A Property Tax for the 21th Century

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1998

The property tax has been in the spotlight for almost two decades now, beginning with Proposition 13 in California that attacked the growth of the property tax with a sledgehammer, and spreading to other states with various revolts, reforms, restraints and even a few unsuccessful efforts at total repeal. In order to understand what has happened to the property tax, and where it may or should be headed, we need to look back at the evolution of this very important revenue source over the course of the 20th century.

Turn back to the golden age of the property tax, if ever it existed, which would have been a century ago. At that time, land and improvements were the tax base and also primary form of wealth, so the property tax was much closer to being a tax on wealth than it is today. Agriculture was still the main occupation, and many farmers only saw cash once a year at harvest time and paid their taxes and stocked their larders at that time. The revenues collected were used mainly to pay for property-related services, including farm-to-market roads and law enforcement which protected property rights. In many jurisdictions, property tax assessors did not attempt to measure market value, that elusive concept that has brought the property tax so heavily under fire. Instead, assessors relied on various proxies for market value, such as acreage, bathrooms, windows, doors, or furnaces.

Between then and now, two important things happened to the property tax. First, it went from being a state and local tax to being mainly a local tax, as states shifted during the Great Depression primarily to sales taxes and later to income taxes. This development took some pressure off the property tax. Even at the local level, the property tax share in total revenue has gradually declined over the decades as local governments increased their dependence on state aid, fees and charges, and local sales taxes. This revenue diversification also took some pressure off the property tax. But in another dimension, the role of the property tax expanded in the 1950s and 1960s, as it became a major source of school funding during a period when education spending was growing very rapidly. The demands of the baby boomers as they passed through the public schools between 1951 and 1982 forced up property tax demands across the nation, except in those few states like Hawaii that rely almost entirely on state funding for schools.

Now let's fast forward to 1996, and ask ourselves why so many people love to hate the property tax. Economists focus on equity and efficiency issues, which are certainly important; but a significant part of the attack on the property tax relates to perception, so we cannot explore the property tax revolt without at least a cursory consideration of public relations issues.

Efficiency Issues

The first efficiency issue is the gradual weakening of the link between tax and benefits. The decay of the tax-benefit link has been reinforced by the increased share of elderly in the voting and taxpaying population. This group has less direct interest in the schools but is more likely to vote than younger adults. While schools may have been the original source of frustration, however, the anti-property tax movement also weakened the acceptability of the property tax as a source of funding for non-education local services.

The second efficiency issue is the perverse locational effects of property taxes, with rising taxes inducing flight and declining property values and further increases in the tax rate. Over time, particularly in areas where cities have difficulty expanding, the reliance on property taxes tends to increase inequities between areas in the tax benefit package offered by different residential locations. This effect is often most visible in large cities, encouraging suburbs to "free ride" on their metropolitan hosts. Another effect is to encourage the growing trend toward creation of gated (or closed) communities that provide a large share of their own local public services, leaving the lower- to middle-income households that cannot afford the entry price into such communities to make do with poorer services.

The third efficiency issue is the competitive effects, often described as "the race to the bottom." Competition between cities to attract industrial and commercial development and to attract or retain higher-income residents often takes the form of cutting property taxes and services and shifting to fees for services, thus underfunding the "social benefit" component of local public services while expanding production of those services that are least public in nature, such as recreation programs, and golf courses.

The fourth efficiency issue is a less clear cut, because it involves weighing the costs and benefits of mobility vs. stability. Economists generally come down on the side of encouraging mobility for efficiency reasons, which is one reason they are concerned about the lock-in effects of some forms of the property tax, particularly California's new acquisition value system, but, in general, anywhere where sale is likely to trigger a reassessment. However, there is a sociological dimension to the mobility-stability tradeoff, learned painfully by corporations like IBM and even by the army, suggesting that there are social benefits to be derived from encouraging more stable communities, so the jury is still out on which way this argument plays.

Equity Issues

Issues of fairness are probably the biggest source of taxpayer discontent. Equity is not a single issue but a whole package of interrelated issues.

<u>Perceived (and actual) inequities in assessment.</u> The universal problem in taxation is to define equality (the value of two parcels being equal) and relative inequality (parcel B is worth twice as much as Parcel A). The solution is easiest in sales taxation, more difficult in income taxation and most difficult of all in property taxation because parcels must be valued without actually generating market income and/or being sold, either of which can be used to establish value. Infrequent reassessment and rural areas with thin property markets exacerbate the problem of determining relative property values.

<u>Perceived inequities in structure</u>. A majority of states use classified systems, either with different types of properties assessed at different percentages of market value or with different types of property subject to different tax rates. In addition, some properties are assessed at use value

(value in current use, which may be as farm or forest land) rather than market value, which is the price the property would bring if sold for its most valuable use.

Inequities in tax bases between local jurisdictions. While school finance equalization schemes in most states alleviate part of these differences, the remaining differences still impact on locational decisions and on quality of schools and other public services.

Base erosion. The tax base shrinks when states or local governments grant partial or total exemption for designated groups such as the elderly, industry, agriculture, or veterans. Base erosion means a higher rate is required on non-exempt property to raise the needed revenue, fueling the resentment of those who don't qualify for special treatment.

Theoretical disagreements over where the burden of the property tax lands. How much of the tax is paid by consumers of property services (renters) and how much is a tax on capital absorbed by owners?

Dual taxation. Those who choose to use private rather than public services (e.g., education, security) usually continue to pay full property taxes. Unless they get partial relief, tax protests are likely to escalate. However, if they are allowed to opt out of part or all of their local tax obligation, the burden on those who remain in the system rises.

Public Relations Issues

Certainly part of the problem facing the property tax is an image problem. The public relations problem is almost as multi-faceted as the equity issues.

The American dream. A man's home is his castle, and the property tax is perceived as a threat to that dream and the sanctity of that castle. While a fixed rate mortgage can guarantee a monthly payment for the dream, property taxes are a threat to a sometimes fragile ability to pay for that dream.

A general anti-tax, anti-government environment. In such a situation, the high-profile property tax becomes the handiest target to attack.

Confusion and lack of understanding. Property tax bills and assessment reports are complicated, as are the procedures for determining valuation. The rules determining other taxes--the sales tax and even the income tax--are less difficult to interpret.

The big bill effect. The property tax is paid annually, unlike most other taxes, in a county where virtually everything else is on the monthly installment plan.

The ratcheting effects of infrequent reassessment. Sudden jumps in assessment have been the fuel for taxpayer revolts in many places.

Multiple users of the tax base. A single taxpayer may be paying property taxes to a city, county, school district, and one or more special districts, making it difficult to determine who is to blame for a tax increase.on a single combined bill. Often it is hard for taxpayers to figure out which local government, and exactly what kinds of spending increases are responsible for a tax increase. Unfocused anger is directed at all governments using the property tax, not just the one raising taxes.

The bearer of multiple burdens. The property tax must not only fund schools and city and county services but also must do its share in offering industrial location incentives, attracting retirees, protecting long-time property owners, and supporting farmers. All of these incentives erode the property tax base, and a higher rate is necessary to make up the lost revenue.

Lessons from Economic Research

What have economists learned about the property tax that might be helpful? We've learned that, as economists have argued for decades, that the property tax is indeed capitalized in the value of the property--one recent article even estimated the discount rate to be about 4 percent -- but that the value of the services and amenities the property tax supports are also capitalized in the property, so the selling price of the property reflects both tax levels and services for a particular jurisdiction.

We've learned the political truth behind the economic proposition that the distortions in economic decision-making from a tax rise with the square of the tax rate! So we know more today about how far we can push the tax rate before we start to systematically eat away at the base that supports it, and far more about the long-term risks of politically engineered base erosion to satisfy special interests.

We've learned, in fact we always knew, although we haven't been able to communicate it to politicians/ legislators, that the long-run effects of any change are usually quite different from the short-run effects. The steady deterioriation of California's local public services for two decades after Prop 13 is a case in point.

We've learned to take a more complex and institutional view of the distribution of the property tax burden between owners and users, recognizing that in a complex world of thin markets and imperfect competition the burden may fall more heavily on users in some areas and owners in others.

Whither the Property Tax?

The events of the last two decades have made it clear that the property tax is in a state of transition. The four Rs of responses are repeal, restraint, relief, reform; and the hardest of these is reform.

The passion for the quick fix is reflected in the aborted efforts to repeal the property tax in both South Carolina and Michigan in recent years. Since there is no good substitute, remnants stay in place, like kudzu roots, to grow back.

The second line of offense against the property tax has been restraint from its beginnings in Proposition 13 to various tax and spending limitations across most of the country. If property taxes are indeed an uncontrollable weed like kudzu, then restraint can be viewed as a way to train this weed, as Japanese gardeners do with the more tolerable bonsai weed.

A third approach is relief, which usually means attacking the symptoms of distress by appeasing the noisiest taxpayers, whether they are homeowners, industrialists, farmers, or the elderly.

The fourth approach -- most complex, most challenging, and least amenable to sound bites -- is to reform the property tax for a new century by diagnosing its weaknesses and restructuring it so as to reduce those weaknesses.

Approaches to a Modern Property Tax: Efficiency Issues

The property tax can continue to do yeoman's service well into the 21st century if these problems can be addressed. There has been a tendency to a patchwork approach, resulting in state and local property tax systems that look more like a crazy quilt than a well-designed and well-ordered system of payment for public services. None of the fixes suggested here are unique, but it is useful to sort them according to which criticism of the property tax each response appears to address..

Weak link between taxes and benefits. This is the oldest issue and therefore the one with the longest list of possible remedies. Remedies almost certainly include rethinking school financing. Perhaps the cost of public education should fall more heavily on state's nonproperty taxes or on industry, which uses fewer local services but has a big investment in education both for workers and for employee children to attract and retain workers. While the quality of schools has historically been reflected in property values, the link is increasingly attenuated with more affluent elderly, more private schools and home schooling. There is, in fact, a strong national trend toward greater state assumption of a role in school financing.

Discouraging investment in improvements. There is ample economic rationale for reweighting the balance of taxable value between site rents and improvements, since the value of tax-financed amenities and services enhances the value of the site rather than the value of the buildings on the site.The notion of site rents, or the single tax on land, goes back more than a century to Henry George's *Progress and Poverty*.

Distortions rise with the square of the tax rate. A change in the mix of local revenue sources so as to reduce the share of the property tax has somewhat alleviated this problem. The property tax still has a role to play in capturing the value of site-specific amenities and services, however.

Locational effects. Some of the locational distortions of the property tax in the current decade may reflect the declining role of federal and state grants as a tool of equalization, a trend we can expect to continue in the next decade. This aid performed an important equalizing function both within and between states. To the extent that the disparities in resources among districts are reduced by equalizing grants, there will be less incentive to relocate from poor to rich areas solely because of the relative attractiveness of the local tax-service package. In contradiction to the economists' naive faith that all processes are equilibrating processes, the locational effects of property taxes continue to exacerbate the segregation of housing and communities into rich and poor, each with their separate and unequal tax bases. Some states have addressed this problem directly with more state aid or state assumption of certain responsibilities; others have targeted industrial location incentives to their poorest areas as a way to equalize tax bases between jurisdictions. Easier annexation also offers a partial solution to the decay of the inner city, allowing these cities to incorporate their suburban "parasites." There is a growing body of research showing that cities that can expand easily do much better than those that are confined to old boundaries or find annexation very difficult.

. <u>Mobility vs. stability</u> The established wisdom is that efficency requires workers to be mobile, to respond to locational opportunities; but location is getting less important as industry gets more footloose, and workers are resisting relocation for a lot of reasons unrelated to property taxes, such as spousal careers and children and uncertain futures even if they do move, and loss of loyalties to downsizing companies with overpaid CEOs.. It's not clear that it's in the national interest to encourage retirees to abandon their friends and support systems and move to where the weather is mild and the taxes are low, but that's what they're doing, and it's those low property taxes in the South, a holdover from the "land-is-wealth" mentality of a century ago, that are an important part of the incentive to move. It's not even clear that moving those workers and their families is good for marriage or good for children or good for communities. So maybe, just maybe, the property tax system ought to be slanted in the direction of low turnover, contrary to the conventional wisdom. Which may mean something like the California acquisition value system, which favors the immobile, who turn out to be disproportionately poor and elderly--or at least a system slanted toward reassessment at time of sale, or toward collecting a larger share of the tax as a one time transfer fee and less in annual property taxes.

Approaches to a Modern Property Tax: Equity Issues

Economists may never totally resolve the distribution of the property tax burden between consumption and capital, and it's not a burning question for most people. Instead, the focus is on several more practical equity issues.

<u>Perceived (and actual) inequities in assessment</u>. Theoreticians, policy-makers, and practitioners have already explored the countless ways in which assessment can be improved or simplified. Pooling data among adjacent areas with low turnover and a limited number of parcels will provide rural areas with a better assessment base. Implementing some variant of an acquisition value system, with major reassessments occurring only at the time of sale, is another option that provides a solid market foundation for any change in assessed value. [In California, property is only reassessed at the time of sale. Otherwise, it is valued at its acquisition price plus an increment of 2 percent per year to adjust for estimated increases in value.] A shift to state administration could offer greater uniformity, scale economies, and a larger pool of sales data, but at the cost of the local knowledge that informs the city or county assessor. Finally, many states have looked to a better and more effective appeals process as a way to address assessment concerns. All of these solutions can alleviate but never eliminate the assessment problem that lies at the core of the anti-property tax feelings.

Perceived inequities in structure. Classified property tax systems involve political choices about the distribution of the tax burden. Those choices are then further modified by various special exemptions, rollbacks, incentives, aimed at either "deserving," "desirable," or politically effective groups such as homeowners, industry, agriculture, or the elderly. Such political choices are subject to constant tinkering, but some tinkering does seem to reduce the level of dissatisfaction, indicating an improvement in perceived equity.

Protecting the poor and the elderly from a burden that is excessive relative to their incomes. There are stock solutions to these problems that have been around for decades, various forms of homestead exemptions and circuit breakers. As the elderly become less likely to be poor, lawmakers will eventually have to bite the bullet and make these distributional devices means-tested in order to avoid too much base erosion and some questionable locational incentives. Already, in my state of South Carolina, which has been attracting wealthy retirees to it coastal and mountain areas, long-time residents question the need for a $20,000 homestead exemption on a $400,000 home owned by someone whose income is well above the state average just because that person is 65 or older.

Bearer of multiple burdens. The property tax is expected to be the major player in such diverse goals as attracting industry, financing education, protecting the elderly, encouraging agriculture, and supporting local services. Some of these goals result in serious base erosion, which reduces both the efficiency (i.e., neutrality in choices about investing/locating) and equity of the property tax. Perhaps a flat property tax should be higher on the agenda than a flat income tax! At a minimum, we should resist further base erosion. Ideally, we would roll back some of the existing exemptions in exchange for lower rates.

Approaches to a Modern Property Tax: Public Relations Issues

The problems of perception and communication that plague the property tax derive primarily, as we have seen, from multiple local governments using the same base, from the sticker shock of infrequent assessments, and from the failure to make the link between taxes and services. The multiple users problems is less an issue of property tax than of how local service delivery is organized. The sticker shock problem calls for more regular reassessment ør reassessment only at time of sale with inflation adjustments in between (the California acquisition value system). Finally, local governments need to do a better job of explaining how they use their funds and how

A 21st Century Property Tax

If we put these concerns and patchwork solutions together, what does the Property Tax of the 21st century look like? The following observations represent a mix of forecasting and prescription:

1. The property tax is still here, contrary to rumors of its imminent demise.
2. The ideal property tax of the 21st century has lower rates, a broader base, and fewer exemptions, limiting distortions and increasing equity. This change is going to be hard to

bring about; partly because it's a lot easier to create exemptions than to eliminate them, and partly because newer forms of wealth are more difficult to find and tax.

3. The property tax continues to finance most city and county services, but with a shift away from property tax financing of education toward a larger state role relying on broad-based income and sales taxes.
4. There will be an increased use of special levies on properties to fund infrastructure and special services. The impact fee is a membership fee for joining a city that has attributes of a club, whose members have already paid for infrastructure, much like a sailing club with an initiation fee and annual membership dues.
5. The property tax of the 21st century will be more heavily supplemented by alternative revenue sources, especially fees, and state aid, a trend under way for several decades that can be expected to continue.
6. Structurally, this improved tax will have moved away from proxies for deserving a tax break on equity grounds, like age, toward direct measure of need for relief, like income.
7. Some of the problems will have been addressed indirectly, not by reform, relief, restraint, repeal of the property tax but by rethinking the way that local government is organized with overlapping responsibilities, difficulties in annexing or letting cities expand, and multiple users of the same tax base. That's called attacking the cause instead of treating the symptoms.
8. Every state will continue to watch other states to see what they try and how it works, like the acquisition value system in California.
9. Property tax administrators will have responded to the demand from the public for truth in taxation by making sure citizens understand not just what they're paying and to whom, but also what they're getting in exchange for their taxes.
10. The property tax will still be still at the bottom of the popularity list, but the revolt will have receded somewhat.

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