Proposition 13 is broken. Annually reassessing commercial properties will fix it.

[Editor's note: this is part one of a two-part series debating Proposition 13 in light of a possible ballot measure in 2020 to "split the tax roll" by changing the commercial property tax provisions and leaving residential tax assessments as is.]

Overview

Proposition 13's promise of helping residential property owners remains unfulfilled 41 years after its passage. By freezing property tax rates on commercial properties, Proposition 13 shifted California's property tax burden from commercial to residential properties. This has harmed consumers and contributed to tax inequality, while delivering windfalls to corporations. By reinstating annual reassessments on commercial properties, voters could alleviate social harms that have festered in California since 1978. This would ensure that future growth is more equitably shared by all Californians.

Proposition 13 was sold to voters as residential, not a commercial tax measure.

Voters passed Proposition 13 in response to real crises in public tax administration in the 1970s. Technocratic assessment methods pushed by anti-corruption reformers and stagflation imposed financial burdens on California homeowners.[1] Facing increasingly expensive tax bills, many homeowners were forced to choose between a reduced standard of living or displacement. Proposition 13 attempted to solve these problems by anchoring property tax assessments to the year the property was acquired, plus no more than 2% annually.[2] Under Proposition 13, property taxes are reassessed only when a property changes ownership. These reassessments (known as acquisition value assessments)[3] are designed to stabilize property assessments and lower taxes overall.

Proposition 13 applies to residential and commercial properties, but its proponents did not advertise the corporate tax benefits during their barnstorming 1978 campaign. Instead, Howard Jarvis and Paul Gann, who spearheaded the initiative, emphasized the benefits of stabilized assessments and property taxes to middle-class and elderly homeowners in California's inner-ring and mid-century suburbs.[4] The opposition campaign, which was hamstrung by in-fighting, failed to highlight the extension of tax privileges to commercial property.[5]

Corporations have benefited from Proposition 13 more than homeowners.

Proposition 13's assessment system did result in predictable tax burdens for homeowners and provided security to cash-poor elderly homeowners. But its benefits have disproportionately accrued to corporate landlords. In 1975, commercial properties paid 46% percent of the property tax roll in Los Angeles County; by 2017 those properties paid just 28%.[6] Citizen activists have found similar tax shifts from residential to commercial properties in Silicon Valley.[7] Given the distinctions between residential and commercial properties, this should have been a foreseeable result. Residential properties are reassessed more frequently than commercial properties because homeowners often move, retire, or die.[8] Because corporate entities undergo similar transitions less frequently, corporations can hold properties longer than people, and so reap greater benefits from the reassessment rule. Corporations can also own interests in properties in ways that evade re-assessment.[9]

Consequently, Proposition 13 has created a de facto tax privilege for corporations and commercial landlords.[10]

This de facto tax privilege is problematic because it is contrary to Proposition 13's rationale of keeping people in their homes. People with fixed incomes, retirees, and those living paycheck-to-paycheck benefit from stable, low property taxes. Unlike that benefited group, corporations and commercial property owners are better able to adjust to fluctuations in property tax assessments. If costs increase, they can increase prices, reduce costs, or move to a lower cost location. Corporations and commercial landlords do not retire; nor do they rely on fixed income; nor need they choose between paying property tax and eating.

Consumers do not benefit from commercial property tax protections.

Proponents of commercial tax privileges argue that consumers will bear the cost of higher commercial property taxes. This is a legitimate concern, given that higher consumer prices often disproportionately impact vulnerable populations. But this claim (known as "pass-through") is flawed because market forces, not property tax rates, determine consumer prices.

The problems with this hypothesis are apparent to anyone who buys gas in the Golden State. Imagine a place in California with two gas stations next to each other: Shale and Standard. The Shale property was purchased in 1985; Standard purchased its similarly-sized and improved property for three times as much in 2018. Under Proposition 13, Shale's property assessments and tax payments are anchored to the 1985 purchase price, while Standard's is based on its 2018 purchase price. Shale's property taxes would be a mere fraction of Standard's. Accordingly, under the consumer pass-through hypothesis, Standard would pass its higher taxes on to consumers while Shale's consumers would benefit from its tax savings.

Yet there is no discernible price difference between the legacy gas station and the newcomer. Both gas stations will charge what the market will bear and the legacy gas stations like Shale will pocket the property tax savings. Nor does this discrepancy benefit consumers. As gas prices increase finding the best deal becomes more valuable to the consumer — but no one has yet found the secret formula for finding lower gas prices based on legacy assessment values. All the pass-through effect does is discourage new gas stations because Proposition 13 makes them less profitable.

Finally, consider the fact that twenty states re-assess real property every three years (or more frequently), including high-cost coastal states like Massachusetts, Maryland, and Virginia.[11] Despite regular re-assessment of gas station real property in these states, their gas prices are much lower than California's — where gas station land assessments are fixed at time of acquisition. For example, Massachusetts gas prices were a full dollar less than California's in August 2019.[12] If property prices are being passed on to consumers they are insignificant relative to carbon taxes, environmental standards, and market demand.

Proposition 13's treatment of commercial properties hurts new businesses.

Proposition 13 disadvantages new businesses against incumbent businesses with lower tax burdens, which harms the economy. Small and emerging businesses account for an outsized share of California's job growth and are vital to the state's economy.[13] New companies add jobs as they scale up; mature companies tend to grow slowly or even shed jobs.[14] Small and emerging companies also tend to bring new ideas and technologies into the market-place, which drives productivity. But because small and emerging businesses are at a competitive disadvantage because they pay higher rents and property taxes than legacy companies. This may not have been apparent in the 1990s, but in the long expansion of the 2010s the effect is apparent. Venture capitalists are increasingly looking away from Silicon Valley, the Bay Area, and California for new investments as a larger share their capital is paying for property costs.[15] By continuing to reinforce the power of incumbent corporations, California risks losing the innovation of Silicon Valley. By embracing the proposal to split the tax roll California can level the playing field for start-ups.

Reassessing commercial properties annually is fair and will help California.

Commercial landlords have benefited tremendously from the hard work of Californians and capital investment, but have given little back to the state in taxes. California's K-12 system, colleges, and universities have educated and trained the workforce that drives the state economy. Federal investments in information technology, aerospace, and agricultural infrastructure have catalyzed economic development. Private capital has poured into Silicon Valley and Southern California to revolutionize software, bio-technology, and other emerging industries with the labor of our publicly-trained workforce. This combination has created the world's fifth largest economy.

But since 1978, public goods like education, welfare, transportation, affordable housing, and parks have languished despite brisk economic growth. Reassessing commercial properties annually would reverse that trend. Take education, for example. In 1965, California ranked 14th out of 50 states in K–12 per pupil funding; currently it ranks 44th.[16] Proposition 13's effective freeze on property taxes — which school districts rely on for funding — has undoubtedly contributed to that decline. Annually reassessing corporate properties will increase the funding available to public education, reversing years of declining funding.

Reforming Proposition 13 would also help alleviate poverty. In 2018, California's poverty rate (including housing and other costs) was 19%.[17] The vast majority of California families in poverty have at least one person working, yet those families still struggle to meet their basic needs.[18] Expansions of direct and indirect aid to poor people with tax dollars raised from annual commercial property reassessments could lift hundreds of thousands of Californians out of poverty. Finally, since 1978 many large cities and inner-ring suburbs cut parks and recreation departments and libraries in budget crunches.[19] A steady source of tax revenue would permit those communities to increase quality of life for their residents.

Besides fulfilling social needs, annual reassessments can encourage businesses and developers to use land more efficiently. Acquisition value assessments can lock in inefficient low-density land uses in areas where more intensive and productive uses might make sense. An annual reassessment will make landowners more responsive to rising property values.

Conclusion

Proposition 13 created tax privileges that have disproportionately benefitted corporations and commercial property owners at the expense of residential property owners. Replacing the current acquisition value assessment for commercial properties with annual reassessments would benefit schools, public services, and the environment.

Closing the commercial property reassessment loophole will be difficult. Proposition 13 remains popular in California despite its contributions to income inequality and other social harms. A recent poll found that 56% of Californians still support it.[20] But the problematic commercial property assessment system created by Proposition 13 has never been clearly examined by voters. Given the opportunity, it is doubtful commercial property tax privileges would survive democratic scrutiny.

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[1] Kuttner, Revolt
of the Haves: Tax Rebellions and Hard Times (1980) pp. 31-36.

[2] Cal. Const., art.
XIIIA.

[3] Legis. Analyst’s
Office, Understanding
California’s Property Taxes (2012).

[4] Kuttner, *supra* note 1, at p. 71.

[5] *Id*. at pp. 69-70.

[6] Office of the
Assessor, County of Los Angeles, Annual
Report 2017 (2017) p. 9.

[7] Batti, *Menlo
Mom Wonders: Who Wins with Prop. 13?,* Palo
Alto Online (Mar. 17, 2010).

[8] California Tax
Reform Association, Systemic Failure:
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[9] ft Editorial
Staff, *Change
the Law: Close Prop. 13’s Corporate Loophole*, ft Journal (Aug. 20, 2018).

[10] California Tax
Reform Association, *supra* note 8, at pp. 6-10.

[11] Tax Foundation, *State
Provisions for Property Reassessment*, (September 3, 2019).

[12] AAA Gas Prices, *State Gas Prices Average*, (September 3, 2019).

[13] Assem. Joint Comm. on Jobs, Economic Developments, and the Economy, Small Business Facts (2018).

[14] *Id*.

[15] Hinds, *Why Venture Capital Firms are Looking Beyond Silicon Valley*, Affinity.

[16] Gumbel, *California Schools Were Once the Nation's Envy. What Went Wrong?*, The Guardian (Jan. 19, 2019).

[17] Caiola, *California Has one of the Nation's Highest Poverty Rates, Again*, Capital Public Radio (Sept. 12, 2018).

[18] Public Policy Institute of California, Just the Facts: Poverty in California (2019).

[19] Kuttner, *supra* note 1, at p. 86.

[20] Levin, *Californians Still Really Like Prop. 13—Except for the Big Parts They Don't Like*, Cal Matters (Sept. 5, 2018).