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Warren Buffett's Call to Overhaul Prop 13: Some Preliminary Analyses

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In what has been called "the tax revolt of 1978", California voters changed the face of the California property tax by enacting Proposition 13, or "Prop 13" for short. Among other significant changes, it abandoned the system of assessing property taxes based on current market values and introduced in its place a system based on the acquisition price.

Under the market value system, property taxes were determined by multiplying the applicable property tax rate by the market value of the underlying property, which usually was updated annually. In 1978, average tax rates were just under 3 percent, and there were no limits on increases to either the property tax rate or the property value assessments. In some areas of the state, property values were climbing 50 to 100 percent, and so were property tax bills. This environment was particularly troublesome for fixed-income and lower-income homeowners, some of whom were forced to sell because they could no longer afford to make the property tax payments.

The situation was ripe for revolt: Enter Prop 13, a voter referendum, which voters backed by nearly a two-thirds majority. In addition to reducing to the property tax rate from 3 to 1 percent, Prop 13 created an acquisition-based property tax system by limiting tax increases to no more than 2 percent per year unless the property was sold. As a result, Prop 13 created "tax-bill certainty" for homeowners—they would they know in advance what their tax payments would be and how much those payments would increase in the future.

Prop 13 had just celebrated its twenty-fifth anniversary when Warren Buffett, world-famous financier and (now former) economic advisor to Governor Arnold Schwarzenegger, called for its reform (see Hallinan 2003). Buffett (2003) explained his position by claiming that California's property tax system "needed to be made more equitable." He offered an example of a home he purchase 30 years ago in Laguna Beach that carries an annual tax bill approximately five to six times lower than an adjacent and similarly valued property he purchased just ten years ago. Essentially, he claimed that Prop 13 needs an overhaul because it creates horizontal inequities—people in similar situations suffer unequal tax consequences. (Since these horizontal inequities occur within the group of homeowners, between short-term and long-term owners, they will be referred to as "internal horizontal inequities.") An implication of his position, then, is that returning to a market value system can in fact cure these internal horizontal inequities.

This Research Brief summarizes a paper that uses the Tiebout hypothesis, empirical evidence of property tax capitalization, and theories of property tax incidence and tax reform to examine whether it is worth changing Prop 13 to eliminate internal horizontal inequities, with an exclusive focus on the impacts to owner-occupied, single-family residential properties.

The Tiebout Hypothesis and the Relation Between Property Taxes and House Values

"Very simply, Tiebout's world is one in which the consumer 'shops' among different communities offering varing packages of local public services and selects as a residence the community which offers the tax-expenditure program best suited to his tastes." (Oates 1969)

The Tiebout (1956) hypothesis introduced the notion that small, local governments set their revenue and expenditure patterns and people "vote with their feet"—that is, consumer-voters choose to live in communities where they like the pattern of public services and the price they have to pay for them in taxes. To the extent that the Tiebout hypothesis holds, property values should reflect the tax and expenditure differentials between communities. Consumer-voters will leave communities with less desirable tax and services patterns to communities with more desirable patterns, causing property values in less desirable communities to fall as the demand for homes falls and vice versa for more desirable communities.

Over the past thirty years, empirical studies have provided evidence that the Tiebout hypothesis does hold, in that property taxes are capitalized into house values—in other words, one of the considerations people make in valuing a house is the tradeoff between property taxes and the public services and other conveniences those taxes pay for. Many studies have dealt with the property tax capitalization generally (e.g., Oates 1969, Sonstelie and Portney 1980, King 1977, and Reinhard 1981), and others have specifically analyzed the property tax capitalization effects associated with Prop 13 (e.g., Gabriel 1981 and Rosen 1982).

Gabriel recognized that Prop 13 provided a unique circumstance to measure tax capitalization for two reasons: (1) the property tax change was non-incremental and (2) the tax reduction was not accompanied by a reduction in local public services because the state agreed to bail out local programs. Gabriel focused on tax differentials among communities by regressing mean home prices against several variables. Although the results lacked robustness and the degree of capitalization was uncertain, the study did indicate that the tax changes resulting from Prop 13 were, to some extent, capitalized into residential home values. Rosen reports that "the results of this regression provide strong confirmation that the differential interjurisdictional tax reductions of Proposition 13 were partially capitalized in the year following the effective date of the statewide initiative." He also found that the overall tax change due to Prop 13 was fully capitalized into home values. Together, these studies offer support for the notion that future property tax increases resulting from a change to Prop 13 will lead to capital losses as residential property values in California fall.

Two Views About Who Would Bear the Burden of the Capital Loss

Aaron (1975) discussed two views about who pays property tax. The "traditional view" breaks down the property tax into two components: the tax on land and the tax on structures. "The tax on land [is] borne by landowners because of the well-established proposition that any tax levied on a commodity in fixed supply will be borne by the owners of that commodity" (p. 38). The tax on structures is viewed differently since the supply of structures is not regarded as fixed. "In theory, property taxes on improvements and on tangible personal property used in business…can be expected to be shifted forward to final consumers of business services and occupants of housing." (Netzer 1966, p. 36) So, the tax on land falls on the owners, while the tax on structures falls on the users. In the case of owner-occupied, residential property, the owner-occupier suffers a capital loss as they are both the owner of the land and the user of the property.

The "new view" "holds that *all* owners of capital bear the property tax" (Aaron, p. 38). When taxes are levied—both uniform and varying local taxes—the rates of return on the taxed assets are reduced. As a result, some owners of those taxed assets will shift those assets to other regions or uses. In contrast to the traditional view, the new view explains how the tax on structures falls on the owners of capital. This is because "[t]o the extent that economic activities are mobile, after-tax rates of return to similar factors of production will tend to be equalized" (p. 39). People in high tax areas will take their capital and move to low tax areas. This increases before-tax returns in high-tax areas while decreasing before-tax returns in low-tax areas until the after-tax returns of the two different areas move to equilibrium. So, "the burdens of a property tax will depress average returns to owners of land and reproducible capital." (pp. 42-43) Under the new view, the entire burden of the property tax falls on residential homeowners since they own both the land and the capital invested in the home.

So under both views, owner-occupiers of residential properties suffer capital losses. Therefore, one can conclude that a change in the California property tax from an acquisition-based system to a market-value system will lead to a capital loss for the California homeowner.

At this point in the analysis, it appears that the costs (capital losses and tax-bill uncertainty) outweigh the benefits (elimination of internal horizontal inequities). But these are not the only costs to consider. The act of reforming a tax system causes other negative effects as it creates tax-law uncertainty and external horizontal inequities.

The Theory of Tax Reform

Feldstein (1976) illustrated the unique problems associated with tax reform. Tax reform itself actually adds to the list of disadvantages that must also be weighed against the benefits of a reform.

There are two primary consequences of tax reform. First is the inefficient behavior resulting from tax-law uncertainty. "Tax changes make individuals uncertain about the future reliability of the tax laws. Their anticipation of future possible changes induces inefficient precautionary behavior" (p. 93).

Second, while changing Prop 13 can resolve the internal horizontal inequities between short-term and long-term homeowners, it creates external horizontal inequities between homeowners in general and non-homeowners. A change in property taxes would create external horizontal inequities as individuals who owned real property would suffer significant capital losses compared to similarly situated individuals that chose other investment vehicles. Individuals who were equally well off before the change, are not equally well off after the change.

Other than avoiding tax reform altogether, little can be done to prevent tax-law uncertainty and the resulting inefficient behavior. However, there is one viable solution that could mitigate the external horizontal inequities—legislative postponement. Postponement also impacts the other advantages and disadvantages of changing Prop 13.

To recap, the benefit of changing Prop 13 is the elimination of internal horizontal inequities. The disadvantages include the capital losses suffered by all current homeowners, the elimination of tax-bill certainty by abandoning the annual 2% tax bill cap, the tax-law uncertainty created by the tax reform, and the creation of external horizontal inequities.

"Postponing the effective date of a tax reform can substantially reduce the [external] horizontal inequities associated with the change….Any postponement lowers the present value of the individuals' losses….[I]ndividuals suffer an immediate capital loss even with a delayed effective date, but the capital loss is reduced by the postponement" (pp. 98-99). For example, in the case of Prop 13, a law changing the property tax system could be enacted today, with the actual change taking effect ten years from today.

What are the results? The primary benefit of changing Prop 13 is minimized as the internal horizontal inequities continue to exist until the future effective date. However, postponement also significantly reduces the disadvantages. Depending on how long the effective date is postponed, the amount of capital loss and the impact of external horizontal inequities can be drastically reduced. Since the future tax payments don't change until some time off in the future, the present value of those payments—and hence the size of the capital loss and the magnitude of external horizontal inequities—will be much smaller than under an immediate effective date. Tax-bill uncertainty is reduced since the 2 percent limit still offers protection during the postponement period. However, tax-law uncertainty remains the same, since the tax reform still changes the law and creates uncertainties about the future.

Although postponement offers the best method of reducing the negative impacts from changing Prop 13, it also reduces the benefits. So, the disadvantages will likely still outweigh the advantages.

Conclusion

This Research Brief has argued that the costs of reforming Prop 13's acquisition-based property tax system are likely to be far greater than the benefits of eliminating internal horizontal inequities. That said, it's important to note that this analysis examined only one of many important issues surrounding any proposal to overhaul Prop 13. For example, this Brief did not include the severe budgetary issues facing California, which clearly would add complications. So, the analysis does not end here. While this paper illustrates some of the main areas of concern, politicians and legislators must still carefully calculate the magnitude of each advantage and disadvantage for any potential change to Prop 13. In doing so, they should also heed the lesson learned by Warren Buffett—Prop 13 *is* the third rail of California politics.

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