Research Department
Federal Reserve
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San Francisco

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FRBSF Weekly Letter

# Limiting Property Taxes

Two well-publicized proposals to limit property taxes will face California voters in the June 6 election. Actually, the voters will have their choice of three different alternatives. They can vote "yes" on Proposition 13, the Jarvis-Gann Initiative. The can vote "no" on Proposition 13 *and* "yes" on Proposition 8, allowing the legislative substitute, the Behr Bill, to take effect in place of Jarvis-Gann. Alternatively, they can vote "no" on both propositions, defeating both measures and leaving property taxes where they were. The Behr Bill has already been signed into law, but it would not become effective unless both Proposition 8 passes and Proposition 13 is defeated (or is declared unconstitutional by the courts). This article outlines some of the essential features of the two proposals and discusses how they might affect the market for California state and municipal debt.

The two measures on the June ballot are certainly not the first attempts by California voters to restrict taxes and public spending. In 1968 and again in 1972, the state's voters rejected the "Watson Initiatives," which would have limited property taxes to 1 percent of market value. In 1973, they rejected Proposition 1, which would have done even more and limited state taxes and spending in general to a fixed maximum percentage of state personal income. Although the 1973 proposition was defeated, similar initiatives are now gaining momentum elsewhere in the country. Just this spring, Tennessee voters approved a measure of this type, while Michigan and Colorado voters launched petition drives to accomplish the same purpose.

**Essentials of proposals**

Although both Jarvis-Gann and Behr aim at restricting public spending by limiting property taxes, Jarvis-Gann goes much farther in this regard. Initially, it would roll back taxes on *all* property to 1 percent of the market values stated on 1975-76 tax bills. This change could result initially in a $7-billion (60 percent) reduction in California property taxes—one-third applicable to owner-occupied homes and the rest to rental and non-residential properties. Tax rates would then be held constant while assessed market values could rise no more than 2 percent per year—except that properties when sold (or newly constructed) would be reassessed at current market values.

Jarvis-Gann also would attempt to prevent other taxes from rising to offset the lost property-tax revenues. First, it would require that State tax increases be passed by a two-thirds vote of *all* members (not just those voting) of both houses of the legislature. Second, it would require that local tax increases gain the approval of two-thirds of all "qualified electors" (i.e., registered voters) in the affected municipality. These added stipulations may be unconstitutional, but if enacted they would severely restrict future tax increases, particularly at the local level.

The Behr Bill takes a less drastic approach. Initially, it would cut the *tax rate* on *owner-occupied* homes by 30 percent (without rolling back assessed values), while leaving unaffected the rates on other real properties. Increases in property-tax revenues—the combined effect of tax rates and assessed values—thereafter would

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not be allowed to exceed the general rate of inflation. The bill also would increase the renter income-tax credit and increase both home-owner and rental assistance for senior citizens.

The bill would require the state to reimburse local districts for revenue losses from the 30-percent homeowner tax cut, but it would also set limits on future state tax-revenue growth. Starting with fiscal year 1978-79, state revenues would be allowed to grow by no more than 1.2 times the percentage increase in state personal income. For example, if California income grew by 10 percent, state tax revenues could grow at most by 12 percent. Thus, state revenues would not face a very tight ceiling, and there is even some ambiguity in the bill's wording such that the limit could be a good deal less restrictive.

**Major issues**

The two major issues at stake in this complex campaign are property taxes in particular and the size of government in general. The complexity of this situation arises partly from the fact that the authors of both propositions attempted to deal with both issues together, instead of separating them. Both proposals focus on the homeowner property tax that has escalated with skyrocketing California property values, but they also attempt to curb the size of state and local government.

Consider the first issue in isolation, with other taxes being increased to fill the revenue gap left by a cut in property taxes. With increases in local sales taxes and state income taxes, properties subject to lower property taxes would become better investments and thus would rise in value. In contrast, other types of spending subject to the sales tax, and work and financial saving subject to the income tax, would become less attractive. Given such a shift in tax structure, individuals would have added incentive to invest in homes rather than in financial assets—especially since in the latter case, interest and dividends are taxable income and capital-gains taxes are payable with each transfer. Indeed, in view of the past decade's rise in inflation and nominal interest rates, existing tax structures have already steered savers away from taxable-income-generating forms of saving and into assets like homes, for which "income" is taken in kind and capital-gains are deferrable.

Consider the alternative case, where a ceiling is imposed on total taxes and spending, but without any reference to specific taxes such as the property tax. This is the approach proposed in California in 1973 or approved in Tennessee in 1978. This method would have left room for a more flexible shift to smaller government and for tax cuts not solely directed to property owners. As it is, voters must approve (or reject) the shift from property taxes and the limitation on government in tandem.

**Municipal-finance issue**

The complex debate over the two propositions is already creating some ramifications in the market for California state and municipal debt—the debt of California's cities, counties, school districts and other special districts. Although many kinds of bonds exist, two categories are of special interest

here: "general obligation" bonds, which are secured by the municipality and paid out of general tax revenues; and "tax allocation" bonds, which are normally secured by the tax base of a redevelopment project and paid out of taxes generated from rising property values. Jarvis-Gann, and to a lesser extent the Behr Bill, would affect both kinds of municipal debt, but particularly the latter debt.

Neither proposal threatens the value of existing general-obligation bonds, because taxes needed to pay principal and interest are specifically exempted from the tax limitation. However, new general-obligation debt could become scarce under Jarvis-Gann, because related spending would require the two-thirds approval mentioned earlier. Under Behr the limit on such debt would not be so severe, although it is difficult to predict the bill's effect on the risk premium in the interest rate. The ceiling on revenues and the disappearance of budget surpluses would tend to increase the risk of default and hence raise the interest rate necessary to attract investors—but on the other hand, the "fiscal conservatism" imposed by spending limits might have the opposite effect. For example, the State's Aaa bond rating might be jeopardized if a large part of the current $3-billion surplus were used to fill the revenue gap left by declining property taxes—yet further surpluses might be amassed if the voters chose to press for conservative spending under either of the two proposals.

Both proposals would have a much greater impact on tax-allocation than on general-obligation bonds. Tax-allocation bonds are normally used for urban redevelopment. Their principal and interest are financed out of the rising property values that result from redevelopment, and thus they are self-financing. Jarvis-Gann, with its rollback on existing valuations and its 2-percent lid on annual assessment increases, might render this self-financing feature unsustainable, threatening existing debt. The 2-percent lid and inability to raise property tax rates will also make new debt of this type exceedingly difficult to issue. Consequently, the two major rating services have begun to look skeptically at such issues. Moody's has suspended rating these bonds until the situation becomes clearer, while Standard and Poor's has been reviewing ratings on a case-by-case basis. The Behr Bill apparently would exert a smaller impact on such bonds, because its assessment rollback applies only to owner-occupied homes, and because its ceiling on property-tax increases moves upward with the inflation rate.

Bond dealers and analysts argue that individual bonds differ depending upon the financial condition of the municipality and the security and revenue source of the bond. Current evidence supports this view. Although the ballot proposals have had varied effects on individual bonds, in general they have had little effect on general-obligation bonds and a substantial impact on tax-allocation bonds (and some revenue bonds). For example, many redevelopment districts are floating debt now because of a belief that financing would be almost impossible to obtain in the wake of Jarvis-Gann. Yet bidding is very thin and net interest costs are very high (often in excess of 8 percent).

In sum, Jarvis-Gann and Behr represent large departures from the status quo. They raise fundamental issues about the tax structure and the size of government, and if passed, will have uneven effects among municipalities. Already, the financial markets indicate that bond analysts are keeping a wary eye on the polls.

**Jack Beebe**

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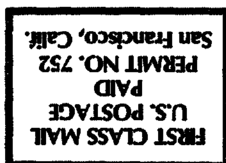


## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 5/10/78 | Change from 5/3/78 | Change from year ago Dollar | Change from year ago Percent |
|---|---|---|---|---|
| Loans (gross, adjusted) and investments* | 110,821 | + 42 | + 14,483 | + 15.03 |
| Loans (gross, adjusted) – total | 88,123 | + 87 | + 14,206 | + 19.22 |
| Security loans | 1,878 | – 121 | + 52 | + 2.85 |
| Commercial and industrial | 27,164 | – 1 | + 3,279 | + 13.73 |
| Real estate | 29,554 | + 144 | + 6,328 | + 27.25 |
| Consumer instalment | 15,531 | – 16 | + 2,889 | + 22.85 |
| U.S. Treasury securities | 8,226 | – 109 | – 558 | – 6.35 |
| Other securities | 14,472 | + 64 | + 835 | + 6.12 |
| Deposits (less cash items) – total* | 107,702 | + 1,164 | + 13,274 | + 14.06 |
| Demand deposits (adjusted) | 29,493 | + 850 | + 2,814 | + 10.55 |
| U.S. Government deposits | 424 | – 301 | + 51 | + 13.67 |
| Time deposits – total* | 76,015 | + 596 | + 10,160 | + 15.43 |
| States and political subdivisions | 7,283 | + 32 | + 1,441 | + 24.67 |
| Savings deposits | 31,489 | + 14 | – 599 | – 1.87 |
| Other time deposits‡ | 34,425 | + 422 | + 8,302 | + 31.78 |
| Large negotiable CD's | 16,202 | + 440 | + 6,977 | + 75.63 |

| Weekly Averages of Daily Figures | Week ended 5/10/78 | Week ended 5/3/78 | Comparable year-ago period |
|---|---|---|---|
| **Member Bank Reserve Position** | | | |
| Excess Reserves(+)/Deficiency (–) | + 54 | + 22 | – 4 |
| Borrowings | 148 | 66 | 8 |
| Net free(+)/Net borrowed (–) | – 94 | – 44 | – 12 |
| **Federal Funds—Seven Large Banks** | | | |
| Interbank Federal fund transactions | | | |
| Net purchases (+)/Net sales(–) | + 903 | + 1695 | – 248 |
| Transactions with U.S. security dealers | | | |
| Net loans (+)/Net borrowings (–) | + 427 | + 63 | + 214 |

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

**Editorial comments may be addressed to the editor (William Burke) or to the author....**
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