assessments are not levied uniformly and are not kept up to date*. Assessment lag has the effect of producing higher assessment ratios in areas where market values have declined (inner city sections, for example) and lower assessment ratios in areas where market values have risen (affluent residential sections). So, while the property tax doesn't have to be regressive, in certain places it turns out to be so. The protests of the poor may not be supported in the public finance text, but they are supported in the urban assessor's records.

The plight of the *fixed-income owner* also has received a good deal of attention. The classic case is that of the person who retires to live on a fixed income in a house whose value has risen substantially since the time of purchase. The capital appreciation can't be realized unless the house is sold, but the property taxes rise to reflect that appreciation. The individual's current income doesn't allow for living in the house, but the value of the asset does. Should such a person have to sell his house? The view of fixed-income homeowners, and of others whose income is temporarily depressed, is really one of vocal and strong opposition to rising tax bills in relation to unrealized gains in housing value. But the opposition lights on the property tax as a whole rather than on any of its remediable defects.

The property tax, then, has been the most conspicuous target of anger in the tax protest

³See Nonna A. Noto, "Uniformity in Assessment: High on the List of Property Tax Reforms," *Business Review*, Federal Reserve Bank of Philadelphia, May/June 1978, pp. 13-23, for an analysis and documentation of the issue.

because of its visibility and because of the accessibility to the taxpayers of those who levy it. Further, it doesn't bear a close relation to services received, it is administered in a way which converts it into a regressive tax, and it falls harshly on the fixed-income homeowner.

Mixed in with these concerns about the incidence of this major local tax are political concerns about the size and efficiency of government and more generalized concerns about the burden of taxation at a time when growth rates of real income are declining. The confluence of these factors produced Proposition 13 and its progeny—state and local budget reform initiatives throughout the country.

PROPOSITION 13 AND ITS PROGENY

'Proposition 13' has become almost a generic term for any legislative proposal designed to hold down expenditures, restrain revenues, or reduce the property tax. Actually, of course, Proposition 13 is a tax-capping amendment to the California constitution which was passed overwhelmingly by almost 65 percent of the voters. Variants of this proposal appeared on ballots in a number of states last November, and though none has reached the voting stage in Pennsylvania, several are being considered here. All in all, very few states have accepted Proposition 13's variety of assault on the property tax, but some have opted for considerably broader types of restraint.

California. Although the rhetoric of the Proposition 13 campaign reflected a desire to respond to all the underlying issues—a government become too big and operating too inefficiently, a total tax burden grown too heavy, and an allocation of the tax burden become too inequitable—the weight of the amendment itself fell on the much-maligned property tax.

The concern about the size of government and its associated tax burden was reflected in

the restraints imposed on state and local tax increases. As a result of the amendment, state increases are permitted only on a two-thirds vote of the state legislature, and enactments of new taxes by local governments require a two-thirds vote of the electorate. The absence of any automatic growth allowance makes it virtually certain that some enactments will occur. But, most important, it imposes no criteria for selecting which services will be curtailed. And it suggests no incentives to achieve restraint by operating with greater efficiency. The concern that government has gotten too big does not mean that every service is regarded as too big. Yet Proposition 13 does nothing to identify which services should be axed. Indeed, the only attempt to be specific is the targeting of, not an expenditure item, but a tax: the legislature is prohibited from enacting any new property taxes (new ad valorem or sales taxes, for example).

The property tax is hit forcefully in the California amendment, reflecting, in addition to the notion that taxes are too high, the notion that property taxes allocate the burden inequitably: Proposition 13 places a ceiling on property taxes at 1 percent of market value as of March 1, 1975, with a few exceptions; it limits increases in assessed valuation to 2 percent per year, unless two-thirds of the voters subsequently decide otherwise; and it prohibits full reassessment except when property is sold. Every which way, the property tax as a source of revenue is checked.

The problems with legislating such a severe attack on one form of taxation are many, and they are only beginning to unfold. For one thing, rolling the tax base back three years means that current taxes do not reflect the relative shifts in market values that have occurred since the base date. If, for example, the demand for housing in one area has become much greater than the demand in another, the increase in the market value in the high-demand area will escape capture arbitrarily. Placing a fixed ceiling on the

percentage annual increase in assessed valuation from a prior base period implies a continuation of this distortion into the indefinite future. Also, allowing full reassessment only at time of sale sets up a direct financial inducement to stay put, though no one suggested during the campaign that limiting residential mobility was included in the amendment's intent or that it ought to be a policy objective at any level of government. And it means that residential property owners will pay a higher percentage of the property tax than businesses, since businesses move less often—again, not part of the original intent of the amendment. Finally, and ironically, the same taxpayers whose vote for Proposition 13 was a vote against Big Government now have demanded rent controls (already set up in Los Angeles and Beverly Hills) because their rents have continued to rise even with the enactment of Proposition 13!

What has happened in California is that the full force of taxpayer discontent has fallen on the property tax. Proposition 13's broad restraints on raising taxes do attack the issue of the total burden. But its other provisions fail to address the property tax incidence issues that people are really concerned with.

Other States. A few states, notably Nevada and Idaho, adopted proposals very similar to Proposition 13; and Alabama, Missouri, and Massachusetts placed strong restraints on the property tax. These states are likely to develop the same set of problems that California has experienced since last July. Fortunately, though, most other states that voted on budget capping did not mix it up with property tax reform. They registered their distaste for large governments and high taxes, but they also recognized the need for some growth factor and did not single out one tax as a target. Arizona passed an amendment to limit state expenditures to 7 percent of personal income; Hawaii and Texas tied growth in state expenditures to

economic growth in the state; and Prince George's County in Maryland, along with the states of Michigan, North Dakota, South Dakota, and Illinois all moved in a similar direction. None of the legislative initiatives, however, took on the issues of government productivity and selection criteria for curtailing expenditures.

Pennsylvania. Pennsylvania differs from California in many ways, so that the buildup of pressures about the size of the total tax burden and the incidence of the property tax has not been as intense. The market value of housing has not risen as much as in California; the property tax is not relied on as heavily (\$62.71 per \$1 thousand of personal income in California, in contrast with \$29.95 in Pennsylvania); for some time, local governments have been able to use nonproperty taxes in Pennsylvania; and there is a circuit breaker law here which refunds property tax payments to those with low incomes and to the elderly. In addition, the Pennsylvania state government is not sitting on a budgetary surplus, and its constitution, unlike California's, does not permit the use of the initiative process for putting questions on the ballot.

Many proposals have been made in this state that address one or another of the underlying concerns. Some try to provide more tax relief to the elderly and those with low incomes. Some try to limit property tax revenue à la Proposition 13. And some try to limit the total amount of state and local spending (which would require a constitutional amendment).

Thus the pressure to pass capping legislation or property tax reform is weaker in Pennsylvania than in many other places because the property tax is relatively low, other more elastic local taxes are used more extensively, and the procedures involved in placing ceilings on revenues and expenditures are more intricate. When and if Pennsylvanians cap or reform taxes, or do both, they should be able to benefit from the expe-

rience of other states and be able to choose legislation which attacks the problems surrounding the property tax and the size of state and local budgets more satisfactorily than does Proposition 13.

SENSIBLE APPROACHES TO GAPPING AND REFORM

To control the size of government, to improve government efficiency, and to reform the property tax are clearly expressed concerns of the American taxpayer. But no one agenda will meet all three of these. Responsible action involves considering several policies to meet the several concerns.

Controlling the Size of State and Local Government Budgets. The most rational approach to budget control would involve careful cost-benefit analyses of all expenditure lines to develop appropriate selection criteria for the services to be curtailed most severely or eliminated entirely. In recent years, cost-benefit analyses have become much more common at the Federal level, but they still are relatively rare at the state and local level. Even where they are done, the political process does much to alter what the calculations suggest. The result is that all across the country we are feeling a dissatisfaction with the size of the total burden and, therefore, a desire to limit that total burden.

If, indeed, the total is what is to be limited, then the expenditure side of the budget is the one to focus on. Overspending is the objectionable activity; revenue collection only provides the means to carry out spending plans. By concentrating on the expenditure side, the major causes of increased spending can be eliminated and the real choices can be emphasized. And those choices have to do mainly with services provided by government. At the state and local levels, taxes go almost entirely for public services. Limiting expenditures means limiting those services, and this tradeoff should be spelled out explicitly in tax limitation proposals.

Clearly, if a decision is made to cap ex-

penditures, the use of *some sort of broad measure of economic activity as the anchor seems appropriate* in calculating the level of the cap. Growth in personal income in a state and growth in gross state product have been suggested as measures. (In some states, limiting growth in expenditures to inflationary growth has been proposed. This, of course, would not allow any growth in the economic base of the state to be translated into growth in public services). In addition to tying expenditure growth to a broad measure, *consideration should be given to using an average over several years of the measure.* Few citizens would want state and local expenditures to fluctuate as sharply, as rapidly, and in the same direction as annual fluctuations in economic activity.

But, beyond adopting an overall ceiling, *rational control of expenditures involves improving productivity in the public sector.* Everyone is for it, but it doesn't happen. And it is unlikely to happen without merit rewards, in the form of merit salary increments, for clear evidence of improved output from the same input. Awareness that a Streets Commissioner has received a merit increase because his department has taken care of more potholes this year with the same number of men and trucks as last year, for example, is likely to do much more for public-sector productivity than exhortation would. Use of the many analytical tools available to improve service delivery probably would be stimulated by the likelihood of tangible rewards. As it stands now, the tools are available but not the rewards for using them.

The desire to limit the size of state and local budgets has been expressed clearly in this country over the last few years. It is to be hoped that this expressed voter preference will not be confused with concern for property tax reform, but that it will be met by a combination of responsible measures—relating expenditure growth to a several-year average of a broad measure of economic growth for the region and providing real incentives to improve productivity in the

public sector.

Reforming the Property Tax. Inner city residents, business, and the elderly all complain about overly high property taxes. But the property tax would be made much more palatable if a number of new procedures were adopted. *Maintaining uniform assessments through frequent and regular revaluation of property* would eliminate the relatively high assessment ratios borne by those who live in areas where property values are growing relatively smaller and would meet much of the concern with the tax on the part of the urban poor. *Reducing the extensive amount of property exempted from the property tax*, much of which clearly is not being used for the public interest, would reduce the percentage of the tax that business has to pay. The concerns of the elderly, those on fixed incomes, and those who are suffering from temporary income squeezes might be met best by *allowing deferral of tax liabilities* until a later date—date of sale for the elderly and for those on fixed incomes, a set date in the future for other homeowners. Circuit breaker laws give relief, but they give relief to the rich as well as the poor, which is costly in terms of tax revenues.

All of these changes could help relieve concerns about the inequities of the property tax and redeem its much-maligned reputation. Simply rolling back the assessed valuations, California style, does not alter these inequities, which arise from defects in the

procedures used to administer the property tax. Altering the procedures is the right medicine for the illness.

SUMMARY

The taxpayer malaise that has reached to all levels of American government in the last few years reflects several overlapping concerns. People have a generalized dissatisfaction with the size of government, with its associated tax burden, and with its waste and inefficiency; and they are concentrating their dissatisfaction in a frontal attack on the highly visible property tax. But meeting these several concerns will require a menu of policy approaches. Controlling the overall magnitude of state and local budgets calls for broad-based ceilings and productivity incentives. Reshaping the distributional effects of the property tax calls for making assessments uniform, for regularizing revaluations, and for reviewing exemptions and deferrals of tax liabilities.

If, in this state, we confuse these issues, we may put a cap on our state and local budgets, but the way those budget dollars are raised and spent will not reflect attainable levels of efficiency and equity for fiscal management. In brief, Proposition 13 should not be Pennsylvania's role model. H.L. Mencken once said that "for every human problem there is a solution which is simple, neat, and wrong." This dictum applies to fiscal reforms as well as to other human affairs!

AVAILABLE FROM THE PHILADELPHIA FED . . .

The Board of Governors of the Federal Reserve System recently issued this pamphlet, which describes the protection provided to credit card users by Federal law. Copies are available without charge from the Department of Public Services, Federal Reserve Bank of Philadelphia, 100 North Sixth Street, Philadelphia, Pennsylvania 19106.

