



Does a California-Style Property Tax System Fit Missouri?

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Legislation to dismantle Missouri's current property tax system in favor of a system that mirrors California's system has again been introduced in the Missouri General Assembly this year. California's current property tax system, commonly referred to as Proposition 13 is vastly different than Missouri's. Proposed Missouri legislation, in various forms, has been proposed as the "Predictable Property Tax Act." This paper examines the major features of the proposed system of property taxation and discusses likely consequences of adoption.

CALIFORNIA'S PROPOSITION 13 & THE MISSOURI PROPOSAL

In 1978 Californians passed Proposition 13, which revamped a property tax system that had produced some of the highest property taxes in the nation. As housing prices in the state rose rapidly, property tax rates did not fall proportionately. As a result many homeowners faced annual increases of 30 percent or more in their tax bills. These increases resulted in an increase in property taxes as a fraction of income and motivated the tax revolt that led to passage of Proposition 13.¹

The comprehensive Missouri proposal is composed of a proposed amendment to the Missouri Constitution (Senate Joint Resolution 4) and implementing legislation (Senate Bill 99). Because some of the provisions of Senate Bill 99 conflict with the existing Missouri Constitution, the bill's implementation is contingent on voter passage of a proposed constitutional amendment which would allow assessments to be based on values other than market value.

There are four key features of Proposition 13 and all are contained within the proposal for Missouri:

- The maximum property tax on any property would be limited to 1 percent of a property's value.
- Tax revenues and assessed values would be reset to 2006 levels adjusted by an inflationary factor and new construction.
- Assessed values would be permitted to rise with the consumer price index, but not by more than 2% per year.
- A change in ownership would trigger reassessment at market value.

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California's property tax system consists of two additional major features that were adopted in 1986.² These features, too, are part of the Missouri proposal:

¹ Haveman, Mark and Terri Sexton. 2008. Property Tax Assessment Limits (Policy Focus Report) Lessons from Thirty Years of Experience. *Lincoln Institute of Land Policy*. <http://www.lincolninst.edu/pubs/PubDetail.aspx?pubid=1412>

² IBID

- It grants a family transfer exemption from reassessment when ownership changes. Transfers of a principal residence and up to \$1 million of other property between parents and children would be exempt from reassessment. When parents are deceased the same provision applies to grandparents. In California this arrangement (Proposition 58) is referred to as the Dynasty Provision.
- It allows persons over 55 to transfer the assessed value of their principal residence to a replacement property of equal or lesser value. In California, this provision (Proposition 60) applies to inter-county moves only if counties adopt reciprocity. Only 10 of California's counties have agreed to accept such transfers. The Missouri proposal, however, applies statewide and is not limited to the principal residence.

In following sections each of these features are examined for their potential consequences in light of the 30 year history of the effects in California. In the next section the circumstances of the property tax in California when the new system was adopted are compared to those that currently prevail under Missouri's current laws.

While the proposed new system for property taxation for Missouri is nearly identical to California's existing system, the circumstances that prevail in Missouri bear little resemblance to those that preceded the adoption of Proposition 13 in California.

DIFFERING CIRCUMSTANCES

While the proposed new system for property taxation for Missouri is nearly identical to California's existing system, the circumstances that prevail in Missouri bear little resemblance to those that preceded the adoption of Proposition 13 in California. California had experienced much greater property value inflation, had no effective controls on tax revenue, had not provided tax relief for senior citizens and had not reacted to public discontent caused by recent events. In each regard, Missouri's situation is much different

In the late 1970s California saw property values skyrocketing. For example, in 1977 the value of single family properties in California increased an average of 21% and in 1978 they increased an average of 27%.³ During the recent run-up of housing prices in Missouri, the average home value increase never exceeded 6.52% per year.⁴ Missouri property assessments are even less volatile. During the period of 1998 through 2007 assessments on existing property climbed by as much as 10% only two percent of the time, despite historically high inflation of property values⁵.

³ Office of Federal Housing and Enterprise Oversight Housing Price Index, <http://www.ofheo.gov/hpi.state.aspx>

⁴ IBID

⁵ _____ Public Policy Research Center <http://pprc.umsl.edu/data/TaxData/Assessment%20History2.pdf>

Before California adopted Proposition 13, it had enacted no means to assure that increases in assessed value did not result in proportionate increases in taxes. Therefore, when taxpayers saw double digit increases in property values, they encountered similar increases in taxes. Missouri, on the other hand, has operated under constitutional and statutory limits that prevent taxes from rising by more than the rate of inflation for more than 30 years. When assessments rise rapidly in Missouri they are accompanied by reduced tax rates to limit tax revenues. Missouri's Hancock Amendment of Missouri's State Constitution and Missouri statutes assure that annual growth in Missouri property taxes on existing property cannot increase by more than the general inflation rate or by 5 percent, whichever is lower, unless taxpayers vote for a rate increase⁶.

Senior citizens with reduced incomes can be particularly susceptible to property taxes, but California had enacted no specific protections for this vulnerable populace. Missouri, on the other hand, has had a circuit breaker program for decades. Under this program, qualifying senior citizens are refunded a portion of their property taxes. This program was most recently improved in 2007 to provide greater benefits to a broader contingent of seniors. Another program, Homestead Preservation Tax Credits, refunds excess taxes paid by seniors whenever their property taxes increase by more than 5% from the previous year.

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As Californian's discontent rose in reaction to double digit increases in assessments often followed by proportionate increases in taxes, no significant relief was provided. With far less provocation, Missouri acted in 2007 to strengthen its taxpayer protection provisions and to improve its circuit breaker program. Before California adopted Proposition 13 in 1978, California's property tax was amongst the highest in the country. In Missouri, property taxes are comparatively low. When ranked according to tax collected per capita, Missouri ranks as 37th in the nation⁷. The proposed legislation would slash taxes further.

REDUCING TAX RATES AND REVENUES

The most profound immediate effect of adopting the proposed system would be the requirement to limit taxes to a maximum of 1% of property value. For residential property this would require that tax rates be reduced to a maximum \$5.26. Missouri's property tax rate currently averages \$6.31 and in many areas local rates are higher. In essence, the proposal would repeal tax rates that were previously set with voter approval. Of course this would immediately reduce property taxes for most Missourians. On average, it also would generate a 16.7% immediate reduction of revenues to the many local governments that depend on the property tax. This would reduce local government revenues by more than \$1 billion immediately. In fact, the funding for current operations would fall even further, since revenues must first be allocated to paying current debt. So, for example, if the current tax rate is \$6.31 and \$0.81 of the rate is devoted to debt service, the post adoption rate of \$5.26 would still need 81 cents to cover debt service. Hence the portion of the tax devoted to current operations would fall by 19.1%. However, many areas of Missouri have current tax rates that far exceed

⁶ *Missouri State Constitution, Article X, Section 22 and RSMo 137.073.*

⁷ *Morgan Quitno State Rankings 2008.*

the average. In an area where the current tax rate is \$8.00, for example, the tax revenue would be sliced by 34.3% and operating revenues would decline even further.

Reductions of local government revenue were similarly severe when Proposition 13 was adopted in California. However there are two key differences in Missouri's situation. First, unlike California, local governments in Missouri have not experienced several years of dramatic revenue increases. Secondly, when California adopted its system the state government had a budget surplus of \$5 billion dollars – funds that were used to ameliorate the effect of the reduction in property tax revenues going to local government. Missouri has no similar surplus that can be used to soften the blow for local government. This level of revenue reduction goes well beyond the level that can be absorbed by *tightening their belts*. Instead, local governments throughout Missouri would need to immediately cut service levels – levels that have been approved by voters. Alternately, Missouri's state government could provide additional funding to local governments, but there is no surplus from which to draw such funding. Therefore, any substantial level of state funding would require an increase in the state sales tax or income tax – an increase that would need voter approval. Even if that unlikely event were to occur, local governments would have no control over the amounts the state might provide or the formula for distributing such aid.

ROLLING BACK ASSESSMENTS AND REVENUES

The Missouri proposal provides that assessments and revenues would return to 2006 levels except as adjusted by new construction and an inflation factor. Given the current downturn in property values this may not have much impact on assessments or revenues. On the other hand, the primary purpose of reassessment is to reallocate the tax burden to make it equitable based on property values. Therefore, rolling back assessments to 2006 would erase the equalization that occurred during the reassessments of 2007 and 2009.

This provision may owe its origin to the relatively large assessment increases that occurred in St. Louis County and a small number of other counties as a result of the 2007 reassessment. While such volatility is rare in Missouri, it occurred at a time when property values had peaked and led to an unusually high level of taxpayer discontent. However, these increases were not caused by volatile markets. Instead the increases were a natural result of the failure to maintain appropriate levels of assessments in previous years. While disconcerting, the increases were necessary to meet legal standards. Such volatility could have been avoided simply by maintaining proper levels of assessment on a consistent basis. The increases do not point toward any systemic defect in the existing system.

Finally, implementation of a return to 2006 assessment levels is of doubtful practicality since many county assessors do not maintain the necessary assessment data beyond three years.

LIMITING ASSESSMENT INCREASES

The proposed legislation would limit assessment increases to the inflation rate, or 2%, whichever is lower. Assessments would be reset based on market value only when a property is sold. This approach is what is known as an acquisition value system. While 20 states have incorporated some limit on assessment increases into their property tax schemes, no state other than California has set such a low limit⁸. While the proposal calls for assessment increases of 2% or the inflation level, whichever is lower,

⁸ Haveman, Mark and Terri Sexton. 2008. Property Tax Assessment Limits (Policy Focus Report) Lessons from Thirty Years of Experience.

even this level of assessment increase would not be achieved. California has annual adjustments to assessment levels, but Missouri law permits revaluations only every other year. The proposed legislation does nothing to institute annual reassessment for existing property. Therefore, the actual assessment changes produced by the proposal would provide growth of no more than 1% on average.

Currently, most property values are decreasing. In such situations, a perverse effect of rising assessments while market values are falling can result since assessments would rise as long as assessments reflect less than 100% of current market values. As an example, consider a home whose assessment had fallen over previous years such that it reflected only 75% of market value. If property values fall 20%, that home would still see an assessment increase of 2%. Such situations are common in California during property value declines.

A significant question in Missouri is what is the driving force behind proposals to limit assessment increases? In California double digit assessments increases preceded the implementation of their assessment limit system. But such situations are rare in Missouri. Over the past 11 years, only 2% of reassessments produced increases of greater than 10% (remember that assessment increases in Missouri represent 2 years of value change). On the other hand, 72% of annual assessments showed decreases or increases of less than 2%.⁹ Had the proposal been in place, it likely would have resulted in higher assessments in those instances. Missouri already shows stable assessments. Over the period of 1998 through 2007, only 9 of Missouri's assessment jurisdictions maintained pace with inflation.¹⁰ Still, in one instance out of 50, assessments do show increases beyond 5% per year, 10% over the two year reassessment period. Substantial evidence, however, indicates that most of these larger increases result from efforts to catch up, preceded by reassessments that failed to maintain pace with market values. Such volatility, while rare, would become even more unusual if assessments were constantly maintained to reflect current market values. Such a change would be far less disruptive than radically changing the property tax approach.

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California's acquisition value system has been in place for 30 years, therefore many effects of such an approach are known. Many of these consequences are discussed in following sections.

EQUITY

Over time those who remain in their homes will have assessments that less and less reflect market values, while those who move will face assessments that fully reflect market values. Horizontal equity, the idea that taxpayers in similar situations should face similar tax burdens, is a core principle of sound tax policy. Acquisition value systems abandon this principle by taxing long-time owners less than new owners of similarly valued property. Studies in California have determined that fifteen years after implementation of an acquisition-value-based system, it would not be unusual, for example, for two

⁹ _____ Public Policy Research Center <http://pprc.umsl.edu/data/TaxData/Assessment%20History2.pdf>

¹⁰ _____ Public Policy Research Center. <http://pprc.umsl.edu/data/TaxData/Comparing%20Assessment%20Change.pdf>

identical side-by-side properties to have legally correct values that differ by 500 percent. Because of these defects, public understanding of who actually benefits and to whom taxes are shifted is extremely limited.¹¹ “Such caps merely pit one segment of any community against another. In the long run, value increase caps function to paralyze reassessment systems that attempt to more equitably distribute the property tax, which, after all, was designed to be a tax on property value.”¹² This effect is illustrated in Table 1, below. The table shows that a new buyer would pay 42% more of the tax burden than an owner who kept their residence for 20 years. This inequity effect would be greater for those who own property for longer than 20 years.

House	Initial Market Value	Initial Assessor's Value	Rate of Value Increase	Owner's Tenure in House	Market Value after 20 Years	Assessor's Value after 20 Years	Share of Burden	Ratio of Burden
A	\$100,000	\$100,000	4%	20 years	\$202,582	142,825	70.5%	1.00
B	\$100,000	\$100,000	4%	Newly Purchased	\$202,582	\$202,582	100%	1.42

Even when owners have lived in their home for the same length of time, inequities arise. Property with rapidly increasing market value is sheltered and redistributes part of its tax burden onto properties with less rapid growth.”¹³ The International Association of Assessing Officers 2004 Standard on Property Tax Policy rejects limiting the amount by which assessed values can increase from one year to the next suggesting that the limits “...may appear to provide control but actually distort the distribution of the property tax, destroying property tax equity and increasing public confusion and administrative complexity.” Table 2, below demonstrates this inequity which benefits those whose property rapidly increases in value. It illustrates that a property in a low value growth area would shoulder 74% more of the tax burden than a property in a high growth area.

Rate of Value Increase	Initial Market Value	Market Value after 20 years	Assessment Value after 20 years	Share of Burden	Ratio of Burden
5%	\$100,000	\$252,695	\$145,681	57.6%	1.00
2%	\$100,000	\$145,681	\$145,681	100%	1.74

Due to the inequities discussed, the International Association of Assessing Officers’ 2004 *Standard on Property Tax Policy* recommends assessments based on current market value as a way to “...maximize fairness and understandability in a property tax system.”

¹¹ _____ International Association of Assessing Officers. 2004. *Standard on Property Tax Policy*.

¹² Dornfest, Alan. 2005. Effects of Taxable Value Increase Limits – Fables and Fallacies. *Journal of Property Assessment and Administration* 2(4):5-15.

¹³ IBID

MOBILITY AND HOMEOWNERSHIP

Acquisition value assessment discourages mobility because those who have moved most recently pay the largest tax share. “Growing families may not move to larger houses, which limits supplies of affordable starter homes – an effect seen in California – and older adults may not move to smaller homes when their children leave the household. Homeowners may not move if their job location changes, even if they face a longer commuting time. These kinds of individual choices result in inefficient resource allocation and decreased economic welfare.”¹⁴ As a consequence the California experience is that while homeownership rates for older residents equal the national average, young families have ownership rates that are barely half the national average. This phenomenon is not found in other states or in pre-Proposition 13 California.¹⁵

LOCAL GOVERNMENT REVENUE and AUTONOMY

As previously discussed, a 1% limit on the property tax for any property would result in an immediate and significant reduction in property tax revenue. That limit together with assessment caps would continually erode the property tax base. Overall the proposed system would assuredly result in substantially less revenue available to local government. For example, in California spending on

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education was \$600 above the national average before Proposition 13, but by 2000 was more than \$600 below average, despite significant increases in aid from the state.¹⁶ Missouri, on the other hand starts with education spending per pupil that is much lower than national averages expenditures.

Aside from assuring inequity and restricting revenues, placing low limits on assessment increases results in other consequences. In Missouri, the bonded indebtedness that local governments may take on to build new schools, roads, etc. is based on the size of the tax base, which would be held artificially low due to limits on assessment increases.

An indirect consequence of the proposals is to reduce local government autonomy. “As the primary revenue source directly controlled by local governments, the property tax has been central to local fiscal autonomy.”¹⁷ As local governments suffer from a limit on revenues and tax base, they have little choice but to turn to the state, but state aid rarely arrives without strings attached, further limiting local autonomy. State aid is also less certain and puts local governments into competition for a share of limited state resources.

¹⁴ Haveman, Mark and Terri Sexton. 2008. Property Tax Assessment Limits (Policy Focus Report) Lessons from Thirty Years of Experience.

¹⁵ IBID

¹⁶ McCombs, Jennifer Sloan and Stephen J. Carroll, “Who Is Accountable for Education If Everybody Fails?” RAND, 2005, <http://www.rand.org/publications/randreview/issues/spring2005/ulttest.html>.

¹⁷ Fisher, Ronald. What Policymakers Should Know About Property Taxes. *Land Lines*. Lincoln Institute of Land Policy. January 2009.

BEYOND PROPOSITION 13 – RELATED AMENDMENTS

Two elements of the California system and the Missouri proposals were not adopted as part of Proposition 13. Each was adopted in 1986 by California voters. The provision that would affect the most property owners provides that owners who are at least 55 may transfer their assessments to a new property when the replacement property costs the same or less than the old property. There is no means test to target benefits to those citizens where such relief is needed. As an example, a qualifying homeowner who owned a \$600,000 property whose assessment has been capped as if it was worth \$200,000 could purchase a new \$600,000 property. The newly acquired property would also be assessed as if it were a \$200,000 property. In California, this benefit is limited to principal residences and limited to counties that adopt reciprocity. Neither limitation is proposed in Missouri.

The second proposed special class of owners provides that parents, and in some cases grandparents may transfer property to their children without triggering a new assessment based on market value. In California this arrangement is referred to as the *Dynasty Provision*.

Both of these characteristics of the California system and Missouri proposal provide obvious benefits to the special classes of owners eligible. On the other hand, they shift the tax burden onto other property owners. Additionally these provisions impose new administrative needs on assessors. Currently, the assessor has no knowledge of taxpayer's ages or means to differentiate between principal residence and other properties. When qualifying seniors transfer property across county boundaries, assessors would need to coordinate implementation. Finally, the complexity of the provision regarding property heirs would create new administrative procedures. Both of the proposed benefits would further reduce the growth in the tax base.

For seniors protection can be afforded directly by programs such as Missouri's circuit breaker and Missouri's Homestead Preservation Act where property tax relief goes to the defined group designated by policymakers as needing assistance. Additionally, Missouri could enact a tax deferral program that is revenue neutral that would allow those with significant equity to defer paying the property tax until the property is transferred or refinanced.

CONCLUSION

Enacting a California style property tax system would reduce property taxes for property owners and provide more assessment predictability. Some provisions would provide additional benefits to qualifying owners. These taxpayer benefits come at a cost. Local government would encounter immediate sharp reductions of revenue, ongoing restrictions to the tax base and a reduction in local autonomy. State government would likely face ever increasing demands from local government for financial assistance. Taxpayers also would face consequences including pressure to increase other forms of taxation. By severing the connection between property values and property taxes, assessment limits impose widely differing tax obligations on owners of identical properties, reduce economic growth by distorting taxpayer decision making, and greatly reduce the transparency and accountability of the property tax system as a whole.¹⁸ “Assessment limits are often presented as helping the elderly and others on fixed incomes. In fact, however, they disproportionately benefit higher-income taxpayers

¹⁸ Haveman, Mark and Terri Sexton. 2008. Property Tax Assessment Limits (Policy Focus Report) Lessons from Thirty Years of Experience.

living in desirable areas, where assessments often increase most rapidly. In addition, since the limits allow for home to be assessed at their full value once sold, they make it more difficult for growing families to buy the larger houses they need. Lastly, they can cause inequities, as homeowners on the same block can face very different property tax bills depending on when they bought their homes.”¹⁹

Missouri system for property taxation has not produced the negative consequences faced by taxpayers in California prior to adoption of Proposition 13 and many of the goals of Proposition 13 are adequately met by alternative means in Missouri. There appears to be little reason for Missouri to consider such a radical change.

¹⁹ Lyons, Karen and Iris J. Lav, 2007. The Problems with Property Tax Revenue Caps. Center on Budget and Policy Priorities.