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What Property Tax Limitation Does to Local Public Services

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Introduction

Property tax reform is a perennial topic in California politics. Ever since 1978, when Proposition 13 limited the property tax and made it more difficult to raise other taxes, many critics have argued that this law may have a variety of undesirable consequences for local government. The proposed solutions vary from outright repeal to more modest reforms that would curb the worst distributional inequities.

The issue of property tax limitation is increasingly important in other states as well. Many states have adopted property tax limitations following California's example. When the real estate market began to recover after the Great Recession, homeowners in many urban areas found their tax bills rising faster than their paychecks, and several cities and states began debating new legislation to cap property taxes. Most recently, New York State enacted a stringent property tax cap in 2012, bringing the total number of states with potentially binding limitations to 36.

Property tax limitation is often presented as a way to protect homeowners, but it comes at a price in local government services. The purpose of this brief is to summarize what is known about the effects of property tax limitation on the ability of local government to provide services. California's long experience with property tax limitation is instructive, but so many things have changed in California since 1978 that it is difficult to know which changes in local government service provision can be attributed to Proposition 13 and which should be attributed to other causes. This brief therefore draws on studies that compare *multiple* states or jurisdictions with property tax limits to jurisdictions without them, on the assumption that these comparative studies can shed light on California's experience. They also may inform other jurisdictions that may be considering adopting or further tightening their own property tax limitations. The advice is cautionary: Property tax limits cut public sector payrolls and thereby reduce the quality of public service delivery.

Property Tax Limitation

Property taxes are generally taxes on the value of real estate. They are often a particularly important source of revenue for local governments because local governments have limited geographic reach, and real estate is immobile.

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Local residents who want to dodge a local sales tax, for example, can take their shopping—and their sales tax dollars—to the next suburb over. But they cannot take their land with them.

Property tax limitation laws constrain the ability of local governments to increase property taxes. Ever since the late nineteenth century, some states have had laws that cap the maximum property tax rate that local governments can charge. The modern property tax limitations passed since Proposition 13 are different: they cap the allowable percentage by which the total property tax revenues of any local government can increase from year to year. Some states, such as California, also cap the annual growth rate of the assessed value recorded for any *individual* property. No matter how rapidly a piece of real estate is appreciating in value, California's property tax limitation means that the value that is recorded for tax purposes can increase no faster than 2% per year, as long as the property is not sold.

These laws do not just limit local property taxes, they also limit local government spending. In theory, a local government subject to a property tax limit could make up for its inability to raise property taxes by increasing other taxes. In practice, few other taxes are as well suited to local government use, and even when local governments increase other taxes after a property tax limitation, they typically do not make up for all of the foregone property tax revenue.[i] Some local governments therefore turn to non-tax revenue sources such as state aid, fees, voluntary contributions, and even speculation on financial markets.[ii] But few of these are as predictable or productive of revenue as the local property tax. If a local government is subject to a property tax limitation, then in the long run, it may have little alternative but to reduce spending.

Property Tax Limits Reduce Wages

Labor is the biggest operating expense for most local governments. It is no surprise, then, that many local governments respond to property tax limitation by attempting to cut labor costs.

One of the most direct ways to reduce labor costs is to cut the salaries of local government employees. There is some evidence that property tax limitations reduce public employee salaries relative to what they would be otherwise. One study found that starting teacher salaries in 1988 were between $1,861 and $4,614 less in school districts subject to property tax limitation than in other school districts.[iii] Other studies have examined the effects of "tax and expenditure limitations," a more general category that includes property tax limitation laws. One such study found that wage growth of local government employees over the period from 1980 to 1991 was about 6% less in states where local governments were subject to tax and expenditure limitation laws.[iv] Another found that average teacher salaries for the years from 1970 to 1992 were no different in states with and states without local tax and expenditure limitations.[v] On balance, it appears that property tax limits may have limited the pay of at least some categories of local government employees.

Another way to cut labor costs is to make do with fewer public employees. The evidence on this point is consistent. Every study that has examined the effects of property tax limitation on school district staffing ratios find that property tax limits force schools to make do with fewer teachers per student (and larger average class sizes).[vi] One study has examined fire departments, and finds that districts operating under a property tax limitation are substantially more likely to be all-volunteer departments.[vii] Local governments probably also cut back on many other kinds of direct service employment when they are subject to property tax limitation.

A local government that is forced to spread more work over fewer employees who work for less pay may find that it has trouble attracting or retaining the most skilled employees. There is some evidence that local governments in states with property tax limitations struggle to hire and keep the best trained staff. One study found that in a state with a property tax limitation, the undergraduate education major tends to attract students with lower test scores, and the teaching profession tends to attract graduates with lower test scores and less training in education, than in a state without a property tax limitation.[viii] Researchers have yet to study the impact of property tax limitation on the recruitment and retention of other public sector professionals.

Property Tax Limits Can Reduce the Quality of Public Services

Property tax limitations reduce the resources available to provide public services, but they do not reduce the demand for public services. Local governments operating under a property tax limitation may, in effect, find themselves asked to do more for less. This is not always possible, and so property tax limitation may reduce the quality of public services.

The effect of tax limitation on the quality of government services is difficult to measure because the quality of government services is, itself, difficult to measure. The most careful econometric studies concern public primary and secondary schools. Researchers have found that property tax limitation has a negative effect on student achievement as measured by standardized tests. Such test scores are obviously an imperfect measure of the quality of education, but when test scores are averaged over a large number of students in a district, and then used to compare large numbers of districts, they may give some indication of differences in the average educational quality. The published research literature includes eight independent estimates of the effects of property tax limitation on student test scores, with different samples, different tests, and different age groups. Seven of the eight show that property tax limitation caused a substantial decline in average test scores.[ix]

We do not yet have careful quantitative studies of the impact of property tax limitation on the quality of other public services, but they are likely to be negative in many cases. Anecdotal evidence from some of the most fiscally constrained cities in California suggests that they are plagued by poor response times for police and fire services, poor infrastructure, and inaccessible government services in general.[x]

We also have some evidence of residents' subjective perceptions of the quality of government services. Proponents of property tax limits sometimes argue that these laws merely force government to reduce wasteful spending. But studies of public opinion show that enacting a property tax limit does not reduce perceptions of government waste or increase satisfaction with government.[xi]

The Case for Reform

These studies of the impact of property tax limitation should lead us to recommend caution to any state that might be considering a new or more restrictive cap on local property taxes. These laws restrict the ability of local governments to pay for the services that the public demands. There is little alternative but to cut spending on service provision. The result is that those services may become worse. There is certainly room for more research on the impact of property tax limits on government services and civic life, but the balance of the published social science evidence suggests that the impact is often harmful. If the goal is to provide middle class homeowners with security against tax increases they cannot afford, then state legislators should consider alternative ways to achieve this goal that do not harm local services.

The research also strengthens the argument for reform in states such as California that already have property tax limitations. Defenders of property tax limitation have sometimes dismissed the impact on public services as a non-issue. When he was told that property tax limitation might force some public libraries to close, Howard Jarvis, the co-author of Proposition 13, once said “That doesn’t matter. Why do we need books? The schools aren’t teaching kids to read anyway.”[xii] Few Californians today would agree with him. Many of California’s local agencies have been forced to make cuts since Proposition 13, and public employees know how difficult it is to provide high-quality services on an austerity budget. Property tax reforms that loosen the constraints on local budgets should be expected to improve the quality of services that local governments can provide.

[i] See, e.g., Anne E. Preston and Casey Ichniowski, "A National Perspective on the Nature and Effects of the Local Property Tax Revolt, 1976-1986." *National Tax Journal* 44 (1991):123–45; Mark Skidmore, "Tax and Expenditure Limitations and the Fiscal Relationships Between State and Local Governments," *Public Choice* 99, no. 1-2 (1999):77–102.

[ii] See, e.g., Matthew D. McCubbins and Ellen Moule, "Making Mountains of Debt Out of Molehills: The Pro-Cyclical Implications of Tax and Expenditure Limitations." *National Tax Journal* 63, no. 3 (2010): 603–22; Changhoon Jung and Suho Bae, "Changing Revenue and Expenditure Structure and the Reliance on User Charges and Fees in American Counties, 1972-2002," *The American Review of Public Administration* 41, no. 1 (2011): 92–110; Douglas C. Bice and William H. Hoyt, "The Impact of Mandates and Tax Limits on Voluntary Contributions to Local Public Services: An Application to Fire-Protection Services." *National Tax Journal* 53, no. 1(2000): 79–104; Mark Baldassare, *When Government Fails: The Orange County Bankruptcy* (University of California Press, 1998).

[iii] David N. Figlio "Did the 'Tax Revolt' Reduce School Performance?" *Journal of Public Economics* 65 (1997): 245–69.

[iv] James M. Poterba and Kim S. Rueben, "The Effect of Property-Tax Limits on Wages and Employment in the Local Public Sector," *American Economic Review* 85, no. 2 (1995): 384–89.

[v] Ronald J. Shadbegian, "Did the Property Tax Revolt Affect Local Public Education? Evidence from Panel Data," *Public Finance Review* 31, no. 1 (2003): 91–121

[vi] David N. Figlio, "Short-Term Effects of a 1990s-Era Property Tax Limit: Panel Evidence on Oregon's Measure 5," *National Tax Journal* 51, no. 1 (1998): 55–70; Figlio, "Did the 'Tax Revolt' Reduce School Performance?"; Shadbegian, "Did the Property Tax Revolt Affect Local Public Education?"

[vii] Bice and Hoyt, "The Impact of Mandates and Tax Limits on Voluntary Contributions to Local Public Services."

[viii] David N. Figlio and Kim S. Rueben, "Tax Limits and the Qualifications of New Teachers." *Journal of Public Economics* 80, no. 1 (2001):49–71.

[ix] Figlio, "Did the 'Tax Revolt' Reduce School Performance"; Thomas A. Downes, Richard F. Dye, and Therese J. McGuire, "Do Limits Matter? Evidence on the Effects of Tax Limitations on Student Performance." *Journal of Urban Economics* 43 (1998):401–17.

[x] See, e.g., Peter Schrag, *Paradise Lost: California's Experience, America's Future* (Berkeley and Los Angeles: University of California Press, 1998); Steven P. Erie, Vladimir Kogan, and Scott A. MacKenzie, *Paradise Plundered: Fiscal Crisis and Governance Failures in San Diego* (Stanford: Stanford University Press, 2013).

[xi] See David Lowery, "The Attitudinal Consequences of the Tax Revolt," *Political Behavior*, 4, no. 4 (1982), 333-52; Isaac William Martin, *The Permanent Tax Revolt: How the Property Tax Transformed American Politics* (Stanford: Stanford University Press, 2008), 142.

[xii] Robert Kuttner, *The Revolt of the Haves: Tax Rebellions and Hard Times* (New York: Simon and Schuster, 1980), 78.