Addressing property tax issues: rational discussion in a charged environment

Lenny Goldberg, California Tax Reform Association

I appreciate the opportunity to elaborate on some of the key issues in the property tax, and am particularly gratified that this issue has piqued the interest of the Commission enough to devote some substantial time to it. I do not believe it is possible to talk about California's tax system without discussing the property tax, although it has been an off-limits subject for many years.

At UCLA, I presented a basic overview of the most irrational hole in our tax system, the assessment of commercial property. I will try not to repeat the prior presentation, but instead will discuss some finer-grained issues. Much of what I have to say will fold into a critique of the Law and Economics Group paper, a critique I will encapsulate but will be evident throughout this paper.

I. Review of the economics

1. The failure to assess commercial property is the reverse of good economic s: the system taxes new investment heavily and fails to tax economic rents.

A consensus view in economics is to limit direct taxation of new investment to the extent feasible, and place the tax as much as possible on economic rents, that is, windfalls. But California does the reverse: new investment is taxed at full market value of the land and the building, and is generally subjected to development fees, exactions, mitigations and easements as a condition of new development.   In addition, a personal property tax is assessed at the full-market value of property placed in service, and then taxed yearly on its depreciated value. Apart from the property tax, the new equipment placed in service is also subject to the sales tax.

A result of this new investment, whether new private development or new public investment in infrastructure, is generally to improve the land values of other landholders. This benefit is a classic example of an economic rent, that is, a benefit which accrues as the result of an action of others, not the decision of the economic actor. Public finance literature argues that the best tax is one on economic rents, insofar as it has no effect on the decision-making of the beneficiary. And frequently these rents accrue to land and other natural resources.

The above explains Steve Shefrin's statement that assessing commercial property at market value is "very close to the economist's ideal of non-distorting taxes ", with very little impact on the cost of capital.   He notes that the increase in tax would fall most heavily on landowners who have had their property since 1980, with virtually no impact on the new investment decision.

2. Homeowner versus commercial

There is a real economic difference between homeowner and investment property, not with regard to the existence of economic rents but from the capitalization of those rents into income. The value of commercial property is the capitalized value of the future stream of earnings from the property, so its valuation is directly related to the income which can be earned from it. But for the homeowner there are no earnings, other than the imputed rents, which determine value.

Proposition 13 is not so different from the very many states which provide a brake on rising homeowner assessments. (See Terri Sexton's survey about the many types of assessment limitations, in https://www.lincolninst.edu/pubs/dl/1412_733_PFR%20Property%20Tax%20Limits.pdf) The homeowner who buys an affordable house in a modest neighborhood which then experiences rapid gentrification is benefiting from the purchasing decisions of others in terms of home value, but homeowner incomes bear no necessary relation to their home value and a market-value based property tax.

With regard to solutions to this problem, Steve Levy and others have recommended that the inflation rate be raised to 4%, requiring a constitutional amendment. This higher rate would apply to those undervalued houses, would increase revenues, and would lower disparities more rapidly as it would not affect houses which were already at market value.

There is a also a conceptual ly consistent solution: recapturing unpaid property taxes at the time of sale, when those benefits are in fact capitalized into income, in the form of a tax on the gain. That could be done by the legislature through the income tax, by something so simple as lowering the permitted capital gains allowance from sale of a principle residence from $500,000 to $250,000, and counting the variation from the federal exclusion as a recapture of underpaid property taxes.

Last time I showed the extraordinary chart from Santa Clara County since Prop. 13, demonstrating a marked shift to homeowners even as Silicon Valley exploded. Here is similar data from Los Angeles:

		Single-Family Residential		Residential Income		Commercial-Industrial	
Year	Total Roll Value	Total Roll	Percent of Value	Total Roll	Percent of Value	Total Roll	Percent of Value
1975	$ 83.2	$ 33.2	39.9%	$ 11.2	13.5%	$ 38.8	46.6%
1980[2]	$ 150.0	$ 71.2	47.5%	$ 22.8	15.2%	$ 56.0	37.3%
1985	$ 245.2	$ 115.7	47.2%	$ 32.7	13.3%	$ 96.8	39.5%
1990	$ 412.8	$ 200.3	48.5%	$ 57.5	13.9%	$ 155.0	37.6%
1995	$ 486.8	$ 251.1	51.6%	$ 64.4	13.2%	$ 171.3	35.2%
2000	$ 569.6	$ 306.6	53.8%	$ 70.5	12.4%	$ 192.5	33.8%
2005	$ 823.7	$ 469.8	57.0%	$ 106.5	12.9%	$ 247.4	30.1%
2008	**$ 1,067.6**	**$ 613.0**	**57.4%**	**$ 136.6**	**12.8%**	**$ 317.9**	**29.8%**

3. Apartments vs. non-residential commercial property

For apartment owners, the economic rents from rising land values do in fact capitalize into income to the extent that rents rise. So should in fact rental residential housing be assessed at market value?

Economic literature (e.g. Henry Aaron, "Who Pays the Property Tax", Brookings) would argue that the owner of property pays the tax. However, perceptually, most renters and voters would say that if taxes on a property rise rents will rise accordingly, which is a perception for small business renters as well.

That in fact would likely be true in residential rent control jurisdictions, which include San Francisco, Los Angeles, San Jose, Oakland, and some smaller cities—in short, a significant share of the low-income rental housing stock in California. All of those cities would allow an adjustment for a property tax increase where rents are below market, and thus the rents in fact would rise. Thus, homeowners would not receive an increase in tax from market value assessment of commercial property, but among the poorest renters would probably see rent increases, an inequitable result. This point is made by LECG, and is the reason in fact no serious reassessment proposals have included apartments.

The Los Angeles data above suggest what we have found elsewhere: the percentage of the roll for residential rental property has not changed significantly.

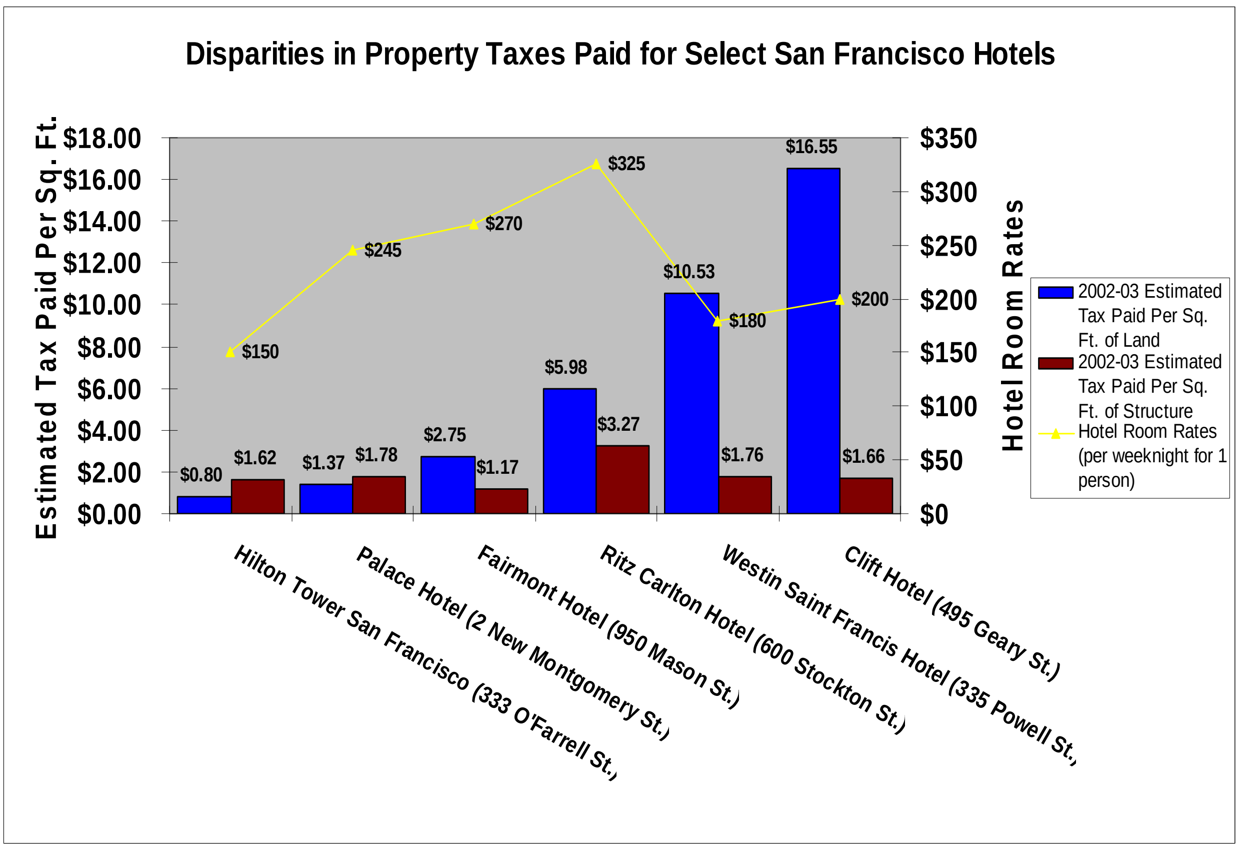
4. Economic benefits. With regard to the benefits of non-residential reassessment, I will here just elaborate slightly on the slide I presented the last time, and hope that you keep this in mind with regard to the LECG presentation:

- Land costs would be lowered. The value of land is inversely related to the tax burden, and inflated land prices detract from investment in productivity by using more capital to pay for land rather than the underlying business. I would argue that the high land prices in California continue in part because we have unceasing demand to live and work in our wonderful state and in part because the land is taxed so low the price is correspondingly so high.
- Development costs would be lower and the permit approval climate improved. To the extent that new development generates land values which are captured by rising assessments—as the current system does not now do—the benefits of new development to a locality are on-going, cumulative, and not all focused on the new investor, as they are currently.
- Competitors will be treated equivalently. New investors who compete with long-standing landholders currently have to pay higher taxes as part of their underlying cost structure, a discouragement to new entry. (See chart below on hotels).
- Costs will be borne by those with locational advantages (market-oriented businesses such as hotels, retail, offices) with the largest economic rents. Non-mobile market-serving businesses, benefitting from highly advantageous locations, will bear the larger burden of the cost.
- Infrastructure development will be encouraged. Infrastructure is investment in the carrying capacity of the land, generating land value increases which would then return to the public sector, which in turn would continue to invest in infrastructure.
- Potential trade-offs for other taxes, particularly personal property, could relieve both business investment and the assessors. A $1 million exemption for personal property would, according to the Board of Equalization, remove 1.4-1.5 million businesses from

the requirement to pay tax on personal property, at a cost of about $800 million. Of course the entire $3 billion in personal property could be exempt from the property tax in exchange for assessing real property, with a disproportionate revenue impact, however, in some counties (Santa Clara).

- Because the value of property is based on future income, the tax burden declines in a time of recession, providing business relief, and only expands as the economy expands. However, in terms of the volatility argument, it is still significantly more stable than other taxes.

By way of demonstration of some of these issues, I have included the following chart with regard to the relationship of hotel room rents and property tax values. Its results are replicated elsewhere, such that there is little relationship of assessments to underlying rents. It suggests three of the above important points: locational advantages are not being captured; competitors are treated differently; and that behavior would not change with higher assessments.



II. Legal considerations: statutory definition of change of ownership

1. Change of ownership difficult to define

We do not necessarily share the frequently stated view that commercial property changes ownership than residential, because much of it depends on the definition of change of ownership. Change of ownership for commercial property, which is the triggering characteristic for re-assessment, is an elusive concept because of the complexity of ways commercial property is held.

The law requires that both ownership and control change, and that one purchaser must take both control and ownership by 50% plus 1. Purchase of significantly less of a publicly-traded corporation generally passes control to a new owner but is not a reassessable event. Similarly, 90% of shareholders might change over a period of time, with no re-assessment. Or limited partnerships will turn over 100% at one event—Martini to Gallo—or cumulatively at many events. With the complexity of property holding by multiple holders, traded as REITs, private placements, LLC's, etc, there is really little relationship between the concept and the taxable value of the property.

The law also makes it relatively easy to effectuate a change of ownership by changing the underlying ownership structure. Thus when the market is down, a change of ownership can lock in lower assessments on a permanent basis, rather than temporarily until markets recover.

2. Legislative solutions: making lemonade from a lemon

Legislation has been proposed to change the definition of change of ownership to a cumulative change in 50% of ownership, over time. In order to avoid the burden of tracking stock, this legislation proposed a rebuttable presumption that publicly-traded corporations changed ownership every 3 or 5 years, and would bring up to market any corporation that has not seen its property change ownership in the last 5 years, subject to the presumption.

There are many complexities to this approach, but none are greater than the current law, which allows for assessment avoidance even when change of ownership occurs. Such a statutory change was estimated in the 1990's to raise approximately $2 billion.

Those who would argue against change in the current system should be able to defend the current system. In many discussions, including with attorneys in this industry, I have never found anyone who defends it as a matter of the intersection and law and tax policy.

III. Land use and fiscal policy

1. Speculation and sprawl: Our prior presentation noted that the system failed to penalize the holding of land off the market, increased the cost of land, promoted big-box retailing and violated the principle that land should be assessed at its highest and best use. In essence, there is no penalty for maintaining low-value uses (e.g. parking lots, used car lots) in high-value areas. The result is the higher land cost which obtains when supply is lower; that is, owners have can hold out for higher prices and hold land off the market. And land-extensive uses which generate sales tax—big-box retailing—are encouraged by the system.

There are many pressures which promote sprawl which are not tax-based, but reform of the current system may be a necessary if not sufficient condition of improving land-use decisions. That is, appropriate valuation of land not only encourages in-fill but also prevents potential leapfrog development and provides appropriate signals for infrastructure finance.

2. Infrastructure: Most infrastructure development is an investment in the carrying capacity of the land—improvements in transportation, water supply and treatment, bridges, transit, etc. The fundamental disconnect in the current system is that such investments generate land value increases but generate revenue only from the new investment which results but not from all the other beneficiaries. In fact, the Bay Area Council in the late 1980's saw commercial reassessment as a means for financing infrastructure, creating a virtuous cycle of new investment. **An assertion: the biggest single cause of infrastructure decay, starting in the 1980's, is the failure to capture land value benefits from infrastructure investment.** If this is correct, it has many implications for both our infrastructure and overall fiscal crisis, insofar as we have turned to the general fund for infrastructure development.

3. Fiscal policy. Michael Coleman has demonstrated that the least local revenue results from new industrial development, hardly a recommendation for a welcoming regulatory or fiscal climate. That would not be the case if cumulative land value increases were to result, as job-generating investment also generates other growth in land values.

What are the numbers and the allocation of reassessing commercial property? Between Proposition 1a and Prop 98, cities and counties (and special districts) would receive about half the increase, school s the other half, which under current formulas would relieve the general fund obligation by about that amount.

The numbers themselves are uncertain. LECG uses Board of Equalization data which suggests that non-residential reassessment will raise approximately $9 billion, and Shefrin concurs with that number, though notices a decline in value which might lower that to closer to $7 billion in the current economic environment. Unfortunately, assessors seem to categorize data in an inconsistent manner, so there is no central repository by type of property, nor is there an agreement on assessment ratios.

However, to the extent that commercial property is about 1/3 of a $37 billion role, and is at 60% of market value, the expected revenue would be in the range of $8 billion. However, assuming that 100% of value can be approached but cannot be achieved, the number is likely to be less, in the range of $6-8 billion. Note that this number does not include rental residential property. And an improved development climate and economy will provide for growth over time.

IV. Discussing a solution

"Non-residential property shall be periodically assessed at market value". What are the potential trade-offs and issues here?

1. Non-residential. There are a few easily resolvable borderline issues. Residential hotels would need definition, as would multiple use property (described in SF assessment data as "flat and store"). Home offices would not be impacted, insofar as zoning categories and predominant use would prevail.

2. Personal property. While presumably commercial rents are at market in a competitive environment, property owners argue that "triple-net leases" would require a rent increase, and presumably some renters have significant investments both in improvements and locational attributes which would be difficult to relocate. We would propose to eliminate the first $1 million of personal property, which we would be $10,000 in tax relief, and would provide net benefits to all small renters. It would also relieve the assessor of significant obligations.

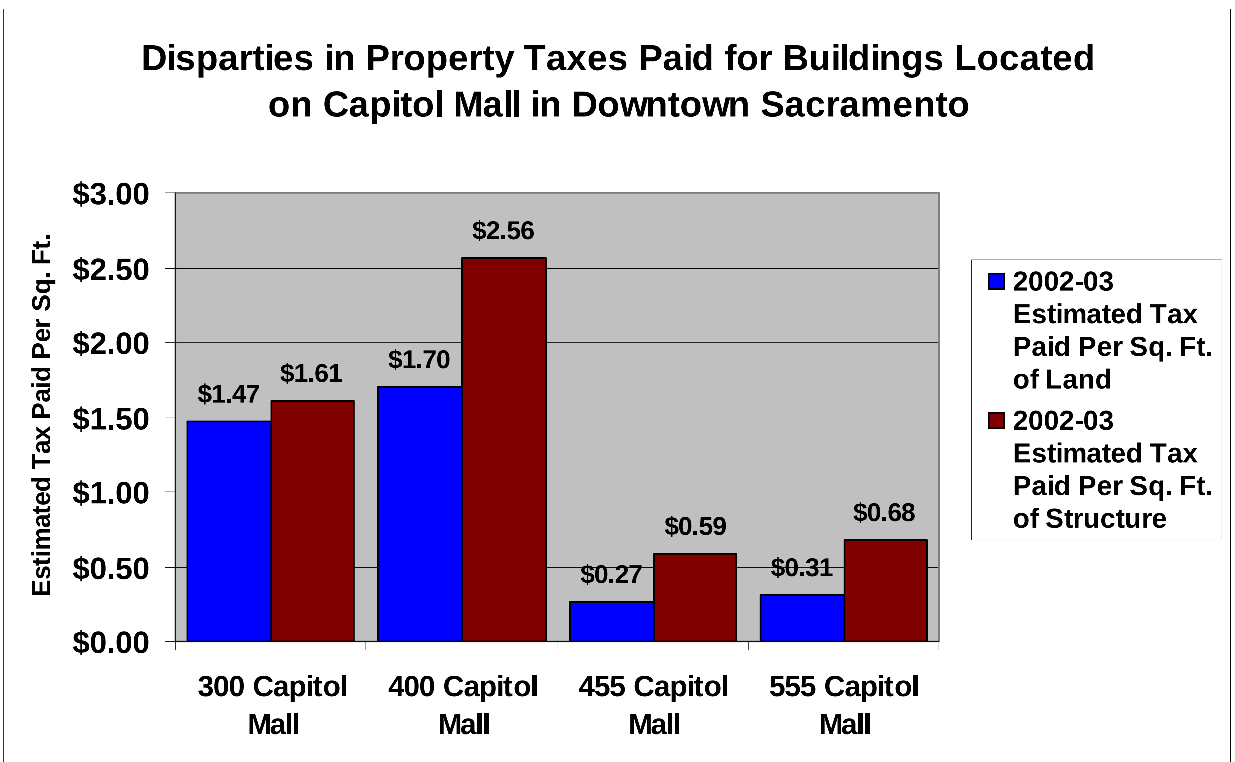
Alternately, to the extent that a "revenue-neutral" solution is proposed, relief of all tax on personal property would lower the revenue by $3 billion, and would shift the tax burden away from new investment goods to land.

3. Farm property and the Williamson Act. To the extent that rising land values create farmland development pressures on the rural-urban fringe, Williamson Act protections and definition would be likely to be maintained in place. Land used for food production was specifically exempt in ACA 16 (Hancock).

4. Assessment options. Santa Clara Assessor Larry Stone has spoken of the difficulties of assessment of property all at once. We would suggest a number of approaches which can mitigate that difficulty, since after all, such property assessment is done in every state but California.

a. Phase-in by increasing assessments by 10%/year or more, depending on base year values. Base year values which are particularly dated (e.g 1975/1980) could be phased in more quickly. Then, the only appeals which would occur would be where those assessed values began to approach market values. This type of phase-in would avoid the extensive appeal process which assessors have argued would clog efforts to bring all properties to value at once. It would, of course, limit revenue until the process is finished, say at a 5-year phase-in.

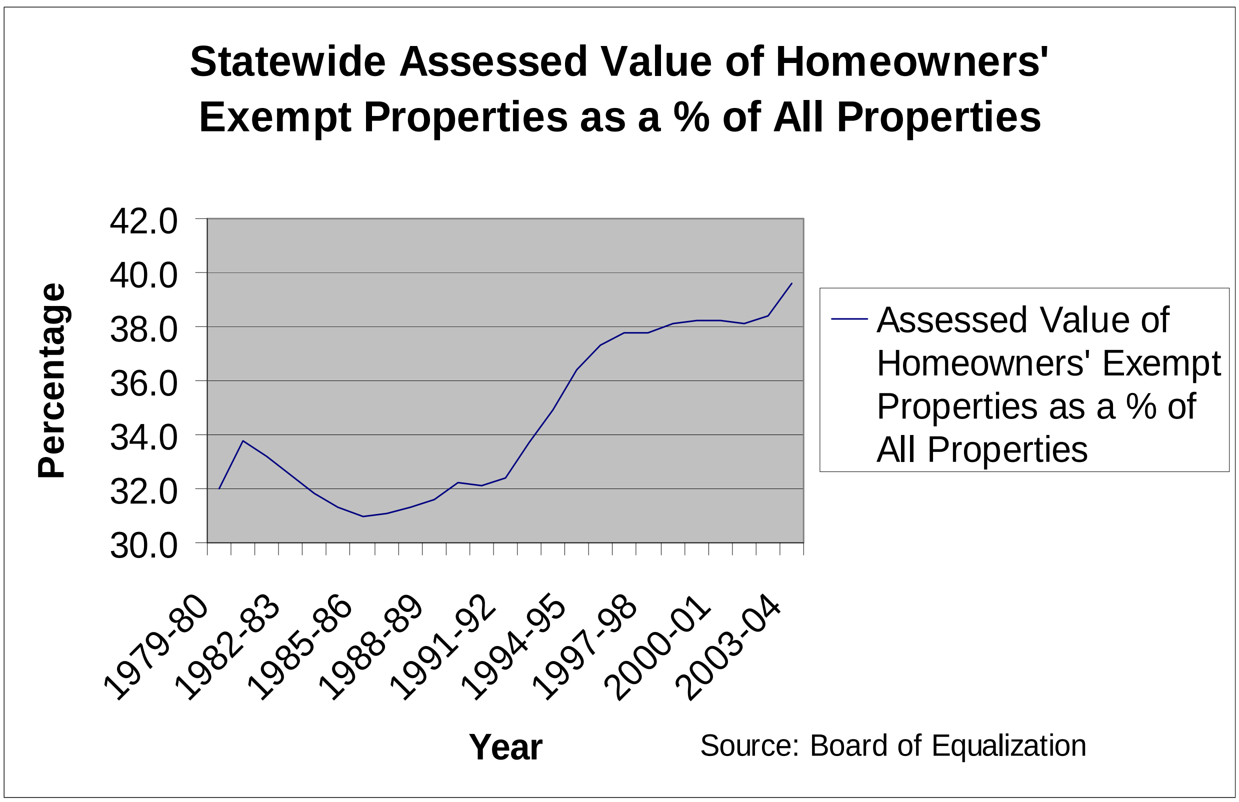
b. Reassess the underlying land values first before addressing the complexities of varied buildings. Land values appear to have the greatest disparities, and are currently reported by the assessor. As an example, here are land values from buildings across the street from each other:



c. Aside from fully-funding the assessors from these proceeds, relieve the personal property tax burden in order to address the need for more detailed assessment . Presumably, this would provide relief to the burden on the assessor as well

V. Comments about LECG study

1. Assessment ratio numbers at one point in time have little to do with the shift over time. We have not found a county in which that shift has not taken place, sometimes modestly, sometimes significantly. Here is BOE's data on homeowner share of the roll. However, this fails to capture what counties capture, the more dramatic split between residential and non-residential property. The 38% number used in LECG's chart is up from a historic 32%, and therefore demonstrates the shift, though to a lesser extent than the major urban counties, whose data includes all residential, not just homeowners.



Note, however, that the case for reassessment of non-residential property is not based on the shifting burden, since we would argue that in fact homes have taken on substantial speculative value while commercial property must be based on the capitalized value of future earnings. Commercial property values will be down in a recession, particularly retail property, but had little of the speculative increases that housing has recently had. The speculative values are likely to be in land.

2. The many comments in LECG about the burden falling on lower income renters would be accurate, as we noted, were apartments to be included. However, there have been no serious proposals which include rental residential property.

3. With regard to small commercial renters, the actual economics is such that renters should be already paying market value. However, as noted, a beneficial proposal would be to limit the personal property tax for 1.4 million small businesses, with substantial benefits to small commercial properties which would outweigh any potential for assessed value increases to be passed through to commercial renters.

4. We agree with LECG on several fronts.

a. There is an increased local incentive to develop land, which we would argue is probably a good thing, particularly since it would be higher value land in an in-fill environment.

b. It would improve the incentive not for commercial development per se but more particularly for job-generating industrial and research development. The incentive for retail is already dominating local government decisions.

5. Most significantly, the model is a black box, using no specifics about the land tax but effectively putting an amount of tax increase into a model, and getting job loss back as a result.

To use a different tax example, an oil production tax is a case of a pure tax on economic rents, above a certain threshold. A detailed Rand Corporation analysis showed it would have no effect on the price of oil and no effect on oil production. Yet the model would show that the $1 billion raised from Governor Schwarzenegger's proposed tax on oil production would have a significant negative impact on jobs.

Another way to look at this is to assume revenue neutrality. If we reassessed commercial property and used that revenue to, for example, eliminate the personal property tax for all businesses and eliminate the sales tax on manufacturing equipment, would that have zero predicted effect on the economy, would it be negative, or would it be positive? Our argument would be that eliminating the tax on new investment would compare favorably with placing a tax on unearned land value increments. But this model would not demonstrate that. It would take only the net dollars generated and spin out a proportional number of jobs lost or gained.

6. The issue of mobility of capital—land is immobile, buildings are not—fails to capture locational value. Obviously buildings represents embedded capital, which can flow elsewhere. But that ignores the fact that a large proportion of underassessment is based on locational values in shopping centers, hotels, and retail development. That is, market-oriented capital will not be mobile, at a far higher percentage suggesting in the study.