

## **Local Property Taxation: An Assessment**

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The property tax is, in my view, a good local tax. It is far from perfect, but perfection in taxation (as in most things) is not of this world. However, relative to the other tax bases available to local government, I think the property tax gets high marks. In this essay, I want to explain this view and explore some of the central issues. I also want to indicate how I think the tax has been subject to some telling but misplaced criticism.

### **Local Property Taxation and Traditional Tax Theory**

Public finance economists have historically evaluated taxes in terms of their efficiency properties, their incidence, and their ease of administration. Let me review briefly the treatment of the property tax in a local setting under each of these dimensions of tax analysis.

From the perspective of economic efficiency, the basic issue is the extent to which a tax introduces distortions into the economic system, thereby creating an “excess burden” in addition to the basic burden of payment of the tax. On this matter, there is currently a lively controversy. On one side, Bruce Hamilton, William Fischel and others argue (persuasively I believe) that local property taxation in conjunction with local zoning ordinances, like those that exist in much of the United States, produces what is effectively a system of benefit taxation that promotes efficient location and fiscal decisions on the part of households. On the opposing side, Peter Mieszkowski and George Zodrow view local tax differentials much like excise taxes, which have a distorting effect on local decisions and discourage to some extent the use of capital. Thus, while the case for property taxation purely on efficiency grounds is not altogether clear, it probably gets better marks than other available tax bases aside from user charges.

As to the incidence of the tax, the older view of the property tax, which saw it simply as an excise tax on housing and business structures, suggested that it was a regressive tax: housing expenditure (it was claimed) took a larger fraction of income from poorer than from wealthier households. Later studies of the income elasticity of demand for housing cast some doubt on this proposition. The finding that housing expenditure is roughly proportional to permanent income suggested that property taxation was something more akin to a proportional tax relative to income.

The (now not so) “new view” proposed by Henry J. Aaron turned all this on its head. Rather than simply an excise tax on housing, this approach sees the average property tax rate across communities as essentially a tax on capital; as such, it is likely to be quite progressive in its incidence. The differentials across communities are another matter: they may function like excise taxes on specific factors, but overall the new view suggests that the property tax is likely to be a good deal more progressive than, say, a sales tax.<sup>1</sup>

The property tax does, however, require some sophistication in its administration. Since housing units are sold only infrequently, tax liabilities must be based upon an estimated or “assessed” value. The vagaries of assessment practices have been the source of some

unhappiness with the tax, as the ratio of assessed value to true market value can sometimes vary widely within a single taxing jurisdiction. But with reform and improvement of assessment practices in recent years, the issue of the administration of the property tax should not, I think, be exaggerated.<sup>2</sup>

### **Local Property Taxation from a Public-Choice Perspective**

The public-choice approach to issues in public finance has focused attention on another dimension of tax systems: their role in promoting effective decision making in the public sector. In this framework, a critical function of a system of taxes is to provide an accurate set of signals, or “tax-prices,” that make clear to local taxpayer-voters the costs of public programs on which they must make decisions. In a local context, this implies that the local tax system should generate tax bills that are highly visible and that provide a reasonable indication of costs so that individuals have a clear sense of the financial commitment implied by proposed programs of public expenditure.

If taxes are largely hidden or don't reflect the cost of local services, they are unlikely to provide the information needed for good fiscal decisions. For example, if a local government were to finance its budget through a local corporation income tax, the residents would have little idea of the true cost to themselves of local public programs. Hidden taxes with uncertain incidence are not conducive to good fiscal choices.

From this vantage point, the local property tax comes off quite well as a source of local revenues. Property tax bills are highly visible; they promote a high degree of voter awareness of the cost of local programs. In fact, local property tax rates are often tied directly to proposed programs on which the voters must decide in a local referendum. It is this high degree of visibility that, I think, explains much of the unpopularity of the tax!

The local property tax thus appears to function well in its public-choice role of providing a reasonably accurate set of tax-prices to residents. There is, however, one important reservation here: renters. Owner-occupants receive regular property tax bills that indicate the cost to them of the local services they receive, but occupants of rental dwellings receive no such tax bills. Under the present administration of the property tax, tax bills go to the owner of the unit, not the occupant, so that renters never see property tax bills. This does not, of course, mean that renters avoid the burden of the property tax. There is good reason to believe that property taxes on rental units are (eventually at least) shifted onto tenants. The point is that renters do not face the same visible tax-prices that confront owner-occupants. Moreover, there is considerable evidence to suggest that renters behave as if they think they pay no local property taxes: they appear to provide much more support for public expenditure programs than if they owned their own homes. This has come to be called “renter illusion.” There is a real need to know just how big this effect is in terms of its impact on local public budgets. If it is large, there is a strong case for reforming the administration of the tax so that property tax bills go directly to occupants rather than to landlords.<sup>3</sup>

## **The Issue of Interjurisdictional Fiscal Inequality**

Over the past three decades, systems of local property taxation have been the subject of intense public attack accompanied in some instances by court decisions requiring their replacement or reform. The basis for these attacks is primarily an equity issue arising from disparities in the size of the tax base across different localities. In several states, the system of school finance, based on local property taxes, has been declared unconstitutional because of the sometimes large differences in the property tax base per pupil across local school districts that can result in large differences in per-pupil expenditure.

A little reflection, however, suggests that this problem of disparities is not basically a problem associated with the property tax per se. It is really a result of virtually any system that relies heavily on local taxation. A system of local sales or income taxes, for example, would surely involve major disparities in tax bases across local jurisdictions—probably at least as large as those associated with local property taxes. The basic point here is simply that fiscal and other economic conditions vary across local areas. (This, incidentally, is a major rationale for local finance: to cater to these differences!) Thus, taxable resources at the local level are bound to vary significantly across jurisdictions.

We may well wish to provide additional support to fiscally weak jurisdictions through some kind of inter-governmental fiscal assistance. But this will be true whether local tax systems rely on property taxation or some other local tax base.

### **Alternative Local Tax Bases**

This brings us to the issue of the available alternatives. Two major tax bases offer themselves as candidates: sales taxes and income taxes. Both, however, have serious shortcomings as the primary source of tax revenues in a nation of many small local governments.

The base of a local sales tax is likely to vary dramatically across local jurisdictions. Communities that are largely residential would have small bases and would have to set a relatively high rate to generate the requisite revenues. Significant sales tax differentials would give rise to costly trips among jurisdictions, as consumers seek to purchase goods and services in jurisdictions with low tax rates. Moreover, sales taxes do not get very good marks on a fairness or ability-to-pay criterion. In addition, they do not stack up at all well on our public-choice criterion of providing the electorate with accurate and visible signals of the costs of public programs.

Income taxes have a good deal more appeal on equity grounds, although most state and local income taxes are not very progressive.<sup>4</sup> They also have the advantage of visibility. But, like sales taxes, they encounter the mobility problem to some extent. A jurisdiction that opts for relatively high income tax rates runs the risk of deterring the entry of new households, especially those with above-average incomes that would face relatively large tax payments.<sup>5</sup> More generally, there is something to be said for avoiding excessive reliance in the economy as a whole on a single tax instrument. The federal and many state governments rely on income taxation as a primary source of revenue, and there is considerable concern that

marginal tax rates on income have become sufficiently high to discourage various sorts of productive activity. From this perspective, local government may contribute to an improved overall tax system by avoiding heavy use of income taxation and staying instead with the revenue source that has been historically its own—the property tax.

The other appealing source of local revenues is user fees, which represent a form of benefit taxation and provide almost a kind of market test for the provision of the service. The problem is that they are limited in their application. It may be possible to charge for the use of certain public services, such as refuse collection, but it is much more difficult to employ charges for collectively consumed services like police protection and local roads. Fees can be used to finance a limited number of local services, but they cannot supplant the need for a major local tax.

For local fiscal choice to have real meaning, it is essential that local residents bear the costs of their decisions to adjust levels of local services. The populace must be in a position to weigh the benefits of public programs against their costs. For this to occur, local governments must have their own revenue systems with some discretion over tax rates. There is surely some scope for mitigating fiscal disparities across jurisdictions with an appropriately designed system of equalizing intergovernmental grants. However, the grants must not be so large as to undermine local fiscal autonomy, and they should, in principle, be lump-sum in form so that localities bear the cost of their fiscal decisions at the margin.

### **Alternative Forms of the Property Tax**

The property tax has much appeal as the primary local revenue source when compared to alternative tax bases, but there are a number of other interesting issues concerning the precise form that the tax takes. Property taxation in the United States consists typically of a single rate that applies uniformly to different kinds of property and to both the land and structures that make up the property.

However, some local jurisdictions have chosen a graded system of property taxation under which land is taxed at a higher rate than the structures on the land. This is a complicated issue that goes beyond the scope of this paper, but let me offer one observation. My sense is that in the realm of “suburban public finance,” where households have a wide choice of communities in which to reside and where (à la Hamilton and Fischel) the property tax functions much like a benefit tax, the advantages of a split-rate system are probably minimal. In a city setting, in contrast, where this view of the tax is less compelling, there may be a stronger case for a graded tax system. Land may provide a superior tax base in fiscally besieged center cities, where taxes on capital can impede efforts at economic development.<sup>6</sup>

## Notes

- 1 The issue of the incidence of a particular tax is often, I think, seen improperly. What really matters from a redistributive perspective is the incidence of the fiscal system as a whole. Indeed, it may make good sense to have some quite regressive taxes that accomplish important social objectives (e.g., taxes on pollution or alcoholic beverages) so long as the overall tax and expenditure system provides the desired redistributive outcome. From this broader point of view, the degree of progressivity of a particular tax becomes less important (unless it is a major tax with a largely redistributive role). The local property tax is admittedly a major tax; hence its redistributive properties assume some importance.
- 2 It is much more of a problem in developing countries, where local governments with little experience in tax administration practices find the property tax a formidable challenge. There are ongoing efforts around the globe to provide needed instruction and support in the development of the administrative "infrastructure" required for property taxation.
- 3 I am grateful to the Lincoln Institute of Land Policy for its support of an ongoing research effort that addresses this issue.
- 4 Martin Feldstein and Marian Vaillant Wrobel present some evidence suggesting that state (and by implication local) government attempts to redistribute income are largely unsuccessful. They find that progressive state income taxes in the U.S. have had little impact on the net-of-tax relative wage rates of skilled versus non-skilled workers. Their claim is that the mobility of workers across state borders undoes measures seeking to redistribute income—and does so quickly. The outcome is one with no significant redistribution, only deadweight losses from inefficient location decisions.
- 5 The mobility problem may be eased somewhat by the capitalization of local income taxes. Efforts to avoid jurisdictions with relatively high taxes (that are not compensated for by superior amenities) will result in a decreased demand for housing. Thus, new entrants into such communities will tend to be compensated for their higher tax payments by lower housing prices.
- 6 See Oates and Schwab (1997).

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