

Narwold, Andrew

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## Historical Designation and Residential Property Values

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# Historical Designation and Residential Property Values

Andrew Narwold

## *Abstract*

*The State of California enacted the Mills Act in 1972. This act allowed local municipalities the option of setting up a historical designation program. The main feature of the program was to allow the owners of historical buildings a reduction in their property taxes in return for an agreement to not alter the exterior façade of the designated building. The extent of the property tax deduction results in a savings of anywhere from 40 – 80 percent. This means that for a \$1,000,000 house, the tax benefits may run to \$8,000 per year. Theory suggests that the value of this tax benefit should be fully capitalized into the price of the home. The degree to which it is not may suggest the cost to the homeowner for agreeing not to alter the building. This paper uses hedonic regression analysis to estimate the value of historical designation to single family residences in the City of San Diego. The results presented suggest that historical designation results in a 16 percent increase in housing value. This result is significantly higher than the capitalization of the property tax savings would suggest, implying market value in the historical designation itself.*

## Introduction

In 1972 the State of California passed a law that since has become known as the Mills Act, named after the author of the legislation. The Mills Act allows for cities and counties to create programs designed to aid in the historic preservation of structures. The program allows for a reduction in property taxes on historically designated properties in return for a commitment by the owners of the property to maintain the property without significantly altering its appearance.

The details of the Mills Act require a participating local government to enter into a contract with the owner of the historical building. This contract has several key features. The contract is valid for ten years, and is automatically renewed yearly, unless notice to cancel is given by either party. Under the terms of the contract, the property owner agrees to maintain and rehabilitate, if necessary, the external façade of the structure. In return, the property tax for the

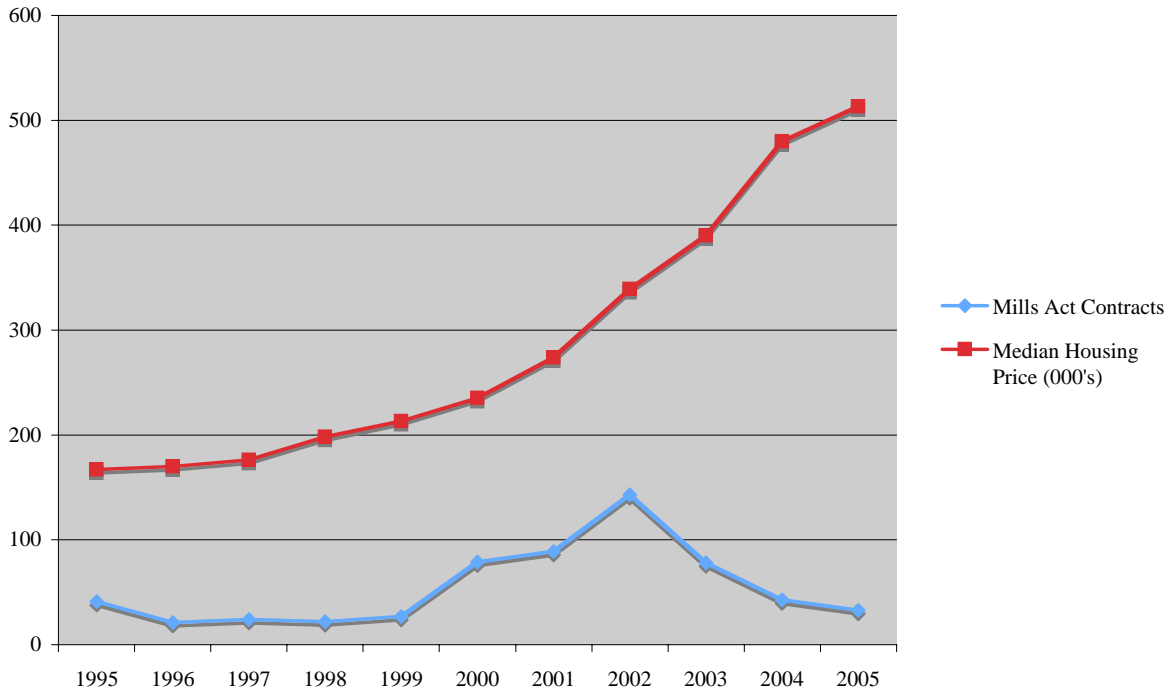
structure is reduced. The tax basis for the structure is based either on the income produced by the building for rented structures, or the income producing potential for owner-occupied structures. This income stream is then converted into a value for the structure based on a capitalization rate. This imputed value then becomes the tax basis for the purposes of property tax assessment. California currently imposes an approximate one percent levy on real property. Estimates of the property tax savings from entering into a Mills Act contract for a historical house range from 40 to 80 percent.

Although there are few exact numbers, a survey in 1995 found that 39 cities were writing Mills Act contracts with a total of 119 statewide. Currently there are an estimated 89 cities and 1662 Mills Act contracts statewide according to the California Office of Historic Preservation. The number of contracts is provided is the lower bound of the actual number of contracts as there is no enforcement to insure that all contracts are recorded with the State of California. However, the City of San Diego has by far the largest number of Mills Act contracts with over 400. The City of Los Angeles is second with around 200 contracts. The City of Anaheim is third with approximately 125 contracts.

The City of San Diego's experience is probably similar to that of most other cities and counties operating under the Mills Act. The City of San Diego did not start writing Mills Act contracts until 1995, though the Historical Resources Board has been assigning historical designations since 1967. Figure 1 shows the relationship between the number of Mills Act contracts written yearly since 1995 as well as the median housing price for San Diego. Not surprisingly, the City of San Diego experienced a large upswing in the number of Mills Act contracts in the late 1990's as housing prices started to soar. The City of San Diego started to experience some financial difficulties in 2002 due to under-funded pension liabilities. This

resulted in significant pressure on the Historical Resources Board to limit the loss in tax revenue associated with the Mills Act contracts. This has led to a major decline in the number of Mills Act contracts being processed annually.

Figure 1  
Median Housing Price - San Diego County  
Number of New Mills Act Contracts - City of San Diego



## Literature Review

### Data

Data were collected on sales of single-family detached housing in two zip codes in San Diego, California from January 1, 2000 through December 31, 2005. The two zip codes, 92103 and 92104, were selected for several reasons. These zip codes contain some of San Diego's oldest neighborhoods and therefore have a relatively large proportion of historically designated homes. The housing stock is relatively heterogenous having been built between the early 1900's

and late 1940's. Since these zip codes are contiguous, many of the neighborhood characteristics such as school quality, proximity to downtown and beaches, and crime rates do not vary greatly.

During this five-year period, 2251 single-family residences were sold in these two zip codes. Of these houses, 35 had received historical designation by the City of San Diego and the owners had signed a Mills Act contract. Table 1 presents the descriptive statistics for the historically designated houses within the data. Table 2 presents the descriptive statistics for the rest of the sample.

Table 1.  
Descriptive Statistics – Historically Designated Houses (n=35)

Variable	Mean	Std. Dev.	Minimum	Maximum
Bathrooms	1.8	0.15	1	5
Bedrooms	3.1	0.15	2	5
SQ FT Structure	1990	141.59	940	4350
Lot SQ FT	7662	737.95	3297	24829
Years old	69	3.42	5	93
Days Since Sold	747	90.71	38	1933
Sale Value	908700	79788.52	315000	2250000

Table 2.  
Descriptive Statistics – Non-historically designated houses (n=2216)

Variable	Mean	Std. Dev.	Minimum	Maximum
Bathrooms	2.2	0.02	1	6
Bedrooms	3.2	0.03	1	9
SQ FT Structure	1743	16.27	900	7595
Lot SQ FT	6781	106.60	1197	49222
Years old	65	0.45	1	100
Days Since Sold	909	12.18	1	2185
Sale Value	636006	7610.04	300000	6500000

There are several interesting results in the descriptive statistics. The historically designated houses tend to have fewer bedrooms and bathrooms, but overall have more square footage in both the structure and lot size. Perhaps somewhat surprisingly, the historically designated houses are not that much older than the other houses. The average year built for a historically designated house is 1936, while for the rest of the sample the average was 1940. The days since sold variable measures the number of days between December 31, 2005 and when the house was sold. During the period 2000-2005, San Diego experienced strong appreciation in housing prices, averaging by some accounts more than 10 percent a year. The larger the Days Since Sold variable, the earlier in this five-year range the property sold, and therefore did not receive the run-up in appreciation that houses that sold later in this period received. Finally, there is the difference in the actual sales price of the houses, with the historically designated houses selling on average for \$270,000 more than the rest of the sample.

## Model and Results

DiPasquale and Wheaton (1996) develop a model of housing values that can be used to incorporate the effect of a Mills Act contract. Equation 1 provides an expression for the market price of house with type  $k$  characteristics in city  $j$ :

$$P_{kj} = [R_{kj} + G_j - t_j P_{kj}] / i \quad (1)$$

where  $P_{kj}$  is the market price,  $R_{kj}$  is the market rental rate for a house with the housing characteristics  $k$  in city  $j$ ,  $G_j$  is the level of government services in city  $j$ ,  $t_j$  is the property tax rate in city  $j$ , and  $i$  is the capitalization rate. In California, the State Board of Equalization insures that property taxes are consistent across all cities and counties, and is currently set at roughly one

percent of the market value of the property upon transfer of the property. This provision effectively eliminates the potential sorting of municipalities by property tax rates and the level of services. It also implies that changes in the property tax rate will be completely capitalized into the market price.

A 50 percent savings in property taxes reduces the property tax rate from 1 percent to 0.5 percent. Using equation 1, and complete capitalization, this would imply that the value of the house should increase by  $0.5/i$  percent. Assuming a low end value for the capitalization rate of 10 percent, would result in the observation that houses covered by Mills Act contracts should sell on average for 5 percent more than similar homes in the neighborhood.

This conclusion does not take into account the possible constraint imposed by Mills Act contracts in terms of the restriction on changing the façade of the house. Presumably, this restriction, if binding, would reduce the value of the tax benefit. On the other hand, some house buyers might be willing to pay more for a house that has been historically designated. Furthermore, one possible avenue for historical designation is based on the architecture and visual significance of the building, and therefore the designated houses may have a higher quality than other houses in the neighborhood.

Table 3 presents the results of simple hedonic regression with the log of sales price as the dependent variable. Since the sample was for two adjacent neighborhoods, there are no variables reflecting neighborhood characteristics. Not surprisingly for these neighborhoods, buyers appear willing to pay a premium for older houses. The time trend variable is very significant, and implies an annual appreciation rate of 10 percent for houses in these two zip codes. Finally, the dummy variable for Mills Act contract is highly significant. The coefficient suggests that

historical designation and the corresponding Mills Act contract increases the value of the house on the order of 16.5 percent.



Table 3.  
Regression Results – Log of Sales Price

Variable	Coefficients	Standard Error	t Statistic
Intercept	13.060248	0.029015	450.120
Bathrooms	-0.000330	0.009290	-0.036
Bedrooms	-0.069888	0.006850	-10.202
SQ FT Structure	0.000390	0.000012	31.880
Lot SQ FT	0.000004	0.000001	3.314
Years old	0.000829	0.000282	2.944
Days Since Sold	-0.000357	0.000010	-36.160
Historical	0.164610	0.045640	3.607

n = 2251, R<sup>2</sup> = 0.57

#### Conclusion

The State of California enacted the Mills Act in 1972. This act allows local municipalities the option of setting up a historical designation program. The main feature of the program is to allow the owners of historical buildings a reduction in their property taxes in return for an agreement to not alter the exterior façade of the designated building. The extent of the property tax deduction results in a savings of anywhere from 40 – 80 percent. This means that for a \$1,000,000 house, the tax benefits may run to \$8,000 per year. Theory suggests that the value of this tax benefit should be fully capitalized into the price of the home. The degree to which it is not may suggest the cost to the homeowner for agreeing not to alter the building. This paper uses hedonic regression analysis to estimate the value of historical designation to single family residences in the City of San Diego. The results presented suggest that historical designation results in a 16 percent increase in housing value. This result is significantly higher

than the capitalization of the property tax savings would suggest, implying market value in the historical designation itself.

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