



# UCLA ECONOMIC LETTER

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## REAL ESTATE AND THE MACROECONOMY

*A partnership between the UCLA Ziman Center for Real Estate and the UCLA Anderson Forecast sponsored by the Ziman Center's UCLA Rosalinde and Arthur Gilbert Program in Real Estate, Finance and Urban Economics*

MARCH 2023

Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. In this March 2023 Letter, Jerry Nickelsburg, adjunct professor of economics in the UCLA Anderson School of Management and faculty director of the UCLA Anderson Forecast, analyzes expected scenarios for Los Angeles' new Transfer Tax, with preliminary conclusions showing that everyday taxpayers may end up absorbing the costs.

## Who Picks up the Tab?

In Several Plausible Scenarios, L.A. Taxpayers Will End Up Paying a Large Part of the Measure ULA Transfer Tax

*By Jerry Nickelsburg*

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In November 2022, with the goal of increasing funding to affordable housing, the voters of the City of Los Angeles approved a new tax on the transfer of property. This "transfer tax," Measure ULA<sup>1</sup>, targets transaction values of \$5M or greater. Who will ultimately pay this tax? The immediate answer was the seller, or perhaps the seller in a negotiation with the buyer<sup>2</sup>.

However, the economics of public finance teaches us that the "incidence," that is who the cost ultimately falls on, is often not entirely the individual or organization that writes the check, but somewhere else (See for example: Fullerton and Metcalf (2002) and Henderson (1985)). Part of the reason for this lies in the phenomenon now called the "Lucas Critique" which, simply put, states that faced with a governmental policy that adversely affects individuals, those

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<sup>1</sup> [https://unitedtohousela.com/app/uploads/2022/05/LA\\_City\\_Affordable\\_Housing\\_Petition\\_H.pdf](https://unitedtohousela.com/app/uploads/2022/05/LA_City_Affordable_Housing_Petition_H.pdf)

<sup>2</sup> The following are examples of studies of Measure ULA supporting and opposing the measure:

<https://www.lewis.ucla.edu/wp-content/uploads/sites/17/2022/09/ULA-White-Paper.pdf>

[https://www.movela.org/measure\\_ula](https://www.movela.org/measure_ula)

<https://escholarship.org/content/qt1jv1p99n/qt1jv1p99n.pdf?t=rjqwgh&v=lg>

<https://centerforjobs.org/wp-content/uploads/LA-Transfer-Tax-Full-Report.pdf>

folks will take defensive actions to minimize the impact (Lucas (1976)). Each of the referenced articles on Measure ULA is subject to the Lucas Critique. In this essay, I outline why part of the cost, perhaps a very large part, will be borne by the taxpayers of Los Angeles. This essay won't quantify that shift but ought to demonstrate that it is likely non-trivial.

*“Defensive action by property owners will likely result in the taxpayers of Los Angeles bearing a significant portion of the burden of Measure ULA, contrary to its stated intention.”*

How will transactors react to the new tax? For the purposes here, we only look at transactions that take place between a commercial buyer and seller. We do not consider any losses due to the migration of development out of the city, nor the disincentive impacts on foreclosures and subsequent development, nor the renting of residential property as an alternative to a sales transaction<sup>3</sup>. Consider an office building that has a market value of \$7M. So long as there are a large enough number of buyers and sellers of property in the metropolitan area, this price will represent the maximum value of the property in its proximate use. That is, \$7M provides a sufficient rate of return for the investment, and a price less than that would bring another buyer who would bid the value up to \$7M. To be sure, properties sometimes trade for less than their value, but the average price is the average value to the buyer. Now suppose a 4% transfer tax is imposed on that sale. The initial or short run incidence of the tax depends on the elasticity of demand (how sensitive the potential buyers are to a price increase) and the elasticity of supply on the part of the seller.

Suppose the buyer has alternatives outside the City of Los Angeles with virtually the same rate of return as would have been earned had the subject office building been purchased for exactly \$7M. Then the buyer would only pay \$7M and the incidence would have to fall on the seller. This would result in a capital loss of \$280K. This example assumes that the seller would take a net price of \$6.72M for the property. The net price to the seller is likely to be lower than \$6.72M because the buyer must account for the transfer tax on a subsequent sale of the property<sup>4</sup>.

It is entirely possible that the seller's rate of return from holding onto the office building would be higher than the rate of return earned on the \$6.72M received from the sale of the building. If that were the case, then no transfer tax would be collected as no transaction would take place. Moreover, the property taxes on the office building would not be marked to market by the new transaction and would remain protected by Prop 13 (which limits taxes on unsold property).

When one runs the numbers for the \$7M sale case, the net revenue decline from the gross revenue estimates is small and there remains a relatively large gain to the City from Measure ULA. Here is where the Lucas Critique comes in. Properties trade with some frequency, five to seven years on average. Sellers can avoid the transfer tax by selling less often or by selling the income of the property rather than the title to the property through a variety of organizational structures<sup>5</sup>. This is important because assessed values protected by Prop 13 are based on transaction prices. Suppose the office property appreciates at 4% per year. In five years, it will be more than 20% more valuable and if sold, assessed property taxes will increase by that amount. But absent a sale, assessed values will be based on the previous transaction five years or more in the past. A casual look at property value increases suggests how important this is.

Consider now a \$20M property. \$1.1M is the gross receipt from the Measure ULA transfer tax if the sale is for the full price. Suppose the buyer holds the property for 14 years. Then assuming no inflation adjustment to the property assessment, the property tax for the next 14 years is \$200,000/year for a gross revenue including the transfer tax of \$3.9M. Alternatively, if the commercial property is sold in year one for \$20M with no Measure ULA tax and then again in year seven with a 4%/annum appreciation, there would be a jump in property taxes to \$263,186/annum from year seven on. This results in \$1,200,000 in property taxes for the first six years, and \$2,105,488 the following eight years for a total revenue of \$3,405,488. Therefore, the net gain from Measure ULA is only \$594,512 with the

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<sup>3</sup> Since foreclosures result in two changes of ownership, one to the lender and one when the lender sells the foreclosed property, this double taxation could make it worthwhile for the lender to let marginal properties languish.

<sup>4</sup> Kopczuk, and Munroe (2015) found shifting and bunching at the tax threshold in a study of New York and New Jersey and a reduction in transactions in the higher tax jurisdiction.

<sup>5</sup> Dachis, Duranton, and Turner (2012) show that a 1.1% transfer tax resulted in a 15% decline in sales. Best and Kleven (2018) found a 1% reduction in transfer taxes resulted in a 20% increase in sales.

balance, \$505,488, being lost property tax revenue. This is a cost to the taxpayers in revenue that would otherwise be available for other services the City would have provided.

As the tax rate varies across sale prices, consider a set of properties valued at \$5M, \$7M, \$10M, \$15M and \$20M<sup>6</sup>. Two scenarios are analyzed. And consider the difference in the number of years before the properties turn over, with one having sales every seven years and the other every five years under no Measure ULA transfer tax, and not sold for 15 years under the transfer tax regime<sup>7</sup>. The 7-year scenario yields a total of \$10,059,225 in transfer tax and property tax revenue, but the net gain is only \$639K. For the 5-year scenario the gross revenue is the same and the net gain is \$93K. This analysis accounts for just a 1% statewide property tax rate. Special assessments in the City of Los Angeles can raise the amount by up to .3% and would lower the net revenue in the two scenarios<sup>8</sup>.

PROPERTY VALUE	ULA TAX RECEIPTS	NET TAX RECEIPTS			
		SALE EVERY 5 YEARS		SALE EVERY 7 YEARS	
		NET TAX RECEIPTS NO ULA	ULA	NET TAX RECEIPTS NO ULA	ULA
\$5M	\$ -	\$ 874,224	\$ 672,000	\$ 826,373	\$ 672,000
\$7M	\$ 268,800	\$ 1,223,914	\$ 1,209,600	\$ 1,156,922	\$ 1,209,600
\$10M	\$ 384,000	\$ 1,748,449	\$ 1,728,000	\$ 1,652,745	\$ 1,728,000
\$15M	\$ 779,625	\$ 2,622,673	\$ 2,764,125	\$ 2,479,118	\$ 2,764,125
\$20M	\$ 1,039,500	\$ 3,496,897	\$ 3,685,500	\$ 3,305,491	\$ 3,685,500

Notes: A 4% per annum appreciation was assumed.  
The ULA column has an initial sale discount by the current owner equal to the tax and only the initial sale of the property in the 15 years span.  
The \$5M initial sale has no ULA tax as it would be sold for less than the \$5M cutoff.

One can view these results in two ways. First, the City would be funding the Measure ULA homeless and affordable housing initiatives in the amount collected by this tax anyway, and the tax allows for borrowing from future property tax revenues. Thus, aside from the disincentives associated with the higher transfer taxes, it accomplishes its goals. Nowhere in the studies reviewed that supported the new transfer tax was this rationale mentioned. Rather, the entire amount collected, the gross revenue, was considered to be new revenue; found money.

The second way to view these results is that the new transfer tax results in two losses: a capital loss by the current property owners, and a reduction in city services that residents of the city would otherwise enjoy in the absence of the tax. How large the shift in property taxes might be is an empirical question and depends on the rate of appreciation, the rate of ownership turnover, and the constellation of property subject to the transfer tax. The example suggests that the actual amount has the potential to be quite large.

The analysis presented here is for commercial real estate transactions. There are similar issues with respect to residential real estate. These are complicated by the fact that the owners of the properties might also use them as their private residences. There is empirical evidence that the Prop 13 disincentive has resulted in homeowners increasing their tenure in their current residence<sup>9</sup>, and this would result in further property tax losses to the city.

<sup>6</sup> Obviously, the distribution of property potentially for sale is more complex than this, however it is instructive to keep the analysis simple.

<sup>7</sup> The time span is 15 years with the first year being the time of the initial sale and the following 14 the years when there is a collection of property taxes. The same 4% per annum appreciation is assumed. This time, it is assumed that there is discounting of the original sale price in the amount of the Measure ULA tax.

<sup>8</sup> <https://auditor.lacounty.gov/forms-important-dates-glossary/#1487189927167-99ccbc6-80b8>

<sup>9</sup> e.g. Nagy (1997), Stohs, Childs and Stevenson (2001) and Wasi and White (2005).

### Net Loss to the City of Los Angeles?

Ways in which the Transfer Tax will cost the City of Los Angeles in lost property tax revenue:

- Migration of development outside of city limits
- Capital loss to current owners resulting in a decrease in property values
- Owners shifting from sales to rentals
- Change in the frequency of property sales resulting in less frequent mark-to-market increases in the assessment for property tax purposes

Implication of the lost property tax revenue:

1. Fewer city services than otherwise would have occurred as taxes are shifted to ULA uses
2. Less incentive to upgrade or develop property within the city
3. Business and households have a smaller incentive to locate in the city

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