The Property Tax Is a Bad Tax, but It Need Not Be

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Economists have long argued over the nature of the property tax—is it a benefits tax or a capital tax with local excise tax effects? Those who see it as a benefits tax draw upon the pioneering efforts of Tiebout (1956) to argue that households equate taxes paid with the value of public services received by "voting with their feet." According to one of the leading advocates of this position (Hamilton, 1975a), the existence of choice among communities, combined with the use of zoning to exclude free riders, transforms the suburban public economy into a quasi-market, with the property tax serving as the price for public goods. If this case holds, as Hamilton (1975b: 13) pointed out, "... then this price should not distort the housing market any more than the price of eggs should distort the housing market." According to those who see the property tax as a capital/excise tax, the national average rate of taxation is a tax on capital, and local differences from the national average rate produce local excise effects.

Regardless of which of the two views of the property tax one subscribes to, to many economists the property tax does not look like such a bad tax. Two principles are used to judge whether a tax is fair: the benefits principle and the ability-to-pay principle. The benefits principle maintains that taxes paid should rise in proportion to the benefits received from public services. The ability-to-pay principle has two alternative interpretations. One is that higher income households should pay more in taxes, and the other is that the burden of taxation, measured as taxes paid as a percentage of income, should be lower for lower income households. If the tax incidence by income class is *progressive* and not *regressive*, the tax satisfies either interpretation of the ability-to-pay principle. Obviously, if the property tax is the price for local public services, it satisfies the benefits principle of just taxation. If the tax is a capital/excise tax, it should be judged on the ability-to-pay criterion of just taxation. As it turns out, the property tax incidence by income class is a complicated issue, but the fact that the property tax is, in part, a capital tax suggests that it may be a progressive tax.

If the property tax is a just tax in the eyes of many economists, why, from the 1970s through today, has it been reported as the least popular tax in repeated surveys of American taxpayers? Cabral and Hoxby (2010: 20) reviewed the survey evidence from 1972 to 2005 and concluded the following: "The property tax starts out unpopular in 1972 and ends up still unpopular in 2005: in both years, about 38 percent of adults stated that it was the worst tax." The alternatives from which the survey respondents had to choose, all of which they liked more than the property tax, were the federal income tax, the Social Security tax, state income taxes, and state sales taxes. Cabral and Hoxby's answer as to why the property tax is the least popular of all taxes was that it is the most *salient*, by which they meant that the property tax is the tax that people are the most aware of paying. Landowners pay property taxes by writing one or two checks a year, which makes the taxpayer acutely aware of the tax and its amount. By contrast, most people pay their income and payroll taxes through payroll withholding, so no physical act of payment is required except when too little has been withheld. In practice, most taxpayers do not have to write a check to the Internal Revenue Service at the end of the tax year, but rather they receive a tax refund, which surely contributes to the popularity of the income tax by comparison with the property tax. Although sales and excise taxes are directly paid by the consumer at the time of purchase, they are part of the gross price of goods and services and are not paid separately from the price, which makes them less transparent to the average consumer. Moreover, the taxpayer pays sales taxes incrementally with each additional purchase and is not confronted with an annual total sales tax bill, so he or she may not be fully aware of just how much sales tax is being paid.

The salience of the property tax, however, is not the only reason for the difference of opinion between the average taxpayer and many economists on whether the property tax is a good or bad tax. The property tax that economists have long debated is an ad valorem tax; that is, it is levied as a percentage of the market value of the property. This tax, however, is not the property tax that now exists in most communities throughout the United States. After the property tax in practice is recognized as something other than an ad valorem tax, it is just as easy for the economist to disdain the property tax as the average taxpayer, although the two groups' dislike of the tax may not be similarly rooted.

Why, then, is the property tax not an ad valorem tax and why does that make a difference in whether the tax is bad or good? Regarding the first question, two factors cause the property tax to differ from an ad valorem tax. First, for many homeowners, state laws restricting increases in assessed values and local lags in assessment practices have broken the connection between the assessed value and the fair market value of their homes. A very useful resource on property taxation in the United States is the Lincoln Institute of Land Policy's website, "Significant Features of the Property Tax" (http://www.lincolninst.edu/subcenters/significant-features-property-tax/). By my count, 18 states and Washington, D.C., are identified as having legal limitations on how much the assessed value of an individual home can increase from one year to the next. In Florida, for example, assessed value can increase annually by 3 percent or the rate of inflation, whichever is less. The Lincoln Institute also identifies 11 states that freeze assessed values on the homes of selected groups of taxpayers, such as elderly, low-income, or disabled people.

Regarding lags in assessment practices, another Lincoln Institute report by Haveman and Sexton (2008) found that 27 states do not require annual assessment, with a 3- to 5-year lag in reassessment quite common. In effect, assessment lags are like the previously mentioned, legally mandated assessment caps, wherein the cap has been set at 0 percent. Regardless of whether an assessment-increase cap is because of legislation or a lag in reassessment, the volatility that housing markets have experienced during the past decade resulted in wide divergences between assessed and market values; hence, by many indications, the property tax is not an ad valorem tax.

A second factor that divorces assessed values from market values adds to these indications. Baer (2003) reported that homestead exemptions existed in 40 states and Washington, D.C., by the year

2000. These exemptions provide owner-occupants with reductions in their assessed values. To illustrate, in Florida, the homestead exemption is $50,000. Say two people each buy a $200,000 house; for one, it will be his primary residence, but for the other, it will be a second home. The assessed value of the first owner's home is $150,000, but that of the second owner's home is $200,000 (that is, the full market value of the home). For homesteaders, the property tax is not an ad valorem tax.

Turning to whether the property tax is a good or bad tax, if assessed values do not reflect market values, the property tax cannot be seen as a good tax based on either of economists' views of the property tax or on either of the principles of just taxation. Consider the possibility that the property tax is the price of public goods where property is assessed at acquisition rather than market value. Acquisition value taxation is a trait that many assessment-increase cap programs have in common. If zoning has done its job to create homogeneous market values throughout the community, people are still potentially paying vastly different property taxes depending on when they first moved into the community. Hence, the property tax is no longer a quid pro quo for the receipt of public services, no quasi-market for public goods exists, and the tax can no longer be judged a good tax based on the benefits view of just taxation.

When we switch to the ability-to-pay criterion of just taxation, the effect of assessment caps on the regressivity or progressivity of the tax will depend on whether the market values of low-income households' homes increase faster or slower than the market values of high-income households' homes. Where acquisition-based assessment is combined with the cap, the regressivity or progressivity of the tax will also depend on differences in turnover rates between low- and high-income households. I have seen no empirical analysis of property tax incidence by income class that accounts for the property tax's non-ad valorem nature, but one carefully done study found that assessment caps diminish the vertical equity of the property tax, when vertical equity is defined as low- and high-valued homes having the same effective tax rate (Moore, 2008). Moore's results showed that, under an assessment cap system, higher valued properties have a lower effective tax rate than lower valued properties. Moore did not explore whether this system results in a regressive tax, because household income information was not available. Housing, however, is clearly a *normal* good (in general, people demand higher quality housing as their incomes grow). If the effective tax rate declines with house value, it surely will also decline with income, rendering the property tax a regressive tax, which would make it an unjust tax based on the ability-to-pay principle.

Moore also investigated how the vertical equity of the property tax is affected by homestead exemptions and found that these exemptions, too, cause effective tax rates to be lower on more expensive homes. On the surface, this finding would seem to be counterintuitive, because homestead exemptions, which are constant dollar amounts, knock a larger percentage off the market values of less valuable homes. Remember, however, that the homestead exemption is provided to only a select group of buyers. Lower valued homes that are bought to be rented or to be used as a second home are assessed at full market value.

In addition to the benefits and ability-to-pay principles of just taxation, which are used to compare the fairness of alternative taxes, a third principle of just taxation, *horizontal equity*, applies strictly to the property tax. This principle states that homeowners living in the same taxing jurisdiction should pay the same effective tax rate; the latter equals the nominal tax rate, which is the same for everyone, times the ratio of assessed value to market value, which may not be the same for everyone. The difference between assessed and market values resulting from an assessment cap typically disappears when a home changes ownership. That is, at the time of the sale the assessed value is reset to market value (or to the statutory assessed-to-market value ratio, which may not be 100 percent). This reset results in homeowners within the same jurisdiction paying different effective tax rates depending on how long they have lived in their homes. This discrepancy violates the horizontal equity provision that homeowners occupying equally valued homes should pay identical amounts of property taxes. Obviously, homestead exemptions also violate horizontal equity because homeowners with equally valued homes pay different effective tax rates depending on whether the home is occupied by the buyer.

In summary, because the property tax is not an ad valorem tax, it fails on all three principles of just taxation. Therefore, it should be judged by all economists as a bad tax. This conclusion begs the question as to whether local governments should continue to use the property tax. The answer to this question might depend on whether alternative taxes are more just. It may also depend on whether property tax reforms can make it a true ad valorem tax. Computer-assisted mass appraisal systems have progressed to the point at which they are quite capable of placing, on each property on the tax roll, an accurate estimate of its market value on an annual basis. In fact, having evaluated the performance of Florida's 67 property tax assessors, I have seen in practice that market-value assessment is not a problem. The problem in Florida, and in a growing number of other states, is that caps on increases in assessed values have broken the close tie that needs to exist between assessed and market values.

Not surprisingly, my policy recommendation is to eliminate all assessment caps, all lags in assessment practices, and all homestead exemptions. The most likely criticism of my recommendation is that caps on assessment increases protect homeowners from unpredictable changes in their property taxes. These caps, it would be argued, were especially necessary during the recent housing price boom, when housing prices appreciated at historically unprecedented rates. An alternative solution to the problem of escalating property tax payments resulting from housing price inflation exists, however. Under a market-value-based approach to property taxation, property tax payments need not rise as housing price inflation occurs, because the nominal tax rate can be reduced to maintain current levels. The tax that achieves this goal is sometimes referred to as the *rollback* rate because it rolls back tax revenues to what they were before housing prices rose.

If the solution to making the property tax an ad valorem tax is so simple, why has the rollback rate not been adopted more frequently? The answer, of course, is that local politicians, for good or evil, desire greater tax revenues and are therefore reluctant to cut tax rates even when tax bases are rising. Nothing, however, prevents states from passing legislation that would institutionalize the rollback rate, which has, in fact, recently happened in the state of Florida. If local politicians want more tax revenues, they should go to voters and ask for an increase in the property tax rate. If revenues rise because of house price inflation, the tax should be rolled back to maintain current revenues. Making taxpayers aware of the rollbacks may also alter the relative unpopularity of the tax.

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