CHAPTER FOUR
PROPERTY TAXES

The property tax is the oldest major revenue source for state and local governments. At the beginning of the twentieth century, property taxes represented more than eighty percent of state and local tax revenue. While this share has diminished over time as states have introduced sales and income taxes, the property tax remains an important mechanism for funding education and other local services. But property taxes are regressive, and because these taxes are usually collected at the local level, the unequal distribution of wealth between rich and poor school districts can lead to inequitable school funding.

The challenge facing state lawmakers today is to preserve this important revenue source while at the same time offsetting its regressivity and reducing the disparities in school funding between rich and poor districts. This task has been made much more difficult by a decline in the popularity of the property tax—in part a result of the disconnect that exists between property tax bills and one's ability to afford those bills. As this chapter shows, however, relatively simple means exist for remedying this unpopular problem. This chapter surveys the basic workings of the property tax, its weaknesses and strengths, and numerous options for providing responsible, fair property tax relief.

Why Tax Property?

Although the personal income tax is best suited to fulfill the "ability-to-pay principle," the property tax can also provide an important contribution toward this end. By taxing those families with large quantities of wealth more heavily than those without such reserves, the property tax can help differentiate between families of very different means (though this could be improved upon further if the property tax were applied to the intangible and other properties often owned by the wealthiest families). As things currently stand, however, the impact that property taxes can have on low-income families, and particularly the elderly, makes clear that the linkage of the property tax to the ability-to-pay principle is far from perfect.

The property tax is also commonly understood as being rooted in the "benefits principle" of taxation, discussed on page 6. Under this view, the property tax essentially functions as a user-charge on local residents for the benefits they receive from the local policies funded by property taxes. These policies benefit local residents both directly, and indirectly in the form of increased housing values.

Finally, the stability and enforceability of the property tax make it among the best options available for providing local governments with a predictable revenue stream that can be used to fund indispensable services like schools, roads, and public safety.

Despite the very good reasons that exist for levying property taxes, however, it is important to keep

How Property Taxes Work

Market Value
X
Assessment Ratio (between 0% & 100%)
=
Assessed Value
–
Exemptions
=
Taxable Value
X
Sum of All Relevant Millage (Tax) Rates
=
Property Tax Before Credits
–
Homestead Credits and Circuit Breakers
=
Property Tax Owed

in mind that property taxes are regressive, and that targeted property tax relief must be provided as a result.

How Property Taxes Work

Historically, property taxes applied to two kinds of property: **real property**, which includes land and buildings, and **personal property**, which includes moveable items such as cars, boats and the value of stocks and bonds. Most states have moved away from taxing personal property and now impose taxes primarily on real property. In its simplest form, the real property tax is calculated by multiplying the value of land and buildings by the tax rate. Property tax rates are normally expressed in **mills**. A mill is one-tenth of one percent. In the most basic system, an owner of a property worth $100,000 that is subject to a 25 mill (that is, 2.5 percent) tax rate would pay $2,500 in property taxes.

In reality, however, property taxes are often more complicated than this. The first step in the property tax process is determining a property's value for tax purposes. In most cases, this means estimating the property's **market value**, the amount the property would likely sell for.

The second step is determining the property's **assessed value**, its value for tax purposes. This is done by multiplying the property's market value by an **assessment ratio**, which is a percentage ranging from zero to one hundred. Many states base their taxes upon actual market value—in other words, these states use a 100 percent assessment ratio.

A large number of states, however, assess property at only a fraction of its actual value. New Mexico assesses homes at 33.3 percent of their market value, and Arkansas uses a 20 percent assessment ratio. Some states place a cap on increases in a home's assessed value in any given year, which in many cases can lead to vastly different assessment ratios among similarly valued homes (see page 34 for more on this issue). And even when the law says properties should be assessed at 100 percent of their value, local assessors at times systematically under-assess property, reporting assessed values that are substantially less than the real market value of the property.

After the assessment ratio has been factored in, many states reduce a property's assessed value further by allowing **exemptions**. For example, Ohio allows an exemption for the first $25,000 of home value. Subtracting all exemptions yields the **taxable value** of a property.

The next step in the process is applying a property tax rate, also known as a **millage rate**, to the property's taxable value. The millage rate is usually the sum of several tax rates applied by several different jurisdictions: for example, one property might be subject to a municipal tax, a county tax, and a school district tax. This calculation yields the property tax owed.

Many states allow **property tax credits** that either directly reduce the property tax bill, or that reimburse part of the property tax bill separately when taxpayers apply for them. Subtracting these credits is the final step in calculating one's property tax bill—though taxpayers are often required to pay the pre-credit property tax amount, only to later have the amount of the credit refunded to them. These "property tax relief" mechanisms are described later in this chapter.

Before moving on, it is worth noting one potentially confusing result created by the complicated process described above. The tax rate most property owners are familiar with is known as the "nominal rate"—that is, the actual millage rate used in calculating your bill. But when comparing property taxes across districts or across states, analysts generally find the "effective" property tax rate to be much more useful. This rate is usually calculated by expressing the property tax as a share of market value. Expressing property taxes this way gives us a better sense of the true rate being paid per dollar of property owned, without the confusions associated with the wide variety of exemptions, assessment ratios, and credits utilized in each state. For example, the owner of a $100,000 home subject to a 25 mill (or 2.5 percent) nominal tax rate will almost always owe less than 2.5 percent of that home's value in tax. An 80 percent assessment ratio and $10,000 homestead exemption, for instance, would drop the home's effective tax rate to just 1.75%.

Property Taxes and Fairness

Although sales and excise taxes are the most regressive taxes, they are rarely as maligned as the property tax. The "sticker shock" effect of the property tax is partly to blame for this: it's a large, very noticeable payment that is made once or twice a year, while sales taxes are spread throughout the year on hundreds of purchases. Homeowners with mortgages are often less shocked than other homeowners, since their property tax payments are usually lumped into their mortgage payments, but once their homes are paid off these bills become harder to overlook. For these homeowners, the property tax can seem more oppressive and more unfair than it actually is, simply because it's more visible.

That said, there is no denying that the property tax is generally regressive. Nationwide, low-income families paid 3.7 percent of their income in property taxes in 2007, while middle-income families paid 2.9 percent of their income and the wealthiest taxpayers paid just 1.4 percent.[1]

The chief reason that property taxes are regressive is that they are based on home values rather than on income levels—and home values do not always vary directly with income levels. Home values represent a much larger share of income for middle- and lower-income families than for the wealthy. It is common for a middle-income family to own a home valued at two or three times their annual income, for example, while wealthier taxpayers are less likely to own homes worth as much relative to their income levels. The box on this page uses two hypothetical examples to illustrate the effects of this discrepancy.

Moreover, property taxes are not responsive to variations in taxpayers' income: someone who suddenly loses his job will find that his property tax bill is generally unchanged, even though his ability to pay it has drastically fallen. (By contrast, income tax bills depend on the level of earned income, so income taxes are much more sensitive to taxpayers' ability to pay—an important consideration in times of economic hardship.) A similar problem is very common among elderly taxpayers at the end of their working careers who find themselves "property rich" but "cash poor."

When the United States was an agrarian society, the property tax was a relatively fair form of taxation. The value of a citizen's land and buildings was an excellent measure of his wealth. But today, rich families have most of their wealth in other forms of property—stocks, bonds, etc. These forms of property are usually not taxed until they are sold. According to the Survey of Consumer Finances (SCF), in 2007 real estate represented less than nineteen percent of the assets of the richest one percent of wealth-holders.

Low- and middle-income families, however, still have most of their limited wealth invested in their homes. Because the wealthy have relatively little of their wealth invested in property subject to the real property tax, while the most valuable thing a middle-income family owns is its house, much more of a middle-income family's wealth is subject to the property tax.

Who is Affected Most by Property Taxes?

Jerry Seinfeld	
Annual Income	$85,000,000
Taxable Value of Home	$32,000,000
Home Value as a % of Income	38%
Tax as a % of Income	**0.5%**

Susan Anybody: Hypothetical Middle-Income Homeowner	
Annual Income	$55,000
Taxable Value of Home	$150,00
Home Value as a % of Income	273%
Tax as a % of Income	**3.8%**

Created based on data from the American Housing Survey, U.S. Census Bureau

Business Property Taxes

Of course, homeowners don't pay all of the property tax. Businesses pay it as well. Property taxes on business are mostly borne by business owners. (The special case of residential rental property is discussed below.) This makes the property tax less regressive since business owners tend to be wealthier than average. Also, some of the business property tax is exported to property owners living in other communities and other states. The business property tax is an important part of ensuring that the businesses that make use of local government services pay their fair share.

Though business property is frequently ineligible for many of the residential "property tax relief" programs described on page 29, it is nonetheless often granted large and expensive tax breaks by state and local lawmakers worried about attracting jobs. One such tax break, Tax Increment Financing (TIF), is described in the "Economic Development" chapter on page 60.

In many cases, lawmakers will strike deals directly with individual businesses in an attempt to encourage them to relocate or expand within the lawmakers' state or district. These types of cuts can have serious consequences for local revenues, thereby necessitating higher tax rates on all other properties, or fewer government services. Their true ability to change companies' location decisions is also a matter of serious question.

Property Taxes and Non-Profit Entities

Non-profit entities are generally exempt from state and local property taxes. While these exemptions can make it easier for these organizations to pursue their missions, localities in which a large amount of property is held by non-profit entities can find it hard to raise enough revenue via the property tax to adequately fund local services. This problem arises most frequently in areas with large non-profit hospitals and/or universities.

In some instances, a payment in lieu of taxes (PILOT) is negotiated in order to partially or fully compensate the

government for the revenue loss associated with a non-profit organization's tax exempt status. Because PILOTs are usually voluntary, however, non-profit organizations often have little incentive to sit down with government officials to negotiate such agreements. As a result, PILOTs are typically negotiated only when the organization in question needs the local government's help in some matter (such as amending a zoning law), or if the organization simply wishes to see the quality of public services in the area improve.

In order to improve the quality of PILOT negotiations that do take place, the Institute for Wisconsin's Future (IWF) recommends that localities take care to update available data on the value of tax-exempt properties.[2] IWF also recommends that states develop systematic and enforceable criteria for determining which entities are truly deserving of tax exempt status.

Residential Rental Property

While the public's attention to property taxes is usually focused on the taxes paid by homeowners, the property tax also affects taxpayers who rent, rather than own, their home. Who ultimately pays the property taxes levied on residential rental properties is disputed. Some economists believe that it is mostly borne by the landlords who own these rental properties. Others argue that it is mostly passed through to tenants in the form of higher rents. It is generally agreed that the answer partially depends on the rental market. When residential rental property is in short supply, landlords are more likely to pass their property taxes on to renters in the form of higher rents. But if rental property is abundant, landlords may find this more difficult.

Of course, most rental markets are not purely dominated by either tenants or landlords—so the answer probably is somewhere in between. And the matter is confused further because many rental markets cross municipal boundaries so that taxes vary on rental units in different parts of the market. Absent significant differences in the local government services renters care most about, landlords in higher tax jurisdictions can't simply raise rents to pay their property taxes if they have to compete with apartments in nearby, lower tax jurisdictions.

Two things are certain about property taxes on rental property. First, lawmakers consistently neglect renters in designing property tax relief, despite the fact that renters are paying some share of the property taxes levied on rental property. Second, data from the U.S. Census indicates that renters generally have incomes about half the size of their homeowner neighbors. "Property tax relief" paid directly to renters is therefore progressive in nature. The discussion of "circuit-breakers" on page 30 looks at how one can go about distributing tax relief to a group that only indirectly pays property taxes.

Personal Property Taxes

Personal property is all property other than real estate. Personal property taxes usually apply to **tangible** property such as individually-owned cars and trucks or business equipment. The tax can also apply to **intangible** property such as stocks and bonds.

Taxing tangible personal property is relatively straightforward, in theory. In the case of cars and trucks, the tax is usually a percentage of the "blue book" value of the vehicle. Since people have to register their vehicles, it's hard to avoid the tax. And business equipment can be assessed based on income tax return data for depreciation deductions.

The most common type of state personal property tax is on individually-owned cars and trucks. Although at first glance this tax may appear to be progressive (rich people have more expensive cars), it is not. Personal property taxes on automobiles are regressive for the same reason residential property taxes are regressive: the value of a person's car (or home), as a share of their income, is higher for low-income people than for the wealthy. Personal property taxes on vehicles are, however, generally preferable to most "vehicle registration fees", which are sometimes proposed as substitutes to the car tax. While some states like to brag that they lack a car tax, these registration fees can be equally as burdensome to low-income families. Unlike a flat-amount vehicle registration fee, the property tax paid on a middle-income individual's $20,000 Chevrolet is actually less than what is paid by a wealthier individual on his $50,000 Mercedes (though as a share of income, the tax on the middle-income person will still often be higher). Though this isn't enough to make the tax progressive, it is preferable to a flat fee. Making matters worse, these fees cannot be taken as an itemized deduction when computing one's federal tax bill, so even upper-income taxpayers—who are more likely to itemize their returns—may not benefit as much as one would expect (see page 37 for more on this point).

On the other hand, business personal property taxes and, especially, intangible property taxes on stocks and bonds are progressive because the wealthy own far more business property and intangible assets than do middle- and low-income people. It's also easy to exempt low- and middle-income people from an intangible property tax by providing generous exemptions.

But as a result of difficulties many states had with enforcing the intangible property tax, no state levies such a tax at this time.

In 2007, Florida became the last state to repeal its intangibles tax. Unfortunately, the movement against the intangibles tax proved to be short-sighted. The rise of the digital age and other advances in technology have greatly improved the potential for states to enforce an intangibles tax. Any state bold enough to reinstate its intangibles tax has a lot to gain, not only in terms of improved tax progressivity, but also in the form of a substantial revenue boost. Before reducing the intangibles tax rate shortly before its repeal, Florida brought in as much as $1 billion annually from the tax.

My Federal Tax Bill Did WHAT?

Federal deductibility can be a confusing concept. In 1998, Utah decided to repeal its car tax and replace it with a vehicle registration fee. Soon thereafter, lawmakers were surprised to learn that their constituents would be facing a $12 million federal income tax hike, as well as a $3 million state income tax hike, because vehicle fees cannot be taken as an itemized deduction unless they are related to the price of the vehicle. The editorial pages of some of the state's largest newspapers sensibly criticized lawmakers for this embarrassing oversight.

Revenue and Stability

Property taxes are generally more stable over time than the income or sales tax. This is because property tax revenue depends on property values, not income. When personal income grows rapidly, property taxes will generally not grow as fast (the recent housing bubble being the obvious exception)—and slower personal income growth is not always reflected in slow property tax growth. If property values are inflated prior to a recession, they will tend to fall once a recession starts. If an area is particularly hard hit by an economic downturn—if a town loses its leading industry, for example—property values also probably will fall. On the other hand, where property values were not inflated and a downturn is not catastrophic, it is not uncommon for property values to hold relatively steady during a recession.

Most localities also have at least some ability to further stabilize property tax revenues by adjusting the tax rate to offset changes in property values. This is an important benefit of relying on property taxes to finance local governments, as it allows for a stable level of local police, fire, and education services even during periods of great volatility in the housing market.

Unfortunately, property tax stability also means that people who are hardest hit during a recession—people who lose their jobs—don't get any relief. Property taxes are insensitive to variations in taxpayers' income: a taxpayer who suddenly becomes unemployed will find that her property tax bill is unchanged, even though her ability to pay it has fallen. By contrast, income taxes vary with income, so income taxes are more sensitive to taxpayers' ability to pay. Adding an income test to the calculation of property tax bills, such as the "circuit-breaker" credit described on page 30, can somewhat alleviate this problem.

Federal Deductibility

Property taxes, like state and local income taxes, are deductible in calculating federal taxable income for those who itemize their returns.[3] This means, in effect, that a portion of some state residents' property tax bills is "exported" to the federal government in the form of reduced federal income taxes for itemizers, and never comes out of those residents' pockets. For a more detailed discussion of this "federal offset" effect, see page 9.

Because property taxes are much more regressive than income taxes, however, a substantial share of property taxes is paid by low- and middle-income taxpayers who are much less likely to itemize than their wealthier neighbors. This means that property taxes offer a lower "bang for the buck" than income taxes in terms of reducing taxpayers' federal tax bills.

Interestingly, vehicle property taxes are deductible, but only when they are calculated as a percentage of the car's value. Car taxes that are based on a flat dollar amount cannot be deducted. This is an important distinction because almost all states levy flat-dollar car "registration fees" that cannot be deducted. Doing away with such fees and replacing the lost revenue with a property tax on car value would result in federal tax cuts for many car owners.

Property Tax Relief Options

As states have moved away from heavy reliance on property taxes, a variety of different mechanisms have been introduced for providing residential tax "relief". These mechanisms vary significantly in their methods, as well as in their quality. Unfortunately, the trend in many states has been in favor of blunt, poorly targeted tax relief, rather than towards more carefully targeted policies that can help those in need without requiring large cuts in government services. The implementation of poorly targeted relief programs have in many cases given the greatest benefits to the wealthy, and have often created grave inequities between neighbors' property tax bills as well. In this way, poorly designed property tax relief programs have frequently violated both the vertical and horizontal equity principles discussed on page 5.

This section surveys each of the major property tax relief mechanisms available to the states. The first three discussed here can actually make the tax less regressive in a well-targeted and fiscally responsible manner. These options include homestead exemptions, circuit-breakers, and deferral programs.

In contrast, split-roll property taxes, income tax breaks (especially deductions), and property tax caps have reduced property tax revenues substantially, while doing little to help those who need it most. Lawmakers have at times used imagery of residents being "taxed out of their homes" as reason to enact broad cuts that are by no means targeted to those vulnerable individuals for whom this possibility is most real. State policymakers and voters should not be swayed by this empty rhetoric.

Homestead Exemptions

More than forty states now allow some form of a **homestead exemption**, which reduces property taxes for homeowners by sheltering a certain amount of a home's value from tax. Homestead exemptions are a progressive approach to property tax relief, providing the largest tax cuts as a share of income to lower- and middle-income taxpayers. These exemptions are usually funded by local governments, so their cost is often made up through higher property tax rates than would otherwise be the case.

There are two broad types of homestead exemptions: flat dollar and percentage exemptions. The more common type, flat dollar exemptions, are calculated by exempting a specified dollar amount from the value of a home before a property tax rate is applied. A flat dollar exemption is especially beneficial to low-income homeowners because it represents a larger share of property taxes (and of income) for low-income taxpayers. Percentage exemptions give the same percentage tax cut to all income levels. This form of exemption is much less effective at targeting relief to those in need than are flat exemptions.

If neglected by lawmakers, flat dollar exemptions can become less valuable to homeowners over time if home values rise while the homestead exemption amount remains constant. A flat dollar homestead exemption that is not regularly updated will gradually become less able to protect a portion of a home's value from taxation, and property taxes will effectively increase as a result. Indexing the exemption (that is, automatically increasing it with inflation every year), is a simple way to avoid this unintentional tax hike.

While homestead exemptions are a progressive approach to property tax relief, even indexed exemptions have two important flaws: first, they provide no tax relief to renters, even though renters are generally agreed to pay some property tax indirectly in the form of higher rents. Second, exemptions are poorly targeted and costly. Because most homestead exemptions are not targeted to low- and middle-income taxpayers, but are available to even the wealthiest homeowners, they are especially costly—and provide little "bang for the buck" to low-income taxpayers.

Expanding homestead exemptions to include rental properties would in most cases be prohibitively costly to local governments. And for lawmakers interested in providing targeted property tax relief to those in need, there are much more effective tools than a means-tested homestead exemption. For these reasons, a modest, broad-based, flat dollar homestead exemption that is available to homeowners of all ages and income levels can provide a good base of property tax relief upon which to build with a circuit breaker program, discussed next.

Circuit Breakers

The property tax **circuit breaker** is a less expensive, more targeted approach to tax relief. Its name reflects its design: circuit breakers protect low-income residents from a property tax "overload", just like an electric circuit breaker. When a property tax bill exceeds a certain percentage of a taxpayer's income, the circuit breaker offsets property taxes in excess of this "overload" level. Circuit breakers are usually funded by state, rather than local governments, so their existence rarely puts any upward pressure on local property tax rates.

Circuit breakers usually give homeowners (and oftentimes renters as well) a credit equal to the amount by which their property tax bill exceeds a certain percentage of their income, though sometimes only a fixed percentage of that amount is given, and there is usually a cap limiting the total amount of credit allowed. Circuit breakers are usually made available only to low-income taxpayers, on the premise that this group is most in need of "relief." Limiting circuit breaker eligibility based on income is far preferable to limiting it based on age—as many states do in restricting their programs to elderly taxpayers—because low-income taxpayers of very different ages can be equally in need of relief.

Because it is generally agreed that renters pay property tax indirectly in the form of higher rents, many states now extend their circuit breaker credit to renters as well. The calculation is the same as for a homeowner, except that some percentage of the rent you pay is assumed to be the property tax paid. Renters in Michigan, for instance, use 20 percent of their rent as their assumed property tax in calculating their circuit breaker credit.

The ability to target circuit breakers to those taxpayers most in need means that virtually none of the property tax relief from a circuit breaker credit will be offset by federal income tax hikes for itemizers. By contrast, when a homestead exemption reduces the property tax paid by a wealthy homeowner, that homeowner will have less property tax to claim as an itemized deduction on his federal tax return—which means that his federal taxes will go up.

Like the homestead exemption, circuit breakers must be indexed for inflation in order to preserve the value of this tax break for low-income taxpayers. For example, if the Illinois circuit breaker's maximum income level for eligibility and the maximum credit amount had been indexed for inflation since it was first introduced in 1972, the income threshold would have been $52,000 in tax year 2010—more than double the current value for unmarried taxpayers—and the maximum value of the credit would have been about five times its current value.

The main drawback of circuit breakers is that, in general, they only are given to taxpayers who apply for them. (By contrast, homestead exemptions are usually given automatically to eligible taxpayers.) Eligible taxpayers will only apply for tax credits if they are aware of their existence. This means that an essential component of a circuit breaker program must be an educational outreach effort designed to inform state taxpayers of the credit. In addition, one way of making it easier for eligible taxpayers to claim the circuit breaker is to make it possible to claim the credit either on income tax forms or on a separate circuit breaker form (for those who do not have to file income tax forms).

Deferral Programs

A number of states allow some homeowners to delay paying their property tax bills by making use of **deferral programs.** The vast majority of these programs are restricted to taxpayers above a certain age. Deferrals can apply to all or part of a homeowners' tax bill in a given year, and the maximum amount that can be deferred over time is often limited to a specific percentage of the property's value. Some deferral programs resemble circuit breakers in that the taxpayer can only defer the portion of their tax bill exceeding a certain percentage of their income. Interest is generally owed on the amount of tax deferred, and payment of the deferred taxes is often made when the home is sold.

Because the state and/or locality eventually receives the amount of property taxes deferred, deferrals cost the government less than any other form of property tax relief. The cost of deferrals is further limited by the fact that they are often not widely used. At least two factors contribute to the relative unpopularity of deferrals among taxpayers. First, many taxpayers are likely unaware of deferral programs, in part because states often do a poor job advertising their existence. Second, because deferred taxes must be paid back with interest, only those taxpayers in genuine need are likely to take advantage of these programs. In this way, deferrals are an extremely targeted form of property tax relief.

Property Tax "Relief" for Renters

Distributing property tax relief to renters is critical on fairness grounds. It is widely assumed that some portion of property taxes are usually passed on to renters in the form of higher rents, and depriving this group of relief from those taxes is unfair not only on horizontal equity grounds, but on vertical equity grounds as well (since renters as a class are generally poorer than homeowners).

Split Roll

A fourth way to provide property tax relief is a split roll, also known as a "classified property tax." Unlike a regular property tax, which taxes the value of all real property at the same rate, a split roll property tax applies different effective tax rates to different types of property. One approach to a split roll property tax is taken by the District of Columbia, which taxes homes at a lower rate than business properties. This shifts some of the property tax load from homeowners to businesses.

A second approach is to assess homeowners at a lower percentage of their value than other types of property. For example, Utah assesses all residential properties at 55 percent of their value, and assesses all other types of property at 100 percent of their value. A single tax rate is then applied to all properties of all types within each taxing district. This approach has exactly the same impact on tax fairness as the District of Columbia approach of using different tax rates.

While split roll taxation is sometimes favored by those seeking to ensure that businesses pay their fair share, it has three main shortcomings that severely limit its usefulness. First, it's poorly targeted. Every homeowner pays a lower tax rate because of the split roll, from the very poorest to the very wealthiest. And the lower rate is available to anyone who owns a property—even those whose principal residence is in another state. Because of these flaws, a split roll system is less targeted than either a circuit breaker or a flat dollar homestead exemption. This latter point is illustrated in the chart below, which demonstrates how more expensive homes can benefit disproportionately from a split

Property Taxes and Age

Many property tax relief programs, including homestead exemptions, circuit breakers, deferrals, and even some assessment limitations are available only to people above a certain age. This is because elderly people are oftentimes among those most likely to be "property rich" and "cash poor." Put another way, while many elderly people own homes that they purchased earlier in life, a significant percentage of those people lack the level of retirement income needed to afford the property tax bills owed on those homes. Ensuring that low- and moderate-income elderly individuals are not taxed beyond their ability to pay is therefore an important goal.

But although the elderly are among those most likely to be in need of relief, this does not mean that such relief should be restricted based on age. After all, a given taxpayer's income, not their age, is what determines whether they can afford to pay their property tax bill. Well targeted relief, such as a circuit breaker, should not be reserved exclusively for the elderly.

roll system. Second, reducing the property tax on one class of property inevitably means shifting a greater share of the tax onto other groups. Unless lawmakers ensure that the "residential" property tax owner includes renters as well as homeowners, split roll taxation can actually make the property tax less fair by shifting the property tax load from homeowners to low-income renters.[4] Third, the split roll makes property tax administration more complicated, because it requires tax administrators to determine not just the value of each property, but also its use.

Homestead Exemption vs. Split Roll: Who Benefits?

	Home #1	Home #2
Assessed Home Value	$100,000	$500,000
Homestead Exemption (HSE)	***$25,000***	***$25,000***
New Taxable Value	$75,000	$475,000
Tax with HSE and 2 mill (2%) rate	**$1,500**	**$9,500**
Split Roll	***1.5%***	***1.5%***
Tax under split roll system	**$1,500**	**$7,500**

Income Tax Breaks for Property Taxes

Most states provide property tax relief through their state income tax forms. This is done in two ways: **itemized deductions** and **income tax credits**. More than thirty states allow itemizers to deduct their property tax payments from their taxable income. Since these deductions are usually only available to state itemizers—and can only be claimed by those who pay state income taxes—this approach to property tax relief excludes many of the low-income homeowners for whom property taxes are most burdensome.

A few states provide other forms of income-tax-based property tax relief. Illinois, for example, allows taxpayers to claim a non-refundable income tax credit equal to 5 percent of the property taxes paid on their home. Credits are usually a more progressive approach to tax relief—but when these credits are non-refundable, those who don't pay enough income tax to claim the full credit receive less relief, despite the fact that these "income-poor, property-wealthy" taxpayers are often less able to pay property taxes than most.

Most income tax breaks for property taxes are restricted to homeowners, and overlook the fact that renters' monthly payments include some amount of built-in property tax. Circuit breakers, which are often administered via the income tax as well, are the exception.

Property Tax Caps

In response to what anti-tax advocates have branded as "out of control" property taxes, a number of states have decided to make use of blunt caps to restrict the growth of the property tax. California's infamous Proposition 13, approved in 1978, was instrumental in inspiring numerous other states to enact similarly ill-conceived **property tax caps**. These caps can come in many forms, but all are poorly-targeted and costly. In most cases, these caps amount to a state-mandated restriction on the ability of local governments to raise revenue. While state lawmakers get to take credit for cutting taxes, local lawmakers are the ones forced to make difficult decisions regarding which services to cut. Among the types of property tax caps in use around the country are:

- **Caps on property tax rates:** Property tax rate caps limit the size of a property's tax bill to a specific percentage of its value. California and Indiana, for example, each restrict homestead property tax bills to 1 percent of the home's value. Massachusetts imposes its rate cap in a slightly different manner, prohibiting total property tax revenues in each municipality from exceeding 2.5 percent of total

assessed property value. Rate caps reduce both the revenue generating potential of the property tax, and the ability of local lawmakers to stabilize property tax collections through periodic adjustments in the tax rate. Both of these flaws cause rate caps to erode local governments' ability to provide a consistent and adequate level of services.

- **Caps on increases in a property's assessed value:** This type of cap prevents the taxable assessed value of a homeowner's residence from rising faster than a pre-determined rate. In California, Proposition 13 limits increases in a homeowners' assessed value to 2 percent per year, or the overall rate of inflation, whichever is lower. In Florida, the "Save Our Homes" amendment limits assessed value increases to the lower of 3 percent or inflation. In addition to being poorly targeted and costly, these caps also result in bizarre and unfair differences in the tax bills paid by neighbors with similarly valued homes. Since a home's taxable assessed value is reset upon changing ownership to reflect its actual value, residents who have recently moved into a home are required to pay significantly more in property taxes than their long-term neighbors who have seen increases in their home's taxable value capped for many years. This same phenomenon has also resulted in some homeowners feeling trapped in their current homes, due to the fact that they would have to pay much higher taxes if they were to change residences. Florida recently sought to address this issue by allowing homeowners to essentially carry over their tax cap savings to a new residence upon moving. While some long-term homeowners have been helped by this change, it has also been an enormously costly change that has made Florida's property system much more complicated, and has done nothing to help first-time home-buyers.
- **Caps on increases in overall revenue collected:** The most restrictive type of property tax caps prevent localities from increasing overall property tax collections beyond a certain annual amount. In Massachusetts, for example, municipalities are prohibited (absent specific approval from voters) from collecting more than 2.5 percent in additional property tax revenue beyond what they collected in the previous year. As is oftentimes the case with caps, there are some exceptions. Towns, for example, are allowed to tax new growth within their borders, which does provide a significant amount of revenue. Nonetheless, since the cost of providing a stable level of local government services has traditionally risen at more than 2.5 percent per year, this cap has noticeably diminished the quality of public services in many localities. New Jersey recently chose to follow Massachusetts' lead with a similar 2 percent cap on revenue increases.

Property Tax Reform: Issues and Options

Property taxes are the most venerable revenue source for state and local governments—but there is some concern that these taxes are unsuitable for the needs of the modern state. This section looks at two such areas of concern: the impact of regional inequities in property wealth on the quality of public education in poor districts, and the quality of property tax assessment.

Property Taxes and Education Financing

The primary purpose of local property taxes is to fund schools. But property wealth is usually distributed unequally between taxing districts. As a result, property-poor districts are not able to fund education as easily as property-wealthy districts. For example, in 2000 the Lake View school district in Arkansas raised only $827 per student in local revenue—just over a quarter of the $3,200 per student raised by the much wealthier Little Rock school district in that year. Left to their own devices, low-wealth districts typically have to tax homeowners at a much higher rate—and still don't raise as much revenue per-pupil as a wealthier district can. This sort of inequity between poor and wealthy districts has been the basis for a series of court cases challenging the constitutionality of school funding systems in various states.

Even property-wealthy districts can find it difficult to raise enough money to fund schools adequately using property taxes. As a result, almost every state has enacted a program of state aid to local school districts, designed to provide a guaranteed minimum amount of education spending per pupil while minimizing the gaps in spending between poor and wealthy districts.

What can go wrong with a school funding system that works in this way? First, the baseline amount of spending per pupil may be well short of the amount required to achieve an adequate education—that is, states can achieve equity without achieving adequacy. Second, property-wealthy districts can usually raise more than this state-sponsored amount per pupil without relying on state help—which means that the amount spent on education will differ between poor and wealthy districts, even after taking account of state aid. Some argue that as long as these differences between poor and wealthy districts remain, equity will not have been achieved.

One tax reform option for the growing number of states that are now confronting court mandates to fund schools adequately

and equitably is to preserve the role of property taxes in funding schools by replacing some of their current local property taxes with a statewide property tax levied at a uniform rate. The statewide property tax requires the same level of effort from all taxing districts in a state, and reallocates some of the resulting tax revenue between wealthy and poor districts in a way that, if done properly, can equalize the revenue-raising ability of all districts.

Assessment Practices

The most important step in the property tax process is assessing the value of a property. After all, under the property tax, home value is the basis for measuring a homeowner's ability to pay—so the property tax will only be as fair as the assessment process. Unfortunately, many jurisdictions don't assess property fairly. Some states don't require regular reassessment of property. In other states, there can be significant variation in assessed values between properties that are actually very similar. When assessment practices are poor, two families with identical homes and the same income level could face different property tax bills. This undermines people's faith in the fairness of the tax system and erodes public support for the taxes needed to pay for government services.

Local assessors routinely assess properties at less than what the law prescribes. For example, a typical state might require that residential properties be assessed at 100 percent of their market value, but assessors might actually assess these properties at an average of 90 percent of their market value. From a tax collector's point of view, this approach has two virtues. First, it gives taxpayers the illusion that government is giving them a good deal by taxing only part of their home values. This is an illusion because the underassessment, by necessity, is offset by a higher property tax rate. Second, underassessment reduces the likelihood of legal challenges to assessments. Unless homeowners compare their assessments with those of other homeowners, even large and unfair discrepancies will not be detected.

When property is under-assessed not because of poor-quality assessments but because of legal rules requiring low assessment ratios, fairness can be undermined as well. If assessments are at full value, inaccurate assessments stand out. But if property is legally assessed at (for example) 20 percent of its true value, it becomes much harder to detect variations in assessment quality because the assessed value is hard to compare to a homeowner's sense of the home's true value. Thus, underassessment makes unfair or corrupt assessment practices more difficult to detect.

Poor or infrequent assessment can also make it difficult for lawmakers to equalize differences between poor and wealthy districts' ability to fund schools. Most state school-aid programs are based on the property wealth of each district—and poor-quality assessments make it hard to know which districts are truly poor and which are simply under-reporting their assessed value. For this reason, reform of local property assessment practices must usually be done before school finance reform can be accomplished at the state level.

Finally, infrequent assessments make it difficult for taxpayers to plan for their financial future, since large changes in a home's property tax bill can occur when a property is finally reassessed after many years. This can also lead to "sticker shock"—which erodes support for the property tax—as well as to an increase in time-consuming legal challenges to assessments, regardless of whether or not those challenges are justified.

Important steps lawmakers can take to ensure accuracy and transparency in the property assessment process include hiring and training professional assessors, making assessed valuation information publicly available, assessing property at its full market value so taxpayers can understand how they are being taxed, and frequently reassessing all properties.[5]

Conclusion

Property taxes are generally regressive, and relying on local property taxes to fund education can create unfair disparities between poor and wealthy districts. But despite these shortcomings, the property tax is truly indispensable in financing essential local services. Progressive tax reform can help make the tax a more sustainable—and less unfair—revenue source for the twenty-first century.

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[1] "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States." Institute on Taxation and Economic Policy, November 2009. http://www.itepnet.org/whopays3.pdf

[2] "Hospitable Taxes: How Non-profit Hospitals Profit from Wisconsin's Outdated Tax System." Institute for Wisconsin's Future, May 2008. http://www.wisconsinsfuture.org/publications_pdfs/tax/hospital_taxes_5_08.pdf

[3] Sales taxes have also been deductible since 2004, though this deduction is only temporary through tax year 2011. See page 9 for more on the deductibility of sales taxes.

[4] This was originally true of the D.C. split roll system. Until fairly recently, homeowners paid a tax rate of 0.96 percent and rental properties paid 1.54 percent. But tax changes enacted in 1999 reduced the property tax rate on residential rental real estate to equal the homeowner rate.

[5] States and localities that lack the resources to frequently reassess all properties can, as a second-best solution, also consider adjusting assessments on an annual basis to reflect changes in the assessed values of a sampling of nearby properties.