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DID *SERRANO* CAUSE PROPOSITION 13?**

WILLIAM A. FISCHEL*

ABSTRACT

Proposition 13 gutted California's property tax system in 1978. Most people think that the tax-revolt initiative was caused by excessive government spending and rising tax burdens on homeowners. I argue that the California Supreme Court's landmark decision, Serrano v. Priest (1971), crippled the Tiebout system by divorcing local property wealth from school spending. Serrano *thus converted most property taxes into a deadweight loss. Voters responded by rejecting the property tax, shifting the school finance burden to the state. My explanation supports the median voter model in contrast to Leviathan theories of state and local government.*

1. *Serrano* and Proposition 13 Are Related Events.

ON August 30, 1971, the California Supreme Court ruled in Serrano v. Priest (96 Cal. Rptr. 601) that reliance on local property taxes to finance public schools was unconstitutional because of the wide disparities in taxable property among school districts. Reliance on local resources was held to violate the equal protection clause of the California and U.S. Constitutions because it made children's educational opportunities dependent on the wealth of the community in which they were located. This landmark decision presaged similar rulings in several other states. Attempts to make it a federal issue were not successful, but the U.S. Supreme Court did not prohibit the state courts from exercising this expansive view of their own constitutions (San Antonio Independent School District v. Rodriguez, 411 U.S. 1 [1973]).

The California court in 1971 declined to order a specific remedy for reliance on local property taxes, though it suggested, among other approaches, district power equalization, which would allow rich and poor communities to generate the same tax revenues for a given local rate (Coons, Clune and Sugarman, 1970). In an attempt to comply with the court's ruling, the state legislature adopted a new school-aid formula that added funds to a previous program so that poor districts got proportionately more money. The state also imposed revenue limits on local districts in 1972 with the intention of holding the wealthy ones down by not allowing them to adjust as rapidly for inflation. Districts could, however, override the limits by local referenda, and about forty percent of 580 override referenda succeeded (Dynarski et al. 1989, p. 252).

In a subsequent decision (*Serrano II*), the California Supreme Court concluded that the revised formula did not go far enough. The court instead required the legislature to assure that state plus local spending, excluding a few categories such as aid to handicapped students, should vary by no more than $100 per pupil across districts (Serrano v. Priest, 135 Cal. Rptr. 345 [Dec. 30, 1976]). The court did not prescribe the $100 range as the sole remedy, but it became the litmus for compliance (Post 1979, p. 384), and, as the judge in *Serrano III* (226 Cal. Rptr. 584 [1986]) noted, other acceptable remedies did not differ much from this standard. The sophisticated district power equalization approach was discarded in favor of the easily-monitored $100 standard, though the court did permit the state to index the $100 for inflation. A law signed by the governor in September 1977, which was to take effect July 1, 1978, attempted to comply with the $100 range. It placed more severe limits on wealthy districts' spending, and it took some of the property taxes raised in those districts and transferred them to the state for distribution to the poorer districts (AB 65, Chap. 894).

In June, 1978, on the eve of the implementation of the legislature's response to *Serrano II*, California voters endorsed by a 2-1 margin a statewide ballot initiative

*Dartmouth College, Hanover, NH 03755.

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called Proposition 13. Its intended and actual effect was a substantial reduction in local property tax burdens across the state. Prop 13 mandated a rollback in assessments to 1975 levels with reassessment only upon sale, except for a two percent annual increase; it permanently reduced tax rates to one percent of market value, well below the average at the time; and it imposed a politically insurmountable barrier on adopting alternative local taxes. It also forbade any statewide property taxes. The importance of this fiscal revolution is suggested by the thickness of the special issue of this *Journal* devoted to it in June, 1979.

Proposition 13 was a state constitutional amendment, so the California court could not dismiss it on the grounds that it impeded the state's response to the court's orders in *Serrano II*. But the vote did not vacate *Serrano*. Instead of implementing its 1977 plan, the legislature devoted most of its accumulated budget surplus and, later, general revenues, to supplementing school expenditures in poorer districts, leaving the richer districts to make do, for the most part, with the greatly reduced local property taxes allowed under Prop 13. This levelling remedy was later upheld by an appellate court (*Serrano III*, 226 Cal. Rptr. 584 [Cal. App. 2 Dist. 1986], which describes the events at pp. 591–5).

2. Overspending Is a Questionable Cause of Proposition 13.

Several explanations for the passage of Proposition 13 have been put forth by economists. The most enduring was first advanced by William Oakland (1979). His analysis indicated that California legislators and administrators simply spent more than was demanded by the public, when compared to spending in other states. A voter initiative, which is less subject to the political pressures of special interests such as teachers' unions, was regarded as a way of correcting the excess. (Oakland mentioned the hypothesis of the present paper in footnote 17 of his paper, but he did not develop it.)

Oakland also suggested (pp. 394–95) that the state's growing budget surplus played a role in making the initiative attractive to voters. The surplus did mitigate the loss of revenue caused by Prop 13 for a year or two after its passage. However, Sears and Citrin, who exhaustively examined the public debate, concluded that the surplus was not a factor in the campaign to pass the initiative (1985, p. 32).

Another explanation focuses on the increases in property tax assessments that occurred because of rapidly inflating house prices in the 1970s. Stories of homeowner tax bills doubling and trebling overnight were commonplace, and Oakland (1979) shows that homeowners in particular suffered large increases in tax burdens. This begs the question of why local tax rates were not reduced to finance the same amount of spending. As Wallace Oates (1979) observed, if rising assessments were a general phenomenon and local spending were not also increasing, tax rates would have been cut so that tax bills would have stayed the same. I thus regard the rising-assessment explanation as another manifestation of the overspending hypothesis. There was, however, a shift in the burden of taxation from commercial property to homeowners in the middle 1970s, which, it must be conceded, must have independently contributed to a popular perception of overtaxation.

One question that the overspending hypothesis raises is how politicians could have spent so much more than voters wanted. Geoffrey Brennan and James Buchanan (1979) answered that voters were not influential in public spending decisions, and that a constitutional limitation such as Prop 13 was necessary to discipline the Leviathan of government. A dissertation by Thomas Downes (1988) found evidence for their interpretation. He discovered that the distribution of educational achievement was not altered by *Serrano* and Prop 13. The reason, he submitted, was that school districts reallocated their tighter budgets away from administrative activities and towards the classroom services that voters presumably desire. Downes thus regarded the initiative as having brought overspend-

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ing bureaucrats under control, which, he notes, supports Brennan and Buchanan's view. This interpretation challenges the median voter theory, which holds that all public decisions may be modelled as if they were voted on by a referendum. The median voter model implies that plebiscites in general should not be necessary.

Downes's evidence is subject to qualification. Dynarski, Schwab and Zampelli (1989) found that the distribution of 1980 test scores in California was largely accounted for by the social and economic characteristics of the households that comprised the school district. (Downes did account for some such characteristics, and Dynarski et al. did not test Downes's budget reallocation theory of Prop 13.) More important is that while *Serrano* and Prop 13 did not alter the *distribution* of scores, some evidence suggests that the overall *level* of education in California fell relative to the rest of the nation. Once among the leading states in primary and secondary education expenditures per pupil in the late 1960s, California now ranks below the national average. The decline in school spending, which was under way before Proposition 13, has paralleled a drop in measures of scholastic achievement. Between 1972 and 1980, California SAT scores dropped 40.5 points, compared to a drop of 23.5 points for the nation (New York Times, 19 Oct. 1982, p. C1). The combination of *Seranno* and Prop 13 seems to have cut meat along with the fat, contrary to notion that *Serrano* had no effect and Prop 13 just brought bureaucrats under control.

The overspending-bureaucracy explanation leaves two important questions unanswered. First, why was Prop 13 a statewide initiative? Citizens of all California municipalities can easily propose local initiatives; the median voter necessarily prevails in such a situation. If too much spending and excessive local taxes were the reasons for Prop 13, there should have been many local initiatives to redirect spending and to limit local taxes rather than a statewide vote. Histories of Prop 13 do not mention local initiatives as precursors.

Second, why did Prop 13 succeed when the Watson initiatives of 1968 and 1972, which would also have cut property taxes across the state, had failed by 2-1 margins? (In each of the initiatives, the legislature had placed on the ballot a moderate substitute measure, and these had prevailed until Prop 13 [Sears and Citrin 1985, chap. 2].) It is hard to believe that California officials had in less than a decade gone from responsive public servants to minions of Leviathan. Something had changed the political climate in six years. The most important new event, I submit, was the *Serrano* decision.

My hypothesis is that Proposition 13 was a rational response by voters who were faced with the implementation of *Serrano*. In the absence of the court's equalizing remedy, a vote for Prop 13 would have been irrational for voters in more affluent communities; they would have been eliminating a system that provided net benefits to them, in that they got good schools without having to pay, through increased statewide taxation, for the schooling of people in poorer areas. After *Serrano*, however, this argument no longer applied, since the court had by stages required equal spending per pupil, regardless of the source of the taxes. As a result, a large constituency that might have opposed Prop 13 was indifferent to or favored its passage. In this sense, *Serrano* caused Prop 13.

3. The Tiebout Hypothesis and Rosen's Regression Suggest that *Serrano* Was the Cause.

3.1. *The Operation of the Tiebout System Favors Wealthy Communities.*

A system of local financing of public goods provides the backdrop for the Tiebout hypothesis, which is the cornerstone of local public economics. Charles Tiebout (1956) argued that the free rider problem endemic to national public goods could be overcome for local public goods. Communities could establish different mixes and levels of local services, and people would "vote with their feet" to choose the optimal bundle. Bruce Hamilton (1975) has

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shown that Tiebout's system, in combination with local property taxation and local zoning standards that establish minimum housing consumption, provides for an efficient level of congestable public goods such as schools. In the Tiebout-Hamilton system, the property tax becomes essentially a fee for services and so has no deadweight loss. A consequence of the sorting of households by demand for public education, which is the major local expenditure, is that there will be substantial variations in fiscal burdens and in spending per pupil among districts according to demand and income.

The Tiebout system would be favored by those communities to whose advantage it is to maintain differences in educational expenditures and property tax base, at least when compared to a system that provided a uniform level of services financed by a proportional state income tax. Such communities include those with a higher-than-average demand for education (functionally represented by family income) and those with higher-than-average taxable wealth per pupil. I will call these the wealthy communities, although the two categories are not perfectly correlated, because some poor communities have a large commercial tax base or unusual demand for education.

A predictable consequence of Prop 13 was to reduce variations in the property tax and to shift the burden of educational finance to the state. Both of these should have been perceived as harmful by residents of the wealthy communities that benefitted from the Tiebout system. As a result, homes in wealthy communities should have been less desirable after Prop 13 than before. The elimination of the Tiebout system in California and its replacement by a system requiring equal spending per pupil should have been capitalized in property values, with *poorer* communities gaining and the wealthy ones losing, other things being equal.

3.2. *Rosen's Regressions Are Not Consistent with the Tiebout Model.*

A study by Kenneth Rosen (1982) of San Francisco area communities shows that all of them experienced considerable increases in residential property values after Prop 13 was passed. Rosen regressed average property tax reductions in sixty-four communities on the corresponding changes in average single-family home values, with the period of change being six months before and after the vote on Prop 13. His property tax reduction variable was significant, indicating that the larger the property tax reduction, the more the increase in home values, other things held equal.

Among his control variables, Rosen included median income, whose influence on property value increases was positive though not significant ($t = 1.34$). He included income to account for general economic conditions and tastes, but this is questionable, given that he is explaining *changes* in property values rather than their level. A more persuasive role for income is to determine if there was any systematic benefit or cost imposed on higher income communities by Prop 13. His results show that wealthy communities gained at least as much as poor ones, even after the magnitude of the tax cut is controlled for.

There is other evidence for this. Polls showed that, while Prop 13 enjoyed majorities in all income classes, the largest majorities were in the highest brackets (Sears and Citrin 1985, p. 98). Rich people and rich communities are not perfectly correlated, but some overlap is fundamental to both the Tiebout hypothesis and the *Serrano* argument. As a further illustration, Rosen's data show by my calculation that the communities whose home values exceeded his sample's median ($73,000) just before Prop 13 had unweighted capital gains averaging 21.6 percent. Those below the median gained only 15.1 percent. The largest and poorest city in the sample, Oakland, gained two percent. The richest community, Hillsborough, gained 38.7 percent in 1978.

Rosen's finding that wealthier communities experienced the same or higher capital gains from Prop 13 is contrary to what we would expect from even a loose approximation of the Tiebout model. If the Bay Area had been in Tiebout-Hamilton

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equilibrium prior to Prop 13 (meaning that households had sorted themselves into jurisdictions that provided the housing and schools they demanded), wealthy communities should have had smaller property value increases than other communities. As a result, income should have had a significant *negative* effect in Rosen's regression, rich people should have opposed Prop 13, and communities with higher-than-average home values should have had smaller increases or even reductions in value after the vote.

There are three explanations for the apparent lack of a Tiebout-Hamilton equilibrium prior to Prop 13. One is that the Tiebout model did not apply to the communities in Rosen's sample even prior to *Serrano* or Prop 13. This seems unlikely. The San Francisco Bay area is a paradigm of the fragmented metropolitan government that is regarded as the ideal setting for the Tiebout model. The fiscal zoning techniques that Hamilton (1975) showed are necessary to achieve an efficient equilibrium in the Tiebout model were perfected in California, whose courts are famous for their deference to local government in zoning decisions, if not in school finance. Some empirical evidence supporting the Tiebout model employs pre-*Serrano* data for California communities (McDougal 1976 [Los Angeles area]; Sonstelie and Portney 1980a [San Francisco area]).

A second explanation is one suggested by Rosen. Immediately after Prop 13 passed, the state government provided revenue from its accumulated surplus that replaced ninety percent of lost local revenues. Thus high-spending districts were left with nearly the same mix of services they had prior to Prop 13, and any adverse effects on the Tiebout model were at least temporarily removed.

The problem with Rosen's explanation is that Prop 13 did not vacate the court's *Serrano* decision. The state had eventually to correct the inequalities in school spending that were the basis of the court's decision, and thus rich communities would eventually have to comply with *Serrano II's* spending limitations. The state's surplus was good for only a partial and temporary bailout of local government (Post 1979), and the *Serrano III* decision notes that the bailout formula gave proportionately more to the poor than to the rich communities. Thus only if real estate markets are myopic would Rosen's replacement explanation be valid.

3.3. The Serrano *Explanation Works Better, as Long as Voters Are Rational.*

The third explanation for Rosen's anomaly, which is my hypothesis, is that the expected effect of *Serrano* eliminated the Tiebout-Hamilton equilibrium prior to Prop 13. If households in wealthy communities expected that *Serrano* would eliminate their fiscal advantages—which was the court's avowed purpose—they would find that the property tax was a deadweight loss to them, rather than, as under the Tiebout-Hamilton system, a virtual fee for public school services. Thus immediately prior to Prop 13, but after the *Serrano* decision, property values in wealthy communities would have fallen relative to those in other communities. (There is no evidence one way or the other on this fall, which would have been difficult to determine because of the indefinite remedy of *Serrano I* in 1971 and short period of time between the legislature's response to *Serrano II* and the passage of Prop 13.) Passage of Prop 13 would then have raised property values in the wealthy communities as much as or more than those elsewhere. Thus a constituency that would have opposed Prop 13 *prior* to *Serrano* would have found it rational to vote for Prop 13 *after* the court decision. Residents of wealthy communities and other people who benefitted from the Tiebout system would have joined with those who, for one reason or another, had always had favored lower property taxes.

My theory is indirectly supported by James Kindahl (1983). His theory of tax limitations pointed out (without reference to *Serrano* or to Rosen's evidence) that increased property values would emanate from a property tax limitation only in the absence of a Tiebout system. Under a Tiebout system, Kindahl shows that an exogenously required reduction in local taxes

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should *reduce* home values. (The net reduction comes because Kindahl assumes that private schooling is the alternative to local public spending. In the more realistic alternative of uniform state funding of public schools, poor districts should simply gain relative to the rich.) Thus if communities are in a Tiebout equilibrium, no one from a wealthy community would vote for Prop 13. Kindahl takes the success of Prop 13 as evidence against the existence of any realistic equilibrium in a Tiebout system. I take it as evidence that *Serrano* had destroyed the previous Tiebout equilibrium and that homebuyers knew it.

Economic theories of voting, on which my theory is based, assume that voters are rational. Such an assumption is contrary to the view of many scholars in other disciplines. For example, Sears and Citrin (1985) concluded that the cause of Prop 13 was that voters acted on the belief that they would get "something for nothing," which seems irrational.

In defense of rationality, it is plausible to assume that voters had enough information on which to decide. The *Serrano* decision and Prop 13 were two of the most widely discussed political events in California in the 1970s. Deacon and Shapiro (1975) showed that Californians were apparently rational, in the sense that their votes improved their economic position, when they voted on two statewide initiatives related to environmental issues in 1972. Sonstelie and Portney's (1980b) study of the city of South San Francisco suggests that voters took account of expected property value changes resulting from school tax referenda in 1970, so that even childless voters often supported school spending that increased their property's value.

Despite such evidence, the idea that voters are rational is difficult to sell even outside of California. The theory of voter rationality does not, however, hinge on voters being able to systematically calculate benefits and costs of each public program. Voters can rely on interest groups with whom they identify to guide them. The *Serrano* explanation for Prop 13's success can turn on the interest group that did not form. In the absence of *Serrano,* leaders from wealthy, high-spending school districts that would have suffered from Prop 13's fiscal constraints would have coalesced to oppose the initiative. Instead, polls showed that a disproportionate fraction of the wealthy favored Prop 13 and, in a finding that seems to have surprised Sears and Citrin (1985, p. 145), "the parents of children in the public schools were not significantly more opposed to the tax revolt than anyone else."

3.4. The Median Voter Model is Rescued from Leviathan by the Serrano *Theory.*

The overspending/overtaxing phenomenon can be reconciled with my view. A frequent complaint by California homeowners prior to Prop 13 was that their rising assessments, driven by a strong real estate market, were not accompanied by lower nominal tax rates. Why didn't local officials, who normally are responsive to voter outcry, reduce rates? The answer is that during this time (1974–78) state funds that had formerly been going to all school districts were diverted to poorer areas in an attempt to comply with *Serrano I.* In order to keep real school expenditures constant, the wealthy districts had to raise more money from the property tax, and in many cases they had to vote to override the increasingly restrictive *Serrano* spending limits. In addition, the state's aid formula identified poor districts on nominal measures of wealth. When property everywhere rose because of inflation, even poor districts got less aid (Levy 1979, p. 77). The net reduction in school aid thus contributed to the state's budget surplus. Levy mentions in passing [p. 83] that the expected cost of compliance with *Serrano* was one reason that the legislature was reluctant to reduce the surplus in 1977.

The voters in the high-spending communities saw that their local taxes were rising, but they were getting no better schools than they had before, and the legislature seemed incapable of providing relief. Hence a large number of voters who had formerly been satisfied with the system of local taxation (for Tiebout reasons) favored its effective abolition by Prop 13.

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The beneficiaries of the state's response to *Serrano* resided in poor districts. Because *Serrano* promised to improve their schools regardless of what tax system was employed, voters in poor districts did not form a coalition to oppose Prop 13.

My hypothesis is not, however, consistent with the Leviathan hypothesis of section 2 above. Overspending is attributed by Brennan and Buchanan (1979) to the median voter model's descriptive failure, which Downes argued was caused by bureaucratic aggrandizement. My explanation for overspending lays responsibility on the steps of California's Supreme Court, not on school superintendents or teachers unions (though the latter did file briefs of *amicus curiae* for the *Serrano* plaintiffs). The legislature had no choice, short of precipitating a constitutional crisis, but to reallocate state spending in ways that caused tax increases for a politically significant segment of the electorate. The *Serrano* explanation deflects criticism of the median voter model, because the local median voter no longer had any power over schools after *Serrano.*

The *Serrano* hypothesis explains other phenomena that the overspending hypothesis does not. Overspending might have been curbed by local initiatives, which were not in fact adopted. The impact of *Serrano,* however, could not be undermined by local votes. No community could by itself vote to shift the burden of school financing to the state after the Tiebout system had been constrained by *Serrano.*

My theory also explains why Prop 13 passed a mere six years after the Watson initiatives had failed. The Tiebout system was still intact when the earlier property tax limitations were voted down. Barkume (1976) found that people in high-spending school districts *opposed* the 1972 Watson initiative significantly more than others, which he noted was consistent with a "Tiebout configuration" (p. 455).

My theory does not explain why the property tax burden shifted to homeowners in the 1970s, which may have contributed to the tax revolt. The legislature had mandated market-based assessments in 1967, which initially lowered the tax burden on commercial property, but that was supposed to have been implemented by 1970. In any case, uniform assessment is the rule in nearly all other states, few of which gutted the property tax system during those inflationary times. Moreover, the Tiebout-Hamilton model does not require *any* tax payments by commercial property, so there is no reason why voter response to a larger homeowner burden should have been to reject local taxes.

A potential weakness of the *Serrano* explanation is that subsequent tax limitations in other states were not obviously motivated by *Serrano*-style decisions, and many states whose courts adopted the *Serrano* approach did not, to my knowledge, adopt stringent tax limitations thereafter. Other state courts did not, however, go as far in their remedial approaches as *Serrano II,* which called for variations in spending per pupil no greater than $100, and no other ballot initiative went as far in cutting taxes as Prop 13. Its best known offspring, Proposition 2 1/2 in Massachusetts, reduced property taxes to a rate that was above the preexisting state average, which imposed few constraints on most communities.

4. Courts Are Dubious Sources of Fiscal Reform.

Proposition 13 has been a fact of life in California for over a decade, and its consequences are still important. It has created enormous disparities in the taxes that neighbors living in identical houses can pay. If one owned a house prior to Prop 13 and did not sell it, his tax bill will be one percent of the 1975 assessment, increased by no more than two percent per year. A person who buys or builds an otherwise identical house next door will be reassessed at the current market value and pay taxes several times what her neighbor does for the same local services. To make up the shortfall in local revenue, many California communities impose special exactions on new developments, requiring that they pay for services that were formerly financed by the public treasury. Forward shifting of exactions

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from developers to homebuyers (which is likely, since the exactions are typically contingent on the size and type of building proposed) adds another burden to newcomers that preexisting residents do not have to bear.

Such violations of basic horizontal equity norms might be viewed as the incidental price that must be paid for voter initiatives. They take on a different complexion, however, if we view their cause, Prop 13, as itself being caused by *Serrano.* In that case, Prop 13 must be viewed as an unanticipated cost of the California Supreme Court's activism. Inequality in school spending and taxing between jurisdictions has been shifted to inequality in taxation within jurisdictions and discrimination against newcomers.

The new inequities might be more tolerable if the post-Proposition 13 implementation of *Serrano* in fact improved the lot of school children in poor districts. These were, afer all, the original *Serrano* plaintiffs. The results after a decade of experience are disappointing. Public spending has become much more equal among California public schools, but, as Downes (1988) found, sixth-grade achievement test results were as unequally distributed among districts in 1986 as they were before *Serrano* and Prop 13. Coupled with the apparent decline of statewide achievement mentioned in section 2 above, *Serrano* looks like a victory of the appearance of equality over substance.

Serrano triggered lawsuits with similar objectives in many other states. The legal battle is continuing, even in Connecticut and New Jersey, whose courts had ordered *Serrano*-style reforms in the early 1970s (New York Times, 4 Oct. 1989, p. B9). The Texas Supreme Court recently held for the plaintiffs in such a case (Edgewood Independent School District v. Kirby, 1989 WL 113161 [Oct. 1989]), though it has not yet (as in *Serrano I*) declared what an acceptable remedy would involve. The Texas decision will almost certainly result in additional litigation about the adequacy of remedies.

The lesson to be gleaned from the California experience, if my hypothesis is correct, is that the preferred impetus for fiscal reform is legislative action, regardless of whether one is disturbed by or applauds the judicial activism that these cases involve. The tricky balancing of the desire for local control, which underlies the Tiebout hypothesis, with the desire to use education to fulfill the promise of equal opportunity is not easily accomplished in a court of law.

The California decision may be contrasted with that of the New York Court of Appeals. Faced with nearly the same fact situation as *Serrano,* the state's highest court held that New York's system did not violate the equal protection or the education clause of the state constitution (Board of Education v. Nyquist, 453 N.Y.S.2d 643 [1982]). While the court did review the state's system on the easily-passed "rational basis" criterion, it noted that public education "presents issues of enormous practical and political complexity, and resolution appropriately is left to the interplay of the interests and forces directly involved and indirectly affected, in the arenas of legislative and executive activity. This is of the very essence of our governmental and political polity" (p. 648). Had the California court reasoned similarly, Proposition 13 might not have passed.

ENDNOTE

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