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Does State Tax Policy Discourage Housing Production?

Authors
Patrick Atwater, Senior Research Analyst, California Forward
Sarah Karlinsky, Senior Advisor, SPUR
Jennifer Lovett, Associate Director of Public Policy, California Forward
Fred Silva, Director of Public Policy, California Forward

SPUR

CAFWD

Introduction

California is in the midst of a housing crisis. The primary driver of this crisis is the fact that the state has failed to produce enough housing for those who want to live here. This shortage threatens California's diversity and economy while impacting the lives of millions of Californians who spend far too much of their income on housing, leaving little left over for the other needs of daily living.

Why does California fail to produce enough housing? The answer to this question is complex. Part of the challenge lies with a governance system that gives local jurisdictions the power to decide what gets built and where and with a complex regulatory system that was built on good intentions but has the unfortunate consequence of impeding housing production. Both of these factors are coupled with an insufficient supply of construction labor, driving up costs.

More recently, the COVID-19 crisis has slowed housing construction and put tremendous pressure on local government finances. California's last several recessions have seen substantial changes in the state-local financial system, highlighting a potential policy window for reform.

With that context, this policy brief examines one contributing factor to the housing crisis: California's tax policies. Each jurisdiction relies on a combination of taxes, including property taxes, sales taxes and business taxes, to cover expenses. They may seek to maximize certain types of revenue, such as sales taxes, by changing their zoning to encourage "rateables," i.e., developments that produce sales tax revenue, such as big-box retail. And they may try to minimize expenditures by minimizing housing production (which adds residents and creates demand for services such as parks and libraries).

Currently, many local jurisdictions view housing as less fiscally beneficial (or even detrimental) to their fiscal health. Proposition 13,[1] which passed in 1978, caps property tax rates at 1% of the assessed value in the base year (typically the year the property was purchased) and limits property tax increases to 2% per year (plus other taxes that have been approved by voters). Additionally, a complex statutory system distributes the property tax to cities and other public agencies within each county. This system limits how much local jurisdictions can rely on property taxes to fund services.

The mix of local city tax revenues matters to development choices. For example, a city that has a small share of the property tax may have a higher reliance on the sales tax since it can control the amount of retail development allowed within its boundaries. This situation creates a fiscal stew that often means little interest in the development of housing and greater interest in retail development, since local jurisdictions are able to retain some of their sales tax revenue.[2]

SPUR and California Forward have partnered to review the relative reliance of the Bay Area's 101 cites on property tax versus sales tax and to test the question of whether those cites with a low share of the property tax would have an incentive to produce more housing if their share of the property tax was increased. We then provide some policy options for reducing the fiscal incentives for jurisdictions to avoid zoning for housing.

[1] https://lao.ca.gov/publications/report/3497

[2] https://lao.ca.gov/2007/sales_tax/sales_tax_012407.pdf

We ask three sets of questions:

1. **What drives the tax base of the cities of the Bay Area and how does the resource base vary from city to city?**

To answer these questions, we reviewed how property tax reliance differs from city to city based on the proportion of the property tax to other taxes such as the sales tax.

2. **How does housing production relate to the reliance on property taxes?**

Cities with a low share of the property tax have little fiscal incentive to approve housing. We examine housing production in Bay Area cities to show how much housing cities produced compared to their reliance on property tax revenue, understanding that there are many other factors that go into a community's decision to approve more housing.

3. **What are the tax and policy changes needed to make housing a fiscal positive for cities?**

If we want cities to change their zoning to allow more housing, what tax and policy changes need to be made? What are the principles that should guide these changes?

What drives the tax bases of Bay Area cities?

Cities derive revenues largely from three sources: property tax, sales tax and other taxes including hotel taxes, utility taxes and business taxes. We focus our analysis on property taxes and sales taxes.

Property Taxes

Property tax represents about 30% of municipal budgets in the Bay Area. These taxes on land and buildings are paid annually and collected by the county. A state statutory system dictates how property taxes are allocated within the county. The allocation that each city receives is based on the share of the property tax that each agency levied in tax rates prior to Prop. 13. Those cities that had higher tax rates before Prop. 13 receive a larger share of the post-Proposition 13 property tax revenues.

The share of the property tax that a city receives varies widely. For example, the city of Hercules receives 3.5% of the property taxes it generates, the city of Berkeley receives 35% of its property taxes and San Francisco receives 62% of its property taxes as a consolidated city and county. See Appendix A for a more detailed comparison among the Bay Area cities.

FIGURE 1.

Allocation Bay Area Cities Receive of the Property Tax They Generate

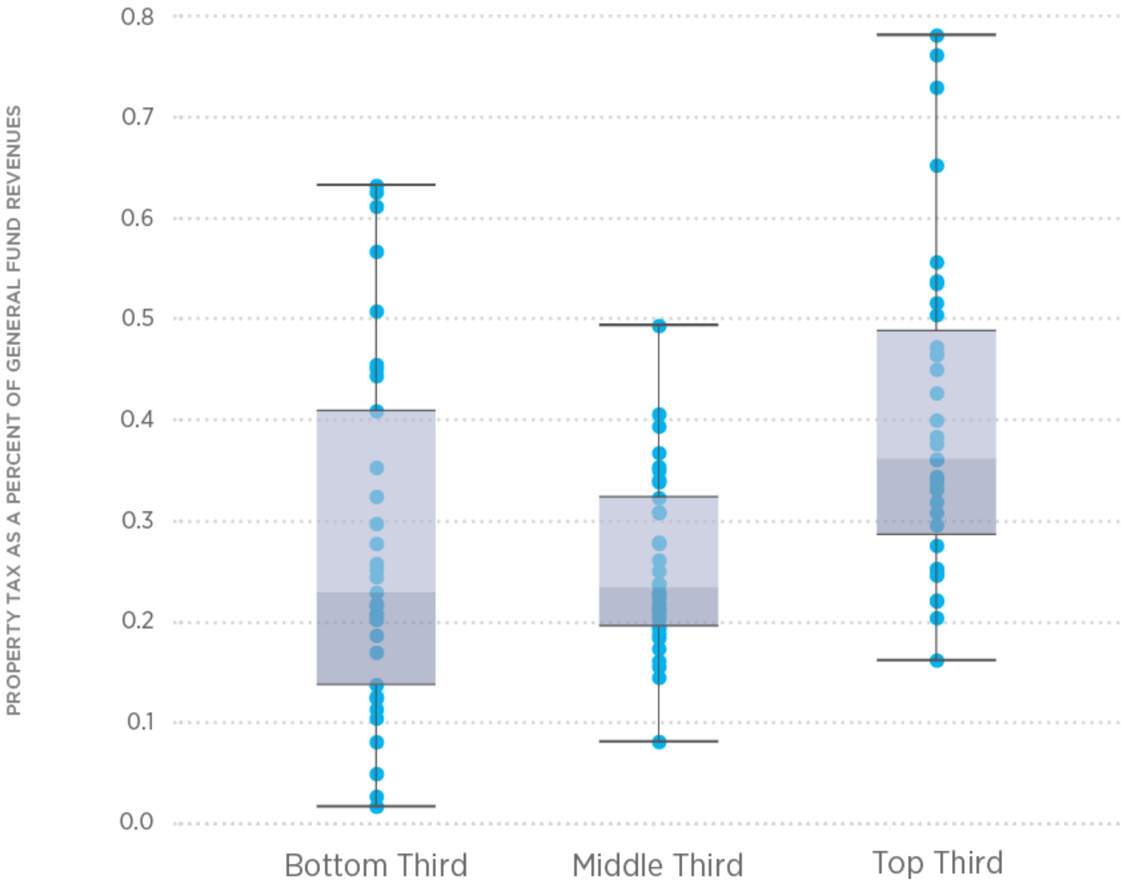
	CITIES (FOR FULL LIST, PLEASE SEE APPENDIX A)	PERCENT SHARE OF PROPERTY TAX
BOTTOM THIRD	Foster City, Emeryville, Pleasant Hill, Lafayette, Santa Clara, Palo Alto	0-9.27%
MIDDLE THIRD	Milpitas, Walnut Creek, San Jose, Fremont, San Mateo	9.49-14.03%
TOP THIRD	Hayward, Redwood City, Oakland, East Palo Alto, American Canyon	14.08%-31.44%
COMBINED CITY AND COUNTY	San Francisco	61.97%

Source: California Building Industry Association for residential construction data and the California State Controller's Office for the local government finance data. Analysis by California Forward.

For the purpose of this analysis, we have grouped Bay Area cities into thirds. The bottom third are those cities that receive the lowest percent share of the property taxes that they generate. The top third are those cities that receive the highest share. Because San Francisco is both a city and a county, it is treated separately from the rest of the analysis.

FIGURE 2.

Property Tax as a Percent of General Fund Revenues



Source: California Building Industry Association for residential construction data and the California State Controller's Office for the local government finance data. Analysis by California Forward.

Figure 2 uses the same groupings as Figure 1. For each third, we analyzed what percentage of the general fund is funded by property tax. The line where the dark grey and the light grey meet is the median value and the box bounding the light grey and dark grey represent the 25th to 75th percentiles. Each dot represents one city.

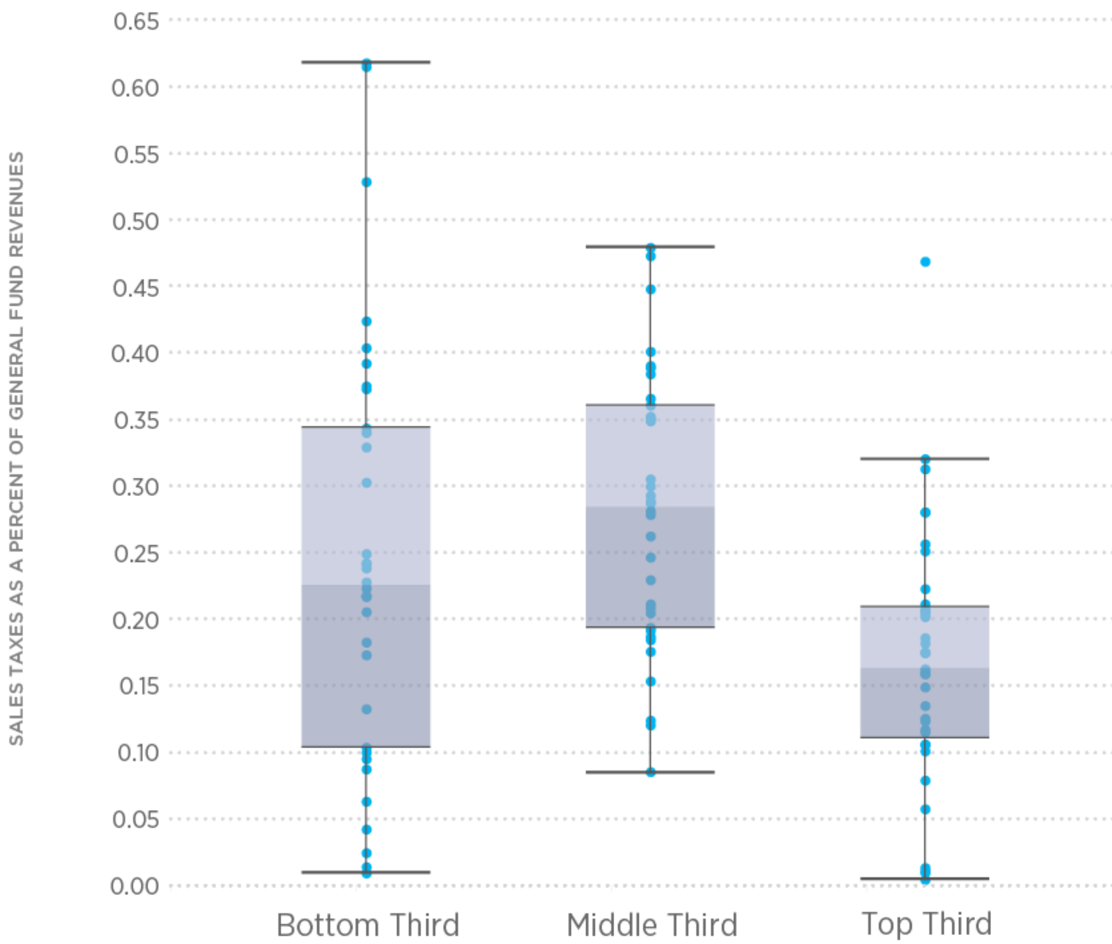
This analysis shows that those cities that receive the highest share of the property taxes they generate also rely more on property taxes to fill their general funds, whereas those in the middle third and bottom third of cities rely less on property taxes to fund general fund revenue.

Sales taxes

Sales taxes are charged on material products and personal property, including everything from furniture to clothing to toilet paper. Local governments may raise their sales tax rates above the state sales tax rate to support their general funds, pay for public transit investments and for other uses.

FIGURE 3.

Sales Tax as a Percent of General Fund Revenues



Source: California Building Industry Association for residential construction data and the California State Controller's Office for the local government finance data. Analysis by California Forward.

Figure 3 uses the same groupings as Figures 1 and 2. This figure shows reliance on sales tax revenue relative to the amount of property tax received by the jurisdiction. Those cities that receive less property tax (i.e., those that are in the bottom third and middle third) in general rely more on sales tax as a percentage of their general fund revenues than those who receive the most property tax revenues.

How does housing production relate to reliance on a particular revenue source?

The mix of local tax revenues has an important impact on a city's development choices. A city may receive a small share of the property tax, leading to a higher reliance on the sales tax. Furthermore, unlike commercial land uses that generate high-revenue sales taxes as well as property taxes, residential property will only generate property taxes and some lower-revenue taxes, such as property transfer taxes and utility user taxes, creating additional disincentives to allow more housing.

The picture is further complicated by the existence of special districts. Cities may receive property taxes from housing but not have to pay themselves for certain services if those services are provided by special districts. For example, a community's fire protection service may be provided by a fire district, such as the San Ramon Valley Fire Protection District in Contra Costa County which provides fire and emergency services for an area that includes the City of San Ramon, the Town of Danville and several other unincorporated communities. Services provided by a special district are funded by a share of the county's property tax revenue, as opposed to drawing from a city's general fund, so that the city's reliance on the property tax may be reduced, along with the incentive to develop additional housing.

In order to understand the relationship between housing production and taxation, SPUR and California Forward asked: Do cities with a low share of the property tax produce less housing than cities with a high share of property tax?

Appendix A shows the share of the allocated property tax to the 101 Bay Area cities,[3] the comparative reliance between the property tax and the sales tax and the number of building permits for single- and multi-family housing issued from 2015–2018.[4]

Figure 4 uses the same groupings as the previous figures. The analysis finds that cities with a larger share of the property tax contributed a larger share of the housing supply in the Bay Area over the four-year period.

[3] Suisun City is omitted from this analysis due to data gaps in the State Controller's Office and CIRB information.

[4] A more robust analysis would be to look at the marginal tax revenue accrued to each city from a new single-family residence or multi-family project rather than the average historical property tax share. That is beyond the scope of this preliminary analysis. For further detail on the complexity of California's local government tax system, please see the excellent http://www.californiacityfinance.com/

FIGURE 4.

Housing Production Relative to the Amount of Property Tax a City Receives

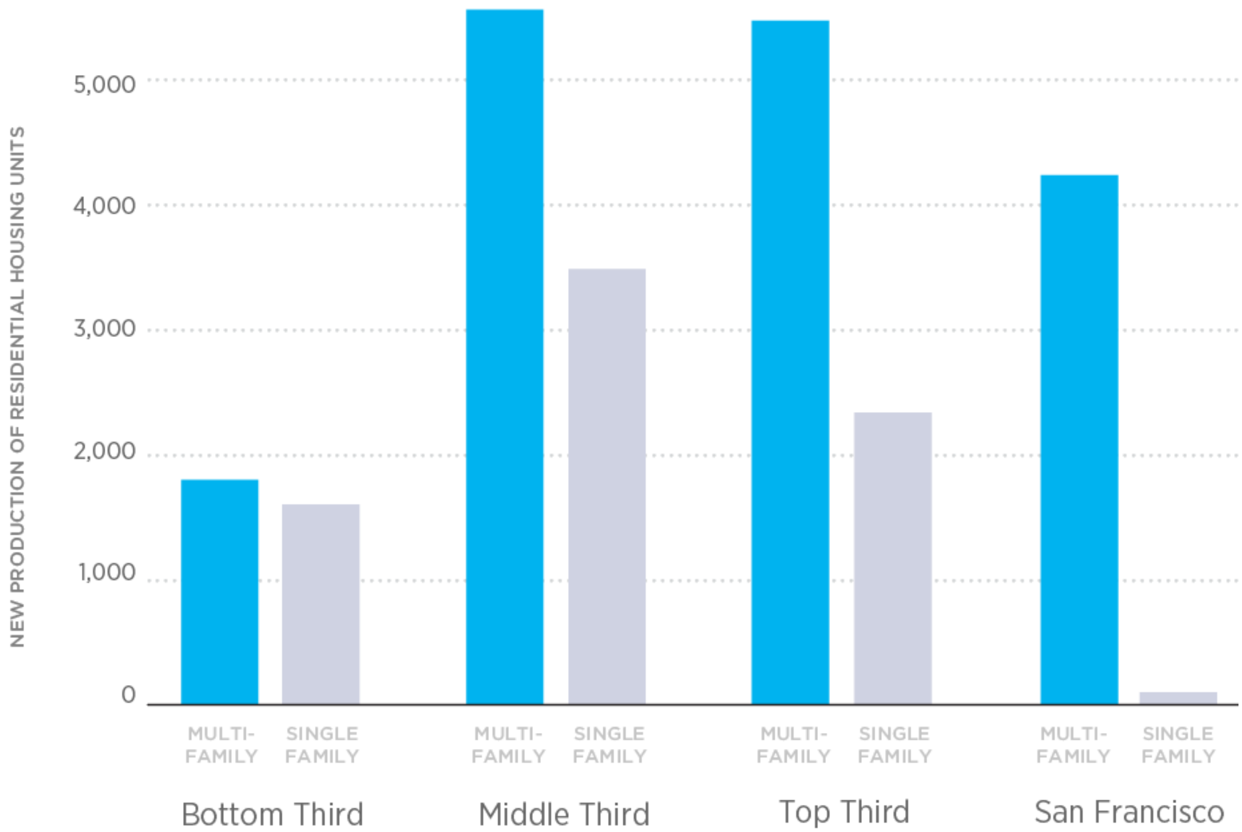
	# OF CITIES	SINGLE FAMILY	MULTI FAMILY	TOTAL RESIDENTIAL UNITS	PERCENT OF TOTAL RESIDENTIAL UNITS
BOTTOM THIRD	33	1597	1801.5	3398.5	13.94%
MIDDLE THIRD	33	3465.25	5544.75	9010	36.96%
TOP THIRD	33	2256	5380.5	7636.5	31.33%
SAN FRANCISCO	1	83.5	4246	4329.5	17.76%

Source: California Building Industry Association for residential construction data and the California State Controller's Office for the local government finance data. Analysis by California Forward.

Figure 5 shows the average amount of single- and multi-family housing produced each year over the four-year period for the same groupings. We also found some distinctions by geography. North Bay cities have a relatively higher share of the property tax and less housing production. Santa Clara County cities tend to have a lower share of the property tax than the North Bay and higher housing production.

FIGURE 5.

Multi-Family and Single-Family Housing Production Relative to the Amount of Property Tax a City Receives



Source: California Building Industry Association for residential construction data and the California State Controller's Office for the local government finance data. Analysis by California Forward.

The two thirds of Bay Area cities that retain more property tax are also the cities that produce the most housing. There can be many reasons for this correlation, not all of them related to fiscal decisions. Some cities, despite receiving a high share of the property tax, may choose not to allow more housing if their constituents oppose housing production. Others might receive a low share of the property tax but allow more housing because they have traditionally viewed themselves as bedroom communities, providing housing without many other services. However, the data indicate that fiscal pressures do play some role in driving decisions about whether or not to allow more housing.

Principles for policy options

A recent analysis by SPUR shows that the Bay Area needs to build an additional 2.2 million units between now and 2070[5] in order to meet demand and keep income inequality from becoming worse. In order to meet this goal, the Bay Area would need to double its housing supply from roughly 20,000 units a year (before the COVID-19 pandemic) to 45,000 units a year. To the extent that fiscal policies impede the production of housing, these policies need to be addressed.

SPUR and California Forward have developed a draft set of principles to guide the development of California state tax reform. We then apply these principles to their impact on the production of housing.

1. The tax system should be fair.
Cities should be treated in an equitable manner and not receive certain property tax allocation shares based on legacy percentages. The system should support cities whose public policy goals align with regional and state values, including allowing sufficient housing, creating resources for affordable housing and discouraging sprawl development. Lastly, the tax system should not unduly subsidize long-standing homeowners at the expense of newcomers.

2. The tax system should provide adequate revenues.
The passage of Prop. 13 in 1978 created a drop in state revenues of roughly 60 percent. While local revenue in California has recovered since that point, city and county tax revenue per person remains lower than it was before the passage of Prop. 13.[6] Cities have responded to Prop. 13's limitations on property tax by changing their zoning to encourage uses they deem to be revenue-creating and passing new sales, hotel and utility taxes. Cities also began taxing new development, including new housing development, in the form of fees and requirements. Any future changes to the tax system should provide sufficient revenues for the activities of local government, so that zoning for rateables and taxing housing construction are not incentivized.

3. The tax system should not discourage housing production.
As outlined above, local governments that receive a greater share of property taxes are more likely to produce housing than those that receive a smaller share. Cities that rely more on sales tax revenue are less likely to produce housing. At the same time, the cap on assessed value as part of Prop. 13 means that if a parcel of vacant land has been owned for a long period of time, an owner does not have an incentive to put that land into active use, because the tax basis is so low. The tax system should incentivize the production of housing, not discourage it.

4. The tax system should be simple and clear.
The current state tax system is so complex that very few people understand it and tradeoffs are not clear to policymakers.[7] Jurisdictions could make better decisions if the property tax system were transparent and clear so the tradeoffs in the system could be made explicit.

[5] https://www.spur.org/publications/white-paper/2020-03-09/what-it-will-really-take-create-affordable-bay-area

[6] https://lao.ca.gov/publications/report/3497#What_Happened_to_Local_Government_Revenues_After_Proposition.A013.3F

[7] http://californiacityfinance.com/LocalReformMenu110114.pdf

Potential policy options that address some of these principles include the following:

A. Amend Prop 13 and replace it with a new property tax allocation model that is more sensitive to housing development.

As outlined above, the current tax system does not incentivize housing production. In order to support the creation of housing, the current system could be amended in a variety of ways.[8] First, sales taxes could be swapped for a greater share of property taxes to decrease reliance on sales tax and increase reliance on property tax. Other swaps could be explored, including sending more sales tax to the state in exchange for receiving a pro rata share of the state income tax.[9]

Second, property tax revenue allocations (including the Vehicle License Fee backfill[10] and the property tax allocation) could be consolidated and a new property tax allocation could be created. This property tax allocation factor could take into account principles of fairness as well as the principle of supporting public policy goals, such as housing production.

Of course, any of these changes would need to be analyzed to ensure there were no unintended consequences to housing production or other important policy values.

B. Promote regional tax sharing.

As mentioned above, many local governments choose to zone for certain uses based on the tax revenue they will generate. This creates a "race to the bottom" as local governments compete with one another for commercial uses that generate property, sales and business taxes and don't incur the same costs as residential uses (parks, police, etc.). This situation will only be exacerbated if Proposition 15, a major Prop. 13 reform effort on the November 2020 ballot, passes.

Prop. 15 eliminates the cap on assessed value at the time of sale for commercial and industrial properties, so that these properties can instead be assessed at their market value. The chief benefit of the measure is that it increases the tax revenue to the state by taxing businesses whose property tax base has been kept artificially low for decades. However, one of the unintended consequences of Prop. 15 is that without regional tax sharing, it could exacerbate the problem of cities zoning for rateables.

The current system should be replaced by one in which sales tax is collected regionally and reapportioned to jurisdictions based on a more equitable formula, such as by population.

C. Add a small increase to the Prop. 13 rate cap for infrastructure investment.

One of the challenges of the current tax system is that there are relatively few sources available to local governments to pay for infrastructure investment. After the elimination of the state redevelopment program as a tool to help pay for new community-serving infrastructure, local governments were left with few tools beyond impact fees. Adding a small increase to the Prop. 13 rate cap specifically for community investments could help address this challenge.

[8] https://www.ppic.org/content/pubs/op/OP_401FSOP.pdf

[9] https://lao.ca.gov/2007/sales_tax/sales_tax_012407.pdf

[10] http://www.mikemcmahon.info/VLFBackground.pdf

Conclusion

California's tax system is enormously complex. It is important to consider the negative consequences of the current system on housing production and to support measures that will encourage the development of badly needed housing. It is also critical to understand the fiscal pressures that local governments face today. Cities are being asked to plan for a sustainable future by promoting housing in urban areas close to transit. California's tax system should reward cities for doing the right thing. California Forward and SPUR look forward to working to support tax reforms that create a state we want to see — one where there is sufficient housing supply in cities and towns and where tax policy supports those that are doing their best to create a better California.

Appendix A

For each city in the Bay Area we analyzed: a.) the percent share that a jurisdiction retains of the property tax they generate, b.) the percent of the general fund that is funded by property taxes and c.) the percent of the general fund that is funded by sales taxes. This analysis is available online at:

spur.org/housing-and-property-taxes

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