SPECIAL ANALYSIS

Proposition 13

Implications for Local Government Finance and the Silicon Valley Economy

Prepared by Stephen Levy

Proposition 13—the landmark initiative passed by California voters in 1978 to limit property taxes—has reemerged in the public discussion about possible fiscal reforms. This Special Analysis section of the 2012 Index is intended to aid in that discussion, by describing the history and implications of Proposition 13 in the context of changing economic and fiscal circumstances.

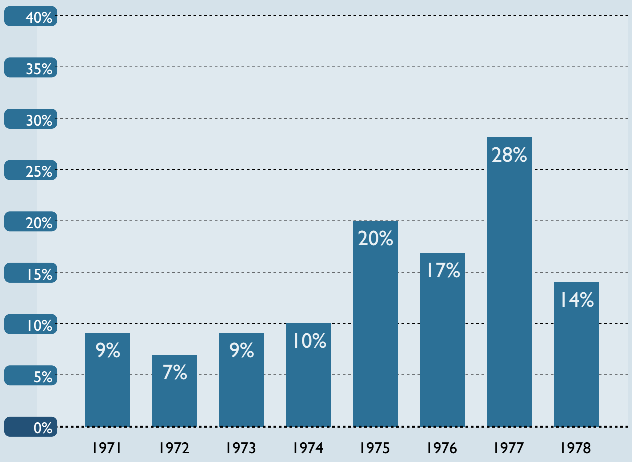
It builds on the Special Analysis published in the 2011 *Index,* as well as two recent other Silicon Valley local workforce and economic competitiveness studies that confronted the fiscal crisis facing local government and identified the critical link between the region's infrastructure, education and other public services and our ability to stay competitive. [1,2,3]

BACKGROUND

As voters went to the polls in June 1978 California was in the midst of a steady and large increase in the price of single-family homes. In 1978 the median home price was $70,890, up 164 percent from the $26,880 median in 1971. Residents were experiencing large property tax increases and feared that more increases were on the way.

Figure 1

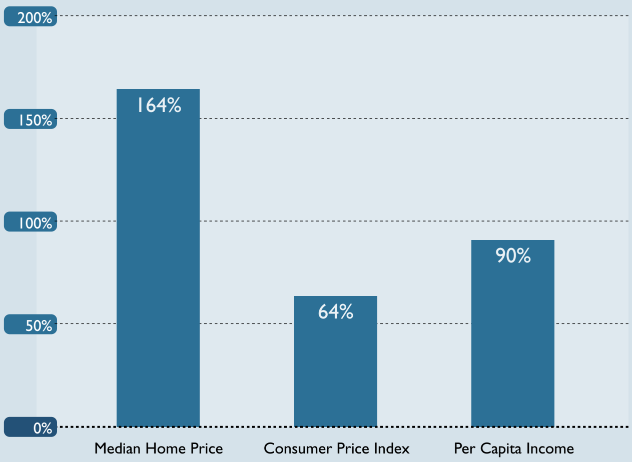
Increase in California Median Home Price



Source:California Association of Realtors

Figure 2

Median HomePrice, Consumer Price and Per Income Growth in California 1971-78



Source: California Association of Realtors, California Department of Finance
Analysis: Center for Continuing Study of the California Economy

In the years from 1971 through 1978 median prices had risen by between 7 percent and 28 percent each year (**Figure 1**), far outpacing the rate of overall inflation and income gains. Even though income gains were historically large and outpaced the growth in consumer prices, both measures were overshadowed by the 164 percent increase in median home prices (**Figure 2**). And for households living on fixed incomes, the effects of rising home prices, assessed values, and property taxes were even more of a problem for them financially.

Though assessed values were surging, local governments did not respond by lowering local tax rates.

Primarily as a result of these trends, voters approved Proposition 13 by a 65-35 percent margin.

The proposition included two components that were well known to voters:

- **Lowering the maximum property tax rate** *to 1 percent—a nearly 60 percent decrease. The purpose of this provision was to lower the property taxes that had recently soared for residents. An additional property tax rate for locally approved bonds was allowed through a later amendment. Though there was less public discussion of the implications, Proposition 13 also lowered property taxes for businesses.*
- **Limiting increases in assessed value** *to a maximum of 2 percent per year as long as the property did not change ownership. The purpose of this provision was to limit future property tax increases and bring a large measure of certainty to taxpayers about their future property tax liability. The certainty about future property tax increases was perceived as a major benefit of Proposition 13.*

These two provisions were easily understood by voters and were very popular.

[1] Index of Silicon Valley 2011, Joint Venture Silicon Valley Network and Silicon Valley Community Foundation, 2011.
[2] Silicon Valley in Transition: Economic and Workforce Implications in the Age of iPads, Android Apps and the Social Web, Silicon Valley Workforce Boards: NOVA, work2future, Santa Cruz Co., San Mateo Co., July 2011 http://www.work2future.biz/images/documents/TechStudyFullReport_03.pdf.
[3] Silicon Valley CEO Business C limate Survey 2011, Silicon Valley Leadership Group, http://svlg.org/docs/2011BusinessClimate_digital.pdf.

The proposition also included three other major provisions whose impacts were not as well analyzed in the public debate about Proposition 13:

- *Prohibiting increases in the property tax rate. After the passage of Proposition 13, local governments and school districts could no longer go to the voters to approve property tax increases to maintain or increase public services.*
- *Requiring a 2/3 vote of the electorate for future state taxes, local special-purpose taxes, and local bonds.*
- *Transferring the authority to allocate property taxes among jurisdictions to the state.*

Now more than 30 years later, thousands of pages of analysis[4] have delineated the major consequences of Proposition 13:

- *Assessed value increases limited to a maximum of 2 percent per year have turned out to be approximately half as large as inflation increases over the first 30 years of Proposition 13.*
- *The majority of local school revenues are now provided through the state budget instead of by local taxpayers, severing the connection between local taxes and the quality of services provided.*
- *Cities (and to a lesser extent, counties) responding to such sharp declines in property tax revenues have introduced a wide variety of new local taxes and fees. This trend reemerged in recent years as the recession deepened and as property tax revenues stopped growing.*
- *Tax measures that would have passed under a simple majority vote requirement have been defeated by failing to get a supermajority (two-thirds) approval.*
- *Property owners pay substantially different amounts on similarly valued properties, depending on the date of acquisition.*
- *The share of property taxes paid by homeowners has increased, while the share paid by owners of non-residential properties has decreased.*

But analyzing the implications of Proposition 13 is complicated for several reasons. For one thing, since the measure's passing the state has made a large number of budget decisions that affect local government and education funding apart from Proposition 13. Additionally, there have been several other changes passed by voters that have transferred local revenue to the state and extended the 2/3 vote requirement for local taxes. Also, the recent recession has had major implications for local revenues and education funding that, while not caused by Proposition 13, are affected by the way Proposition 13 is implemented.

PROPOSITION 13 IN THE FIRST 30 YEARS

Three trends lessened the impact of Proposition 13 on local government revenues in the first 30 years after its passage: 1) *surging home prices and assessed value growth,* 2) *the related increase in assessed value as properties were sold and reassessed,* and 3) *a wide range of new taxes and fees imposed or expanded by local governments.*

1. After the Initial Rate Cut, Assessed Values and Property Tax Revenue Surged. Proposition 13 reduced property tax revenues by approximately 60 percent in the year after it was adopted, as the base rate fell from 2.4 percent to 1 percent.

However, in the years after the initial rate cut housing prices surged, and high construction levels combined with the turnover of properties led to large increases in assessed valuation and property tax revenues in Silicon Valley (and across California).

For nearly all years from 1980 through 2008, assessed values in San Mateo and Santa Clara counties increased faster than consumer prices, and often at rates more than double the rate of consumer price increases.

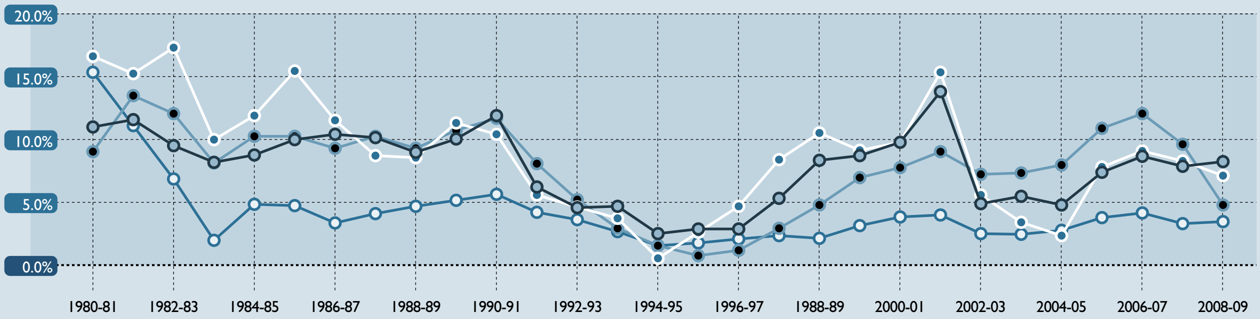
Assessed value in Santa Clara County increased at an average rate of 8.4 percent between 1980 and 2008, while the growth rate in San Mateo County averaged 7.7 percent and both growth rates were more than double the Bay Area consumer price increase of 3.7 percent per year. There were three factors driving the growth in assessed value: the increase in housing and commercial property prices, new construction, and the increase in assessed value that comes when properties change ownership.

A similar result was experienced statewide. The average annual increase in assessed value for all counties combined was 7.8 percent between 1980 and 2008, while the average increase in consumer prices was 3.6 percent (as shown on **Figure 3**).

[4] After the Tax Revolt: California's Proposition 13, edited by Jack Citrin and Isaac William Martin, Institute of Governmental Studies, University of California Berkeley, 2009; Has Proposition 13 Delivered? The Changing Tax Burden in California, Michael A. Shires, John Elwood and Mary Sprague, Public Policy Institute of California, 1998; The Demographics of Proposition 13, Dowell Myers, U.S.C. Population Dynamics Research Group., September 2009; Proposition 13: Some Unintended Consequences, Jeffrey

Figure 3

Growth of Assessed Value and Consumer Prices

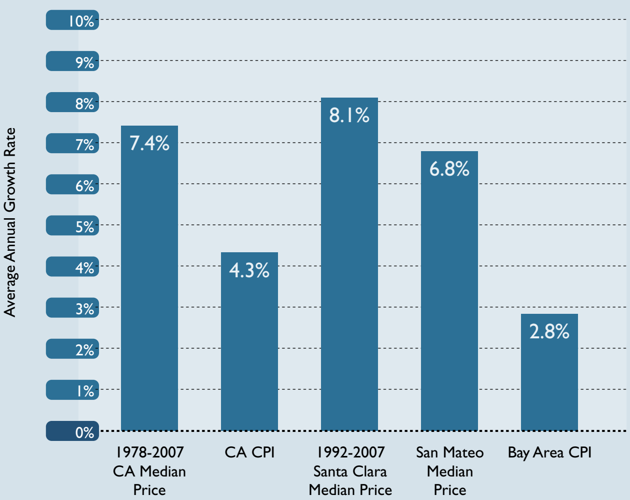


Source: California Board of Equalization, Santa Clara and San Mateo County Assessor's Offices, California Department of Finance
Analysis: Center for Continuing Study of the California Economy

2. Large Increases in Home Prices Kept Assessed Value Growing. Median home prices in California and Silicon Valley increased far faster than consumer prices until 2008. This did not affect the tax liability of existing property owners but did affect the taxes paid on newly built or recently sold properties. In California, median prices increased by 7.4 percent per year from 1978 through 2007, compared to an average increase in consumer prices of 4.3 percent (as shown on **Figure 4**). Available data on home prices in San Mateo and Santa Clara counties for 1991-2007 show an annual increase in median home prices of 8.1 percent in Santa Clara County and 6.8 percent in San Mateo County, compared to the Bay Area consumer price gain of 2.8 percent per year.

Figure 4

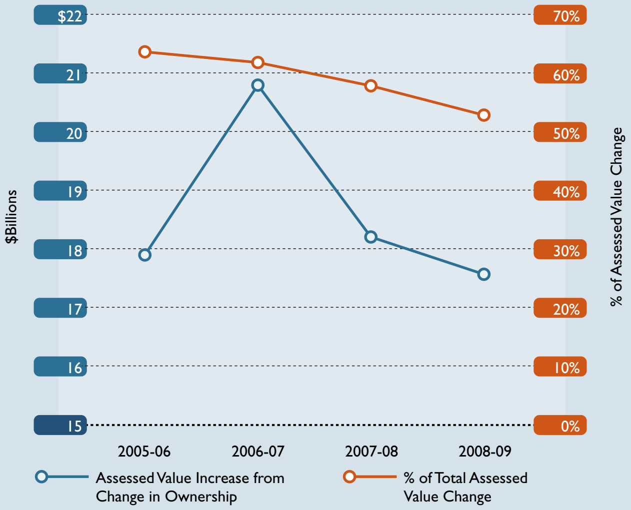
House Prices Surge Through 2007



California Association of Realtors, California Department of Finance
Analysis: Center for Continuing Study of the California Economy

Figure 5

Impact of Change in Ownership on Assessed Value Growth in Silicon Valley



Santa Clara and San Mateo County Assessor's Offices
Analysis: Center for Continuing Study of the California Economy

So even though there was a limit of 2 percent annual increases in assessed value on properties that did not change ownership, these large gains in home prices not only boosted the assessed value for newly built homes and commercial space, but also made a substantial contribution to increases in assessed values when properties changed ownership.

There was also the impact of changes in ownership to consider. Increases in assessed valuation from changes in property ownership contributed between $17 and $21 billion, or close to 60 percent of the growth in assessed value in Santa Clara and San Mateo counties in the years leading up to the housing crash (**Figure 5**). Without these gains, which came largely as a result of surging home prices, the growth in assessed value would have been much smaller in these years.

The contrast between this period and the years following the housing downturn is shown on **Figure 12**, which illustrates the changing composition and level of growth in assessed value after 2007.

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3. **New Taxes and Fees.** Since the passage of Proposition 13 in 1978, local governments have added or expanded a wide variety of taxes and fees. These include development fees on new residential and commercial construction, transient occupancy (hotel) taxes, utility taxes, and taxes on the transfer of property.

Prior to 1986 local governments could increase certain taxes without a vote approval by residents. It is in this period that many new utility, hotel and business license taxes were introduced or increased.

In more recent years leading up to 2008 some cities passed increases in their sales tax rates and adopted parcel taxes for local government services—a trend that accelerated with the onset of the recession.

However, increases in property tax rates are prohibited in California under Proposition 13. While communities across the country are implementing or considering property tax hikes it is not legally permissible in California even if two-thirds of the voting population are in support.

One question for consideration is whether the taxes and fees that are adopted or increased make for better public policy today than if the same amount of money could be raised from property taxes.

In summary, after the initial decline in property tax revenues caused by Proposition 13, local governments saw a steady growth in property tax revenue while at the same time adopting additional taxes and fees to offset the impact of the decline in the property tax rate. But this came to a halt in 2008.

PROPOSITION 13 IN THE NEW NORMAL

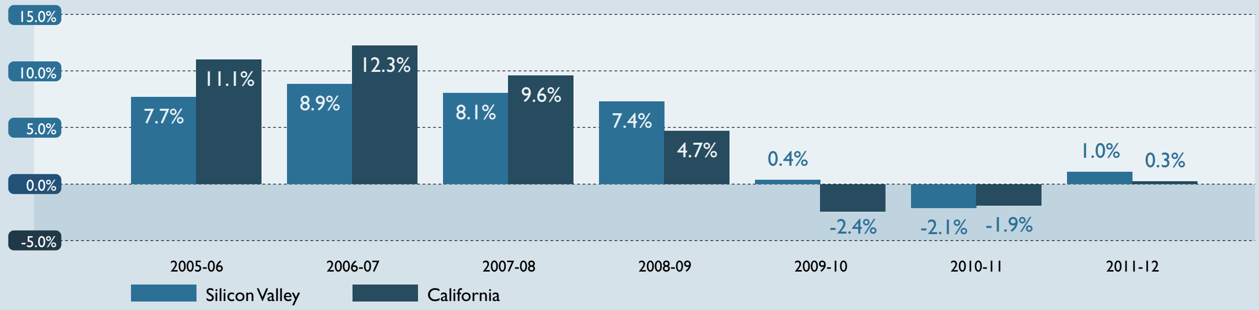
Dramatically (and unexpectedly), the prior 30 years' experience with Proposition 13 and property tax revenues was turned upside down in 2008, when California's economy plunged into recession.

The downturn took California and Silicon Valley from a world where new construction and large increases in assessed value generated ongoing tax gains (despite Prop 13), to a world where all the positive trends turned negative. Recent events have produced five major impacts on property tax revenue, all of them negative:

1. *Median home prices have fallen.*
2. *The gain in assessed value and property taxes from new construction has plummeted. Some construction gains are expected in the coming years, but construction levels are unlikely to return to peak levels any time soon.*
3. *The gain in assessed value and property taxes from changes in ownership has plummeted.*
4. *A large share of the assessed value in most California counties is in properties with a recent base year valuation, including many bought at peak prices. As a result, we will see lower gains from change in ownership, for many years to come.*
5. *The number of properties reassessed downward has surged.*

Figure 6

Change in Assessed Value in Silicon Valley and California



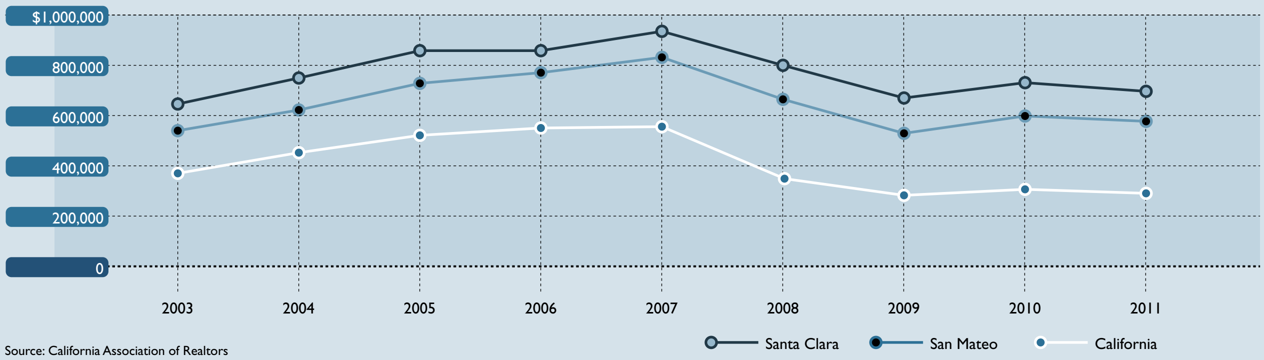
Source: California Board of Equalization, Santa Clara County Assessor's Office; Analysis: Center for Continuing Study of the California Economy

We discuss each in turn below, but the cumulative result of these changes has been a dramatic slowdown in the rate of growth for assessed valuation and property taxes. The changes in Silicon Valley and California are shown on **Figure 6**. Assessed values increased by more than 8 percent per year between 2005 and 2008 in Silicon Valley (more than 10 percent per year in California) but the 2011-12 values are **below** the assessed value for 2008-09 because the increases that had been so steady for most of the preceding three decades suddenly stopped.

Other counties suffered even larger drops in assessed value, with losses of 15.5 percent in Riverside County, 12.2 percent in Sacramento County, 10.5 percent in San Bernardino County and 16.8 percent in San Joaquin County, all locales hard hit by the housing slump.[5]

Figure 7

Median Home Price



Source: California Association of Realtors

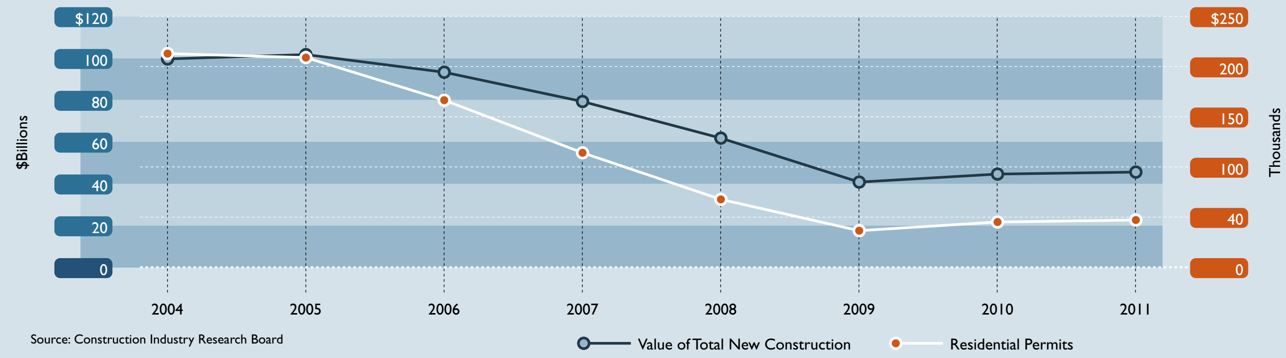
1. Median Home Prices Decline. The period of large increases in home prices—and large contributions to property taxes from changes in ownership and new construction—came to a crashing halt with the arrival of the housing market crash, the recession, and new financial conditions for lenders and potential homebuyers. There is no doubt about what happened after 2007 but the real question is whether or not the post-2007 world is the "new normal" or whether a return to the pre-crash days for property tax increases is close at hand.

Housing prices fell substantially in Silicon Valley with even larger losses in the statewide data. Median resale home prices fell 37 percent in Santa Clara and 28 percent in San Mateo County between 2007 and 2009 while they declined by 51 percent statewide as shown on **Figure 7**. After a brief rebound, median prices were declining again toward the end of 2011.

[5] California Board of Equalization

Figure 8

Value of New Construction in California



Source: Construction Industry Research Board

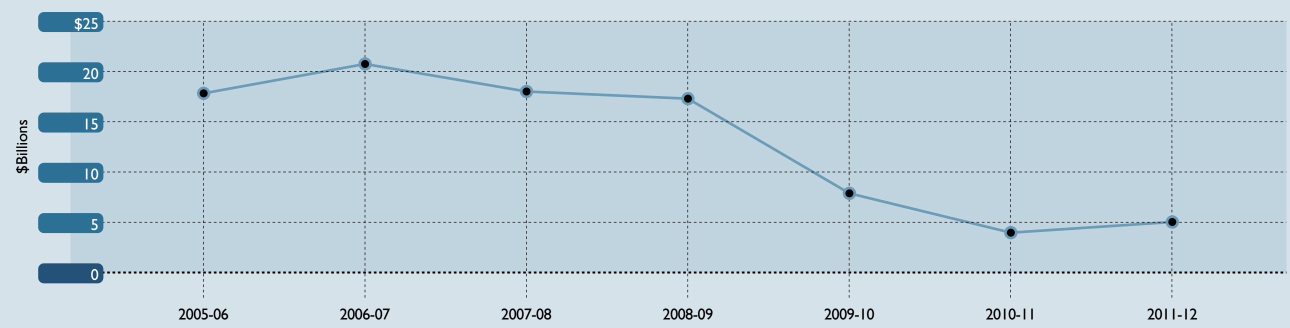
2. Value of New Construction Plummets. At the same time, the volume of new construction fell throughout California as the state went from 213,000 building permits in 2004 to 36,000 in 2009 (see **Figure 8**). As a result the value of new residential and non-residential construction dropped from $100 billion in 2004 to $40 billion in 2009. And construction values have remained near the lowest levels throughout 2010 and 2011, with no substantial upturn expected in 2012.

3. Assessed Value Growth from Change in Ownership Plummets. Often, the largest component of assessed valuation growth is the gain from revaluation when properties change ownership. Until very recently these changes often brought large increases in the assessed valuation for properties where the prior acquisition date was many years ago. In Silicon Valley changes in ownership provided an average of $18.5 billion per year in increased assessed value for the four years starting in 2005-06--over half of the overall increase in assessed value. For the most recent three years, changes in ownership averaged just under $6 billion per year (**Figure 9**).

Figure 9

Increase in Assessed Value from Change in Ownership

Santa Clara and San Mateo County ($Billions)



Source: Santa Clara and San Mateo County Assessor's Offices

In Los Angeles County the annual increase in assessed value from changes in ownership went from an average of $56 billion per year between 2005 and 2009 to an average of $12 billion between 2009 and the 2011-12 tax year.[6]

4. A Large Share of Assessed Value is in Properties Bought Near the Peak. A large number of properties in California and Silicon Valley are now valued on the market at less than or close to their original acquisition price. This trend has two implications:

First, some properties are being reassessed at reduced valuations. In the 2010-11 tax year there was a decrease in assessed valuation of $8.5 billion, equal to 2.0 percent of total assessed value in Santa Clara and San Mateo counties. In the 2009-10 tax year the decline was even larger, with a loss of $11.5 billion or 3.5 percent of total assessed valuation resulting from successful appeals and adjustments to property assessed values.

[6] 2011 Annual Report of the Assessor, Los Angeles County Assessor, http://assessor.lacounty.gov/extranet/news/rollrls2011.pdf.

Large reductions were noted in other counties as well.

Second, as a result of the slump in housing prices, the number of properties held for a long time and with a low assessed value is steadily declining as properties turn over. In Santa Clara County only 5.5 percent of the total assessed value is in properties purchased prior to Proposition 13 (**Figure 10**). Another 40.7 percent are properties purchased when prices were still rising rapidly.

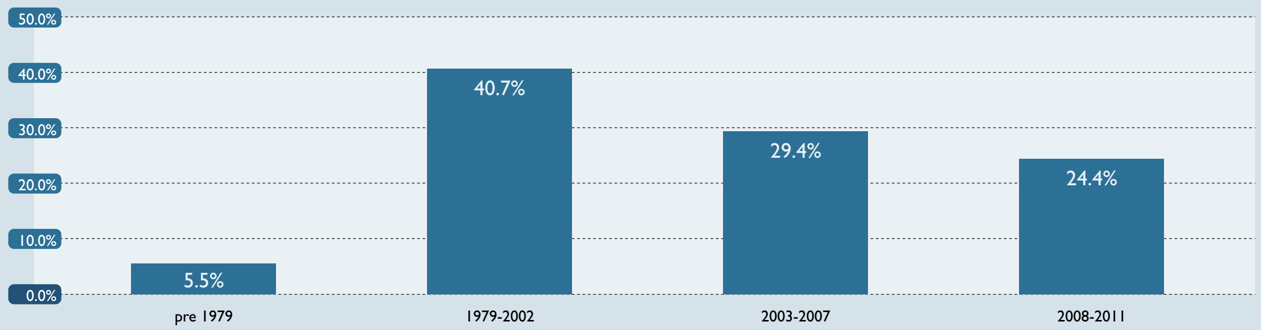
Data for Sacramento County, which may be more typical of counties that experienced the sharpest increase in home prices during the boom, shows a similar result but with an even higher share of assessed value (43.1 percent) for properties purchased in the 2003-2007 period.[7]

Moreover, forecasts of home price trends by the California Association of Realtors and other organizations anticipate a very slow increase, if any, in home prices from current levels for the coming years.

Figure 10

Distribution of Assessed Value by Base Year

Santa Clara County



Source: Santa Clara County Assessor's Office

5. There has been a Surge in Properties Receiving Reduced Assessments. Many properties bought before the recession now have market values below their purchase price. Under Proposition 8 county assessors have the responsibility to adjust assessed valuations, and thus lower property taxes, when market value has fallen below the base year purchase price.

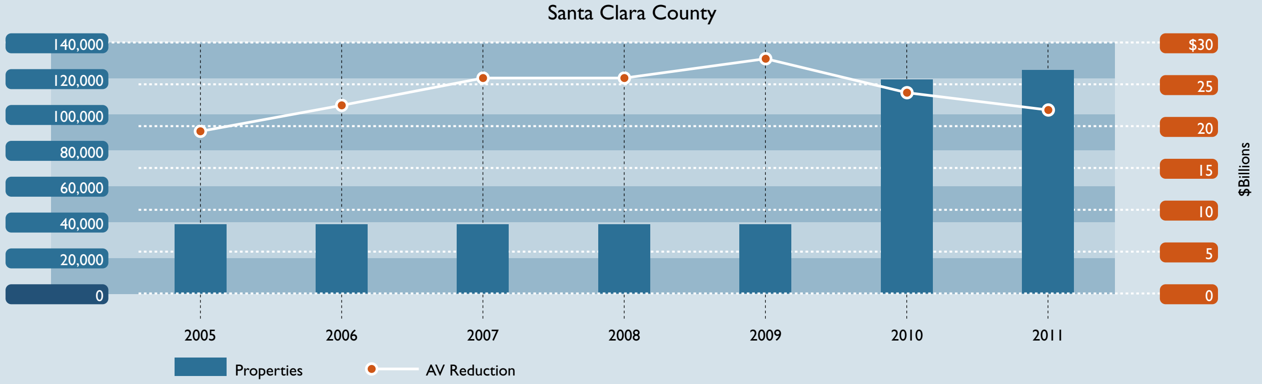
While these reductions can be recovered as prices rise, there has been a surge in assessment reductions since the recession and it will take many years in some cases before prices rise to pre-recession levels.

Figure 11 shows the number of properties with an assessment reduction in Santa Clara County, and the total value of all reductions. For the 2011-12 tax year, there were 124,148 properties with reduced assessments for a total value of reductions of $25.9 billion as shown on **Figure 11**.

Figure 11

Assessed Value Reductions

Santa Clara County



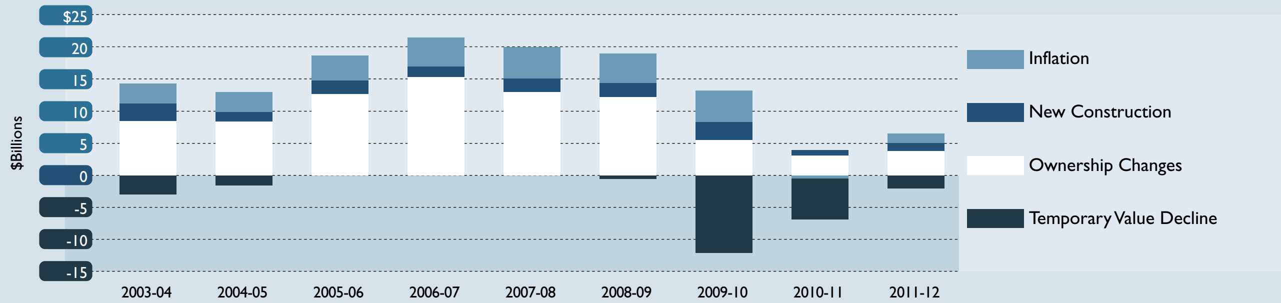
Source: Santa Clara County Assessor's Office

[7] 2010 Annual Report, Sacramento County Assessoris Office

Figure 12

Changes in Assessed Value

Santa Clara County



Source: Santa Clara County Assessor's Office

In summary, the level and composition of assessed value growth has changed substantially since 2007. The trends for Santa Clara County, typical of the changes throughout California, are shown on **Figure 12**. In recent years the gains from ownership changes, new construction and the annual inflation increase have ceased, and assessed value remains below peak levels.

The result has been a sharp drop in the annual change in assessed value and related property taxes.

While some of these changes may be temporary, growth in assessed value and property taxes is likely to remain low since large increases in home prices and new construction are not expected soon, and because gains from reassessment of properties upon sale are likely to remain at low levels for many years.

DIRECT AND INDIRECT CONSEQUENCES OF PROPOSITION 13 THAT INCREASED OVER TIME

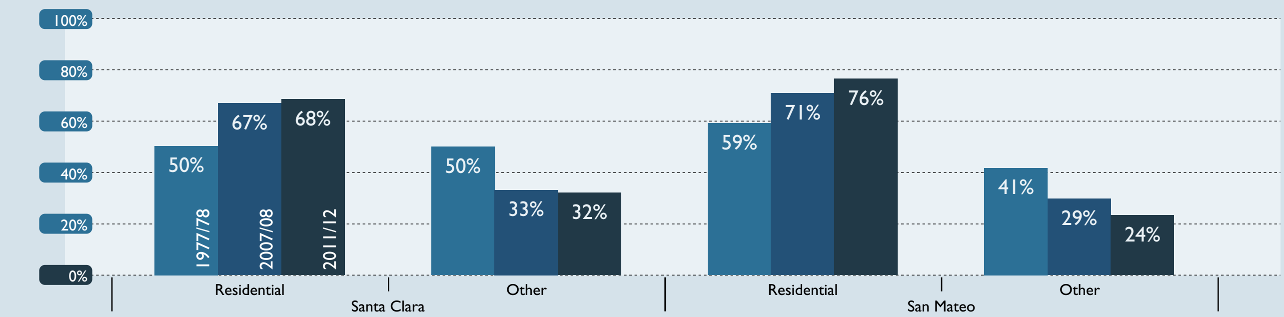
Unlike trends in the growth of property taxes, many consequences of Proposition 13 did not change with the recession and have been increasing with the passage of time.

1. The Residential Share of Assessed Value Has Increased. One goal of Proposition 13 was to protect homeowners from large increases in property taxes, and that has been largely achieved. But one unanticipated consequence of Proposition 13 is that the residential single family and condo share of assessed value has increased since 1978. Figure 13 shows this for Santa Clara and San Mateo County but the trends are similar for other jurisdictions.

In the 1977-78 tax year, the residential share of assessed value was 50 percent in Santa Clara County and 59 percent in San Mateo County. By the 2007-2008 tax year, those shares had increased to 67 percent in Santa Clara County and 71 percent in San Mateo County (**Figure 13**). The residential shares continued to increase after 2007 despite a sharp drop in home prices. As a result, homeowners as a group pay a much higher share of total property taxes currently than at any time since Proposition 13 was adopted.

Figure 13

Residential Share of Assessed Value



Source: Santa Clara and San Mateo County Assessor's Offices

There are two primary reasons for the increasing share of property taxes paid by single family homeowners. One is that these properties turn over (are sold) more frequently than commercial properties, and until very recently most sales resulted in large increases in single family property assessed values as home prices continued to rise significantly until 2007.

The second reason is because there was a larger increase in new residential construction versus non residential uses, particularly in the early years after 1978 when some agricultural land was converted to homes and other uses.

2. Property Owners Can Pay Substantially Different Property Taxes on Similar Valued Property. This possibility exists for both residential and non-residential property and depends on the length of ownership. The discussion here uses data on home prices to illustrate this consequence of Proposition 13.

The savings to homeowners from the 2 percent maximum annual increase in assessed value depends on when they bought their home, the length of time it has been owned and also on where they live. A new buyer of a median priced home in 2007 would pay more than four times the property tax of an owner from 1978, but only double the property taxes of owners who bought median priced homes during much of the 1990s.

The sharp decline in housing prices since the 2007 peak has reduced the difference between property taxes paid by long-time homeowners and recent buyers. For example, a median priced home in California bought in 1985 would have a maximum AV increase of 64 percent if the 2 percent increase was applied each year. The median price of a home in California increased by 153 percent between 1985 and 2010 so a median price buyer in 2010 would pay roughly 2 1/2 times the property tax of a 1985 median home price buyer—less of a differential than the 4x differential that existed in 2007.

But recent buyers in the higher-priced markets are still paying 4 times as much as 1985 buyers of a median priced home. For example, median prices in the Bay Area increased by 291 percent between 1985 and 2010 compared to the maximum 64 percent increase in assessed value, with similar increases in Orange and San Diego counties.

Dowell Myers authored a paper exploring the implications of Proposition 13 in the new world of housing price declines after the peak in 2007. His paper highlights some of the generational impacts of Proposition 13. Owners who have lived in the same home since 1978 or even since 1990 are older, on average, than owners who bought more recently since many of them are younger, first-time buyers. Younger owners who are starting their careers and family, as a result of Proposition 13, pay higher taxes on similarly valued properties than do older owners. Myers argues that these young, new buyers not only struggle with the affordability of purchasing homes, but also implicitly subsidize the lower property tax payments of long-time owners.[8]

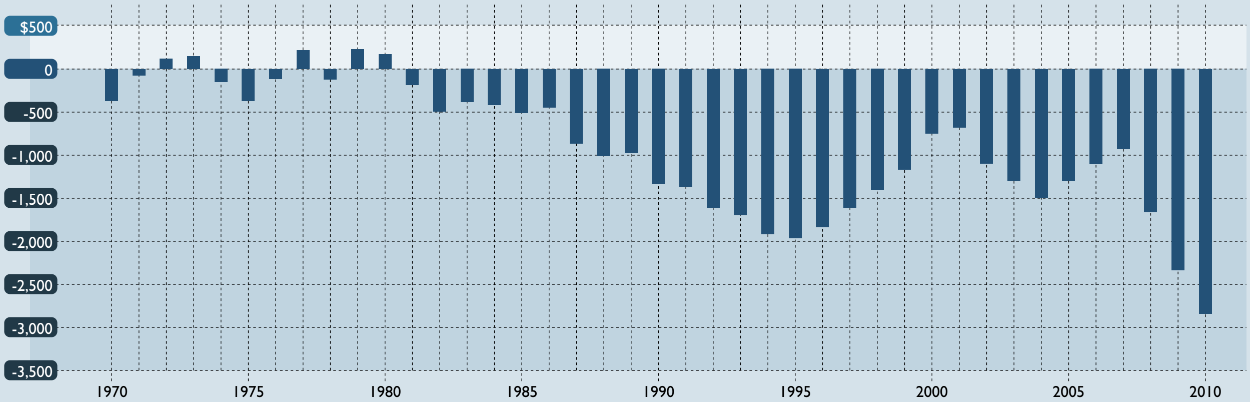
There is a distinct generational aspect about those who receive the most benefit from the 2 percent limit on assessed value imposed by Proposition 13. This generational benefit for older homeowners is increased by the provision (added after Proposition 13's passage) that owners aged 55 and above can retain the assessed value base on their old home in most cases even if they sell and buy another home.

Rather than providing an incentive for new economic activity, Proposition 13 places a higher tax burden on new investments. The result of the 2 percent limitation on assessed value increases as long as property does not change hands results in a situation where new home owners or new business owners are paying much higher property taxes than those who bought homes or business property years or decades earlier.

[8] The Demographics of Proposition 13, Dowell Myers, U.S.C. Population Dynamics Research Group., September 2009

Figure 14

California's Per Student Spending Lags the Rest of the U.S.



Source: Santa Clara County Assessor's Office

3. **Per Pupil Spending on K-12 Education Falls Relative to the Nation.** Ed Source reports that state spending per pupil ranked 43rd among states in 2007-08 before the recession hit.[9] The California Budget Project estimates that state spending per pupil fell to 46th in the 2010-11 school year and that per pupil spending in California lags the nation by the largest amount ever as shown on **Figure 14**.[10] Both Ed Source and the California Budget Project report that California ranks in the bottom two states in teachers per student, last in librarians per student and next to last in school counselors per student.

This decline in K-12 per pupil spending relative to the nation is the result of multiple factors, and the link to Proposition 13 is indirect. It is also true that a major culprit in the recent decline in K-12 funding is the state's continuing budget and fiscal woes, which are explained by larger dynamics as well as the effect of Proposition 13.

However, there is a link between Proposition 13 and K-12 funding challenges. It has to do with the way Prop 13 shifted primary responsibility for K-12 funding to Sacramento and away from the localities. Under California's current system of K-12 funding, the state provides funds that are needed to meet the K-12 revenue limit in each year after subtracting the amount contributed by local property taxes.

As a result, if property tax revenues grow faster than the revenue limit as happened in many years before the housing crash, the required state contribution to K-12 education is lowered. However, when property tax growth slows as occurred in recent years, the state contribution would normally increase. But that has not been possible to maintain in recent years since the recession led to a decline in state revenues. The upshot is that in the 2010-11 budget year (and before the recent K-12 spending cuts), California students received nearly $3,000 less than the national average.

4. **The Impact of the 2/3 vote majority.** Proposition 13 imposed a two-thirds majority vote requirement for state tax increases and for local bond or special tax elections. The two-thirds majority was reduced to 55 percent for school bond elections by Proposition 39 (passed in 2000).

A study of recent elections shows the extent to which a lower majority of 50 or 55 percent would have led to the passage of local taxes and bonds that did not receive a 2/3 majority vote.[11]

[9] EdSource, adjusted to use comparable wage index, http://www.edsource.org/data-ca-per-pupil-exp-compare-states.html, September 2010
[10] A Decade of Disinvestment; California Education Spending Nears the Bottom, California Budget Project, October 2011
[11] Data from http://www.californiacityfinance.com/. Scroll down to Local Tax Votes

In the November 2011 election five school parcel tax increases or extensions received more than two-thirds of the votes, while two taxes failed but both received more than 55 percent of the total vote. Six of eight school bonds passed, but only three would have been approved if the required majority was two-thirds rather than 55 percent. Nine city, county and special district parcel taxes received more than two-thirds of the vote but three more failed while receiving more than 55 percent. One other tax got less than 50 percent of the votes.

In the November 2010 election 10 city, county and special district parcel tax elections received more than two-thirds of the vote while nine others failed, even though receiving more than 55 percent of votes cast. Six received less than 55 percent. Two school parcel taxes passed while 11 failed thought receiving more than 55 percent of votes cast. Five received less than 55 percent. Sixteen school bond elections received more than two-thirds of votes cast while 30 elections received more than 55 percent but less than two-thirds. 17 elections did not receive 55 percent of votes cast.

While local tax and bond elections continue to be adopted by voters even with a two-thirds majority, it is also true that a substantial number of elections have failed that would have passed with a 55 or 50 percent requirement.

5. **Control of the allocation of the 1 percent local property tax among jurisdictions.** One of the issues that underlies the shift in power between local government and the state is the provision in Proposition 13 that requires the state to allocate the property tax among local governments within each county. This provision was a significant break in the long-standing tradition that the property tax was to be used as a source for local, as opposed to state services. The authority for local government to control the property tax was put in the constitution in 1910, when the Progressive movement pushed for greater local control. Proposition 13 reversed that trend by granting the power to allocate the tax to the state and ended a 68 year tradition connecting the local property tax payer and local services.

Not only do local governments no longer have power to raise property taxes, they do not have the power to adapt to changing circumstances and develop local agreements to reallocate the 1 percent among local jurisdictions.

THE BOTTOM LINE

Proposition 13 substantially reduced the ability of local governments to control their property tax revenues. This was achieved by reducing the maximum tax rate to 1 percent (which was 60 percent below previous levels), by mandating that annual increases in assessed value on each property be limited to 2 percent and by prohibiting local governments from increasing property tax rates.

All of these changes gave property owners a high measure of certainty about their future property tax liability.

However, from a governance standpoint Proposition 13 reduced the ability of local governments and the state to raise many other tax rates and transferred the allocation of property taxes among local jurisdictions to the state. In addition, Proposition 13 effectively made state government the primary source of local education revenues.

After the passage of Proposition 13 there were many legislative and ballot measures that mitigated the impact of Proposition 13 and also many that made raising local revenues more difficult. Cities responded to Proposition 13 by adopting or increasing other local revenues. In December 2011 the courts upheld the right of the legislature to end redevelopment agencies as presently structured and this decision will have implications for the allocation of property tax revenues depending on legislative decisions in 2012.

For some thirty years, many of the adverse impacts were softened by rapidly rising property tax revenues, which increased faster than consumer prices, faster than the growth of the economy, and faster than most other local government revenue sources. This happened because home prices surged over this three-decade period; because population growth and new construction levels increased; and because as properties were sold and reassessed to market value, there were usually large gains in assessed value for the local jurisdiction.

The era of rapidly rising property tax revenues came to a halt around 2008. All three components of rapid property tax gains ended with the housing slump that brought a large decline in new construction, a fall in home prices and a sharp drop in the growth of assessed value as properties were sold and reassessed. These changes were amplified by the recession that followed, which lowered all state and local government revenues.

CONCLUSION

If property tax revenues were soon going to return to pre-recession growth rates, it is possible that talk of reforming Proposition 13 would fade away. But such a favorable outcome is unlikely. For the next few years and possibly longer, property tax revenues are likely to grow more slowly than the economy, and more slowly than local government expenditures. It is most likely that the years since 2008 and the recession are more like the "new normal" than the preceding thirty. This is because of three primary factors:

1) Home prices are expected to recover slowly and take several years to reach pre-recession levels.

2) Population growth in California has slowed and it is very unlikely that the demand for additional housing will ever reach the levels experienced between 1978 and 2008. Between 1978 and 2008, annual population growth in California was 467,000 or 1.6 percent per year. During the past three years annual growth has averaged 240,000 or a 0.6 percent annual gain.

3) The gains in assessed value from changes in ownership are likely to continue at low levels for many years as many properties now are worth less than when they were purchased. Moreover, the number of residential properties bought more than 20 years ago now makes up a small proportion of total properties in most jurisdictions.

While these changes are not the result of Proposition 13, the impact on property tax revenues in the future is a direct result of how property taxes are structured under Proposition 13.

In addition, sales taxes, the other major general revenue source for local governments, have grown more slowly than the economy over the past three decades as consumers are spending a larger proportion of their income on services instead of goods and these services are not subject to sales tax.

As the economy recovers there will be a temporary surge in local government revenues compared to recent recession levels, but the long-term outlook under the existing tax system is for local government revenues to grow relatively slowly. This trend, combined with continuing population growth and the challenges of funding retirement benefits, will make it more difficult for local government to fund high quality public services.

Moreover, the slow future growth in property taxes will put pressure on the state budget. While rapid property tax growth during the period from 1978 through 2008 reduced the state budget allocation for local school funding, the slower growth expected in the future will translate into larger state budget funding responsibilities given the way that the state budget helps fund local education.

In light of all this, it is clear we face considerable challenges in financing our future. If we don't raise new revenues, then Silicon Valley and California must (continue to) make significant cuts. If we're not willing to cut into education and services any further, then a serious conversation has to take place about new revenue streams.

That conversation is critical for Silicon Valley's economic competitiveness.

The 2011 CEO Business Climate Survey conducted by the Silicon Valley Leadership Group reported:

"Increasingly it is difficult for Silicon Valley companies to compete against other centers of innovation and entrepreneurship—both domestic and abroad. Among the unique challenges are globalization and the international competition for talent. A deteriorating state infrastructure in areas ranging from public education to public transportation has added to the difficulties of recruiting the best workforce, finding them available housing, and educating their children to be tomorrow's world-class workforce." [3]

Raising taxes versus cutting services is normally viewed as a stalemate: the political climate doesn't allow for one and political dysfunction prevents the other. But there might be a way out of the stalemate—a third way—and that would be to reform our tax system so that it addresses the abnormalities we've described here and tracks more closely with the 21st century economy.

That discussion should proceed with Proposition 13 squarely on the table along with other options. The year 2012 is the time to begin that discussion in earnest.

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