City of Alexandria, Virginia

MEMORANDUM

DATE: MARCH 28, 2005

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT: BUDGET MEMO #14: IMPACT OF TAX AND ASSESSMENT CAPS

This memo is written in response to Councilwoman Pepper, who asked about the effects of California's Proposition 13 and legislation in other states which has limited the growth of real property assessments and other local tax revenues. This information will focus on the California experience, Colorado's Taxpayer Bill of Rights, and Prince George's County's TRIM initiative. It is based primarily on a review of on-line literature dealing with California and Colorado and an interview with Prince George's Office of Management and Budget. Although other state and local governments have initiated similar programs to cap the growth in state or local revenues, few have been in existence long enough to generate the same amount of information on long-term effects as these. In addition to the following information, attached is a recent *Washington Post* article on state tax cut and budget limitations.

California's Proposition 13

Proposition 13 was passed by California voters in 1978. It limits real property assessment increases to two percent annually. If, however, the property changes ownership, the two percent limit does not apply and the assessment is increased to actual value. Proposition 13 also capped property tax rates at one percent (the equivalent of a $1.00 tax rate in the City); rolled tax assessments back to their 1975-76 level; and gave the California legislature responsibility for allocating property tax revenues among jurisdictions. Also as a result of this initiative, any state legislation that would increase revenues now requires a two-thirds vote of the California General Assembly, and any new local tax requires approval by two-thirds of the locality's voters.

Proposition 13 had a number of immediate effects on California governments, including:

- It lowered local governments' reliance on property tax revenues to meet their needs. In 1972, prior to Proposition 13, real property taxes accounted for about 25 percent of the general fund revenues of California's cities. By 1997, they provided only 15 percent of general fund revenues. Fees and other miscellaneous (non-tax) revenues, on the other hand, grew from 23 to 38 percent of general fund revenues over this same 25 year span.

- Proposition 13 not only increased local reliance on other non-tax revenue sources such as user fees, it also resulted in significant increases in taxes unrelated to property, such as business taxes, hotel taxes, and recordation taxes.

- Proposition 13 shifted the tax burden from commercial to residential real estate, or from businesses to homeowners, since residential real estate tends to change hands (and thus undergo reassessment and increased taxes) more often than commercial real estate.

  Table 1 shows the taxes that would be paid over 9 years for two properties, one residential and the other commercial, that are of equal value ($750,000), under a Proposition 13 type of tax limit. The actual value of each property is assumed to increase at a constant rate of 10 percent annually. The scenario assumes that the residential property is sold in years 2, 5, and 8 (this would not be unusual in Alexandria), and that the commercial property does not change ownership. After nine years, the residential property owners have paid $98,087 in taxes on their property, while the commercial owner has paid only $84,763.

- Since the passage of Proposition 13, California localities have become over reliant on uncertain state revenues for many of their programs. As we have seen in Virginia, California state government often looks to local assistance programs for reductions when there is a downturn in the economy, or when it needs funding for other programs. During California's last budget crisis, aid to local governments was reduced drastically.

- It is generally acknowledged that the quality of the California public school system dropped due to the effects of Proposition 13, with state aid countering a portion of the revenue loss. However, it has also made local school budgets subject to reduction during state budget crises.

- Bond ratings for localities went down after Proposition 13, raising the cost of borrowing money. Rating agencies do not look favorably on measures that put limits on a locality's ability to generate revenue. There are only three AAA/Aaa rated jurisdictions in California (Palo Alto, Manhattan Beach and Santa Monica).

- A study by the Public Policy Institute of California reviewed some less noticed unanticipated consequences of Proposition 13. Among the Institute's findings was that localities in some cases have favored developments that would generate revenues in addition to property taxes (e.g., a strip or big box shopping center producing sales tax revenues might be favored over an office development).

- Proposition 13 has raised serious questions of equity (one of the main purposes of annual assessments at 100% of value is to maintain fairness and equity among property owners). It has resulted in property owners paying taxes which vary substantially for properties that are of equal value, since someone who had held a parcel for a long period of time pay a much lower tax than a new owner. One study showed that the average Los Angeles homeowner who had owned his home prior to Proposition 13 and sold it in the mid-90's received a purchase price that was 3.84 times his assessment (which was artificially low because of Proposition 13).

Table 2 shows the taxes that the owners of 5 homes (given the pseudonym of "Smith Street" here, although they represent real properties) would have paid in 2005 if a Proposition 13 scenario had been enacted prior to the 2002 tax year. The last column shows the difference in the tax paid under the system currently used in the City and the Proposition 13-type scenario. The differences are dramatic, with owners of properties of similar value paying as much as $1,000 or $2,000 more than others.

- Column 1 shows the street address;
- Column 2, the actual 2005 assessment;
  Column 3, the assessment under a Proposition 13-type scenario, taking into account actual sales of individual properties that have occurred since 2002;
- Column 4, the tax that would be paid under the current actual assessment with a $1 tax rate;
- Column 5, the tax paid under the Proposition 13-type scenario; and
- Column 6, the disparate taxes paid for the same valued house under the Proposition 13-type scenario.

Colorado TABOR (Taxpayer Bill of Rights)

Colorado enacted a Taxpayer Bill of Rights (TABOR) in 1992. It requires the voters to approve any state or local government tax increase. It also restricts total state revenue increases each year to a percentage equal to the percentage growth in population plus the inflation rate. Any revenues in excess of this limit must be refunded to the voters. When revenues fall (as they did in Alexandria in the early 90's), the following year's limit is based on new, smaller revenue total.

A comprehensive study of Colorado's TABOR was undertaken recently by the Bell Policy Center, a non-profit policy and research organization in Denver. That study, and a recent report by the D.C.-based Center on Budget and Policy Priorities, noted the following effects resulting from Colorado's TABOR and its limits on state and local revenues:

- Elementary and secondary school class sizes are larger than in most other states.
- Teacher pay is 7 percent below the national average, and the ratio of teacher salary to private sector earnings is lower in Colorado than in any other state.
- State spending for health care for children, aid to localities, mental health, and child care has been reduced substantially.
- Since taxes cannot be increased, many new fees for services have been implemented.
- During economic downturns, when caseloads for government social service programs increase, there is no provision to increase revenues to pay for these services. As a result, other government services are reduced to free up money needed for these social services.

Prince George's County

Prince George's County, Maryland, has limits on assessments and tax rates that are similar to those in California. A referendum passed in 1978 and amended in 1984, known as the Tax Reform in Maryland (TRIM) initiative, limits the tax rate on real property in the County to $.96. In addition, while Maryland law limits annual assessment increases to no more than 10 percent, local ordinances can ratchet the increases down further. In Prince George's, assessment increases cannot exceed the rate of inflation. The only exception to this is when a property is sold or transferred, and it is reassessed at its actual value. Besides the fact that owners of identical properties can pay significantly different taxes (one who has owned a home for thirty years will often pay several times less than the new owner of an identical property), County staff have noted other problems that have resulted from TRIM:

- The County's revenue structure is inflexible. If there is a need for a new program or to expand an existing program, or if home values decrease, the County cannot raise the tax rate to address County needs.

- Bond rating agencies have told County staff that they view the County's inflexible revenue structure negatively. Inevitably, such views negatively affect the ratings (and therefore the cost of borrowing) that the rating agencies would give a locality.

Attachments:

1. Table 1 – A Scenario for Tax Revenues from Residential and Commercial Properties of Equal Value Under a Proposition 13 Type of Tax Limit
2. Table 2 – Tax Equity Disparity on "Smith" Street, Alexandria
3. "GOP Governors Fight Tax Limits," *Washington Post*, March 27, 2005

Table 1

A Scenario for Tax Revenues from Residential and Commercial Properties of Equal Value Under a Proposition 13 Type of Tax Limit

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Total
Residential Property City Assessment	$750,000	$825,000	$866,250	$909,563	$1,098,075	$1,152,979	$1,210,628	$1,461,538	$1,534,615	Not Applicable
Taxes Paid	$7,500	$8,250	$8,663	$9,096	$10,981	$11,530	$12,106	$14,615	$15,346	$98,087
Commercial Property City Assessment	$750,000	$787,500	$826,875	$868,219	$911,630	$1,005,071	$1,055,324	$1,108,090	$1,163,495	Not Applicable
Taxes Paid	$7,500	$7,875	$8,269	$8,682	$9,117	$10,051	$10,553	$11,081	$11,635	$84,763
Annual Tax Equity Discrepancy	- 0 -	$375	$394	$414	$1,864	$1,479	$1,553	$3,534	$3,711	$13,324

Assumptions:

- Both properties are worth $750,000 in Year 1
- Actual value increases at a constant 10% annually for each property
- Tax rate remains at a constant $1/$100 in all years
- City assessment is frozen at 5% annually except for those years when property is sold
- Residential property is sold in year 2, 5, and 8, and City assessment is increased to match actual assessment
- Commercial property remains with same owner

Effect:

Over nine years, the commercial property yields $84,763 in tax revenue. The residential property, with the same value, yields $98,087 in revenue or nearly 16% more than the commercial property.

Table 2

Tax Equity Disparity on "Smith" Street, Alexandria Using a Proposition 13-type Scenario

(1) Address	(2) Actual 2005 Assessed Value (no assessment cap)	(3) Capped Assessment in 2005 (includes a 5 percent annual increase since actual 2002 assessment, or a reassessment if sold)	(4) Tax That Would Be Paid in 2005 with a current assessment system and a $1 tax rate	(5) Capped Tax (rate=$1)	(6) Capped Tax Payment Differential (6=4-5)
2503 Smith St.	$575,600	$575,600	$5,756	$5,756	$0
2601 Smith St.	$582,300	$474,185	$5,823	$4,742	$1,081
2600 Smith St.	$587,500	$398,918	$5,875	$3,989	$1,886
2506 Smith St.	$590,400	$401,464	$5,904	$4,015	$1,889
2605 Smith St.	$591,600	$591,600	$5,916	$5,916	$0

(A) Assumes that the tax rate is $1; that assessment increases between 2002 and 2005 were capped at 5 percent annually; and that assessments were increased beyond the cap to actual cash value only when the residence was sold.

(B) Column 1 shows the street address; Column 2, the actual 2005 assessment, Column 3, the assessment under a Proposition 13-type scenario, taking into account actual sales of individual properties that have occurred since 2002; Column 4, the tax that would be paid under the current actual assessment with a $1 tax rate; Column 5, the tax paid under the Proposition 13-type scenario; and Column 6, the disparate taxes paid for the same valued house under the Proposition 13-type scenario.

A4 SUNDAY, MARCH 27, 2005 S

GOP Governors Fight Tax Limits

Foes of Big Government Blame Crunch on Cuts in Federal Aid

By T.R. REID
Washington Post Staff Writer

DENVER — Gov. Bill Owens (R) has been crisscrossing the country for years promoting the virtues of this state's strict constitutional limits on government spending. He has repeatedly urged other states to adopt restrictions of their own, based on Colorado's "Taxpayer Bill of Rights" amendment, known here as TABOR.

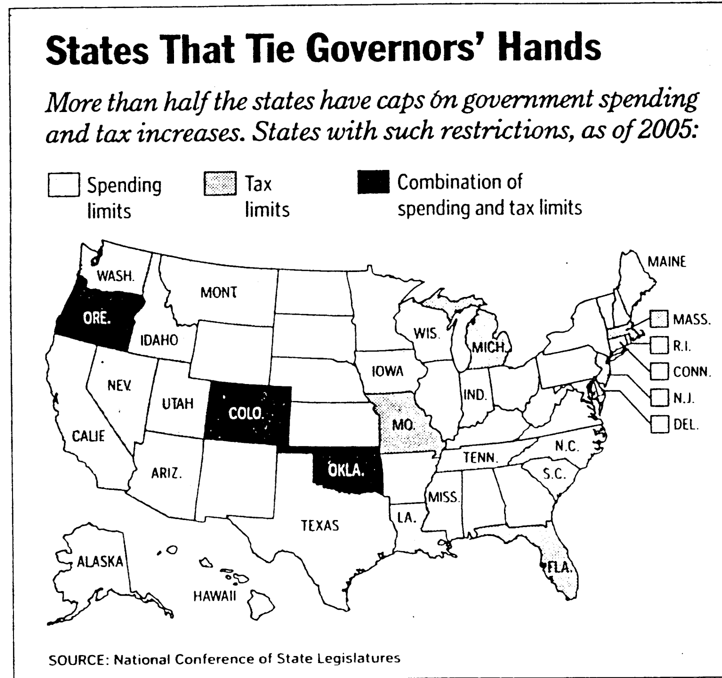
But this summer, Owens says, he'll be traversing his own mountainous state pushing the opposite message. Midway through his second term, Owens is working to persuade Coloradans to suspend the limits he championed and let the state government spend $3 billion more in tax money than TABOR would allow.

Owens thus becomes another low-tax, limited-government advocate who has found those princi-[illegible] hard to hold onto amid a slug-[illegible] economy and a sharply [illegible]inished flow of federal money to the states.

In the past two years, Republican governors including Nevada's Kenny Guinn, Idaho's Dirk Kempthorne, Georgia's Sonny Perdue and Ohio's Bob Taft have dumped no-new-taxes pledges to push for major new revenue and increased state spending.

Perhaps the most stinging reversal for tax-limitation groups in Washington was the quick conversion of Mitchell E. Daniels Jr. (R), who was President Bush's first budget director and an outspoken advocate of lower taxes — until he was elected governor of Indiana last November. In his first state budget, Daniels recently proposed a 29 percent increase in the income tax, targeted at the upper brackets. Daniels cited a $250 million revenue shortfall and said spending cuts of that size were untenable.

All of these tax-raising Republicans offer the same basic reasons for their change of heart. "I have done something that is absolutely [illegible]art of my fiber," Kempthorne [illegible] when he proposed Idaho tax increases in 2003. "But I'm not going to dismantle this state, and I'm not going to jeopardize our bond rating, and I'm not going to reduce my emphasis on education."



Guinn provided a similar explanation after he pushed through the biggest tax increase in Nevada history.

"Some people say that makes me a bad Republican," said the former banker and corporate executive. "Well, I would be a worse Republican, and a worse grandfather, and a worse citizen, if I didn't find enough money to educate our children and fund our Medicaid program and provide decent prenatal care."

For Owens, as for his fellow GOP governors, a key reason for the tax increases at home has been tax-cutting in Washington. Facing sharply decreased revenue and record deficits, Bush has targeted transfers to the states as a ripe place to reduce federal spending. In his budget for fiscal 2006, the biggest single reduction is a $60 billion cut in Medicaid funds that help the states provide health care to the poor.

"The federal cuts have been very difficult for states to manage," said economist Bert Waisanen of the National Conference of State Legislatures. "Governors have to run programs like Medicaid, No Child Left Behind, homeland security. But there is less and less money coming from Washington to pay the bills."

For all those problems, Colorado hardly seemed a likely state to throw in the towel on spending limits. Among the 30 states that have enacted some form of tax or spending limits, Colorado's was known as the toughest. "When legislators around the country call me to ask about spending limits, they always want to know how it is working in Colorado," Waisanen said.

The TABOR constitutional amendment passed by the voters in 1992 says that government spending levels must be based on changes in population and inflation. Tax increases at any level of government must be approved by referendum. When tax revenue exceeds the permitted spending level, taxpayers must get a refund the next year; thus the state cannot build up "rainy day funds" in good years.

"The result is the public sector cannot grow at a rate faster than the private sector," Owens wrote in a column for the Wall Street Journal praising TABOR.

During the boom years of the 1990s, with population and personal income soaring, the limits worked well. But the economic downturn and the reduction in federal support during the first Bush term proved disastrous for Colorado's finances. The state put off building roads and maintaining infrastructure. It reduced services and raised fees. Spending on higher education fell so sharply that the president of the University of Colorado declared the flagship state school a "private enterprise."

Voters grew increasingly angry and demanded changes from Owens and the Republican-controlled legislature. But GOP leaders refused to act. "So long as I am governor, we will not raise taxes," Owens pledged in 2003.

Last fall, the Democratic Party launched a statewide campaign against the TABOR limits — and scored a huge victory at the polls. While Bush was easily carrying the state, Democrats took control of the state House and Senate.

"We have a clear mandate," said Rep. Andrew Romanoff, Democratic leader of the state House. "The voters sent us here to do something about the TABOR roadblock."

Owens conceded the point. On St. Patrick's Day, he agreed to a plan designed largely by Democrats that will suspend the spending limit for five years, allowing the state to spend $3.1 billion that otherwise would have been refunded to taxpayers.

Because this is considered a tax increase under the TABOR rules, voters must approve the change in November, or it will not take effect. Owens says he will campaign with Democrats to win voter approval of the anti-limits plan. "This will put Colorado back on track," the governor said.

The striking turnabout by a onetime tax cutter has generated rage in some GOP circles. Republican legislators have rapped their governor as a "turncoat" and a "big spender." Owens has fired back. After Rep. Joe Stengel (R) announced his opposition to the proposal, Owens said: "When the next volume of 'Profiles in Courage' is written, there won't be a chapter on Joe Stengel."

While Republicans exchange insults, Colorado's Democratic leaders are exultant.

"Less than three months after they took over the legislature, the Democrats produced a solution and got a Republican governor to go along," said Democratic consultant Terry Snyder of Denver. "That's exactly what the voters put them in office to do."