Improving the Incentives for Property Tax Administration

Is the State Under-Investing in Property Tax Administration? How Can It Ensure That an Appropriate Level of Resources Is Committed for This Purpose?

Summary

The state has a significant interest in the property tax. Although the property tax has been considered a local tax, the state is in fact the largest beneficiary of property tax revenue growth. This is because increases in property tax revenues generally result in commensurate decreases in the required state contribution for education.

In spite of the considerable state interest in the property tax, the costs of property tax administration are borne almost entirely by local governments. Specifically, counties receive less than 20 percent of property taxes collected, yet they pay more that 70 percent of property tax administration costs. As a result, counties face a disincentive to investing in the property tax administration system.

While the Legislature has acted on several occasions to improve the fiscal incentives for counties and has recently made funding available for loans to local assessors for property tax administration purposes, the problem of inappropriate fiscal incentives remains.

We propose a system that can create the appropriate incentives for counties to invest in property tax administration. Under this system, the state would pay a share of all future property tax administration costs but would not pay a share of costs in the base. Because the state would pay a share of costs for all increases in expenditures, counties would not bear a disproportionate share of these increased costs. As a result, the county-level decision to increase expenditures for property tax administration would no longer have to take into account the adverse fiscal incentives associated with the current system. The state contribution would increase as property tax administration costs increase; however, the state could expect that future investments in property tax administration would result in sufficient returns to justify the expense.

INTRODUCTION

Each year, the property tax raises nearly $20 billion for California local governments, ranking just behind the income and sales taxes as the state's third largest revenue source. Although the property tax is a local tax, it nevertheless benefits the state as a result of California's state based education financing system. Under this system, increases in property taxes generally translate into reductions in the required state contribution for education.

As a result of this interaction, the state has a significant interest in the proper administration of the property tax. However, the majority of property tax administration costs are paid by the counties. Counties pay more than 70 percent of property tax administration costs, yet they receive less than 20 percent of property taxes collected. As a result, counties face a fiscal incentive to under-invest in property tax administration. The result of this incentive structure may be a weakened property tax administration system that is less efficient and less equitable.

In this piece, we explain the state interest in the property tax, describe the disincentives faced by counties, and review the major legislative actions designed to improve the property tax administration system. Finally, we propose a solution that will provide appropriate incentives to invest in property tax administration, yet will not require a significant new commitment of state resources.

WHAT IS THE STATE INTEREST IN THE PROPERTY TAX?

While it may seem paradoxical that the state should have an interest in the administration of a local tax, the state is indirectly the largest recipient of property tax revenues. Because of Proposition 13 (Article XIIIA of the State Constitution), the *Serrano* Supreme Court decisions, and Proposition 98 (Article XVI of the State Constitution), California now has a system of school finance that is primarily state, rather than locally, based. Each year the level of spending on the education system is determined by the Legislature and the Governor according to the rules set out by Proposition 98. This spending level is financed from a combination of state General Fund revenues and local property tax revenues. *Increases* in property tax revenues generally allow for *decreases* in the state contribution to education. Therefore, the state benefits when local property tax revenues increase. Conversely, when property tax receipts decline, the difference must be made up by the state.

In certain instances, the minimum funding level called for by Proposition 98 *is* dependent on property taxes. Under the so called "Test 1" calculation, any increase in property tax revenues increases the overall level of school funding and does not offset the required state contribution. In these cases, it is the state education system as a whole that benefits from increases in property tax revenues.

As the largest recipient of property taxes, the state benefits from an efficiently administered property tax system. Increased property taxes generally decrease state costs for education. The state also benefits from a fairly administered system. An appropriate level of investment in this system leads to accurate determinations of value, complete property tax rolls, accessible records, and full compliance with the laws governing property tax administration. Such a properly funded system will function more efficiently and be viewed more favorably by taxpayers.

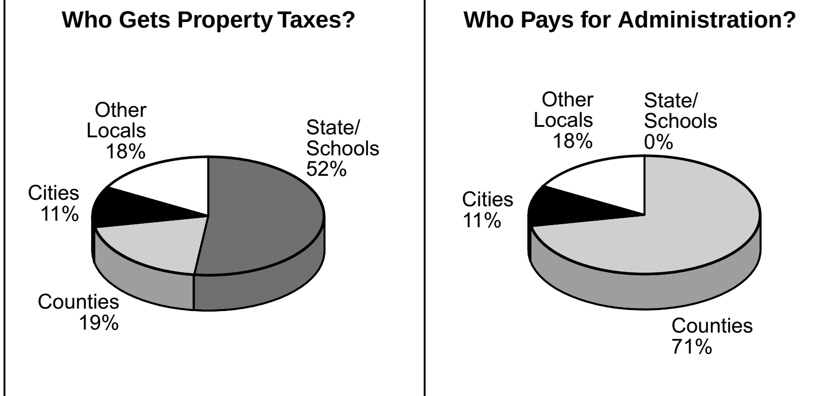
WHO PAYS FOR PROPERTY TAX ADMINISTRATION?

Under the current cost sharing system, counties pay more than 70 percent of the costs of administering the property tax, yet they receive less than 20 percent of property taxes collected. Cities, special districts and redevelopment agencies pay the remaining 30 percent of property tax administration costs. Schools, the largest recipients of property taxes, do not pay for property tax administration. While the cities, special districts, and redevelopment agencies pay a share of costs that is proportional to the revenues they receive from the property tax, counties pay a disproportionate share, since they in effect also must pay the school share (see Figure 1 on the next page).

Counties Face Fiscal Incentives to Under-Invest in Property Tax Administration. Although county assessors are guided by a constitutional obligation to fairly administer the property tax, increases in funding for administration must nevertheless be justified to county boards of supervisors. Assessors must show not just that an increase would improve the system overall, but that the increase would generate sufficient benefits—both financial and nonfinancial—to offset the disproportionate share of costs paid by the counties. Because the benefits of increased investment in the property tax administration system accrue primarily to the schools (or the state) rather than to the county, counties have a reduced incentive to invest their own resources in the property tax administration system.

Figure 1

Property Tax Administration Costs And Share of Property Tax Going to Local Entities



[a] All amounts are for 1995-96 and include debt levies. Administration amounts do not include revenues from the property tax administration loan program.

HOW WE GOT WHERE WE ARE

Prior to Proposition 13, counties levied a county-wide property tax rate sufficient to cover the costs of property tax administration. Although other local entities received property tax revenues, they did not directly pay for the costs of administering the property tax. Because the county levied a county-wide property tax rate, however, all property tax payers in the county did share in the costs of administration, so it was not necessary to charge other local entities.

As costs for administration changed, counties could adjust the county-wide property tax rate to generate sufficient revenue to cover the costs of administration. When Proposition 13 limited the property tax rate to a constitutional maximum of one percent of assessed value, however, counties could no longer increase the county-wide property tax rate in order to pay for increased property tax administration costs. Counties were, however, still responsible for these duties.

What Is Property Tax Administration?

The amount of property taxes paid by any individual property owner is determined by two factors: the assessed value and the property tax rate. The amount of tax owed is simply the assessed value multiplied by the tax rate. Under the terms of Proposition 13, the maximum allowable property tax rate is one percent of assessed value. The assessed value, in turn, is determined by locally elected county assessors.

Under the terms of Proposition 13, the assessed value can only be increased by the rate of inflation or by a maximum of 2 percent per year. When a property is sold or transferred, it is entered on the property tax roll at the new acquisition value (usually the purchase price) and subsequently increased by the inflation factor until such time as the property changes ownership once again. In addition to increases for inflation and upon a change in ownership, the assessed value can be increased if new construction has occurred.

What if the Assessed Value Is Too High? In cases in which the market value of a property may have *decreased*, it is the job of the assessor to determine the market value and adjust the assessed value if it exceeds the market value. These temporary downward assessments remain on the property tax roll until such time as the market value increases once again. During the period in which properties have reduced assessed values, assessors must carefully monitor market values to ensure that assessed values do not exceed market values. Once values start to increase, assessors must monitor values to permit appropriate increases in assessed value.

Assessors are also responsible for handling appeals of assessed value. Generally, property owners do not disagree with the assessor's determination of value since this value is simply the acquisition value increa gcent-0.00ation. However, in times of falling property values, such as occurred in California during the late 1980's and early 1990's, many property owners will seek to have their assessed value adjusted downward. In other cases, property owners will simply disagree with an assessor's determination of value, believing that the assessor has not accurately appraised the property.

Tax Collection and Distribution. The work of the assessor is the first step in the property tax administration process. Once the assessed value has been determined, it is the job of the county tax collector and the county auditor to send out tax bills, collect tax revenue, and allocate that revenue to the local jurisdictions that receive property taxes. This system involves millions of tax bills and billions of dollars in tax revenue. We estimate that the current costs of administering the property tax system are about $450 million annually.

How Did the Property Tax Shifts Affect Property Tax Administration?

In spite of the fiscal incentives faced by counties throughout most of the post Proposition 13 period, the property tax administration system nevertheless continued to function adequately. County officials, mindful of their responsibilities for this important function, continued to fund property tax administration at a level sufficient to carry out the most important property tax administration responsibilities.

In 1992-93 and 1993-94, the state shifted over $3 billion from local governments to schools, resulting in a comparable savings to the state through reduced education spending. The property tax shifts increased the share of property taxes going to schools from 35 percent to 52 percent and decreased the share going to counties from 33 percent to less than 20 percent, thereby reducing county revenues by about $2.5 billion annually. The result was considerable budgetary pressure in all county discretionary programs. Because property tax administration must be financed out of this limited pool of discretionary funds, assessors' offices faced increased pressure to absorb budget cuts or go without increases.

The property tax shifts had another impact. By reducing the share of revenues going to the counties, the shifts further reduced the incentives for the counties to invest in property tax administration.

Assessors Also Faced Increased Workloads

The property tax shifts and corresponding budgetary pressures came at a time of significant increases in the workload of county assessors. During the past eight to ten years, California has experienced a period of flat or declining property values. As a result, assessors have been flooded with requests for downward assessments and appeals of assessed values. Fivefold increases in the number of appeals during this period were not uncommon. Hundreds of thousands of parcels received reductions in their assessed value.

The property tax shifts in conjunction with increased workload for assessors resulted in significant stress on the property tax administration system. In many cases, appeals went undefended, downward assessments were not granted automatically according to law, and changes in ownership and new construction were not entered onto the property tax rolls in a timely fashion. Moreover, legally required audits were not performed on time. In general, assessors struggled to maintain good assessment practices, efficiently run operations, and conform with the laws governing property tax administration.

LEGISLATIVE RESPONSE

The Legislature has recognized the state interest in the property tax and the inappropriate fiscal incentives faced by counties to invest in property tax administration. The Legislature has acted on several occasions to ease the financial burden on counties of administering the property tax. Figure 2 highlights the recent major legislative actions with respect to property tax administration.

Figure 2

Recent Major Legislative Actions On Property Tax Administration

Year	Legislation	Action
1990	Chapter 466 (SB 2557, Maddy)	Allowed counties to charge other local entities, including schools, for pro rata share of property tax administration.
1991	Chapter 75 (SB 75, Maddy) and Chapter 282 (SB 282, L. Greene)	Repealed provision allowing counties to charge schools.
1992	Chapter 697 (SB 1559)	Allowed counties to charge schools for the share of property tax administration costs associated with property tax shift. (Repealed by Chapter 66, Statutes of 1993.)
1994	Chapter 139 (SB 2120, Budget and Fiscal Review Committee)	$25 million in grants to counties for property tax administration included in the 1994-95 budget agreement.
1995	Chapter 915 (AB 818, Vasconcellos)	Created property administration tax loan program, making $60 million in forgivable loans available to counties each year for three years for property tax administration.
1996	Chapter 1073 (AB 1055, Caldera)	Allowed counties to charge non-school local entities for their pro rata share of defending property tax appeals.

Recent Laws Improve Incentives

Share of Costs Paid by Non-School Local Entities. Among the most significant legislative actions taken to improve the fiscal incentives faced by counties was Chapter 466, Statutes of 1990 (SB 2557, Maddy). This bill allowed the counties to charge other local entities for their proportionate share of the costs of administering the property tax. Originally, a provision allowing counties to charge schools was included in the legislation. Schools, however, argued that the state was the primary beneficiary of increased property tax revenues and that funding for educational purposes was being compromised by the need to pay for property tax administration. As a result, the provision allowing counties to charge schools was removed one year after enactment.

By reducing the share of administration costs paid by the counties, Chapter 466 reduced the disincentives counties faced. Counties were, however, still responsible for paying the school share. Consequently, they continued to face a disincentive to invest appropriately in property tax administration, albeit to a lesser extent.

Share of Appeals Costs. A bill conceptually similar to Chapter 466, Chapter 1073, Statutes of 1996 (AB 1055, Caldera), allowed counties to charge nonschool local entities for their proportionate share of the costs of property tax appeals. This bill recognized that the same county-level disincentives apply in the case of property tax appeals, which comprise a significant part of assessors' workload and can result in substantial reductions in property taxes collected. Although this bill improved the incentive structure, the disincentive to invest adequately in defending appeals remains because the counties must still pay the state/school share of appeals costs.

Property Tax Administration Loan Program

Recognizing the financial strain placed on counties by the property tax shifts, the significant increase in workload, and the disproportionate share of property tax administration costs that counties pay, the Legislature and the Governor included a program in the 1994-95 budget agreement to ease this financial burden. Specifically, $25 million in grants for property tax administration was made available to counties. The grant program, however, lasted for only one year.

In 1995, the Legislature and the Governor created the property tax administration loan program. This program makes available $60 million in loans to counties for property tax administration. Loan funds are issued based on contracts between local assessors and the Department of Finance. In 1995-96, 40 counties applied for and were granted loans by the state totaling $48 million dollars. Based on reports from the participating counties, we estimate that the expenditure of these loan funds has generated in excess of $100 million in new revenue for schools and other local entities and prevented the loss of an additional $100 million.

Loans Forgiven. Under the terms of the program, the loan funds may be forgiven if the assessor can demonstrate that the activities financed with the loan produced sufficient new revenue for the schools (and therefore the state) to offset the amount of the loan. For example, if an assessor borrows $5 million under the terms of the loan program, but can demonstrate that $5 million in new revenues were generated for schools, the loan will be forgiven. Similarly, the loan funds may be used for non-financial purposes that contribute to a fair and efficient operation of the property tax system, but the assessor must demonstrate that the activities agreed to in the contract were carried out and that the benefits promised were in fact produced. It is likely that the Department of Finance will forgive all of the loans made in 1995-96, and in future years as well.

How Well Is the Loan Program Working?

The property tax administration loan program serves several valuable goals. First, it helps to strengthen the property tax administration system to make it more fair and efficient. Loan funds are used to process downward assessments of properties that have declined in value and to complete legally required audits. Second, the loan program also generates additional property tax revenues that benefit local governments and the state. Loan funds are used to process backlogs of new construction and other roll updates and to pay the costs of property tax appeals that would otherwise go undefended.

Is the Loan Program the Best Long-Term Solution? In general, the loan program appears to be achieving its goals. However, the loan program may not be the most effective mechanism for ensuring the long term viability of the property tax administration system. While the loan program does infuse additional resources into the system, it does not alter the underlying disincentives faced by the counties. The level of funding for an assessor's office is not necessarily determined according to need or return on investment, but rather by available state resources. Additionally, the loan program was intended as a temporary solution. It was created for a limited term of three years (ending in 1997-98).

The loan program also places the state in the cumbersome position of annually reviewing and renewing contracts with up to 58 counties. In addition, the Department of Finance must evaluate the performance of each participating county in order to determine if the county has complied with the terms of the contract. More importantly, the loan program places the state in the difficult position of determining the types of expenditures and activities that are acceptable for local assessors. While assessors still determine their own budget priorities, they must seek approval from the state before they can use loan funds for a specific purpose.

Improving the Incentives

In order to ensure adequate funding for the property tax system and to ensure that counties face incentives to invest at the appropriate level, we propose that the state assume a larger role in paying for the property tax administration system. Rather than have the state contribute a fixed amount for property tax administration, as is currently the case with the property tax loan program, we propose to have the state pay its pro rata share of all *future* property tax administration costs. Under this system, *increases* in property tax administration costs would be paid for by *all* of the entities benefiting from property taxes, according to their share of revenues from that system.

The resulting financing structure would provide an incentive for counties to invest an appropriate amount in the property tax administration system. Counties—*as well as other entities*—would pay only the share of additional or increased costs associated with their share of benefits to be generated. Counties would, therefore, have an incentive to spend more if benefits are expected and to spend less if no additional benefits are expected from increased expenditures.

Current Expenditures Would Continue to Be Paid by Locals. Under this system, current expenditures (about $450 million) would be paid according to existing sharing ratios—about 70 percent counties and 30 percent cities, special districts, and redevelopment agencies. (The level of current expenditures or "base year" level could be adjusted or reduced to account for property tax administration loan funds.) While the counties would still pay a "disproportionate" share of the costs in the base, these costs can be considered as "fixed costs" for the system. In other words, the fact that the counties pay these costs will not affect their future decisions about whether to change the overall level of funding for the system. The increased or marginal costs would be shared among all the taxing entities, providing appropriate incentives to invest more or less, as indicated by local circumstances.

The State's Contribution

Unlike the system created by Chapter 466, the state / schools would not be responsible for paying a share of costs in the base, but rather would pay a share of the increases over this base. The amount of the state's fiscal commitment would depend on the rate of increase in property tax administration costs. If these costs increase by 5 percent annually—approximately the recent rate of increase—total costs for the system would grow by about $20 million annually. The state would be billed for about half—or $10 million—of this increase.

Would Costs Be Controlled? Although the state would not directly control spending on property tax administration by counties, the state could be assured that costs would be controlled and increases in spending justified. Because the counties would pay their own pro rata share of these cost increases, the state's costs would only increase if the counties' costs increased as well. Because the counties would be investing their own, scarce resources along with the state's, local boards of supervisors would not invest more in property tax administration unless they expected to earn a reasonable "return" on their investment. Finally, the state would need to annually appropriate funds for this purpose. If costs seemed to be increasing excessively, the state could investigate the causes of the costs increases and evaluate whether the program was providing the anticipated benefits.

Should the Schools Pay a Share?

While the state is the beneficiary of increases in property tax revenue under most circumstances, schools benefit from such increases under Proposition 98's Test 1. This is because under that test increases in property taxes do not reduce the required state contribution for education. These increases do, however, increase the overall level of funding for schools. In addition, some school districts receive all of their funding from property taxes, except for a minor contribution from the state. These school districts are called "basic aid" districts because they receive only a "basic" contribution of $120 per student from the state. Overall funding for such basic aid districts increases as property taxes increase.

Another important consideration is the increasing share of state General Fund resources devoted to education. During the past several years, property tax receipts have not increased as rapidly as the school funding level guaranteed by Proposition 98. As a result, the *share* of state resources going to education has increased significantly. In 1993-94, schools received about 37 percent of state General Fund revenues. In 1996-97, schools are expected to receive nearly 41 percent, and this amount is expected to increase again in 1997-98. The increasing share of state resources devoted to education places pressure on other important areas of the state budget, which are funded with the resources remaining after schools are funded.

For all the above reasons, the schools do have a stake in the administration of the property tax and should pay a share of these costs. However, one of the key issues in implementation of our proposal would be determining the appropriate share of costs to be borne by the schools.

CONCLUSION

An increased state role in property tax administration would allow assessors to continue to improve the property tax administration system and carry out their constitutional responsibilities in this regard. Our proposal would create the right incentives to encourage counties to invest in property tax administration and would allow the budget for the property tax administration function to expand or contract to respond to needs as they arise. This improved incentive structure could be achieved without the need for a significant new commitment of state resources.