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Proposition 13, the Recession, and the Tax Assessor's Dilemma

Under Proposition 13, the assessed value of property cannot increase by more than 2 percent per year until the property is sold, at which time it is reassessed at its full market value, usually the selling price. Until the early 1990s, inflation in real estate generally exceeded 2 percent per year, creating a widening gap in property taxes between homes bought more recently and those owned for many years.

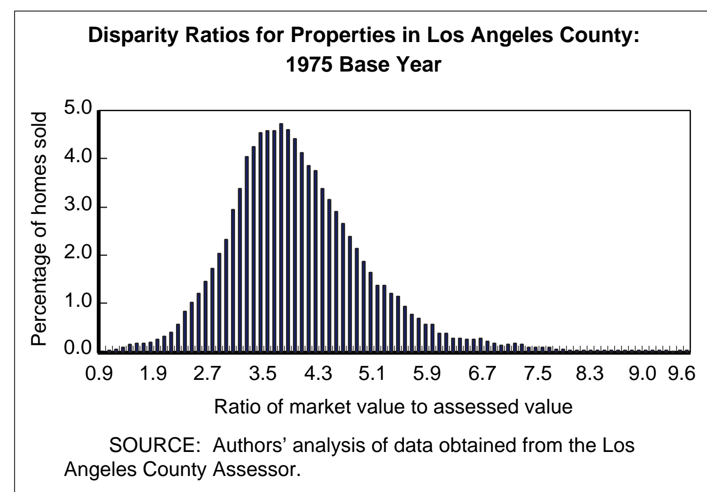
However, from 1991 through 1995, California experienced a severe recession. Property values fell throughout the state, dropping as much as 30 percent in many places. Although the decline in property values helped to eliminate some of the inequities in the property tax system, reducing the gap between market value and assessed value, it also placed a tremendous strain on California's understaffed and underfunded county assessors' offices. As property values fell, residents and businesses throughout the state inundated county assessors with appeals for reassessment. In their study *Proposition 13 in Recession and Recovery*, Steven M. Sheffrin and Terri A. Sexton analyze the dynamic interplay between market value and assessed value since 1975 and the far-reaching effects it has had on property tax administration in California.

Research Approach

When Proposition 13 was passed by the voters in 1978, assessments were rolled back to the property values that prevailed in 1975. This was the initial "base year" for all existing properties in the state. When property is sold, it is reassessed and has a new base year. As long as housing price inflation exceeds 2 percent per year, properties with more recent base years will be assessed closer to market value than properties with older base years. The base year is the key piece of information needed to estimate the disparity between market value and assessed value, which the authors define as the disparity ratio. Once they have identified the base year of a property, they can calculate the disparity ratio by dividing the market value of the property by its assessed value in the preceding year. They did this for properties sold in Los Angeles and San Mateo Counties in 1990–1991 and in 1995–1996, the years bracketing the recession. The analysis involved about 8 million property records for Los Angeles County and 1.4 million for San Mateo County, with base years running from 1975 to 1996.

Tax Disparities in Los Angeles County

The figure below shows the distribution of disparity ratios for single family, owner-occupied homes in Los Angeles County that had a base year of 1975 and that were sold in 1995–1996. The median disparity ratio for all these homes is 3.84. This means that an average new homebuyer in Los Angeles today will pay almost four times the basic property tax as a household that has been in its home since 1975. The disparity between market and assessed value was much greater in 1991, when the median disparity ratio for 1975 base year property was 5.19 or 26 percent higher than



Most homes in Los Angeles County owned since 1975 sold for about 3 to 4 times their assessed value in 1995–1996.

in 1996. The decline in the disparity ratio was a direct consequence of the recession and falling real estate prices.

The fraction of 1975 base year property also decreased substantially during this period. In 1991, 43 percent of all properties in Los Angeles County had 1975 base years. By 1996, the number had fallen to 33 percent. Two primary factors contributed to this decline. First, some of the 1975 base year properties were sold and thus assumed later base years. Second, new construction increased the total number of properties and thereby reduced the 1975 base year percentage. The 1975 base year percentages are key statistics because they are the most important source of property tax disparities. The median disparity ratio in all base years after 1980 currently falls below 1.3, and a 30 percent difference between assessed and market values is not unusual in states using a market-value-based rather than an acquisition-value-based property tax system. In other words, the inequity of the post-Proposition 13 tax system is not that serious in the case of properties with base years after 1980.

Whether inequities in the property tax system will continue to be reduced through turnover and new construction depends largely on two factors. The first is property appreciation. If housing inflation again begins to exceed 2 percent per year on a sustained basis, inequities will increase. The second factor is the stock of 1975 base year housing. Whether the owners of these properties sell or pass the properties on to their children or grandchildren (and thereby maintain the base year) will largely determine whether the number of such properties—those with the greatest disparities—will decrease over time.

Property Tax Administration: Overwhelmed

Before 1991, the assessor's job was relatively easy. For the majority of properties, it was simply a matter of adjusting the previous year's assessed value upward by 2 percent or the rate of inflation, whichever was smaller. However, between 1991 and 1996, hundreds of thousands of property owners who believed that the market value of their property had fallen below the base year value filed appeals for reassessment. Under Proposition 8, a constitutional amendment passed by California voters in 1978, such properties must be reviewed and reassessed each year until the market value again exceeds the factored base year value (base year value plus 2 percent for each subsequent year). If an appeal is not resolved within two years, the assessor is obligated to enroll the property at the value claimed by the owner of the appeal (which may be artificially low).

At the same time that hundreds of thousands of appeals were being filed, assessors' budgets were being cut. In 1992 and 1993, at the peak of the recession, the Governor reduced the state's financial obligations to schools by shifting $3.4 billion in property tax revenues from local agencies to schools through the Educational Revenue Augmentation Fund. This led to a significant reduction in counties' share of property tax revenues, which continues to this day. For example, Alameda County saw its revenue share decline from 40 percent to 16 percent, and Orange County keeps only about one nickel of every property tax dollar collected in the county. Although the state enacted certain measures to help counties enhance their property tax administration, including a temporary loan program that has enabled assessors' offices to hire additional staff, many counties are still working through a 12–18 month backlog of cases.

Looking Ahead

Sooner or later, property values will fully recover, assessments will be completely restored to their base year levels, and appeals will decline from their peak levels. But unless the fiscal relationship between the state and its counties changes, property tax administration problems will remain. Because counties' share of property tax revenues is so small, they have little incentive to spend their scarce budgetary dollars on staffing and modernizing assessors' offices, at the expense of other county services.

One solution to the budgetary problems would be to ensure that all recipients of property tax revenue pay a portion of the administrative costs, in proportion to what they receive. This was the essence of a bill passed in 1990, SB 2557. However, in 1991, schools were exempted. According to the allocation of property tax revenues in 1995–1996, schools received over 53 percent of all property tax revenues. Thus, under this proposal, the state would pay 53 percent of property tax administration costs on behalf of schools. However, relieving counties of some of the administrative costs does not provide them with the type of incentives for thorough and accurate assessments that come with having a larger stake in the outcome, namely, property tax revenues. A better (but politically difficult) solution would be to shift property tax revenues back to counties as their primary source of revenue.

This research brief summarizes a report by Steven M. Sheffrin and Terri A. Sexton, Proposition 13 in Recession and Recovery *The report may be ordered by calling (800) 232-5343 [mainland U.S.] or (415) 291-4415 [Canada, Hawaii, overseas]. A copy of the full text is also available on the Internet (www.ppic.org). The Public Policy Institute of California is a private, nonprofit organization dedicated to independent, nonpartisan research on economic, social, and political issues that affect the lives of Californians. This project was supported by PPIC through an Extramural Research Program contract.*

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