TALKING TAXES

Capping Assessed Valuation Growth: A Primer

Across the nation, rapidly rising home values are prompting increasingly vocal complaints from homeowners afraid that growing property taxes will outstrip their ability to pay them. In response, lawmakers are showing renewed interest in property tax reform options. This policy brief looks at one option that has gained visibility as part of California's Proposition 13: capping the annual growth in the assessed value of homes.

How Assessed Value Caps Work

In many fast-growing metropolitan areas, home prices have shot up dramatically in recent years. This usually means that home values in these areas grow rapidly too. Assessment caps are typically enacted to ensure that very rapid growth in a home's market value (the amount the home would likely sell for) does not result in equally rapid growth in the home's assessed value (its value for tax purposes). These caps typically limit the amount by which a home's assessed value can increase from one year to the next. For example, California's assessment cap limits the annual growth in a home's assessed value to 2 percent a year. When a California home's market value increases by 10 percent due to the booming real estate market, its assessed value will grow by only 2 percent. A cap will be most valuable for taxpayers whose homes are appreciating most rapidly, but will provide no tax relief at all for homeowners whose home values are stagnant or declining.

Factors Shaping the Effectiveness of Assessment Caps

More than a dozen states now impose caps on the annual growth of assessed value. But not all assessment caps are created equal: some have severely curtailed states' ability to adequately fund services, while others have had less of an impact. The differing impact of these caps on homeowners can be traced to a few important policy choices:

☞ **How big is the cap?** In California, the annual limit is 2 percent or the rate of inflation, whichever is lower. Other states employ annual caps as high as 10 percent. A lower cap will give bigger tax cuts to eligible homeowners, and will make more homeowners eligible—but will also make assessment caps potentially much more costly to local governments.

☞ **Does the state impose additional caps on property tax rates?** Taken on their own, assessed value caps will not reduce overall property taxes at all: when caps reduce the total assessed value of property in a district, lawmakers can simply increase tax levy rates to make up for all of the lost value. In this situation, assessment caps simply shift the property tax load away from rapidly-appreciating properties and towards properties experiencing slow or negative growth in value—many of which are likely owned by low-income families. As a result, assessment caps can actually *increase* property taxes for the homeowners for whom property taxes were most burdensome to begin with. When combined with caps on tax rates (such as the 1 percent cap used in California), however, assessed value caps can result in overall property tax cuts.

☞ **Which types of property benefit from the limits?** In California, the same limit applies to both residential and business properties. In Florida, only owner-occupied residential properties benefit from the assessment cap. When caps are applied to all types of property, the result is a bigger tax shift away from rapidly-appreciating properties—which means a bigger tax shift onto properties with slower-growing (or decreasing) assessed values.

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Funding for this Policy Brief was provided by the Annie E. Casey Foundation

☞ **What happens when properties are sold?** Caps usually include an "acquisition value" rule that resets the assessed value of properties to equal their market value when they are sold. This creates unfair differences between the tax treatment of otherwise identical homes that were purchased in different years. The "acquisition value" rule puts residential properties at a tax disadvantage, since homes typically change hands more frequently than do businesses, and creates a "lock-in effect" that makes homeowners less likely to sell their homes for fear of incurring huge property tax increases.

☞ **Does the cap apply to individual properties or classes of property?** Most caps apply to the growth of a particular home's assessed value. But a few states restrict the total statewide growth of residential assessed value. In these states, either every homeowner receives a tax break (if statewide growth exceeds the limit), or no one gets the break. This sort of cap is not designed to cope with rapidly growing assessed values for individual homes.

If property tax relief for fixed-income homeowners is the goal, assessment caps are among the least effective strategies available to lawmakers. Targeted "circuit breaker" tax credits for low-income homeowners and renters would offer better "bang for the buck" for state and local governments.

If Assessment Caps are the Solution, What's the Problem?

Lawmakers supporting assessment caps are implicitly making a statement about property tax reform priorities that is hard to defend: that it is more important to shelter upper-income taxpayers from increases in their home values than it is to provide tax breaks for low-income homeowners for whom property taxes were quite burdensome to begin with. Of course, lawmakers rarely describe their property tax reform objectives in this way. Instead, lawmakers typically point to the impact of growing assessments on low-income or fixed-income families as the problem to be solved. As one Democratic candidate for the Nevada state legislature explained in the fall of 2004, "I think we should put up to a 6 percent cap on property taxes so we don't tax low income and seniors out of their homes."

But if tax relief for fixed-income homeowners and renters is the goal, assessment caps are among the least effective tax strategies available. Caps give tax breaks to anyone whose home value increases rapidly, reserving the biggest tax breaks for those (typically wealthy) homeowners whose home values grow fastest, and provide nothing at all for low-income homeowners whose assessed values are stagnant. This makes assessment caps very expensive and very poorly targeted. A less expensive and better-targeted approach is a "circuit breaker" tax credit, which typically provides targeted tax breaks to low-income and elderly taxpayers for whom property taxes exceed some percentage of their incomes above which property taxes are deemed too burdensome. Circuit breakers are more inclusive, because they provide relief to taxpayers for whom property taxes are most burdensome, and more exclusive, because they limit eligibility to taxpayers for whom "ability to pay" is clearly an issue. (See ITEP Policy Brief #10 for more details on property tax circuit breakers.)

Assessed Value Caps: An Expensive, Untargeted Tax Cut

For most people, the most objectionable feature of property taxes is the disconnect between a homeowner's tax bill and their ability to pay the tax. While personal income taxes are sensitive to ability-to-pay issues, varying directly with a taxpayer's earnings each year, property tax bills can go up dramatically even when a homeowner's income falls sharply. Assessed-value caps are simply not designed to deal with this "ability to pay" problem, which makes them a poor policy choice to mitigate the anger many fixed-income taxpayers feel about their property taxes. Perhaps most important for cash-strapped states, assessment caps offer less "bang for the buck" than virtually any other property tax break, often lavishing the largest tax breaks on the wealthy homeowners for whom property taxes are least burdensome while providing little or nothing to many fixed-income taxpayers.

To find out more about this issue, contact ITEP at (202) 626-3780