

Economic Aspects of A Split-Roll Property Tax

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The Commission on the 21st Century Economy will be considering alternatives to California's current tax and revenue structure that would promote additional stability in revenues. I believe that moving towards a split-roll property tax, under which commercial and industrial property is assessed yearly at its fair market value, can be an important part of a re-design of California's revenue structure. My analysis is based on my prior extensive research on Proposition 13 with colleagues, and can be readily accessed at:

<http://www.iga.ucdavis.edu/Research/CSLT/Publications/index.htm>

In my view, moving towards a split-roll has several important virtues.

- It would increase the share of the tax base from property taxation, which is one of the more stable components of a revenue structure.
- It would provide the potential for additional revenue which could be used to reduce the reliance of the tax system on more volatile revenue sources, particularly capital income.
- The increase in tax revenue that would be received from market value property taxation of commercial and industrial property will have only minor impacts on the cost of capital

for new investment by commercial and industrial enterprises. Most of the additional revenue that will be collected will be from taxes on undervalued land holdings and will not distort investment incentives.

- The incidence of the additional property taxation is likely to fall on higher income taxpayers.

Let me elaborate on each of these points.

As is now well documented, compared to other states, the California revenue structure relies heavily on the income tax and much less on the property tax. In general, income taxes are considerably more volatile than property taxes. Within the income tax category, California also taxes capital gains as ordinary income thereby further increasing the volatility of the income tax base.

The two key provisions of Proposition 13—a two percent limitation on increases in the assessed values of properties until they are sold and the one-percent cap on the property tax rate—restrict the total amount of property taxes collected by the state and localities and thereby place the burden of funding government services on other taxes. These assessment provisions also moderate fluctuations of property tax revenue itself. In periods of price increases, the assessment provisions in Proposition 13 limit the increase in total revenues. However, in periods of market decline, properties that are assessed at values lower than their current market value continue to pay at least their current level of taxes and may even pay two percent more.

According to the most recent “4-R Act Equalization Ratio” study by the Board of Equalization (May 6, 2008), commercial and industrial property for the 2006-07 roll was approximately 60 percent of market value.¹ Their estimates would imply that taxing commercial and industrial property at fair market value would raise approximately \$9.1 billion per year in new revenues.

¹ Board of Equalization, Memorandum to Mr. Ramon J. Hirzig from David E. Hayes, 4-R Act Equalization Ratio, May 29, 2008, Consent Agenda, May 6, 2008.

However, these estimates do not take into account the recent declines in the market value of properties. For example, if market values of commercial and industrial property have fallen by 30 percent since the BOE's analysis, then the additional revenue from market value assessment would decrease to about \$2.1 billion per year.

Two important points emerge from thinking about these figures. First, there are clearly additional revenues available from moving towards fair market value taxation for commercial and industrial property. These revenues could be used to offset other particularly volatile elements of the tax structure. Second, the additional revenue available from market value taxation is sensitive to the state of the property tax market. Moving commercial and industrial property to market value would bring in additional revenue, but would increase the volatility of this component of the revenue stream. Overall, however, property taxes—even when assessed at market value—are less volatile than income taxes. Thus, the overall volatility of the tax system would depend on what revenues were replaced by the additional revenues available from market value taxation.

In contrast to many other possible tax increases that could be levied on businesses, assessing commercial and industrial property at fair market value would cause only minor increases in the cost of capital for new investment by firms. Several factors contribute to this important result.

Under Proposition 13, when new buildings or structures are added to existing land, the buildings are assessed at their market value when they are built, but the land retains its original assessed value. As documented in O'Sullivan, Sheffrin, and Sexton (1995), many large commercial and industrial properties fit into the category of properties with substantial modifications.² In particular, there are many large commercial and industrial properties which sit on land which has not been sold since Proposition 13 was enacted. Many of the structures on this land are typically taxed closer to market value, but the land itself is substantially under-

² Technically, modified properties have multiple base years. See Arthur O'Sullivan, Terri A. Sexton, and Steven M. Sheffrin, *Property Taxes and Tax Revolts: The Legacy of Proposition 13*, New York and Cambridge: Cambridge University Press.

assessed. Implementing market value assessments would raise the tax bills from owners of these properties but not appreciably change the marginal incentive to invest in new structures or equipment. Effectively, market value taxation for these properties serves primarily as a higher tax on land. It is very close to the economist's ideal of non-distorting taxes.

Potential buyers of existing properties or for firms making new investments face a one percent property tax rate and their initial assessment is at market value. The only benefit to new investors of the assessment provisions in Proposition 13 occurs if inflation over the life of their holding period of the property exceeds two percent per year. In this case, purchasers would then gain the present value of the cost savings from the difference between two percent and the actual inflation rate for the property. As an example, if inflation averaged four percent over a 10 year holding period, then the present value of the tax savings (at a four percent rate) would be less than 10 percent of the total present value of property taxes. This would reduce the effective tax property tax rate to 0.9 from 1.0 percent, which is a relatively minor tax incentive.

Although the relatively minor benefits of the assessment provisions of Proposition 13 may be surprising, by far the actual beneficiaries of Proposition 13, for both residential and non-residential properties, have been property owners who have not sold since approximately 1980.³ Inflation was very high in the late 1970s and Proposition 13 rolled back assessments to 1975 values. By far, the greatest disparities between market and assessed values for properties occur for these properties. While the periodic rises and falls of property values have created winners and losers for purchasers after 1980, the bulk of the tax benefits accrue to long-time owners of properties. Market value taxation for commercial and industrial property would reach an important segment of this group, without creating significant distortions in the marginal incentives to invest.

³ See my paper, "Re-Thinking the Fairness of Proposition 13," in Citrin, Jack and Isaac Martin, ed., After the Tax Revolt: California's Proposition 13 Turns 30. Berkeley, CA: Berkeley Public Policy Press, forthcoming 2009.

Finally, my analysis also suggests that the incidence of increased taxation of commercial and industrial property is likely to fall on higher income taxpayers. Effectively, much of the increase in revenue will stem from taxation of under-assessed land holdings in the commercial and industrial sector. Since this is effectively a tax on land holdings, it cannot be shifted forward in the market and will be borne by the owners of the property. The profile of these owners are likely to correspond to the owners of capital generally, who are concentrated at the higher end of the income distribution.

The Commission will certainly be considering other changes in California law to reduce the volatility of revenues. Some of those changes, for example changing the treatment of capital gains, would benefit higher income individuals. The increased revenues from a split roll, therefore, could be used to preserve distributional neutrality (as well as revenue neutrality) for the tax system as a whole.