

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. 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 making the tax less regressive, and reducing the disparities in school funding between rich and poor districts. This chapter surveys the basic workings of the property tax, and assesses its weaknesses and strengths.

The Property Tax: How it Works

Historically, property taxes applied to two kind 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 tax 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. 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.

But many states 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. And even when the law says properties should be assessed at 100 percent of their value, local assessors often systematically under-assess property, reporting assessed values that are substantially less than the real market value of the property.

Effective versus Nominal Rates—An Example

Here's an example of why it's important to look at effective tax rates instead of nominal rates. Property tax assessments vary greatly between localities, with some places assessing property at only a fraction of its real value. So some localities are applying their tax to a broader base than others.

By only comparing nominal rates, one might conclude from the example below that Town A has higher property taxes than Town B. But by looking at effective tax rates we see that the property tax burdens are, in fact, equal. Effective rates take into account the different assessment practices in Town A and Town B. (Town A assesses at 50 percent of market value, Town B at 100 percent).

Calculation of Property Tax	Town A	Town B
1. Nominal Tax Rate	3%	1.5%
2. Real Market Value	\$100,000	\$100,000
3. Assessed Value	\$50,000	\$100,000
4. Tax (line 3 times line 1)	\$1,500	\$1,500
5. Effective Rate on Market Value (line 4 divided by line 2)	1.5%	1.5%

Many states reduce a property's assessed value further by allowing exemptions. For example, Florida 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.

The rate most property owners are familiar with is the nominal rate—the actual tax rate used in calculating your bill. But when comparing property taxes across districts or across states, analysts will often look at effective property tax rates, which are usually calculated by expressing the property tax as a share of market value. Expressing property taxes this way gives us a better sense of how all exemptions and assessment ratios affect the tax paid.

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. These property tax relief mechanisms are described later in this chapter.

A Regressive Tax

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. So the property tax often seems 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 3.0 percent of their income in property taxes in 2002, while middle-income families paid 2.4 percent of their income and the wealthiest taxpayers paid just 0.8 percent.

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. For example, it is common for a middle-income family to own a home valued at two or three times their annual income, but wealthier taxpayers are less likely to own homes worth as much relative to their income levels.

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 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.) And the property tax can be especially burdensome for elderly taxpayers at the end of their working careers who find themselves “property rich” but “cash poor.”

Who Bears the Brunt of Taxes on Homes?

Is it...

Warren Buffett, of Omaha, Nebraska--One of the 400 Richest Americans?*

Net Worth	\$36 billion
Taxable Value of Home	\$690,300
Home Value as % of Net Worth	0.002%
Tax as % of Net Worth	0.00004%

*"400 Richest in America," Forbes, 2003; Omaha World Herald, 8/22/03

Or is it...

Susan Anybody, a Hypothetical Middle-Income Homeowner?

Net Worth:	\$80,000
Taxable Value of Home	\$50,000
Home Value as % of Net Worth	62.5%
Tax as % of Net Worth	1.3%

When the United States was an agrarian society, the property tax was a fair form of taxation. The value of a citizen's land and buildings was an excellent measure of her 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. According to one recent study, in 2001 real estate represented less than twenty percent of the assets of the richest 0.5 percent of wealth-holders.⁵

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.

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 important because without it, many businesses that use local government services would go largely untaxed.

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 on residential rental real 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. 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, owners lobby against property tax hikes as if they think owners pay the tax, but when they try to raise rents they tell their tenants that tenants have to pay it. Second, because renters as a class are poorer than homeowners, "property tax relief" (discussed below) paid directly to renters is progressive regardless of whether the relief really is related to tenants' actual property tax burdens.

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

⁵Arthur Kennickell, "A Rolling Tide: Changes in the Distribution of Wealth in the US, 1989-2001", November 2003. Levy Economics Institute Working Paper No. 393.

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.

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.

Unfortunately, taxation of intangibles is hard to enforce because of the difficulty in valuing many taxable stocks and bonds and the ease of hiding many intangible assets. If these problems can be solved, however, an intangibles tax is extremely progressive, and can be a substantial revenue raiser, even with very low rates.

Florida raised \$717 million in 2001 from its intangibles tax. Enforcement is, however, largely confined to intangibles for which income is reported on the federal income tax. It is widely believed that there is a significant compliance problem in Florida—with much of the intangible wealth of rich Floridians escaping taxation.

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—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.

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.

Deductible in Computing Federal Income Tax

Property taxes, like state and local income taxes, are deductible in calculating federal taxable income (for those who itemize their returns.) This means, in effect, that a portion of a state resident's property tax bill is "exported" to the federal government in the form of reduced federal income tax for itemizers, and never comes out of the pocket of state residents.

Because property taxes are much more regressive than income taxes, the lion's share of these taxes are paid by low- and middle-income taxpayers who are less likely to itemize. This means that property taxes offer a lower "bang for the buck" than income taxes in terms of the federal offset.

Car 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 consideration because almost all states levy flat-dollar car "registration fees" that cannot be deducted.

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. This section surveys various approaches to property tax relief, including general exemptions, targeted low-income tax credits, “split roll” taxes and income tax-based deductions and credits.

Homestead Exemptions

More than forty states now allow some form of a **homestead exemption**, which reduces property taxes for all 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.

There are two broad types of homestead exemptions: flat dollar and percentage exemptions. 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 also progressive—but is less effective at targeting relief to poor taxpayers than are flat exemptions.

The table at right illustrates this point using two examples. If the state allows a flat exemption for the first \$15,000 of home value, a home worth \$60,000 will see a 25 percent property tax cut. A home worth \$500,000, however, will only see a 3 percent property tax cut. By contrast, a percent exemption will give each taxpayer the same percentage cut.

Fixed dollar exemptions tend to become less valuable over time. In Florida, for example, the average home value jumped from \$88,000 in 1998 to \$140,000 in 2003—a 59 percent increase in

only five years. But during that time, the value of Florida’s homestead exemption remained at \$25,000. So for most Florida homeowners, the exemption is now a much smaller portion of their home value than it was in 1998. Indexing exemptions (that is, automatically increasing the exemption every year to take account of the rising cost of living) can avoid this unintentional tax hike.

While homestead exemptions are a progressive approach to property tax relief, they 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.

Circuit Breakers

The property tax **circuit breaker** is a less expensive, more targeted approach to tax relief. Its name reflects its design. Because it protects 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 reduces property taxes in excess of this “overload” level.

Circuit breakers usually give homeowners a credit equal to the amount by which their property tax bill exceeds a certain percentage of their income, though there is usually a cap

Flat Dollar versus Percentage Exemptions: Who Benefits?		
<i>[Calculation Assumes 20 Mil (2 percent) Rate]</i>		
Assessed Home Value	\$60,000	\$500,000
Tax Without Exemption	\$1,200	\$10,000
Flat \$ Exemption	\$15,000	\$15,000
New Taxable Value	\$45,000	\$485,000
Tax With \$ Exemption	\$900	\$9,700
Tax Cut	25%	3%
Percent Exemption	15%	15%
Exemption in \$	\$9,000	\$75,000
New Taxable Value	\$51,000	\$425,000
Tax With % Exemption	\$1,020	\$8,500
Tax Cut	15%	15%

limiting the total amount of credit allowed. Circuit breakers are usually made available only to low-income taxpayers, on the theory that property taxes are most burdensome for the least wealthy homeowners. 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 \$45,000 in tax year 2004—more than double the current value for unmarried taxpayers—and the maximum value of the credit would have been more than four 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).

Split Roll

A third way to provide progressive 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 burden from homeowners to businesses. The chart on this page shows the current tax rates in the District of Columbia.

District of Columbia Split Roll Property Tax Rates, 2004		
Class	Tax Rate (in Mills)	Description
I	9.6	Residential
II	18.5	Commercial
III	50	Vacant

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.

Split roll taxation has three main shortcomings. 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. A better-targeted approach would provide tax cuts only for the low- and middle-income homeowners for whom these taxes are most burdensome. 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 burden from homeowners to low-income renters.⁶ 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.

Income Tax Breaks for Property Taxes

Most states provide property tax relief through their 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.

Property Tax Issues

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.

⁶This was originally true of the D.C. split roll system. Until quite 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.

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 equalizes 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, 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.

Important steps lawmakers can take to ensure transparency in the property assessment process include:

- Hiring and training professional assessors;
- Making assessed valuation information publicly available;
- Assessing property at its full value so taxpayers can understand how they are being taxed.

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 the property tax plays an important role in funding public services, and progressive tax reform can help make the tax a sustainable—and less unfair—revenue source for the twenty-first century.