2010

The Untold Story Behind California's Scapegoat: An Analysis of Proposition 13

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The Untold Story Behind California’s Scapegoat: An Analysis of Proposition 13

SUBMITTED TO

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FOR

SENIOR THESIS

FALL 2010
NOVEMBER 27, 2010
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Introduction

The United States of America is a nation founded on a tax revolt. The Founding Fathers recognized that citizens would never enjoy their freedom if they were taxed without representation. Once they secured independence, they framed our Constitution with ten initial amendments, the Bill of Rights, which were a series of the limitations on the power of the United States government. The goal of the Bill of Rights was to protect the natural rights of liberty and property of the citizens of the United States. Prior to the passage of Proposition 13 in California, the citizens of America knew that even with representation, our individual liberty could still be threatened by the government. In California, the conservative, anti-big government tide in American began with the passage of Proposition 13.

The California experience previous to the passage of Proposition 13 taught the citizens of California that even with representation, the freedoms of individuals could be threatened. This lesson is especially true when we see the assessment scandals, a rapidly increasing real estate market and the failure of California’s representative officials to respond to the threat to individual liberty. In addition to watching corrupt tax assessors take advantage of the system, individuals were tired of paying inflated property taxes that were changing drastically from year to year. People’s homes were literally being taken from them by the power of the tax collector. This strongly deviated from the initial founding of our
nation that was supposed to be “of the people, by the people and for the people.” While few people initially expected Proposition 13 to pass, ultimately it passed with 64.8 percent of the vote. The initiative process in California gave individuals the opportunity to make a constitutional amendment to the California Constitution in regards to the taxation processes of the government. With the passage of Proposition 13, the citizens of California made their statement.

Proposition 13, passed on June 6, 1978. The measure lowered property taxes by rolling back property values to their 1975 levels, states that the maximum amount of any tax based on real estate shall not exceed one percent of the full cash value of the property, and restricts annual increases in assessed values of real property to an inflation factor cap set at two percent per year. It also prohibited reassessment of a new base year value except upon change in ownership, completion of new construction or a newly built property. In addition to lowering property taxes, the initiative contained language requiring a two-thirds majority in both legislative houses for future increases in all state tax rates or amounts of revenue collected, including income tax rates. It also required a two-thirds majority vote in local elections for local governments that wished to raise special taxes.

Since its inception Proposition 13 has had powerful enemies. Politicians have opposed it because they see it as limiting their power. Public employee unions have resisted it because they see any restriction on government’s ability to tax as a threat to their jobs and wages. There have been misunderstood consequences of Proposition 13 that are often wrongly attributed to having come about as a result of the initiative. Redevelopment, new city incorporations and annexations and the fiscalization of land use are all attributed to
Proposition 13. While Proposition 13 has had an influence on how California communities are shaped and planned, there are a wide number of reasons why these things have happened, and probably would have happened in the absence of Proposition 13. The fight for money has also been and always will be an issue in regards to the government.

The services that the government are expected to provide are feasible only if there are enough revenues. This constant battle between costs and revenues and the desire for services is a politically charged one that is common in today’s world. The truth is that Proposition 13 did not have a negative effect on overall revenues at both the state and local levels. By analyzing the statistics from state revenue streams as well as local revenue streams it is evident that not only have overall revenues increased in the state of California, but for local governments, property tax revenues have increased proportional to inflation. Additionally, the acquisition-value system that was set up as a result of Proposition 13 has worked to provide a solid level of predictability for both individual property owners and budget directors. Currently, the most popular movement to reform Proposition 13 is to develop a split-roll tax system. This type of system would take the place of the current acquisition system and it would divide the tax treatment of commercial and residential properties by removing the protections form commercial properties. The negative consequences of the split-roll tax far outweigh the positives. The split-roll would adversely impact small businesses which would create a less-competitive climate for California’s businesses to expand and created jobs; further hurting the already fragile economy.

The final chapter of this thesis is a Case Study of the County of Orange in Southern California. The study of Orange County provides a strong demonstration for the contentious
struggle between blaming Proposition 13 and recognizing that aggressive spending is to blame. This analysis also addresses the invalid statement that revenues are not able to increase as fast as inflation because of the two percent cap that Proposition 13 placed on reassessments.

Proposition 13 is one of the most popular, voter-approved tax measures that has passed in California. As some proponents of Proposition 13 argue, the fiscal problem is in the failure of the state to get its budgetary house in order. It is not at the local level. Those who live off of government dollars do not like to see restrictions. This is how most of the enemies of Proposition 13 come about, they do not have enough money and need a scapegoat, and Proposition 13 is the answer. Property tax is a county or city revenue source. The state backfills counties with a surplus of revenue and when this surplus was reduced by Proposition 13, counties and local governments had to find a different way to raise taxes.\(^1\) This was something new that they had never had to do before. Local governments felt entitled to the monies that were no longer available. Today, counties and cities have to live within more restricted means then they had to previous to Proposition 13 when they had unlimited dollars to spend.
Chapter 1: The Beginning of the Tax Revolt

For California’s local governments the world changed dramatically in 1978, with the passage of Proposition 13. Prior to that time, the property tax was considered a “local” tax, and counties, cities, special districts, and school districts had the authority to levy taxes in order to generate revenues. Taxpayers reacted to the dramatic increase in property taxes and the growing state revenue surplus of nearly $5 billion by voting to amend California’s Constitution through Proposition 13. Due to assessment scandals, a rapidly increasing real estate market and the failure of the legislature to act, the historic Proposition 13 was the catalyst of the tax revolt in California and across the United States.

Assessment Scandals

In 1965, when it was revealed that elected tax assessors were receiving campaign contributions from interested parties as they reviewed and adjusted assessments on business properties, the idea for Proposition 13 was planted. Due to the corruption, local governments dramatically increased property tax throughout the state in the mid 1960’s. The assessors of San Francisco and Alameda County were convicted of bribery and sent to prison, and the San Diego County Assessor committed suicide after these bribery schemes were uncovered. Spurred by the outcry over these scandals, the California State Legislature
passed AB 80 in 1967. This law required communities to reassess all property at 25 percent of their values, within three years, and then to conduct frequent reassessments in order to keep the ratio intact. AB 80 helped curb corruption by requiring local officials to assess homes at a uniform fraction of their current market value. However, the unintended consequence of this reform was that assessments for homeowners increased rapidly, since as real estate values escalated, so did home assessment fees. Previously, commercial properties had been assessed at a higher ratio of market value compared to single-family housing. Since the uniform rate of twenty-five percent brought down the total amount of revenues that local governments and the state collected from property taxes, homeowners had to assume a greater share of the tax burden if the overall level of revenue was to be maintained. As residential property tends to change hands more quickly as long as real estate prices moved upwards, shortening the reassessment cycle, and making the estimates more frequent, overall tax burden of individual homeowners was increased. Due to these changes made by AB 80, the property tax was collected twice a year in large, in increasing sums of money and began to create panic among homeowners. For the tax collector, the ideal tax is neither seen nor felt, it is simply absorbed without causing an additional burden on the consumer. At this time the property tax had the exact opposite characteristics.

In the aftermath of A.B 80, Phillip Watson, the Los Angeles County Tax Assessor, sponsored Proposition 9 in 1968. This measure proposed property taxes cuts and increased sales and sin taxes. Sin taxes are state-sponsored taxes that are added to products or services that are seen as vices, such as alcohol and cigarettes. The 1968 initiative required that property-tax revenues be used for “property-related” services only and that the state governments relieve the burden on homeowners by assuming the responsibility for such
“people-related” services such as health and education. More importantly, it provided that property taxes could not exceed 1 percent of a property’s current value. Leaders of the state Democratic and Republican parties, including Republican Governor Ronald Reagan, opposed the initiative. Reagan and the state legislature approved their own measure, Proposition 1-A, and placed it on the ballot in attempt to try to stave off Proposition 9. This measure offered more modest property tax relief by exempting the first $750 of a home’s assessed value from taxes. On Election Day, Watson’s Proposition 9 was rejected by a margin of 68 percent to 32 percent, and the legislature’s Proposition 1A was approved.

In 1972, in a second attempt to try and combat increasing property taxes and reform the system, Watson qualified a second measure, Proposition 14. This initiative specified increases for the state sales tax, liquor tax, cigarette tax, and corporate income tax. The measure also proposed a uniform limit on per-pupil expenditures for local schools. State leaders from both parties, as well as a coalition of tobacco and alcohol industries, and public school employees attacked Proposition 14. Just as they had opposed Proposition 9, the state’s political and business leaders, including Governor Reagan, opposed this initiative. The political establishment was against the measure because they argued that slashing property taxes would necessitate increases in the income and sales tax in order offset the difference and remain able to pay for government programs. The business community was scared that Proposition 13 would work like an “atomic bomb” as all sales, income and corporate taxes would have to be increased substantially to make up for the difference in lost property tax revenues. Again, the State Legislature responded by approving an alternative tax relief program, S.B 90, that increased the exemption on homes to $1,750 in assessed value, increased sales taxes, and placed some limits on city and county tax rates. On Election
Day voters again overwhelmingly rejected Watson’s initiative as they still had optimism about the state’s economy and did not want to risk cuts in public spending.

Even though Watson’s two attempts to reform the property tax system had failed, the legislature sensed a growing constituency for government downsizing. Seeing the increased popular support for reducing in property taxes, Governor Reagan and the State Legislature responded to the threat to government revenues posed by Watson’s initiatives by reaching bipartisan agreement on more limited forms of tax relief that were acceptable to the electorate. In 1973, Governor Reagan proposed Proposition 1, an amendment to the state’s constitution to limit the size of the public sector. This measure would have limited the annual growth of total state expenditures to the increases in state income, tightened the limits on local tax rates imposed by S.B. 90, restricted the growth of state government to the growth rate of personal income, and required a two-thirds legislative majority for state tax bills. Written with the help of economist Milton Friedman, Proposition 1 would have embedded the spending limit in the state constitution. Governor Reagan argued that this was the only sure way to reverse the steady increase in the size of the state government. His opponents, who included the state’s Democratic leaders and the public employee’s unions, rebutted that such a limit would either force renewed reliance on the property tax to fund services or would result in unacceptable cuts in public programs. The opposition’s argument resonated and by a vote of 54 percent to 46 percent this measure failed.

Rampant Inflation in the Real Estate Market
The basis of Proposition 13 was simple. People were angry. Howard Jarvis’ famous line in the campaign for Proposition 13 was, “we’re mad as hell and we’re not going to take it anymore.”\textsuperscript{15} In addition to watching corrupt tax assessors take advantage of the system, individuals were tired of paying inflated property taxes that would drastically increase from year to year. The backbone of Proposition 13 was as straightforward as helping people keep their home that they had worked so hard to purchase. The heavy burden being placed on property owners was the most significant tax problem for the individual from 1956 to 1978. In 1974, the boom in California’s real estate market began. The resulting inflation carried the anti-tax spirit throughout California. This economic boom caused property taxes to soar as the procedures governing assessment ensured that rising values were registered in tax bills. During this time, real property was appraised cyclically, with no more than a five-year interval between reassessments. Since property values were systematically reviewed and updated, assessed values were usually kept at, or near, current market value levels. Some properties were reassessed upwards by 50 percent or 100 percent in just one year and their owner’s tax bills, as a percentage of that increased value, jumped correspondingly. It was not uncommon that an individual in the 1950’s who had bought their house for $14,000 was being taxed on a value of a house worth $100,000.\textsuperscript{16} As a result of an efficient assessment system, rampant inflation in California’s home prices, drove up residential property tax bills at astronomical rates. While this did create a positive impact for individuals who sold their homes, it created a major problem for those who were trying to keep their properties. Owning a home does not increase one’s income, yet an increase in property tax value or property tax reassessment can easily outstrip any increase in a person’s personal income or ability to pay, especially if the homeowner lives on a fixed income. In some cases, home prices would
double, and then double again, in a period of four to five years, rising to the point where thousands of people genuinely feared that they would lose their homes. Between 1974 and 1978, the market value of an average home in California went from $34,000 to $85,000. By 1977-78 property taxes in California were approximately 52 percent above the national rates. Just before the vote on Proposition 13, the overall per capita burden of state and local taxes in California was exceeded only in Alaska and New York.

Table 1: Comparison of Property Tax Bills under Pre-Proposition 13 and Post-Proposition 13 Assessments

<table>
<thead>
<tr>
<th>Assessments</th>
<th>2006-2007 Using Pre-Prop 13 Method</th>
<th>2006-07 Using Post-Prop 13 Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>California Median Home Value</td>
<td>$556,430</td>
<td>$556,430</td>
</tr>
<tr>
<td>Assessment Ratio</td>
<td>92%</td>
<td>51.30%</td>
</tr>
<tr>
<td>Assessed Value</td>
<td>$511,915</td>
<td>$285,448</td>
</tr>
<tr>
<td>Average Tax Rate</td>
<td>2.70%</td>
<td>1.10%</td>
</tr>
<tr>
<td>Annual Property Tax Bill</td>
<td>$13,668</td>
<td>$3,129</td>
</tr>
<tr>
<td>Monthly Property Tax Bill</td>
<td>$1,139</td>
<td>$261</td>
</tr>
</tbody>
</table>

Table 1 illustrates this difference. If the median value California home of $556,430, in 2006 was taxed using 1977’s average tax rate and assessment ratio, the tax would be $13,668, rather than just over $3000. Compounding this problem was the cyclical reassessment plan used by most assessors that could cause property taxes to more than double in one year. This created a major problem for homeowners since so much of California, and America, was settled on the foundation of moving west and homeownership.
One of the major core foundations of our country was being threatened by a seemingly uncontrollable property tax.

The tax revolt in California erupted in the context of high and rising levels of state taxation in many ways. While inflation affected property taxes, it also contributed to the rise in the amount of sales and income taxes paid. While inflation and nominal incomes were increasing, a stagnant national economy stalled corresponding growth in real incomes. The result was bracket creep, a situation where inflation pushes income into higher tax brackets resulting in an increase in income but no increase in real purchasing power. Even though individuals did not have any increase in the number of goods and services they could purchase, they were paying more in federal and state sales and income tax for each bundle. On top of this, property taxes were out of control. Many singled out property taxes as particularly unfair because of how unpredictable they were. The need to deal with the problems of the rapidly climbing property tax bills was apparent by 1977. This time the state government had failed to meet the demands of the people which opened the door for Howard Jarvis to start his revolution.

*Failure to Change spurs the Campaign for Change*

Howard Jarvis and Paul Gann became the faces of Proposition 13. While Jarvis was working to qualify a property tax-cutting initiative in southern California, retired real estate agent Gann was making a similar attempt in Northern California. After Phillip Watson’s attempts to reform the property tax failed, he decided to work with Jarvis, and he brought
Gann into the mix.\textsuperscript{21} Since all three had worked separately on property tax reform measures it made sense that they combine their efforts on a new measure. However, Watson’s office was being investigated for serious wrongdoing and Jarvis did not want the investigation to cloud the initiative effort. Watson stepped back and Jarvis and Gann became the proponents of Proposition 13. They began circulating petitions for their initiative only after the legislature’s efforts to pass a tax-relief bill during its 1977 session failed.\textsuperscript{22} Elected officials in Sacramento could not reach an agreement over the amount of tax relief how to target the assistance. Additionally, with statewide elections approaching, how to apportion political credit for a tax cut became a bitterly contested issue. Republican legislators suspected Governor Brown of having allowed the surplus to accumulate in order to be able to provide a tax rebate at the time of his campaign for reelection, thereby making himself look good politically.\textsuperscript{23} Republican’s interest in thwarting the governor’s political ambition made them reluctant to accept compromise proposals for tax relief that Brown was willing to sign. On the Democratic side, the governor’s separation and aloofness from the legislature reduced his ability to force consensus between both parties. There were many political factors and general distrust in the government that led to the passage of Proposition 13.

Howard Jarvis had a simple rule of economics when it came to the government, “You can’t take more water from a bucket than you can put it.”\textsuperscript{24} Initially, nearly the entire political establishment opposed Proposition 13; from then Democratic Governor Jerry Brown, the state’s Democratic leaders, many of the prominent Republicans in the state, to public employee unions, chambers of commerce and many of the major businesses in the state. Businesses were against Proposition 13 because they believed that if property taxes were cut, the legislature would raise corporate and business taxes to compensate for the
Proposition 13 was a significant change and many people were wary to vote on something so dramatic. Additionally, many thought Howard Jarvis was a nutcase and did not take him seriously. The opposition centered on the “devastating” consequences of the massive tax relief Proposition 13 would have. They argued that local services would be cut, and that the state surplus was not enough to cover the lost revenues so other taxes would have to be raised. With the campaign for Proposition 13 underway, the legislature finally reached an agreement and decided to act. Proposition 8, also known as the Behr bill, emerged. This bill reduced property taxes by about one-third, taxed homeowners at a lower rate than commercial property owners, and limited future state and local expenditures to general economic growth factors. While Proposition 8, unlike 13, did present renters with a rebate, it did not reduce government spending and instead substituted state revenues for lost local tax dollars. Howard Jarvis attacked this as a “cruel hoax” that represented another attempt by the politicians of California to deny citizens a tax cut.

While initially the prospects of Proposition 13 passing looked dim, things began to change in the final month leading up to the election. In the first week of May, a month before the election, Proposition 13 held only a slim margin in the polls of 42 percent to 39 percent, with 19 percent undecided. Then news came that pushed Proposition 13 to victory. The first was the revelation that the state of California was sitting on a huge surplus of taxpayer dollars that could be used to offset the tax cuts. The second was from Los Angeles County Assessor, Alexander Pope. Pope had only been in office for only ten weeks at the time and was under growing pressure to make new assessments for the year available to those taxpayers who wanted to come downtown and look at them. While County Supervisors tried to keep the results secret until after the election, Pope gave in three weeks before the
The results were far worse than most people had imagined they would be. Most of the new assessments at this time were from the wealthier West Side of Los Angeles and the increases were immense. In addition, the state’s huge surplus confirmed another fact for the voters—the government was taking in too much tax revenue. State revenue had increased over the last few years, but the revenue was coming in at a faster rate than the government could spend. At this point, the cautious approach people were taking to Proposition 13 ended. In a panic, Governor Brown and the Los Angeles County supervisors agreed to order Assessor Pope to roll back the assessments, but at that point the City of Los Angeles declared it had been counting on those assessments. If they were rolled back, the city would have to raise its rates. This meant that there would be tax increases for hundreds of thousands of Los Angeles City property owners who had not had their properties up for reassessment that year. The anger in Los Angeles reverberated around the state and public attention was concentrated on the reality of rising taxes, crowding out the warnings about the disruption of services that would result should Proposition 13 pass. Despite the huge state surplus the State Legislature, for two consecutive sessions, was unable to enact a property tax or income tax relief measure from among the 20-odd bill proposed. The citizens of California were finally seeing the truth in what Howard Jarvis had been preaching; property taxes were certain to increase, and people would struggle to keep their homes.

On June 6, 1978, voter turnout was high and the citizens of California passed Proposition 13 with nearly 65 percent of the vote. Proposition 13 lost in only three of California’s 58 counties. The people had finally spoken and Proposition 13 became a reality.
Chapter 2: Immediate Impact and Steps taken after the Passage of Proposition 13

More than just providing a stable source of government revenue, the property tax has appealed to voters because it gives a highly visible tax price tag for public services and directly links the costs of services to tangible economic developments in a community. In the 1960’s, the visibility of this tax made it a target for voter frustration about government spending. Once Proposition 13 passed, the entire process for assessing and allocating property taxes among local governments in California was revised. Prior to Proposition 13, locally assessed real property was valued each year using a current market standard. After the initiative passed, the legislature was given the power to create an acquisition value system that created a more predictable stream of property tax revenue. This process changed the entire landscape of government in California.

Proposition 13 amended the California Constitution to subject locally assessed real property to a new set of valuation rules, commonly referred to as the “acquisition value” standard. This change immediately reduced property taxes on homes, businesses, farms and other property across the state by about 57 percent, or a total of about $7 billion. Under the acquisition value system, property taxes were rolled back to the 1975-76 fiscal year fair market value levels. Property tax base values cannot exceed one percent of the property’s market value, and, absent a sale or major remodeling, a property’s base year value is adjusted
upwards each assessment year to reflect inflation as shown by the California Consumer Price Index. However, these adjustments are capped at a maximum of two percent annually. When a property is sold, newly constructed, or subjected to any other change of ownership, the property is reassessed at the current fair market value. This market value becomes the property’s new base value and then begins to be reassessed each year with the maximum increase capped at two percent. Additionally, Proposition 13 requires that all state tax rate increases be approved by a two-thirds vote of the legislature and that local special tax increases be improved by a two-thirds vote of the people.

Prior to Proposition 13, the tax rate throughout California averaged a little less than 3 percent of market value and there were minor limits on increases for the tax rate and no limits on increases in property value assessments. Some properties were reassessed upward of 50 percent to 100 percent in a single year, and the owner’s tax bills, as a fixed percentage of that increased value, increased accordingly. Proposition 13 made property taxes more predictable, as new buyers would know both what the current tax rate would be and the maximum amount the property tax could increase each year they owned the property. Under Proposition 13, property tax revenue has become far more stable than other forms of tax revenue such as income tax and sales tax.

Because of Proposition 13, the composition of California’s revenue stream has changed. Property taxes now are a much smaller share of the total pie, and because of this the state now relies heavily on much more volatile sources of income such as sales and income taxes. Property taxes collected by the state have to be allocated among several thousand local governments, pursuant to a complex state statute that was put into place after
Proposition 13 was passed, as property taxes are linked to local revenue sources. In the wake of Proposition 13, the state legislature had three weeks to adopt measures to reorganize local finance, find a way to allocate property taxes to each of these portions fairly, and help smooth over the transition period.

Creating the Allocation System

By setting a statewide property tax rate of one percent, Proposition 13 removed the debate over local property tax rates from city council chambers and county board rooms and replaced it with a discussion at the state level about how to allocate portions of the fixed budget pie. Instead of a debate that directly affected many members of the community through their property tax bills, the debate turned into a competition for resources among specific programs. In designing the allocation formula, the legislature looked at various models when trying to decide how to best apportion property tax funds fairly.

The current system is governed to a large extent by two bills developed by the legislature soon after Proposition 13 was passed – SB 154 and AB 8. One plan that they proposed would have divided the property tax equally among various levels of government, however, this idea was rejected by a Proposition 13 conference after protests from jurisdictions that would have lost a substantial amount of property taxes. The only politically feasible option the legislature could come up with, and the one adopted by SB 154, was to give all local jurisdictions the same proportionate share of the property tax that existed before Proposition 13 was passed. SB 154 was termed the “bail-out bill” and allocated property tax revenues from the one percent to local agencies as well as provided some backfill to local agencies for the revenue loss that resulted because of Proposition 13.
Additionally SB 154 established a formula for the distribution of the remaining amount of property taxes. This formula allocated revenues from the one percent rate established by Proposition 13, to all counties, cities, special districts, and schools on a proportionate basis. Average property tax revenues for the prior three fiscal years were calculated for each agency and each level then received its percentage share of the counties new, smaller, property tax revenue pot. However, this formula has since come into criticism for giving some counties a much larger share of the property tax than others as it did not account of population growth or other changes that have occurred over the last thirty years. While the property tax rate and assessment practices are uniform statewide, there is considerable variation in the distribution of property taxes among local governments. Since these percentage rates were determined in 1978 based on the amount of services each level of government was providing, many places argue that those numbers are not brought up to current day standards. Recognizing individual counties responsibilities to provide health and welfare programs jointly funded by the state, SB 154 also relieved a portion of counties’ financial obligation for certain programs. Additionally, $878 million in state General Fund revenues was provided to local governments as block grants. These payments were structured to protect local agencies from falling below 90 percent of their pre-Proposition 13 property tax revenue receipts.

In 1979, the Legislature passed AB 8, which created a more long-term response to Proposition 13 by making two significant changes in the allocation formula that was outlined by SB 154. Although it has been amended several times and now contains a multitude of topics, AB 8 is the basic operating legislation today. Most importantly, AB 8 created a new plan for allocating property tax revenues among local agencies that would restore fiscal stability, as well as eliminate the need for annual budget battles over local government
bailouts. It shifted property tax revenue from school districts to counties, cities, and special districts, and then replaced the schools’ losses with state General Fund revenues. The AB 8 shift basically increased each local agency’s share of the property tax by the amount of its SB 154 block grant, as follows:\textsuperscript{42}

- Cities received 82.9 percent of their 1978-79 block grants.
- Special districts received 95.2 percent of their block grants.
- Counties received the sum of the 1978-79 block grant, plus an amount specified in AB 8, representing the reduction in the state’s buy-out Aid to Families with Dependent Children (AFDC) costs, minus a new state grant for county health services.

Importantly, AB 8 also allocated the growth in property tax revenues based on the location of the subject property. Thus, property tax revenues that resulted from increases in assessed valuation accrue only to the jurisdictions in which the increases took place. Provisions were also included to allocate revenue when there was a jurisdictional change such as an annexation, the creation of a new city, or transfer of services.

Since SB 154 and AB 8 there have been three major changes to the property tax system. The first was the Legislature’s approach to no and low property tax cities. These are cities that, prior to the passage of Proposition 13, did not levy a property tax, levied only a very low property tax, or were not incorporated. Using the AB 8 formula, these cities were not allocated a significant share of the property tax. Beginning in 1984, the Legislature shifted property tax revenues from counties and gave them to cities that were characterized as “no or low.”\textsuperscript{43}
The second significant change was the property tax shifts of 1992-93 and 1993-94. The state was experiencing severe budget deficits during the recession of the early 1990’s and implemented a $3.6 billion shift of property tax revenue from counties, cities, and special districts to schools, thereby reducing the state’s General Fund obligation to schools by an equivalent amount. To compensate for these losses, the state government ordered county auditors to transfer about twenty-five percent of property taxes that had been previously allocated to cities and counties, to schools.\textsuperscript{44} This reduced the state general fund commitment to K-14 education. These property tax revenues that were shifted were known as the Educational Revenue Augmentation Funds, or ERAF shift. This tax shift continues today with a total transfer of approximately $5 billion annually. With ERAF, the state government shifted its fiduciary responsibility from local governments to schools.

The third significant change was the Legislature’s use of ERAF as a mechanism for fiscal reform and relief. In 2004-05, two changes to the allocation of property taxes were implemented. The first, termed the “triple flip”, provided the state with a mechanism to fund $15 billion in economic recovery bonds without raising taxes.\textsuperscript{45} The triple flip was passed by the Legislature and approved by the voters as Proposition 57 in March 2004. It involves increasing the state share of the sales and use tax rate by 0.25 percent and reducing the local sales and use tax rate by a corresponding 0.25 percent.\textsuperscript{46} The revenue lost by cities and counties as a result of the local sales and use tax reduction were backfilled by property tax revenues from ERAF. The state’s share of the increased sales and use tax revenues is dedicated to repayment of the economic recovery bonds. Once the bonds are repaid, the state sales and use tax rate will be reduced by 0.25 percent and the local rate will increase by 0.25
percent, bringing all entities back to the sales tax rates effective in 2003-04, and the backfill will end.47

In some counties, these changes will have a substantial impact on the amount of property tax revenues that they receive. While the triple flip will not necessarily mean an increase in overall revenues, counties will most likely become more reliant on property tax as a revenue source. In order to lessen this dependence, local governments are able to enact additional fees and taxes on the consumer in order to offset the loss of property tax revenues they have experienced from Proposition 13. Counties have the ability, with voter’s permission, to increase local sales tax in order to fund local services. Vehicle license fees have also become an area that has helped local governments to retain some of the lost property tax funds. Local governments have had to be creative with coming up with way to try and make up the lost property tax revenue. However, as will be shown in Chapter 4, even though property tax revenues are probably lower today than they would have been without Proposition 13, they are still increasing at a rate higher than inflation.

One issue that has brought about exasperation from individual taxpayers is the fixed charges and special assessment fees that appear on each Property Tax Statement. These fees predate Proposition 13.48 They are measures either voted on by the constituents of an area, or passed in statue that allow counties, cities, school districts, water districts, or other such entities to enact an additional charge or fee on the taxpayer for a specific purpose. Proposition 13 states that the maximum amount of any tax shall not exceed one percent of the full cash value of the property. This one percent was set, but still allowed for additional fees
to be imposed in order to provide a mechanism for jurisdictions to collect additional revenue. 49

Constitutionality of Proposition 13

As early as April 1978, opponents of Proposition 13 began to come up with a strategy to attack Proposition 13’s constitutionality based on this apportionment system. Proposition 13 and AB 8 generated two important outcomes. First, the property tax is no longer a local tax, which is something Howard Jarvis did not expect to happen. Proposition 13 set the rate and the base value; and AB 8 – enacted by the state – allocates who receives what portion of the money. Second, because of this formula there is large amount of variation in the allocation of the tax. Many arguments about the fairness of this policy arose since these levels were locked in at 1978 values. This discrepancy in the allocation process is a major reason why the argument that Proposition 13’s acquisition tax plan is unfair, is so prevalent.

The Amador Valley Joint Union High School District, feeling unfairly treated by Proposition 13, became the lead school district to challenge Proposition 13 in the Amador case. 50 The lawsuit challenged Proposition 13 on five main issues - breaching the single-subject rule, violating the prohibition against an initiative revising the Constitution instead of amending it, impairment of state contract since the tax cut would require local government to forgo its contractual obligations that it could no longer afford, and most importantly, claiming that equal protection under the state law was violated. Under the new tax system, side-by-side homes which were identical would pay different tax amounts based on when the homes were purchased. The California Supreme Court, by declaring that the measure
operated functionally within a relatively narrow range to accomplish a new system of taxation, made a definitive 6 to 1 ruling that Proposition 13 did not violate the state constitution.

Critics argue that market-value inequity is one of the major flaws of Proposition 13. They point to these discrepancies in property tax values for side by side properties. The Amador case was not the final ruling for these issues, in fact, a case challenging the validity of Proposition 13 on federally constituted grounds made it all the way to the U.S Supreme Court. In 1991, Stephanie Nordlinger appealed to the Supreme Court under the equal protection clause of the Fourteenth Amendment in the United States Constitution. Nordlinger purchased a home in the Baldwin Hill’s section of Los Angeles in 1988, and soon realized she was paying five times more in property taxes than her neighbors who had lived in similar homes since 1975. On June 18, 1992, the U.S. Supreme Court ruled by an 8-1 margin that Proposition 13 was constitutional. The Supreme Court put all doubts on Proposition 13’s constitutionality to rest when they held that “California’s new property tax system rationally and plausibly furthered legitimate state interests in restraining increasing property taxes and preserving neighborhood stability.”

When looking at the equal protection under the law argument one must compare the changes Proposition 13 made to previous property assessments. If one person bought a home at an inflated price, through no action of their own, all of the neighbors would see their homes reassessed to reflect the inflated price of the home they did not buy, and they would all be taxed according to the new tax rate set by the county. While under Proposition 13 neighbors may be paying largely different property taxes, each individual’s value is based on
the market value of when they purchased their house. Therefore, each individual has a property tax that reflects the year they bought their home and the price they paid for it, not the value of the homes surrounding them. This creates a more fair and equal tax base. All taxpayers are treated equally when they set their property taxes as the sales price under Proposition 13. The perceived inequality comes later when a new buyer enters into the neighborhood and that buyer’s taxes are adjusted according to the current assessed value of the property. Additionally, disparities in property tax systems are not something that occurred only because of Proposition 13. Data for an assessment roll in 1965, pre-Proposition 13, demonstrates that there were serious departures from the goal of uniform assessments. In San Francisco, where the countywide assessment ratio was 18.6 percent, one industrial property of a sample of 42 different properties was assessed at 4.6 percent of full value while another was valued at 114 percent. San Francisco was not an isolated incident, these discrepancies were occurring across the state. This shows that property tax disparities pre-Proposition 13 were at least, as blatant, if not more so than Nordlinger argued in her case to the U.S. Supreme Court.

While unease about individual tax rates have been addressed, a common concern people have is regarding the wide discrepancies that occur across counties. Three factors of why these variances have occurred are, the number and value of homes and businesses in the area, the extent to which a local government provides municipal services, and the state laws that govern the share of property taxes retained by a local community.
**Number and Value of Homes and Businesses in the Area**

Throughout California a very diverse range of communities exist. Some regions are extensively developed and have many high value homes and businesses, while others have few land developments and residential areas. Generally, high property values yield high property tax revenues. Because property taxes are levied in proportion to the assessed value of property, communities with more land developments and higher-value land developments receive more property taxes than communities with fewer developments. This is because there are fewer services to provide for vacant or undeveloped land, which has led to the widespread expansion of redevelopment agencies.

**Local Government providing Municipal Services and State Laws**

All local governments are not created equally. Besides the obvious differences in size and population, counties, cities, and school districts vary according to the demands of their constituents and the nature of the local economy, as well as the needs and services of the jurisdiction. Some cities and counties supply a full array of government services while other cities and counties rely upon special districts to provide some or all of these services such as: fire protection, police protection, park and recreation programs and trash and water maintenance. Less than twenty-five percent of California cities are full-service cities, responsible for funding all of the major city general fund-supported services: such as public protection, infrastructure and capital improvements. Statewide 557 special districts issue fire protection services and 293 special districts provide park and recreation services. In
most full-service cities, the cost of providing fire protection will take up almost the entirety of the property tax revenues of that city. On the revenue side of the budget these differences in financial responsibility among cities are generally reflected in the allocation of property tax revenue. Therefore, in a partial service city, that does not dispense all of these services, any property tax revenue that the city receives is essentially money ahead compared to its neighbor.

In addition to this variation in program responsibilities, county governments also vary in the extent to which their residents live in cities. In some counties, such as Los Angeles and Alameda, the vast majorities of residents live in cities and receive municipal services from their city governments. Other counties, have fewer, or no, cities – or function as both a city and a county, such as San Francisco, therefore having fewer responsibilities. Unincorporated areas are prevalent in California. In 2000, almost one in every five California’s lived in an unincorporated area. These areas are regions of land that are not part of any municipality. Lacking the state and federal funds that support mandated countywide programs, the services delivered to unincorporated areas depend primarily on property tax and sales tax raised in that particular area. Thus, local governments with wider responsibilities, and more incorporated cities, typically receive more property taxes than governments with fewer responsibilities. The discrepancies that occur across counties happen for a range of reasons. It is not only because of the allocation formula that was enacted because of Proposition 13 that local governments receive different portions of revenue.
Has Proposition 13 Worked?

It is important to realize that Proposition 13 has accomplished its primary goal despite some of the issues that are brought up in opposition to the measure. Property taxes have been kept low and individuals have been able to stay in their homes. Despite Proposition 13’s initial tax cut and large decrease in revenues, property tax revenue has become one of the most reliable of any tax revenue source in the state. Even with the two percent assessment cap property tax revenues have held steady at a rate higher than inflation. Assuming that government is functioning responsibly, revenues have kept up with the cost of providing services.

Proposition 13 has provided California with a steady increase in property tax revenue while serving to protect the individual taxpayer. Rampant inflation was driving people out of their homes, and if were not for the two percent cap set on assessment values per year, many people would not be able to own homes today. Taxpayers in California have been able to enjoy something they rarely, if ever before, had under property tax reassessments: certainty. As economist Adam Smith stated: “The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.”60 Prior to Proposition 13, counties were able to decide what rate they wanted to set for revenues each year. They were able to move the rates up and down and thus were never struggling to reach the amount of revenues needed to match expenditures. It is imperative that people are able to understand the amount and be able to predict the amount they will be paying in taxes from year to year. Now with Proposition 13,
counties are not able to control rates. Taxation has become more equal across the board and the struggle has come because now governments have to learn to live within their means. They only receive a certain amount of revenues each year and they must make tough decisions on what to spend their money on, since they do not have unlimited amounts. The current acquisition value property tax system is no more equitable than the traditional method of property taxation where owners of more valuable property pay a higher tax fee for the same services. This argument of equality ignores the nature of taxes. If we were that concerned that there is a direct correlation between the amount of tax paid and level of services we would create a system that only used user fees. Un-equity is not a sufficient argument to use against the constitutionality of the acquisition system set out by Proposition 13. Proposition 13 removed the fear that future taxes would be controlled by an inflated value, would be based on activity in the real estate market, as well as other economic factors over which the taxpayer had no control over.
Chapter 3: Why Proposition 13 is Misunderstood

 Counties have multiple roles in California. Since they are the administrative arm of the state, they are responsible for public assistance, public protection, and health services in their geographical boundaries. Counties, however, are also responsible for delivering local assistance and providing local services to unincorporated areas. The results from property taxes being tied to county revenue sources has led to some unintended consequences for local governments. In addition, critics of Proposition 13 have linked a number of misunderstood factors to the measure. Redevelopment, new city incorporations and annexations, fiscalization of land use, and the two-thirds majority vote requirement in local elections for local governments that wish to raise special taxes are often said to have been caused specifically by Proposition 13.

Redevelopment used as a Revenue Generator

 Redevelopment has been used as a creative mechanism to recapture “lost” funds. In 1980, California had 197 redevelopment agencies with 300 project areas by the end of 1996 these numbers had grown to 399 agencies and 744 project areas. It is often argued that through Proposition 13, Californian’s deprived cities the ability to raise revenues through property tax increases, but still expected cities to provide the same level of services.
Proposition 13 set limits and restrictions on local government revenues. This change required governments to find ways to allocate funds more efficiently. Before Proposition 13, local governments did not have economize because they could set rates wherever they wanted from year to year. The redevelopment process is often attributed to becoming popular due to cities and counties need for revenue after the allocation process for Proposition 13 was formed. However, even with the cap set by Proposition 13, it is not true that overall revenues in counties decreased after Proposition 13, they increased, but by a contained amount.  

Beginning in the late 1940s, California became the first state to use the technique of tax increment financing as a development tool. This strategy is a method to use future gains in taxes to finance current improvements, which theoretically will create the conditions for those future gains. Redevelopment is a very powerful financial tool that is often used by local governments to influence the direction and economic situation of a community. Under the redevelopment process a local jurisdiction forms a redevelopment agency, which is authorized by the statute under the general provisions of the state constitution. This agency can then declare a section of the jurisdiction to be “blighted.” Any increase in the property tax receipts that occur after this designation is shared only by the redevelopment agency as well as any overlapping jurisdictions. The goal is to ensure that redevelopment occurs and thus a tax increment will be generated. In order for this to happen, the redevelopment agency issues debt, with the proceeds of the debt issuance going to improve the blighted area. As the area improves, developers move in and cause an increase in property values, which in turn generates the property tax increment. This tax increment funds the original debt that was issued by the redevelopment agency.
There are at least three reasons why redevelopment agencies are being used in an increasing way to combat fiscal stress. First, prior to 1993, the criteria to establish a blighted area were not very well defined. Any property could be deemed blighted and would therefore provide justification for creating a redevelopment area. Even empty, undeveloped land could be designated blighted, which was particularly attractive because undeveloped land does not generate much, if any, property and sales tax revenue so any type of building on that land would yield significant tax dollar increases. Second, voter approval is not needed to use redevelopment debt to finance infrastructure. This creates a new revenue source by avoiding a lengthier approval process. Finally, redevelopment can be used as an incentive tool to encourage businesses to relocate to that particular area with the promised benefits of infrastructure improvements that are provided by the redevelopment agency.

The expansion of redevelopment has represented an enlargement of the government into our traditional system of private property and free enterprise. Because the criteria for designating a city as blighted are extremely vague, many areas that are not in despair have been classified as redevelopment areas. This means that increases in property tax revenues are diverted to the redevelopment agency and away from cities, counties, and school districts that would normally receive the funds. Additionally, cities cannot use redevelopment money to pay for operations, public safety, or maintenance, which are by far the largest share of municipal budgets. Legislation has been passed to tighten definitions of blight however, the enforcement of the law is relaxed. If redevelopment were a temporary measure, the diversion of funds may be sustainable. Once the agency disbanded, all of the property tax revenues would be restored to local governments, however, while legally agencies are supposed to sunset after forty years, the law to do this is easily circumvented. Of the 359
redevelopment agencies that have been created by cities across California, only four have ever been disbanded. 66 While the passage of Proposition 13 did have an effect on the rapid increase in redevelopment districts, it does not make a valid argument to attribute to the proliferation of redevelopment districts to the initiative. Legislation has been passed by the state in order to reign in redevelopment districts, and in order to mitigate this issue these laws need to be enforced. The definition of blight needs to be better clarified and restricted only to districts that are actually in decay and need to be repaired. Additionally, the 40-year sunset law must be enforced. If redevelopment agencies have truly been using their resources and have efficiently eliminated blight, there should be no further need for them. If, in 40 years, a district has not eliminated the degeneration, then there should be some set structure to analyze what additional steps need to be taken to help move the process forward. If these two steps were taken it would go a long way in helping to mitigate the negative effects of redevelopment. Redevelopment agencies, similar to the property tax situations pre-Proposition 13, allow governments to do things with the input of voters including accumulating huge amounts of debt. There is a positive aspect behind redevelopment but it needs to be regulated in order to fulfill its ambition of being a powerful financial tool to help influence the direction and economic situation of a community in a productive way.

City Incorporations and Annexations

Other types of districts have sprung up in the last thirty years in addition to redevelopment agencies. The most obvious is the wave of city incorporations and annexations. When a new city incorporates or an existing city annexes land, property tax
revenues are shifted from the county to the new or expanded city. Essentially when areas have seceded from the counties in which they are located and incorporate as their own city, they take away a piece of the property tax revenue allocated to counties.

In 1990, the legislature enacted SB 1559, which required city incorporations to be revenue neutral. 67 Under these provisions, a county Local Agency Formation Commission (LAFCO) cannot approve a proposal for incorporation unless it finds that the amount of revenues a new city would take from the county and affected agencies after incorporation would be substantially equal to the amount of savings the county or agency would attain from no longer providing the services that would be transferred to the city. This measure has provided counties with the assurance that they can continue to receive the necessary funds in order to remain able to provide countywide services to the new jurisdiction as well as the residents of the county.

While revenue neutrality went a long way to assist counties in coping with new city incorporations and annexations, the majority of new cities in California were incorporated prior to 1992, with the peak coming prior to Proposition 13 in the period from 1946-67.68 People who dislike Proposition 13 argue that the county in which the incorporation takes place is then deprived of the property tax and the sales tax that the new city makes. However, critics do not always mention that the city is now responsible for providing services and the county no longer has to take on that burden. The funds should be almost directly transferrable if the county is keeping tabs on their budgets. Any sales tax generated by the area, before incorporation, should have been used by the county to provide services in that particular area. The only difference after incorporation is that the city is responsible for funding services
based on its own tax stream. If it decides to contract with the county in order to receive services, then it is directly paying the county for the work. Critics also argue that after Proposition 13 local agencies could no longer adjust the property tax rate to compensate for lost revenue when a new city incorporated. This argument solidifies the grounds for why Proposition 13 passed: to protect the taxpayers. Local governments were able to move the property tax rate to wherever they needed it to be without regard for the individual’s they are affecting. Proposition 13 has increased the level of awareness and responsibility that local governments must have as they no longer have unlimited resources.

Fiscalization of Land Use

While many supporters of Proposition 13 hold the idea that fiscalization of land use is a bureaucratic term coined after Proposition 13 to point out more flaws in the initiative; it is a valid type of taxing policy that has emerged in California and must be discussed. Often times the fiscalization of land use is given a negative connotation and discussed in a way that suggests it only appeared because of Proposition 13. However, regardless if we had Proposition 13, the way land planning has been organized in local jurisdictions would not be much different today.

Land planning in California is heavily influenced by the way that local governments finance their operations. In California, a portion of the state-collected sales tax is returned to the general fund of the local government where the sale took place – the situs jurisdiction. This rule means that localities with larger retail sectors will receive greater portions of sales
tax. Because Proposition 13 reduced the revenues that would be received from property taxes, local governments often make land use decisions based at least in part on fiscal outcomes associated with new development. In California, sales tax now exceeds property tax as the largest single source of tax revenue for municipalities. Due to this fact, land uses that will generate sales tax revenues, in addition to property taxes, have become important for local governments.

Local governments receive sales tax based on two formulas. The principle method, originated in the Bradley-Burns Sales and Use Tax Act of 1955, generates sales tax revenues as a function of the dollar value of sales that occurs in a specific location. Under this act, for every dollar of sales the local government in whose jurisdiction the transaction occurred receives one cent into the general fund. Local governments that feel fiscal stress and have the desire to generate more revenue, and to maximize revenue, pay close attention to commercial activities. The three most popular ways to generate a large amount of sales tax for an area are “Big Box” retail stores like Walmart, Costco, shopping malls, and car dealerships. Many jurisdictions try to encourage these types of structures over housing developments, in order to benefit from the sales tax increases.

While some Proposition 13 critics have charged that this desire to chase sales tax producing places has skewed land decision uses in cities; fiscal zoning and competition between local governments precedes Proposition 13. It has never been empirically demonstrated that there is a fiscalization of land use. While it would be hard to prove, or disprove, it is important to remember simple market economics of supply and demand. Business will not enter an area if there is not a demand for them and/or if it does not make
financial sense. Regardless of the sales tax kick-back to the local government or the municipalities preference for business’ that will generate sales tax, if a company is not going to survive in a particular area they will not enter the market. Retail sales are essentially fixed in quantity at any given level of population and wealth. Residents of a region can support only so much retailing because individuals tend to budget only a limited portion of their income for retail goods. If Proposition 13 were to disappear, it is safe to assume that a majority, of the businesses in an area would still be in that market. The overall amount of retailing is unlikely to change markedly because of sales tax competition among local jurisdictions. Additionally, economic development battles occur all over the country where local governments, communities, and states battle to receive a larger portion of the tax cut. It does not logically follow to conclude that the reason local governments influence what types of businesses are in their jurisdictions is solely the fault of Proposition 13 and the impact the measure has had on limiting property taxes.

*The Two-Thirds Vote*

Proposition 13 changed the law to require a two-thirds vote for the Legislature to raise state taxes and a two-thirds vote of the people to raise local taxes for special purposes. However, contrary to what some people may think, Proposition 13 is not responsible for the two-thirds vote requirement to pass the state budget or to pass local general obligation bonds. Both of these requirements pre-date Proposition 13. These two issues, the budget and bonds, make a point that the supermajority vote is often required in particular instances when the people believe that this hurdle is necessary to being a sense of overall agreement to important
issues. One flaw with the two-thirds vote is that it is only in place when taxes are going to be raised. It only seems to follow to also request a two-thirds vote of the people to lower taxes. When making a decision that will affect each and every Californian it makes sense that there should be a super-majority consensus. If that cannot be reached, either by the legislature, or by the people, then that decision is not what the people want, and therefore should not be enacted. The government is supposed to provide goods and services for the people, and with that comes a direct correlation to tax dollars paid in order to provide a revenue stream to fund costs. If the people do not want to increase taxes, then they are also voting to limit services. The struggle between big and small government is a constant tug of war in California, and it should only be by votes of the super-majority of the people or legislature that these decisions are enacted.

*The Scapegoat*

The largest misunderstood consequence of Proposition 13 is that on the ballot it seemed as though it were simply a measure that would keep property taxes low and predictable. While it did accomplish this, it has also turned out to be one of the largest scapegoats for things that have gone wrong in California. However, it is not a justifiable scapegoat. While it has had an influence on how California communities are shaped and planned, there are a wide number of other reasons that these things have happened, and would have happened in the absence of Proposition 13. The fight for funding has always been an issue with government. The struggle to create a prosperous city with a steady stream of taxes in order to fund services has always been a concern, and will continue to be one.
While Proposition 13 did have an effect on the amount of property taxes generated, it is important to remember that Proposition 13 did not eliminate the property tax, it reduced it. Property taxes still generate a large amount of tax dollars. The issue now is that local governments have to figure out the best way to spend their dollars. They do not have the freedom to set property tax rates wherever they want to, Proposition 13 set up fences and roadblocks that governments have to deal with.
Chapter 4: Revenues and Inadequate Alternatives to Proposition 13

Ever since its passage, Proposition 13 has been cast as the curse of cash-strapped local governments as it limited property tax revenues even as the California housing market soared. An analysis of the revenue stream in the state of California and in local governments shows that Proposition 13 is an unjustifiable scapegoat. It is an easy target that is often pointed to for the reason why California is in, and has been in, such a significant fiscal crisis. By analyzing the statistics from state revenue streams as well as local revenue streams, one can see that not only have overall revenues increased over the last 30 years for the state of California but, property tax revenues have increased proportional to inflation for local governments. Despite shocks to the economy like the dot.com boom and bust, and the housing bubble, overall revenue levels have adjusted and steadily expanded. Additionally, the acquisition-value system has worked to provide a solid level of predictability for both individual property owners and budget directors. While many alternatives have been proposed to reshape Proposition 13, the bottom line is that Proposition 13 has accomplished its goal.

Revenue Streams for all Levels of Government

Table 2: California Public Revenues for all Levels of Government and Percentage Share

|-------------------------|------|------|------|------|------|


Table 2 highlights two facts. First, all levels of government in California between 1978 and 1995 have experienced significant growth in reported revenues. Revenues at nearly every level of public service averaged an annual growth rate of just below eight percent. Second, there has been an extremely constant and stable rate of growth, especially given the economic shocks and disruptions that have occurred over this period of time; demonstrating one of the main benefits brought about by Proposition 13’s two percent cap on reassessments. This would indicate that at the macro level, the revenues of all state and local governments were equally affected by these shocks, although, the shocks did not change the nature of the revenues or the distribution of power between state and local governments.

Revenue Stream for the State
Property tax revenues did take a large cut immediately following the passage of Proposition 13. State and local property tax revenues fell from $11 billion in fiscal year 1978 to $6 billion in fiscal year 1979. However, since the initial revenue shock, overall General Fund revenues in California have consistently increased since the passage of Proposition 13. Opponents of the initiative have voiced concerns that the property tax reductions created by Proposition 13 have required excessive program cuts and led to the poor state of our education system, infrastructure, and general shape of California today. In spite of the limits and rollbacks that Proposition 13 imposed, state and local revenues did not fall proportionately. When revenues are adjusted for inflation and population growth, they have grown 20 percent from fiscal year 1977-78 to fiscal year 2009-10. The overall tax base expanded by more than enough to offset the initial decline in revenue that occurred.

Chart 1: Total State General Fund Revenues in Real Dollars

As shown by the above chart, state government real General Fund revenues, which are adjusted for inflation and population growth increased between fiscal year 1977-78 and fiscal year 2009-10. Additionally, relative to other states, California has been able to
keep property taxes at a lower, but steadily increasing rate, which has increased predictability as well as dependability on this source of tax revenue. Property tax revenues directly affect the General Fund because they are used to support K–12 and community college districts as part of the Proposition 98 formula. Proposition 98 sets a minimum funding guarantee for K–14 education based on growth in the economy and overall General Fund revenues. Once the guarantee is determined, local property taxes going to schools offset a portion of the state’s obligation under Proposition 98. The General Fund pays for the remaining amount. As a result, increases or decreases in property tax revenues affect the General Fund cost under Proposition 98. In 2007–08, local property taxes contributed $14.5 billion to schools and community colleges. Thus, property taxes represented a larger “revenue source” for the state than corporate taxes. The changes in control, composition, and spending discretion of public finance over the last thirty years have generally favored the state government compared to local governments.

Revenue Stream for Local Governments

The below chart, chart 2, shows total revenues for local governments in California in constant 2003 dollars for fiscal year 1977-78 to fiscal year 2006-07. Similar to overall state revenues, local government revenues have steadily increased since 1978. County government real revenues in California have increased by about 8.43 percent from fiscal year 1977-78 to fiscal year 2002-03.
Chart 2: Total Local Government Revenues, Real Dollars

As local government’s ability to raise revenue, particularly property taxes, was constrained and as the state took more control of education, the power of the state government began to increase relative to local governments. Due to this, local governments have become increasingly reliant on revenue streams that are not under their control, namely revenue transfers from the state. Additionally, state transfers to counties have increased tremendously and now constitute, by far, the largest source of county revenues.

As shown by the below chart, chart 3, federal transfers to county governments have also grown during this period, from a little over $6.2 billion in fiscal year 1977-78 to almost $8.6 billion in fiscal year 2002-03. Property tax revenues, largely due to Proposition 13, have declined significantly. They have fallen from almost $7.8 billion in fiscal year 1977-78 to
approximately $4.9 billion in fiscal year 2002-03. This decline in property tax revenues has been countered by a sharp increase in charges for current services by local governments. There is a prevalent issue of local self-control and the ability of local governments to respond to local preferences. The declining ability to generate revenue streams for local purposes has become increasingly problematic as local governments seek to provide services to the growing and changing populations that are emerging as a result of demographic shifts sweeping the state. As unfunded mandates and other requirements are directed to local governments by the state, local governments ability to respond to local needs and preferences are furthered hampered.

Chart 3: Total County Revenue by Category, Real Dollars

Local governments have responded to fiscal limits by maximizing revenue sources over which they retain control in order to replaces losses in property taxes. In spite of Proposition 13, California per capita local government revenue has increased over time and
remains higher than the average in other states. The main issue that has changed has been the make-up of the composition of local revenue, not the total dollar amount.

California counties have a dual fiscal structure reflecting their multipurpose role, heavily reliant on two revenue sources – property taxes and state money. With Proposition 13, counties had to respect the cap placed on assessment values and were not able to set rates to wherever they needed to bring in the amount of revenue they needed to meet expenditures. Compared to pre-Proposition 13, counties now have limited countywide taxing power, with their power to raise general-purpose revenue from sales taxes, utility use taxes, and transient occupancy taxes in unincorporated areas. California counties have the ability to raise sales taxes by one-half cent for transportation purposes, subject to voter approval. These funds make up about one-third of local transportation revenue in California. Because of their heavy dependence on property taxes, it is often argued that California counties were hit hard by Proposition 13. However, in looking at the above charts that compare property tax revenues received at the local government level in 1978 and 2009, when compared to inflation, the rates remain relatively unchanged.

Advantages of Acquisition-Value Assessments

Acquisition-value assessments provide substantially greater predictability and certainty of revenue flows, with property tax revenues growing at a steadier clip than any other revenue source in the state. Since the adoption of Proposition 13, property tax revenues have grown on average about ten percent compounded annually from 1980-81 to 1991-92.
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<td>1990-91</td>
<td>$16,398,256</td>
<td>11.4%</td>
</tr>
<tr>
<td>1991-92</td>
<td>$17,687,106</td>
<td>7.9%</td>
</tr>
<tr>
<td>2004-05</td>
<td>$34,520,776</td>
<td>51.0%</td>
</tr>
<tr>
<td><strong>Average Annual Growth (excluding '04-05)</strong></td>
<td><strong>9.80%</strong></td>
<td></td>
</tr>
</tbody>
</table>

This shows that one of the main goals of Proposition 13 has worked; keeping property taxes stable and predictable. High volatility in tax systems lead to a lack of certainty of revenue for governmental agencies for planning, budgeting and management purposes. A Cal-Tax study based on reports published by the Board of Equalization shows that property tax revenue under the pre-Proposition 13 market-value tax system was 2.9 times more volatile than the acquisition-value tax system under Proposition 13.\(^83\) Recently, in the last five years, California has been in an economic cycle that had reduced the value of residential property, and the impact has been dramatic in many regions of California. Yet, despite these reductions in some assessments of more than thirty percent for recently acquired properties, the acquisition-value based system continues to produce modest increase in overall property
In 1992, a recession year, property tax revenue growth was 7.7 percent, as shown by the above chart. The acquisition value assessment system acts in a counter-cyclical manner, working against the tendencies in the economy to cool down the economy when it is in an upswing and stimulate the economy when it is in a downturn. This works to provide stability in the flow of steady property tax revenue to local governments. While some argue that the recession has had a negative impact on property taxes because of the way the system is currently set up, they are incorrect in these judgments. The unrealized market value that is taxed when properties change hands ensures that there will be steady revenue flows. Acquisition value assessments create reserve of value that accrues to local entities each year when homes are sold, remodeled, or increased by the two percent inflation factor and brought up to current market value. Even with falling real estate values property taxes have grown steadily because of this built in reserve value. Furthermore, homeowners who hold on to their property for a period of time do not pay less property tax in a down market, even if the current market value of their home drops. The only option property owners are given to have their property reassessed at a lower value, is to file an appeal to the County Assessor asking for a reduction. If California did not have Proposition 13 and was still using a market-value property tax system, during times of an economic recession, property taxes would have drastic reductions, resulting in diminishing revenues to the state and to local jurisdictions.

Pressure to Change
Currently, the most popular argument to change Proposition 13 is to develop a split roll tax system to take the place of the acquisition system. A split roll tax would divide the tax treatment of commercial and residential properties by removing Proposition 13 protections from commercial properties, while leaving the protections intact for residential properties. Currently the reassessment cap of two percent is extended to both residential and commercial properties, a split roll tax would change this requirement for commercial properties.

The strongest argument against a split roll tax is that it would undermine the intent of many of the protections that were put into place with Proposition 13. Prior to Proposition 13, assessors used the theory of “highest and best” which meant that the property value was determined by considering the highest and best use of property, rather than the actual use. Because of this, assessments were unpredictable and subjective. A return to market value assessments for commercial property would return to this undesirable assessment theory by shifting taxes from an objective standard to a subjective one, leading to arbitrary assessments and more appeals.

Commercial properties contribute significantly in tax dollars – and implementing the split roll would mean tax increases for California businesses likely to exceed $3 billion a year. Increasing taxes for commercial properties would not occur in a vacuum – it will not only harm business, especially small business, but it will reduce their ability to provide jobs, benefits and cost savings to both employees and customers. Such a move would create a less-competitive climate for California’s businesses to expand and create jobs and would hurt the
state’s already fragile economy. It has been predicted that bringing all business property to full-market value could result in the loss of 100,000 to 150,000 jobs.\textsuperscript{86}

Even the most limited split-roll tax would increase taxes by billions of dollars annually. The Legislative Analyst’s Office estimated that if a split-roll measure was passed in 2005 that would have changed assessment of business property to reflect fair market value, it would have resulted in a $3.5 billion gross increase in property tax revenues.\textsuperscript{87} The split-roll would adversely impact small businesses because their rental costs would increase with higher property taxes. Commercial buildings, shopping centers and business parks are all held in corporate ownership and most commercial leases allow for increases in rent to reflect increased property taxes. Smaller business however, would be less able to absorb a sudden rent increase due to reassessment, and would likely have to close down if the split-roll tax were enacted.\textsuperscript{88}

\textit{The Real Issue}

In 1911, an amendment to the California Constitution established the California initiative process, giving voters the right to enact legislation. This was a huge step in giving voters a power equal to the power of the legislative branch of state government. Of the 1234 initiatives that have been circulated from 1912-2000, 303 of them, 24 percent, have been on matters of taxation and government regulation.\textsuperscript{89} Proposition 13 is one of the best known initiatives and one of the first in a long series of voter-approved initiatives that have constrained state and local governments’ ability to tax citizens. Some of the most significant of these initiatives include Proposition 4 in 1979, which limited the growth of state and local spending; Proposition 98 in 1988, which set minimum spending levels for K-14 education;
Proposition 218 in 1996, which restricted local government revenue raising ability by reducing the amount of fees, assessments and taxes that individuals and businesses pay; and Proposition 26 in 2010 which required a two-thirds vote to pass fees, levies, charges and tax revenue allocations that under previous rules could be enacted by a simple majority vote. While Proposition 13 did have a large effect on revenue streams for local governments, the initiative by itself has not caused the downfall of California. One area that has had a large impact on the current situation in California involves bond debt. Bond financing is a type of long-term borrowing that the state uses to raise money for various purposes. The state has traditionally used bonds to finance major capital outlay projects such as roads, educational facilities, prisons, parks, and water projects. The state’s cost for using bonds depends primarily on the amount sold, their interest rates, the time period over which they are repaid, and their maturity structure. The issue that comes with bonds is while having a bond on the ballot looks nice, and the projects they are supporting are often positive, many individuals do not understand that bonds must be repaid. Therefore, they often approve them without understanding all of the consequences that come with them.

The initiative process was designed as part of the progressive movement, molded out of people’s frustration at the government. It was created in order to give voters a say in how they would like government services to work. The plethora of voter initiatives dealing with local finance have worked together to hamper governments ability to raise revenues to pay for desired local services and their discretion over how to spend the monies that they do obtain. Over the last three decades, the initiative has had three significant effects on fiscal policy. First, it has cut the overall size of state and local government, second, the initiative process shifted disbursement of funds from state to local governments and decentralized
government spending and third it altered the way funds are raised: it reduced the reliance on
taxes in favor of user fees and charges for services. ⁹⁰

The California initiative process is a fundamentally different form of policymaking
then the process the legislature and executive branch perform. Among the other twenty-three
state that have an initiative process, some have a blend of the functions of the
legislative/executive branch and the initiative process. ⁹¹ Once an initiative receives enough
signatures and qualifies for the ballot, it only requires a majority of the voters to vote on it in
order to become a law, even when the initiative requires a constitutional amendment. This
difference in the two-thirds vote needed by the legislature, compared to half the voters plus
one needed to pass an initiative, can make the initiative process a very attractive option for
interest groups, as well as the general public.

The inherent flaw with the initiative process is that citizens vote to mandate a
spending obligation without understanding the long-term budget impacts of the proposals.
Voters tend to be far more supportive of tax cuts or of increased spending on popular
programs, when these questions are proposed in isolation, as often done in an initiative.
Without a massive media campaign to explain the stakes and effects the measure will have, it
is too easy for voters to approve both the tax cuts and the spending hikes, regardless of the
consequences on the state budget. Initiatives also lack the given and taken of the legislative
process. Once something is placed on the ballot it cannot be tweaked or debated like
legislation through the House and Senate is. It would be beneficial to have an indirect
initiative. This reform would allow a path for initiatives to qualify for the ballot with a lower
signature threshold on the condition that they would be first submitted to the legislature for
review. A sunset review for initiatives that contain fiscal impacts should also be enacted to place a limiting provision on all initiatives that have a fiscal impact, either positive or negative, on the state. This expiration date would allow the legislature to review the effectiveness of the initiative, including its monetary consequences, and then they could decide whether or not the program should be extended. An additional reform, that would permit some check to be made on the voter’s decisions, would be to allow the legislature to amend initiatives, as is the rule in other initiative states. California is the only initiative state where the legislatures may not repeal or amend a statutory initiative. It would be beneficial to establish a nonpartisan, appointed panel to review initiative proposals before they go on the ballot and allow this group to make non-binding suggestions for improvement. Currently, in California successful initiatives can only be changed by a subsequent vote of the people regardless of the success or failure of the program or policy that the initiative implements. This reform would maintain the goal of allowing citizens to demand policy changes via the initiative, yet allows enough flexibility to offer suggestions to improve the measure and allows the initiative to change course if the desired outcomes of the policy changes are not achieved. The initiative process is an important aspect of California’s government. While it would not be politically feasible to prohibit all initiatives that affect the budget, a strong argument can be made for creating a rule that would require future ballot initiatives that would affect the budget to be revenue neutral. Any initiative that had the effect of lowering taxes would have to specify which spending programs would be cut in order to offset the loss in revenues. Any ballot initiative that increased spending would need to specify which taxes would be raised in order to pay for this spending. Although requiring revenue neutral ballot
initiatives would solve all of the problematic dynamics, this proposal would counteract the main negative consequences of passing complicated tax legislation by an initiative process.

Proposition 13 by itself has not had the power to change the scope of California. However, when combined with other initiatives and other fiscal constraints that are passed by the initiative process, a larger ungovernable beast is formed. Some of the issues that have come about because of these laws could be mitigated if the above suggestions were put into place.

Proposition 13 has accomplished its ultimate goal of protecting voters and creating a predictable property tax structure. However, the fact is that it has done so while creating a large amount of controversy. The above data analysis demonstrates that revenues at both the state and local levels have not been negatively affected by the passage of Proposition 13. However, the assessment cap placed at two percent remains, and will remain, a major point of contention. Regardless, the above charts as well as the following case study show that revenues have increased at a rate faster than inflation over the last thirty years.
Chapter 5: Case Study of Orange County

The following chapter analyzes the revenues and expenditures of Orange County, California to support the argument that Proposition 13 is not the cause of fiscal crisis in California’s local governments. Despite arguments that the two percent cap on reassessments has kept property tax revenues lower than inflation, when the numbers are crunched, this argument proves to be false.

Orange County, the Southern California County located in between Los Angeles and San Diego is best known as the home of Disneyland and the rich and famous who live in its million dollar coast homes. There is a myth that Orange County works within a bubble that has no bearing on the rest of California. While it is often described as a wealthy white suburb, Orange County’s population is in line with the rest of the state. The vast majority of Orange County’s 3 million residents are not wealthy; they are people who are living in the middle class. The county can no longer be described as racially homogeneous and white. After a large foreign immigration in the 1980’s and 1990’s, Hispanics and Asians make up
about a third of the County’s population. A large number of residents live in poverty and depend on the health care and social services that are provided by the County government.

As the sixth more populous county in the United States, Orange County provides a strong basis for my case study. While it may not be the typical California County, the wide range and number of people that reside in the County and the broad list of services the County is expected to administer, gives a strong background for analyzing property tax revenue levels compared to inflation as well as expenditures.

As discussed in Chapter 2, the allocation structure for Proposition 13 was set by SB 154 and AB 8 in 1979. The state formula indicated what percentage of funds would be allocated to counties, cities, special districts and schools. These levels were chosen at this point, and have not been changed since 1979. While it may make sense to re-calculate the formula up to the current state of counties, if Orange County were to increase its percentage, then other counties would have to decrease theirs in order to keep the total allocation equal. While Orange County would benefit from a percentage increase, it is not feasible to assume other counties will give up some of the revenues they are receiving. At the time the formula was created, Orange County was not as populous as it is today. In 1980, Orange County only had 1.9 million residents. Therefore, the County government was not offering as many services and using as many resources as it is today. As a result, while the state average of property tax funds given to counties is 17 percent, Orange County receives 13 percent, which equals about $511 million in general fund revenue per year. Since that time, the population of Orange County has increased dramatically, yet the percentage of monies allocated remains the same. Orange County has been able take steps to offset the low levels of property tax
revenue that it has received. The citizens of Orange County, passed Proposition 172, a local ballot measure in 1993 that earmarked one-half cent of the existing sales tax for local public safety services, including law enforcement, prosecutors, and fire protection.

Frank Kim, the County of Orange’s current budget director, argues that Proposition 13 has depressed growth in property tax revenues received by the County. He stated that in Orange County, property values are going up almost every year but because of the restrictions Proposition 13 imposed, the County Assessor is not able to increase property taxes by that amount. This has restricted the amount of revenues received and has created an internal struggle in the budget office. In creating the budget, the CEO Budget Office has to be careful in how they manage expenses, because if expenditures grow faster than 2 percent, the County will be in trouble.

In Orange County, as shown in the below chart, chart 4, property taxes make up 75 percent of the General Fund.  

Chart 4: Orange County General Fund Revenue: 2009-10 Total = 700.8 Million
However, the County also benefits from vehicle license fees and sales tax. Orange County does have a leg up on other counties since tourism is such a large industry, and there is a pocket of affluent individuals in the County. People tend to buy more consumer goods and products in Orange County then compared to less affluent counties, like Orange County’s neighbor, Riverside County. Additionally, in comparison to other counties, in Orange County a larger percentage of people drive new cars, and own more cars then the number of drivers per household. This allows the County revenue stream to benefit from receiving more vehicle license fees, as well as sales tax than in other counties. Kim stressed that, “we do well compared to other counties based on our revenue sources.” Despite the ability that Orange County has to rely on vehicle license fees and sales tax, property taxes still make up the majority of the General Fund. Therefore, analyzing the overall revenues in Orange County, and comparing them to expenditures will provide a solid glance into the question if Proposition 13 has created the budget crunch that many local governments are battling today.

Kim held the idea that among budget directors across California, most counties are unhappy with Proposition 13. Strictly from a budget prospective, he noted that counties lose the ability to grow the revenues at the same time expenses are growing. However, when this was occurring previous to Proposition 13, the rampant inflation and huge increases in assessed housing values were running people out of their homes. Previously the county controlled the rates; now it does not have the ability to do that. Before, Orange County, and many other counties never had a revenue issue because they could make the rates whatever
they wanted from year to year; now, with Proposition 13, they have a cap that they have to work with.

The main argument against Proposition 13 is that with the two percent cap, revenues have not been able to increase as fast as inflation. Kim argued that on an average year the CPI in California is about three percent, and property taxes cannot grow at anything faster than two percent, revenues suffer. As inflation increases, prices increase and the cost of operating services increases. Due to Proposition 13, he contends that revenues have been set at an artificial limit and not been able to keep up with inflation, so as a result services have had to be cut. The below graph indicates that net revenues over the last 30 years have generally stayed above revenues that have been adjusted for inflation. This means that revenues in Orange County are increasing faster than the inflation rate. Right after Proposition 13 was passed revenues were at about the same level, then around 1990 they began to increase at a faster rate, holding steady in 2000 and then increasing faster than inflation over the last ten years. According to this chart and my analysis of the budget numbers, even though Proposition 13 set the limit at two percent for reassessments, and inflation tends to run at 2.5 percent-3 percent, this has not had any negative impact on the way revenues have increased over the last 30 years.
In addition, the below chart graphs expenditures over the last thirty years in order to see if costs have been increasing at a faster rate than inflation and at a faster rate than revenues. If so, then the argument that Proposition 13 is the cause for the budget crunch among local governments is invalid. Instead, it should be stated that excessive costs are the cause of the difficulty. According to my data, and the below graph, net county costs have increased faster than costs adjusted for inflation, as well as revenues adjusted for inflation.
According to these findings, rising, rampant, costs are the main reason why Orange County is facing a budget crunch. While Proposition 13 did set a two percent limit on reassessments, we see in the first graph that revenues have increased at a rate faster than inflation. Webster Guillory, the Orange County Assessor, noted that “there is no question that the government has less money to spend today. But, Proposition 13 is not the culprit.” In Orange County, when the newly assessed houses are factored into the equation, property valuations per year are around eight percent to eleven percent which, as shown in both charts, is exceeding the CPI. Across California property taxes have averaged an 8 percent increase per year. Because change of ownership brings property values to full market value, plus new construction, the total property tax increase is greater than average inflation.
Throughout Orange County there are approximately 900,000 parcels of property that are assessed each year. As of 2010, there are about 100,000 parcels that still have pre-Proposition 13 base values. Each year this number slightly decreases as a percentage of these houses are sold or remodeled and brought up to the current base year. Even with ten percent of the parcels having a base value coming from prices more than thirty years ago, County revenues have still increased quicker than inflation.

The main question that comes about because of these results is the political argument of how much one is willing to pay for services. Many people who vote tend to be in the middle to affluent class, and they are not the people who tend to rely on County services. There is an inverse relationship between people who fund local government and the people who use local government. Proposition 13 is not the reason why the County budget is in such a terrible state. Rising costs that are, as shown by the above graph, increasing at a rate faster than inflation and faster than revenues, are the issue. The overall structure of the government was set up to serve the people, and the goods and services that are offered are directly affected by how much the people pay in taxes. In addition, local governments are often required to provide services that are often not cost effective to provide, but they have to administer them as no one else, particularly not the state, will do so. Expenditures need to fall in line with revenues in order to have a strong budget. In order to do this, costs need to be brought down. If the people vote to decrease taxes, and therefore decrease revenues, this is speaking to the government to decrease services and their scope of influence, and the steps to do this need to be taken. However, this is much easier said than done. Individuals tend to be contradictory in that they want to pay less in taxes but prefer service levels to stay the same,
or increase. This balance is impossible to achieve, yet it remains an important factor to understand when discussing taxes.

Conclusion
California has been seen not as a promise but as the embodiment of the American future – the dream made into a reality. “No. 1 State: Booming, Beautiful California,” said *Newsweek*’s cover line. “California: A State of Excitement,” said the headline in *Time*. California is a pioneering megastate that has become a world force with eclectic people, commerce, tourism, and technology. California is a state possessed of a certain glamour, rich with the possibilities of a greater life. However, California today is largely different from California 50 years ago. California is no longer the progressive model in its public institutions and services – the overall condition of the state has declined.

During the three decades since the passage of Proposition 13, California has been in a constant revolt against large government. Proposition 13 is often talked about as the reason why California has experienced such a decline. It is the scapegoat for everything that has gone wrong in California. However, Proposition 13 remains sacrosanct, an icon of public policy that no politician dare attack. Proposition 13 is credited with preserving the homes and economic security of millions of people. Despite the negativity attached to it from politicians and academics, Proposition 13 would still pass today by a 2-1 margin.

It is valid to argue that had Proposition 13 not been passed, revenues would be much higher today. However, as shown in Chapter 4, total state General Fund revenues and total local government revenues have increased since 1978. Additionally, the reason why Proposition 13 passed was to protect the individual homeowner, and the measure successfully accomplished this goal. Proposition 13, by itself, has not created the budget crisis in California. There are a diverse range of reasons why California is in trouble, and Proposition 13 should not be looked to as the scapegoat for California’s problems.
Proposition 13 is always going to be controversial, regardless of what evidence comes out supporting or opposing the measure. There have been and there will continue to be moves to reform the process. However, the evidence that Proposition 13 would still pass today is significant. Symbolism is important in politics. The symbolism that the citizens of California still have a strong desire to support Proposition 13, speaks volumes about the authority and strength that the measure holds.


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