FRBSF Weekly Letter

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Prop. 13 Nine Years Later

In 1978, California voters passed Proposition 13, the pathbreaking property tax limitation initiative aimed at controlling the size of local government. This *Letter* examines the effects of Proposition 13 on local government revenues in California and on the extent of differentiation among localities in terms of the quantity and composition of taxes and public spending. The evidence suggests that Proposition 13 has reduced the overall size of local government in California, but that it has had little effect on fiscal differentiation among school districts and cities.

Differentiation among local governments

Statewide initiatives that limit local governments potentially could interfere with the federal system of government, in which different levels of government provide different types of public or quasi-public goods and services. In the federal system as practiced in the United States, the national government is responsible for providing the "pure" public goods, such as defense, which must be consumed by all if they are consumed by any.

Most services provided by local governments, including education, fire and police protection, and road maintenance, are hybrids between pure public goods and the private goods sold on ordinary markets. These quasi-public goods combine some of the qualities of private and public goods. Like private goods, they can be priced because individuals benefit directly from them and the cost of providing services rises with the number of individuals served. They also have the public quality of benefitting some who do not directly consume them as, for example, when a fire department protects a neighborhood by putting out a fire in one house.

Because of their "spillover" effects, quasi-public goods cannot be provided efficiently, in an economic sense, through private markets alone. Instead, they are particularly well-suited to provision by local governments because jurisdictional fragmentation creates rudimentary "markets" that allow individuals, by choosing a place to live, to select the combination of taxes and public services that suits their tastes and needs.

Measures that circumscribe local governments, such as Proposition 13, potentially could limit the extent to which jurisdictions can differentiate themselves from one another. Such limitation would prevent some individuals from consuming the level and type of government services that they would have chosen and for which they would have paid in the absence of restrictions.

Proposition 13 and California taxes

Proposition 13, passed in 1978, placed a one-percent ceiling on property tax rates and stipulated that a higher rate could not be imposed without a two-thirds majority of voters. Since effective property taxes had averaged about 2.7 percent of total assessed valuation in 1978, Proposition 13 immediately cut property tax rates dramatically.

In addition, the initiative rolled back all assessed property values to their 1976 levels. Assessed values could rise by no more than 2 percent per year or the inflation rate, whichever was lower. Upon sale, however, properties automatically would be reassessed at their market value.

These tax rate cuts, and the imposition of a maximum tax rate, would decrease the variation in tax *rates*, but their impact on tax *revenues* is unclear since property tax revenues are a function of wealth as well as of tax rates. Before Proposition 13, tax rates and wealth tended to be inversely related since a wealthy district could raise a given amount of money with a lower tax rate than could a less wealthy district. After Proposition 13, less wealthy districts no longer could levy higher tax rates to compensate for their lower wealth, so the variation in revenues actually could have risen.

The dramatic changes that Proposition 13 wrought in California's fiscal environment are illustrated in the chart. In fiscal year 1977-78 (hereafter "1978"), just before Proposition 13

took effect, 6.4 percent of California personal income went toward paying property taxes. In the following year, the property tax burden had fallen by more than half, to 3 percent of personal income. Property taxes provided 40 percent of all state and local tax revenue in California during 1978, but only 25 percent in 1979.

As a result, California's total state and local tax burden fell from 15.8 percent of personal income in 1978 to 12.1 percent in 1979. By 1984, the burden had fallen still further, to 11.5 percent. This dramatic decrease in the total state and local tax burden occurred with no significant changes in the burdens of sales or personal income taxes, and was almost entirely due to Proposition 13. (In 1977, gas, cigarette, alcohol, and corporate income taxes together comprised 60 percent of miscellaneous taxes.)

Effect on local jurisdictions

While Proposition 13 clearly reduced the total state and local tax burden, it affected different types of local jurisdictions differently. For example, school districts and cities had different functions and revenue sources, and therefore had different responses to the changes in the fiscal environment.

School districts

The degree of differentiation in spending levels among school districts appears to have declined during the decade that ended in the early 1980s. According to calculations by Osman and Gemello, in 1974 a $256 per pupil gap separated the twenty-fifth and seventy-fifth percentiles for revenue limits among unified school districts. By 1983, the gap had narrowed to $67 in inflation-adjusted 1974 dollars.

For school districts, the property tax was a particularly important revenue source during the early 1970s. In 1972, the property tax accounted for 54 percent of school district funds, and school districts consumed 52 percent of all property tax revenues. School district financing had changed significantly even before Proposition 13, due to the 1971 *Serrano* decision in which the California Supreme Court ruled that it was unconstitutional for some school districts to provide inferior schooling because low wealth limited their property taxing capacity.

Starting in 1974, the state implemented *Serrano* by placing a cap on the amount of property tax revenues per pupil that school districts could raise. At the same time, a minimum per pupil *spending* level was established for all school districts. State funds filled the gap between the 1973 property tax revenue base and the minimum per pupil spending level for those districts with low property tax revenues. As a result, the share of property tax revenues in total school district funds fell to 46 percent in 1974, when *Serrano* was implemented, while the share of state aid (generated by state income and sales taxes) rose commensurately.

In 1978, Proposition 13 drastically reduced the amount of property tax money available to school districts, thereby increasing the gap between property tax revenues and the minimum spending level and dramatically expanding the role of state aid. By 1985, the state provided 63 percent of school revenues, and property taxes accounted for only 22 percent of school funds. The overall per pupil level of school spending changed little after Proposition 13.

Because *Serrano* was aimed explicitly at limiting spending differences among school districts, it likely bears more direct responsibility for reducing the degree of differentiation in district spending levels than does Proposition 13. Nevertheless, Proposition 13 probably reinforced the trend by accelerating the replacement of property tax revenues by state aid.

Cities

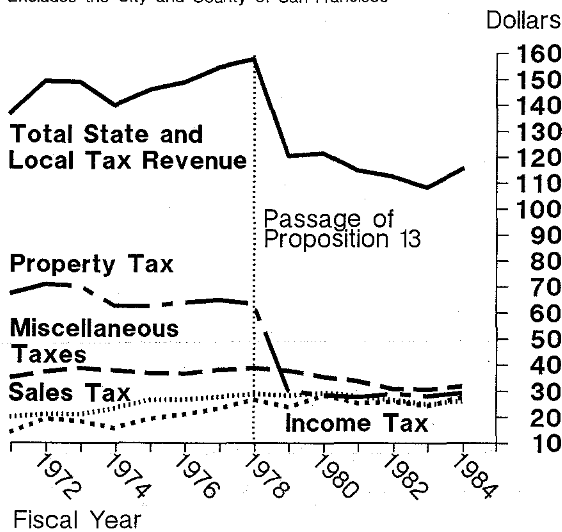
City financing changed significantly after Proposition 13, but the evidence suggests that cities experienced little or no change in their ability to differentiate themselves from one another.

California cities, traditionally having few spending mandates from higher levels of government, are relatively free to spend their money as they see fit. Typical city services include fire and police protection, streets, parks, and libraries.

Cities also can tap a relatively broad range of revenue sources, including taxes on sales, hotel rooms, utility use, and business licenses, as well as charges for services rendered. In 1978, property taxes provided 14 percent of total city revenues while nonproperty taxes provided 19 percent, current service charges 31 percent, state and federal grants 20 percent, and miscellaneous other sources the remainder.

Thus, cities appear to have been less vulnerable than school districts to Proposition 13-related declines in property tax revenues. However, prior to Proposition 13 they were more able to differentiate themselves from each other than school districts were, in terms of both the quan-

California State and Local Tax Revenues Per $1000 Personal Income
Excludes the City and County of San Francisco



tity and mix of services they provided, so the potential for change in differentiability among cities was greater.

The impact of Proposition 13 on California cities was complicated by the loss of substantial federal grant money. Between 1978 and 1985, inflation-adjusted federal grants to cities fell by 50 percent as the federal government rolled back its grants-in-aid programs. Proposition 13 and reduced federal funds together caused total city revenues to fall substantially relative to personal income after 1979.

As it turned out, cities were able to compensate for those losses by increasing their use of alternative revenue sources. By 1985, their total revenues stood only 4.4 percent below the level in 1978, just before Proposition 13 was implemented. Between 1978 and 1985, revenues from nonproperty taxes grew 19 percent, "miscellaneous" revenues (primarily investment and rental income) grew 62 percent, and service charge revenues rose 13 percent.

One way to explore whether the constraints on cities affected the extent to which they could differentiate themselves from one another is by examining the variation in revenue across cities. Calculating a consistent data set for all California cities is a prohibitively time-consuming task, so summary statistics were calculated for two years using data from two counties only. These two counties, Alameda and Contra Costa, comprise the Oakland Metropolitan Statistical Area (MSA) and, in 1985, included 31 cities that varied substantially in terms of the incomes and other characteristics of their residents.

For these cities, real per capita revenues on average fell about 10 percent between 1978 and 1985, although some cities made gains. The standard deviation, which measures the extent of differentiation in the level of revenues, fell slightly, from $240 to $235, while the ratio of the standard deviation to the mean rose slightly, from 0.617 to 0.671. These changes suggest that cities as a group lost revenues following the dual shocks of Proposition 13 and the cuts in federal grants, but their ability to differentiate themselves from each other did not change significantly.

Conclusions
On the whole, Proposition 13 appears to have reduced the size of local government, as measured by taxes paid as a proportion of personal income, but it has had little apparent effect on the degree of spending variation among local governments.

For most localities, the changes wrought by Proposition 13 appear to have been tempered by increased reliance on other revenue instruments. School districts now rely more heavily on state aid, although *Serrano* bears most of the responsibility for that change. As a result, the level of differentiation has decreased for school districts since Proposition 13 was passed.

Among a small sample of cities, the variation in revenues has not changed significantly since Proposition 13 took effect. City revenues continue to be derived primarily from local sources. Proposition 13's impact on cities was complicated by the sharp reduction in federal grants that occurred at about the same time, but both shocks to city finance were mitigated by cities' initial limited reliance on property taxes and by their ability to increase revenues from alternative sources, such as service charges and nonproperty taxes.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/19/87	Change from 8/12/87	Change from 8/20/86 Dollar	Percent[7]
Loans, Leases and Investments[1 2]	204,446	− 287	1,560	0.7
Loans and Leases[1 6]	180,922	− 438	− 2,735	− 1.4
Commercial and Industrial	51,188	178	267	0.5
Real estate	69,928	81	2,691	4.0
Loans to Individuals	36,953	54	− 4,150	− 10.0
Leases	5,425	2	− 82	− 1.4
U.S. Treasury and Agency Securities[2]	16,547	126	5,060	44.0
Other Securities[2]	6,976	24	− 768	− 9.9
Total Deposits	204,890	− 1,388	− 1,294	− 0.6
Demand Deposits	50,590	− 1,047	− 718	− 1.3
Demand Deposits Adjusted[3]	35,566	− 820	290	0.8
Other Transaction Balances[4]	19,793	− 131	2,885	17.0
Total Non-Transaction Balances[6]	134,507	− 210	− 3,461	− 2.5
Money Market Deposit Accounts—Total	45,078	651	− 1,875	− 3.9
Time Deposits in Amounts of $100,000 or more	31,294	− 162	− 4,292	− 12.0
Other Liabilities for Borrowed Money[5]	23,803	− 21	− 1,023	− 4.1

Two Week Averages of Daily Figures	Period ended 8/10/87	Period ended 7/27/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	32	61
Borrowings	12	21
Net free reserves (+)/Net borrowed(−)	19	40

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change