Response to Chairman Gerry Parsky's Request to *California Forward:*

Can State Revenue Volatility be Reduced by Including the Property Tax in the Mix of State Taxation?

At the February 2009 meeting of the Commission, Chairman Parsky asked *California Forward's* reaction to the proposal by Jerry Nickelsburg, Senior Economist at the Anderson School of Business at UCLA that would include the property tax in the mix of taxes as a method for curing revenue volatility. Matched against the income tax, the property tax has very little variation year over year and tends to lag with the economy.

Since it reflects housing market activity, as opposed to the market value of property, property tax will decline as the real estate markets slow, as they are currently doing. This is primarily due to the property assessment system that is based on changes of ownership and new construction. Communities that welcome urban growth and have the capacity to finance the corresponding growing levels of service find themselves in a weaker position when real estate markets slow. A forecast done for *California Forward* by Beacon Economics suggests that the property tax will be in decline over the next two years with modest recovery in 2012.

Professor Nickelsburg suggested that the property tax be included in the analysis of options for dealing with volatility out of its revenue structure since the property tax has sustained a fairly steady growth over time and as noted is the least volatile of all of the major taxes. Although it would be worth the Commission's time to consider the property tax with the other major state taxes, the property tax has not been evaluated in the context of the economy or in the context of overall principles that might govern the state tax system.

There is an assumption that major taxes could be aligned in order to reduce volatility.
The Commission analysis of volatility and that of the Department of Finance is focused on general fund revenues – primarily the income, corporate and sales taxes. The property tax, while important to the overall fiscal health of the state is not a tax managed by the state. It remains a locally levied and collected tax used for local purposes. To the extent that it was to be used in the mix of taxes to assist in reducing the volatility inherent in a tax system tied to a dynamic economy, the property tax would need to the transformed into a state tax with the power of the legislature to revise and adjust it over time so that it worked in coordination with other taxes. Until that threshold is crossed, attempts to match the property tax with the income tax for the purposes of reducing volatility will not be effective.

Two major steps would need to be taken in order to combine the income and property tax rates in order to smooth out the volatility of the current tax system:

1. Convert the property tax to a state tax.

The property tax is currently levied in each county under a rate capped at 1% and is allocated locally to local governments including cities, counties, school and community college districts and other special districts. In order to include the property tax in the mix of state taxes, the State Constitution would need to be amended in order for the state to consolidate polices over the total tax structure. State tax rates for income, transactions and property could be set for greater equity in the incidence of taxation as well as greater control over the problem of volatility.

2. Establish a State Subvention for the Lost Property Tax

The property tax makes up about half of the current revenue available to support local community services including schools. To the extent that the property tax becomes a state general fund revenue source, the state would need to find a method to replace the lost property tax in order to not incur a major impact on community services. The impact of this proposal would make community governments more dependent on the state for the level of community services.

Note: The response to the Commission's interest in exploring Jerry Nickelsburg's proposal is not intended to support the proposal but to simply explain the steps that would need to be taken in order to use the property tax as a means to deal with general state revenue volatility.

California Forward's recommendations to the Commission are reflected in our February 12, 2009 testimony (resubmitted here). Further, *California Forward* is developing additional recommendations based on the outcomes of a series of dialogues about revenue reform currently being conducted across the state.