

## ***Point of Contention: Property Taxes***

*For this issue's Point of Contention, we asked four well-known public economics specialists to argue either for or against the following proposition—"Relative to the other revenue sources generally available to local government, the property tax generally is superior on efficiency grounds, because it induces less undesirable behavior and avoidance, and on equity grounds, because it bears less harshly on those less able to afford it."*

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# **Three Points in Favor, One Big Flaw**

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*Some of the text in this article comes from my unpublished comment on Fischel (2010).*

The statement as written is almost certainly true, but it does not necessarily imply that the property tax alone should fund local governments and schools. Let us begin with the basic truth of the statement, and then discuss why property taxes should be a principal, but not the lone, source of funding for local government and schools.

The property tax has three strengths to recommend it. First, in economics jargon, it is a tax on something that is fairly inelastically supplied (that is, real estate) in the medium (and sometimes long) run, and hence it does not create much deadweight loss. In other words, owners of real estate generally cannot physically move their buildings, so a somewhat higher tax rate does not change their medium-term behavior much; therefore, society does not suffer much loss of overall income or welfare from property owner reactions to tax changes.

Second, as a benefits tax, the property tax aligns the interests of government service providers with those of government service users (that is, taxpayers). In an ideal world, the *tax price* of government goods is unity. That is, the marginal cost to taxpayers of a service is equal to its actual cost. If they pay less at the margin, taxpayers will demand more services; if they pay more at the margin, they will demand fewer.

When property taxes fund services, property owners have the incentive to demand services up to the point at which benefits equal costs—the point at which property values reach their highest levels. Fischel (2010) hypothesized (and I think demonstrated) that in a world with a median-voter model of government decisionmaking, ad valorem property taxes lead to optimal and efficient service provision.

The most common criticism of the property tax is that it is regressive, which is true at a particular location at a particular point in time. As Aaron (1975) noted in his groundbreaking book, however, the property tax likely falls largely on holders of capital, who are on average richer than those who do not hold capital, and so the tax may well be progressive. Moreover, lifetime housing consumption is proportional to lifetime income, and consequently although a tax on housing at any point in time may be regressive, during the life cycle, it is not.

Although the property tax has virtues and should, in my view, be a principal source of local government spending, relying on it can produce one profoundly unfair outcome.

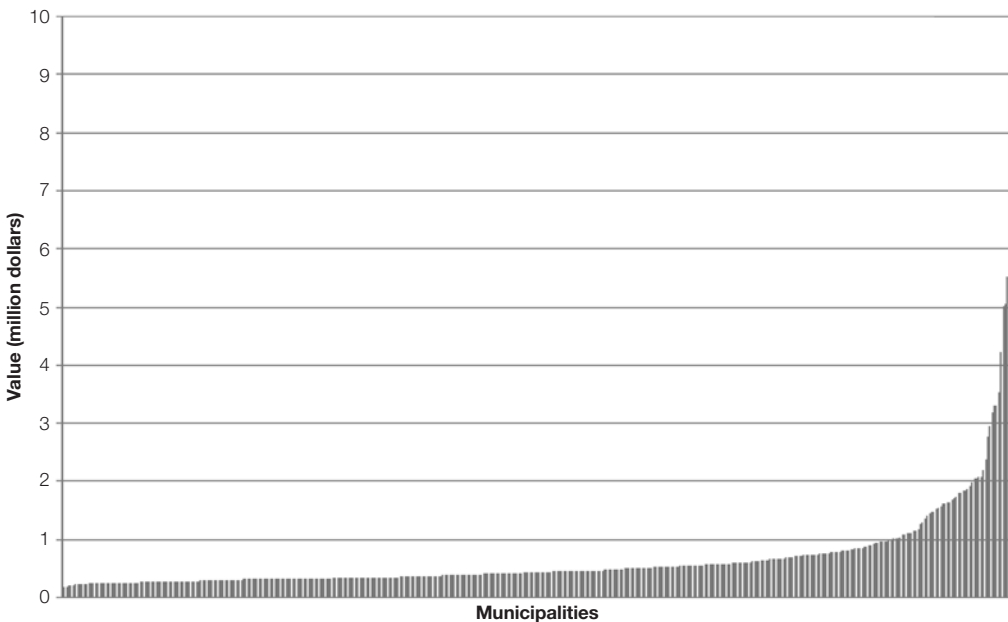
Differences in property values (and particularly commercial property values) lead to differences in tax prices that produce unequal outcomes for school children.

As Oates (1969) showed, in a municipality where schools are funded locally, higher school spending produces higher property values. We can infer from this finding that the net benefits of schools are greater than the net costs of funding them; moreover, this inequality may be self-reinforcing.

I will use Wisconsin as an example to illustrate the problem. Wisconsin effectively illustrates two dilemmas we face when using the property tax to finance schools. First, in 2006, the distribution of property values per pupil was both highly dispersed and skewed (exhibit 1). The average school district in Wisconsin had taxable property values per pupil of \$664,000, and the standard deviation of property values was \$773,000. The dispersion is not driven only by outliers: at the top quartile of the property value distribution, property value per pupil is roughly double the value at the lowest quartile of the distribution.

**Exhibit 1**

Property Value per Pupil, Wisconsin, FY 2006–07



*FY = fiscal year.*

Also, the tax price of schools varies dramatically. In the town of Brookfield, more than 50 percent of property value comes from commercial property, so the tax price of schools is quite low. In the city of Wisconsin Rapids, on the other hand, substantial sections of manufacturing property are exempt from the property tax, and farmland is taxed at use value.<sup>1</sup> Because of this disparity, residential property comprises a disproportionately large share of the tax base, and the tax price for schools is higher there than elsewhere.

Of course, direct methods do exist for redistributing resources across districts and putting children on a level playing field: vouchers that do not tie children to their local schools. Nechyba (2000) argues that it makes no policy sense for geography to determine child outcomes. I tend to like school vouchers myself, yet it is the nexus of geography and schools that leads to the positive outcomes that Fischel and others have attributed to property-tax-based school funding. Moreover, as a practical matter, it can be difficult for parents to transport children across large metropolitan areas to obtain good schooling.

Compounding the dilemma is the fact that the evidence, much of which Fischel (2010) cited, suggests that central government funding of education does not work very well. Public school systems in California used to be jewels of the state. During the years when most school funding has flowed through the state government in Sacramento, public schools in California have deteriorated.

So where does this leave us? Perhaps an answer arises from a simple insight of microeconomics: what matters is not the price at which you buy everything, but the price at which you buy the last thing. The best policy (or perhaps I should say second best policy) might be one in which all schoolchildren have access to the minimum level of resources necessary to receive an adequate education. I think there might be a consensus about what constitutes this minimum: proficient reading and math test scores at the grade school level and sufficient numbers of classes to prepare students for college at the high school level.

Each school district would receive the funding necessary to provide the minimum level of education. This minimum level might not include things such as advanced placement courses. From an efficiency standpoint, the ideal tax would be a lump-sum tax leveled at the state—or perhaps even federal—level. Such a tax would, of course, be politically infeasible and regressive. The least distortionary tax I can think of is a sales tax or a value-added tax. Any spending a community did beyond the bare minimum would be determined and financed by the community via the property tax. By implementing this tax policy, the marginal tax price of marginal improvements in education would be close to unity. Such plans exist and are known as foundation plans. Andrew Reschovsky, among others, has designed such plans.<sup>2</sup>

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<sup>1</sup> If farmland were taxed as, for example, potential new residential property, the same land would nearly always be worth more than its agricultural value.

<sup>2</sup> For an example, see [https://docs.google.com/viewer?a=v&q=cache:sQugQPpzyMJ:citeseerx.ist.psu.edu/viewdoc/download?doi%3D10.1.1.152.881%26rep%3Drep1%26type%3Dpdf+school+finance+network+wisconsin&hl=en&gl=us&pid=bl&srcid=ADGEEsGEn75LGC2eNyYiVdSmAzCfEUYBIU7cewDWovPFk4uc3if\\_ax-2\\_\\_2xb3tc7GHe89VZqOH910xXgrPq\\_H6X3GDyf8pH-Y\\_CnQHsITfeXdZWexovaU4X6peOeKxidSazPaB1An9l-&sig=AHIEtbTr7GKqG3VsuAVOWFEWa4dZJu\\_WYQ](https://docs.google.com/viewer?a=v&q=cache:sQugQPpzyMJ:citeseerx.ist.psu.edu/viewdoc/download?doi%3D10.1.1.152.881%26rep%3Drep1%26type%3Dpdf+school+finance+network+wisconsin&hl=en&gl=us&pid=bl&srcid=ADGEEsGEn75LGC2eNyYiVdSmAzCfEUYBIU7cewDWovPFk4uc3if_ax-2__2xb3tc7GHe89VZqOH910xXgrPq_H6X3GDyf8pH-Y_CnQHsITfeXdZWexovaU4X6peOeKxidSazPaB1An9l-&sig=AHIEtbTr7GKqG3VsuAVOWFEWa4dZJu_WYQ).

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