

Core Module Outline

Alternative Perspectives on Property Taxation

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What *is* the Property Tax?

The property tax, which sometimes seems the most simple and straightforward of taxes, can actually be considered a cluster of related taxes, each with its own definition of “property,” its own method of measuring the tax base, and its own tax rate. Most owner-occupied residential property is subject to a different tax than that which applies to commercial property. Farmland is not taxed in the same manner as urban land. Property owned by governmental or charitable organizations is not subject to the same tax as similar property held by individuals. In some jurisdictions the tax on land is not the same as the tax on buildings. Property tax reform efforts must begin with a clear understanding of the specific tax under consideration, and the range of alternatives available.

Real Property and Personal Property; Tangibles and Intangibles.

The original property tax in colonial times was a “general property” tax, reaching *all* types of property - land, buildings, farm implements, household effects, and livestock. At that time tangible property was an index of ability to pay, and an appropriate base for a "faculty" tax imposed "upon every man according to his estate, and with consideration to all his other abilities whatsoever."¹

The shift from an agrarian to an industrialized economy changed the relative importance of land and buildings as an index of wealth. The general property tax fell heavily on farmers whose land and equipment was readily identifiable, and lightly on those whose assets took the form of intangibles such as stocks, bonds and bank accounts. Replacing the general property tax with a tax on land and buildings, coupled with an income tax, was an important goal of nineteenth-century tax reform. The economist Edwin Seligman decried a “general” tax on all forms of property as “nothing but an incentive to perjury,” “corrupting and demoralizing.”² He quoted an 1897 New Jersey report: “[I]t is now literally true that the only ones who pay honest taxes on personal property are the estates of decedents, widows, and orphans, idiots and lunatics.” Seligman felt that “the general property tax as actually administered is beyond all doubt one of the worst taxes known in the civilized world....its alteration or its abolition must become the battle cry of every statesman and reformer.”³ Because of efforts such as his, land and buildings form the major part of the property tax base today, together with only selected items of personal property, such as certain equipment, inventories, and automobiles. Locally-assessed personal property constituted only 9.8 per cent of the property tax base in 1986.⁴ This reform recognized the impracticality of attempting to value and tax property of every kind. However, the explicit change to a more narrow tax base, primarily land and buildings, meant that the tax made no attempt to gauge a taxpayer’s general wealth or ability to pay.

What “Property” is Subject to Property Tax?

Originally - *all* property
 Later - real property
 Some personal property
 Some intangible property

Note that as a legal matter, “property” refers not to a physical object but to a set of interests relating to a specific object. Only administrative convenience prevents a

¹Jens Jensen, *Property Taxation in the United States* 27 (1931) (quoting the 1634 Massachusetts property tax statute).

²Edwin R.A. Seligman, *Essays in Taxation* 27-28 (1895; 10th ed. 1931) [citations omitted].

³*Id.* at 62.

⁴1987 Census of Governments, Vol. 2, *Taxable Property Values*, Table B. See also S. Gold, "How the Taxation of Business Property Varies Among the States," 9 *Assessment Digest* 14 (1987), and A. Manvel, *Paying for Civilized Society* (1986), Chapter 3.

property tax from being levied on each of the interests in a specific parcel, such as the interests of landlord and tenant, or the interests of mortgagor and mortgagee. This has practical consequences for the taxation of partial interests in real estate owned by a governmental entity, such as mineral or grazing rights on federal land. These interests are as much a form of “property” as is ownership itself.

Types of Real Property and Personal Property	
Real Property	Personal Property
<ul style="list-style-type: none"> ·<u>Land</u> ·<u>Buildings</u> ·<u>Fixtures</u> - personal property that is attached to real estate and becomes a part of it. For example, an elevator may be personal property before installation, and real property after it is incorporated into a building. 	<ul style="list-style-type: none"> ·<u>Tangible Personal Property</u>, e.g.: <ul style="list-style-type: none"> -Machinery, Equipment -Inventory -Household Goods, Jewelry -Automobiles ·<u>Intangible Property</u>, e.g.: <ul style="list-style-type: none"> -Goodwill, Going-Concern Value -Licenses, Franchises -Representative Property, e.g.: <ul style="list-style-type: none"> ·Stocks, Bonds ·Bank Accounts, Currency ·Notes, Commercial Paper

Market Value as a Tax Base.

Statutory definitions of fair market value usually refer to the amount a willing buyer would pay a willing seller in a voluntary transaction. This straightforward language presents a number of important choices that will affect the measure of that value and, therefore, the tax base. For example, some property has a value to its owner that diverges drastically from its sale value. Specialized manufacturing and assembly plants may have a high value on the basis of their depreciated cost but a market price that reflects only salvage or warehouse value. Such special-purpose properties are sometimes valued according to their value to their owners (reflected in a cost-based assessment) rather than their value to the market. Resolution of these kinds of valuation problems is as important to defining the tax base as are statutory formulations referring to “fair market value.”

Business Value and Property Value.

Only a very small number of intangible items are explicitly included in property tax base. However, the presence of intangibles such as licenses, franchises, and business good will

can have a dramatic effect on the valuation of real estate used in a business. Assessors and courts therefore must determine at what point allowing intangibles to influence real estate value becomes tantamount to taxing the intangibles themselves. This problem often arises when business property is valued by reference to the income that a purchaser could expect from it, because that income is generally the joint product of tangible and intangible factors. One dramatic example concerns cable television property. In response to growing litigation on this point, California enacted legislation in 1988 stating that intangible assets or rights in a cable television system were not subject to property taxation, but that the system's right to use public property "may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the cable television possessory interest to beneficial or productive use in an operating cable television system."⁵ The difficulty of applying such a standard was illustrated in a case the following year⁶ in which the Post-Newsweek cable television network charged that an increase in its assessment from \$5.5 million to \$16.1 million reflected the value of its franchise. The assessor contended that the network's ability to charge a fee for cable access and to make a profit from its franchise were inseparable from the value of its interest. Although the franchises were themselves exempt, the court found it permissible for the assessor to take into consideration "the presence of the intangible assets."

Taxation of business personal property such as machinery, equipment and inventories raises problems of measurement (for example, determining average inventory value over the course of a year) and potential disincentive to business location. For these reasons it has declined in importance in recent years.

An Economist's View of the Personal Property Tax:

"The valuation of personal property is a joke."⁷

Highest and Best Use.

The standard of highest and best use is central to the definition of fair market value. It directs that property be valued at the amount that would be paid by a purchaser contemplating its most profitable legal and feasible use, even if that is different from its current use. Such a purchaser might bid an amount unrelated to current yield in the expectation of a different and more profitable use in the future. This allows the tax base to more closely approximate real property wealth. It also helps to discourage speculative withholding of land from the market in hopes of higher future gains. These advantages are also a political disadvantage, for the current use more closely tracks the realized cash income with which owners may expect to pay the tax and exerts less development pressure on low-density areas in the urban fringe. For this reason some form of income-

⁵ California Revenue and Taxation Code, §107.7(d).

⁶ *County of Stanislaus v. County of Stanislaus Assessment Appeals Board*, 213 Cal.App.3d 1445, 262 Cal.Rptr. 439 (1989).

⁷ Henry Aaron, *Who Pays the Property Tax: A New View* (Brookings Institution, 1975), p. 87, n.31.

based “current use” assessments is available for qualifying agricultural and open-space property in each of the fifty states.

For and Against “Highest and Best Use” Assessment:

Connecticut Supreme Court, 1971: “A taxpayer who chooses to use his land in a manner which is not consistent with its highest and best use should not be rewarded with a lower assessment, the effect of which is to increase the tax burden on others.”⁸

Michigan Supreme Court, 1981: This is “as unjustified as the Internal Revenue Service saying to a taxpayer that he was imprudent to buy long-term Treasury bonds a number of years ago at 5% when he could now buy 90-day Treasury bills at 15% and that his income from those bonds, for tax purposes, will be deemed to be 15%.”⁹

What’s Wrong with the Property Tax?

It is easy to see why the property tax is the subject of endless political controversy. It is highly visible, often billed in large installments, and unrelated to the cash income that the owner may rely on to pay the tax. Property values, and property tax assessments, can rise in dramatic and unpredictable ways without any action on the owner’s part. The tax no longer bears a strong relationship to wealth or ability to pay, as it did in colonial times, when *all* property was taxed. Nor does it necessarily reflect use of municipal services.

“One reason for the continuing controversy is that in a nonagricultural economy the property tax is a poor index of both the public service received by households and businesses and the economic status, or ability to pay, of the taxpayer.”¹⁰

Wealth Tax/Asset Tax.

The real property tax may no longer attempt to serve as a wealth tax, but it does function as an asset tax, imposing a payment obligation on owners without regard to their cash income. Moreover, a tax based on market value may reflect unpredictable fluctuations in real estate prices. A tax billed in annual or semi-annual installments is also highly visible. Political scientists find this a virtue but politicians rarely agree.

A New York Politician Attacks “Market Value” Assessment:

“Can market value ever be fair? Not when it is the sole basis of assessments. Use of market value alone means that if my house has the same selling potential as yours, say a market value of \$90,000, then we should both pay the same taxes on that property. That would be true even if I were a 42-year-old corporation president with a salary of \$160,000 per year (not including dividends, stock options and the like)

⁸ *Federated Department Stores, Inc. v. Board of Review*, 162 Conn. 77, 291 A.2d 715 (1971).

⁹ *C.A.F. Investment Co. v. Township of Saginaw*, 410 Mich. 428, 302 N.W.2d 164, 175 (1981) (concurring opinion).

¹⁰ Henry Aaron, *Who Pays the Property Tax: A New View* (Brookings Institution, 1975), p. 1.

while you were an 84-year-old retiree living on \$365 per month from Social Security.”¹¹

While there is no question but that this is an important political problem, it is difficult to determine the actual magnitude of the difficulties posed by property taxes to farmers, widows and retirees. Young householders who cannot afford residences large enough for their growing families might question the relative importance of subsidizing retirees who have enjoyed large appreciation in the value of their houses. There is widespread support for measures that permit the elderly, infirm or temporarily unemployed to retain their homes despite disruption in their incomes. However, the middle ground of permitting low-interest tax deferral has not attracted many participants, indicating that such taxpayers seek actual tax reductions as much as they seek to maintain their homeownership.

These problems are not limited to the United States, as shown by comments on the debate over reform of local taxes in Britain:

The Debate in Britain:

“It is hard to exaggerate the political potency of the ‘little old ladies’ to the poll tax debate. As a beleaguered minority, they excited the anguish of everyone involved in the review; and as an image in the minds of Tory politicians, they usurped rational thinking on the subject of the pros and cons of different taxes, and the capacity of rebates to iron out flagrant anomalies.....Were the Tories being deluged by letters from elderly widows unable to pay their rate bills, or was it a convenient, tear-jerking justification for a change decided upon for other reasons? In reality, probably neither the one nor the other.”¹²

Is the Property Tax Regressive?

A large portion of the public clearly believes that the property tax is regressive - that is, that its burden is heaviest on lower-income taxpayers. Many economists would disagree, arguing that the tax is largely proportional to income.

Regressivity of the Property Tax: An Economic Evaluation:

“[T]he burdens of the property tax are not distributed regressively, but on the contrary, are distributed approximately in proportion to the ownership of capital goods. Furthermore, it has been shown that even under the old

¹¹ Alan G. Hevesi, “100% Market Value as Assessment Basis for Homes is Unfair,” *Newsday*, January 29, 1982. Hevesi was elected New York City Controller in 1993.

¹² David Butler, Andrew Adonis, and Tony Travers, *Failure in British Government: The Politics of the Poll Tax* (Oxford University Press, 1994), p. 52.

theory of tax incidence, the property tax should not be regarded as regressive if one classifies families on the basis of income measured over a period longer than one year - namely, about five years.”¹³

A Local Official Disagrees:

“Mr. Diamonte, the Assessor, said he believed that property tax laws were ‘repulsive and regressive pieces of legislation....’”¹⁴

Traditionally, a tax on buildings was analyzed differently from a tax on land, because the supply of buildings, unlike that of land, can be increased through new construction or decreased through a failure to maintain existing improvements. Therefore, in the long term the supply of building capital will respond to a tax by reducing the building stock, resulting in less construction and higher prices. Because many investments compete for capital, this reasoning assumed that the burden of the property tax would be borne by users of property rather than suppliers of capital. In the case of business property, the potential for shifting the tax to suppliers or customers left the ultimate incidence uncertain. In the case of residential property, where this possibility did not exist, it was assumed that the long-run incidence of the tax was on the homeowner or renter. Studies have differed as to whether expenditures on housing are proportional to income or form a lower percentage of income as income rises. The widespread belief that the percentage of income devoted to housing falls as income rises has supported the popular view that the residential property tax is regressive.

These assumptions have been questioned in recent decades. Newer analysis has considered the property tax to consist of two elements: a basic rate equivalent to the tax common to all forms of wealth or capital, and the additional tax that would bring the rate to the actual amount paid by real property in a given jurisdiction. That second element could be in the form of a subsidy where actual property taxes were below the hypothetical common tax rate on capital. A tax on all wealth or capital would have incidence effects similar to those of a tax on bare land. To the extent the supply of capital was fixed, owners of capital would bear the economic burden of the tax. Under this approach only the second, variable tax could be avoided by withdrawing building stock from high-tax areas. The first component would remain in place whatever form the owner's investment might take. From this perspective, the uniform portion of the property tax may be viewed as part of a nationwide tax on capital. Because capital ownership generally increases with income, to this extent the property tax would be progressive. The second element of the tax, which varies

¹³ *Property Tax Relief Programs for the Elderly: An Evaluation*, prepared by Abt Associates, Inc. for the U.S. Department of Housing and Urban Development, Contract Number H-2205-4, 1975, p. 4.

¹⁴ J. McQuiston, “Fire Islanders Stirred to Anger by ‘Imperialism’ of Taxes,” *The New York Times*, July 15, 1982, p. B1.

with the local rate, would be a selective tax on certain forms of capital, and therefore appropriately analyzed under the older view of property taxes.

These two approaches are not mutually exclusive. In some circumstances, a change in the property tax should clearly be analyzed as a local, selective measure. This would be the case if a specific jurisdiction were contemplating a change in its tax base or rate. On the other hand, nationwide property tax changes would be appropriate for consideration under the newer view of property taxes as in part a uniform tax on capital.

Yet another perspective on the property tax views it as the equivalent of a fee for local services. This position has gained much attention in recent years, particularly because services provided by local government lend themselves more readily to this analysis than do such federal functions as national defense and foreign relations. A 1986 Treasury Department report contended that both state and local taxes are no more than "the cost paid by citizens for public services provided by State and local governments, such as public schools, roads, and police and fire protection."¹⁵ To the extent a property tax is considered a charge for local government services it would not properly be analyzed as a "tax" at all. Questions of incidence and market distortion that are critical to understanding the economic operation of a tax on goods or services are largely inapplicable to an analysis of the price of those goods or services themselves.¹⁶

"If consumers treat the local property tax as a price for public services, then this price should not distort the housing market any more than the price of eggs should distort the housing market."¹⁷

What's Right with the Property Tax?

A Revenue Source for Local Governments.

Perhaps the most important function of the property tax is as a source of autonomous revenue for local governments - a source that does not need to be

¹⁵*Treasury Report on Tax Simplification and Reform*, U.S. Treasury Department, Report to the President, November 27, 1984, Ch. 5, §IV(B)(1) ("To the extent that state and local taxes merely reflect the benefits of services provided to taxpayers, there is no more reason for a Federal subsidy for spending by state and local governments than for private spending.")

¹⁶"If consumers choose residential locations based on the property tax and service package offered by the local government and if some mechanism arises to maintain the equilibrium, consumers who desire the same fiscal package are grouped together. The property tax is the 'price' for consuming local services, with all consumers paying the costs that their consumption imposes on the government. In that case, it does not make sense to separately discuss the incidence of the tax separate from the provision of public services because the tax simply reflects the demand for services." R. Fisher, *State and Local Public Finance* (1988) 156.

¹⁷ B. Hamilton, "Property Taxes and the Tiebout Hypothesis: Some Empirical Evidence," in *Fiscal Zoning and Land Use Controls, the Economic Issues*, E. Mills and W. Oates, eds. (1975), at 13, quoted in H. Rosen, *Public Finance* 488 (1st ed. 1985).

legislated, administered, collected or redistributed by the state. Because the advantages of the property tax are so closely tied to the autonomy of local governments, it is not surprising that nearly all its revenue accrues to cities, counties, school districts, townships, and special districts. In 1990 more than 96 per cent of all property tax collections in the U.S. supported these local government units.¹⁸ This represents a dramatic change from earlier times. At the turn of the century, before widespread adoption of sales and income taxes, property taxes represented nearly half of all state revenue.¹⁹ During the intervening period the portion of *state* tax revenue derived from the property tax has fallen to less than 2 per cent.²⁰ At the same time the property tax share of local tax revenue only dropped from 88.6 per cent in 1902 to 74.5 per cent in 1990.²¹ The property tax contributed at least 66 per cent of local tax collections in every region of the country in 1990; in New England, 98 per cent.²²

In Great Britain, which has encountered tremendous difficulties in seeking a replacement for local property taxes, or “rates,” an official 1983 review concluded, “The Government recognises that rates are far from being an ideal or popular tax. But they do have advantages. They are highly perceptible to ratepayers and they promote accountability. They are well understood, cheap to collect and very difficult to evade. They act as an incentive to the most efficient use of property... The Government has concluded...that rates should remain for the foreseeable future the main source of local revenue for local government.”²³ This position is only strengthened by the intensely negative political reaction to the poll tax that was intended as an alternative residential property taxes. That response played an important role in bringing an end to Mrs. Thatcher’s term of office.

What happens when local expenditure functions are shifted to the state? One fear, of course, is that they will take low priority, either in direct state spending or in state distribution of revenue to localities. The example of school finance in California is a sobering illustration. The combination of judicial challenges to property-tax funding of education and the state’s reduction of property taxes in general under Proposition 13 means that nearly 70 percent of California’s school funding is a state responsibility. At the same time, California has fallen in the last

¹⁸Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 64.

¹⁹Glenn Fisher, "Property Taxation and Local Government: Four Hypotheses," 8 *Property Tax Journal* 113, 119-120 (1989). See also U.S. Bureau of the Census, *Historical Statistics of the United States from Colonial Times to 1970*, 1086-1135 (1976).

²⁰Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 65.

²¹Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 102; Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism* 1991, Vol. 2, Table 81.

²²Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 102.

²³ 1983 White Paper, *Rates* (Cmnd. 908, Dept. of the Environment).

thirty years from fifth among the states in per-pupil spending to fortieth. A 1995 article in the *Sacramento Bee* commented, “Political support for education in California has been eroding steadily for two decades....Under the current system, the governor and legislature decide how much funding schools get, and the state Department of Education tells them how to spend it.”²⁴

<u>The Property Tax in Local Government Finance, FY 1990²⁵</u>		
	Percentage of Local <u>General</u> Revenue	Percentage of Local <u>Tax</u>
Revenue		
United States Average.....	29.2%	74.5%
New England.....	49.0%	98.0%
Mideast.....	31.7%	66.7%
Great Lakes.....	35.2%	81.1%
Plains States.....	31.4%	82.9%
Southeast.....	23.4%	70.2%
Southwest.....	32.0%	78.7%
Rocky Mountain States.....	30.7%	76.4%
Far West.....	20.8%	70.0%
Selected States:		
New Hampshire.....	71.1%	99.3%
Connecticut.....	56.2%	98.5%
New Jersey.....	50.8%	98.1%
Oregon.....	42.3%	89.5%
Michigan.....	40.6%	92.6%
Iowa.....	36.4%	95.9%
Colorado.....	30.7%	68.7%
New York.....	29.5%	61.0%
Georgia.....	25.2%	69.2%
California.....	19.7%	69.1%
Washington.....	18.1%	59.7%
Louisiana.....	15.7%	43.4%
New Mexico.....	11.9%	56.1%

The Special Nature of Land: Efficiency Considerations

²⁴ “New Report Blasts Education in State,” *Sacramento Bee*, April 19, 1995, p. A1.

²⁵ Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1992, Volume 2, Tables 39 and 49.

Professor C. Lowell Harriss: “The American property tax is really two taxes in one. The first, a tax on land values, deserves even more intensive use than it is getting. The second, a tax on man-made capital such as buildings, machinery and inventories, warrants even more condemnation than one hears.”²⁶

Although we commonly think of the real property that is subject to tax as a single entity - land and buildings - there are extremely important distinctions between these two portions of the tax base. Land is a commodity in fixed supply (with the exception of unusual cases, such as reclamation of shoreline property). Tax incentives will not increase the amount of land available, and taxation will not cause the amount of land to decrease. The *inelastic* nature of this supply is unresponsive to outside incentives.

This inelastic supply offers an unusual opportunity from the point of view of efficiency. A tax upon an item in inelastic supply does not carry with it the usual economic loss that accompanies a distortion in the price signals for supply and demand. When taxes were levied upon buildings according to the number of their windows, the number of windows fell. A tax upon buildings according to the number of stories in their construction led to development of the Mansard roof, whereby an extra story of living space could be accommodated without an extra story of building, by expanding the living space (and the windows!) into the section that had been the roof. Changes in supply and demand in response to taxation are familiar to us in numerous contexts. The availability of a home mortgage interest deduction raises the price of houses, while a luxury tax reduces the demand for yachts. Each distortion of the structure of supply and demand exacts an additional cost, over and above the amount of tax revenue raised, by reducing economic efficiency.

Land Taxation - An Inelastic Base

- Supply cannot be increased or diminished
- Tax does not affect quantity available
- Avoids “deadweight” efficiency loss

This is not the case when supply and demand do not respond to the changes in price occasioned by a tax. In that case, the tax does not produce a “deadweight” loss in efficiency because it does not distort economic signals for production and consumption. Yet it is a rare tax that does not influence supply and demand. Even a tax on income affects individuals’ choices between work and leisure. A “poll tax,” or head tax, that could not be evaded would satisfy this criterion, but few others - a crude instrument for distributing the costs of government, it is generally associated with unsophisticated

²⁶ C. Lowell Harriss, “Property Taxation: What’s Good and What’s Bad,” *Challenge*, September-October, 1973.

economic systems. As noted above, its most recent introduction, to replace residential property taxes in Great Britain, helped end Margaret Thatcher's term as Prime Minister. The land portion of the property taxation is a most unusual instrument: nearly exotic in the unique inelasticity of its base, yet a familiar and longstanding element of local finance.

The Special Nature of Land: Equity Considerations.

Two considerations should be taken into account in judging the merits of a tax upon land. First, a portion of the increase in value that any individual realizes is due, not to his or her own effort, but to social growth and investment. A plot of land in an undeveloped area with a low market value may later command a high price after urban growth has left it in the midst of a downtown area. Because this particular increase would be the result of development entirely apart from the owner's effort, it has long been considered appropriate for a special form of taxation. The second consideration concerns the process of capitalization, by which anticipation of future taxes can reduce the price a purchaser pays for property. In this case, abolition of an existing tax would constitute a windfall to the owner who purchased while the tax was in effect.

What about Capitalization?

Capitalization" of a tax refers to the process by which anticipation of the need to pay a tax on property affects the amount a buyer will bid for it. An investor choosing whether to purchase a tax-free bond or a parcel of taxable land will take future taxes into account in determining what to offer for the land. Consider this very simplified example:

Rate of return on untaxed investments (e.g., bonds)	10%
Anticipated return on hypothetical parcel, net of all but property taxes	\$100
Anticipated annual property taxes on hypothetical parcel	\$10
Amount bid to obtain 10% return on parcel (\$90/10%)	\$900

If the current owner purchased the property before the imposition of a property tax, he or she might have paid \$1000 for the parcel under the same assumptions. In that case, the owner who sold for \$1000 was not harmed by the tax, and the new purchase who will only pay \$900 will not be harmed by the tax. The entire burden is borne by the owner holding the property at the time the tax is imposed, because it is capitalized into the price he or she can obtain for it in the future. In fact, abolition of the tax in the future would constitute a windfall to the \$900 purchaser, who only anticipated a \$90 net annual return. This is why it can be said that "the taxpayer, by virtue of the process of capitalization, has bought himself free from any calculable, unequal part of the tax, and as for the general or equal or uniform part of it, he bears that in common with others. So long as the tax does not increase rapidly either generally or locally, the payers of taxes on real property can have no valid claim, on the grounds of justice."²⁷

²⁷ Jens Jensen, *Property Taxation in the United States* (University of Chicago Press, 1931), at p. 75.

Alternatives for Reform

“Current Use” Assessment.

All states in the U.S. have adopted measures to reduce the tax burden on farmland, forests and open space and so prevent property taxation from forcing development of these areas. These provisions generally base the tax upon some measure of the income that the property will yield in its current use rather than its market value. In effect, this transforms a tax on property value into a tax on income, actual or imputed.

Such a tax is not based on market value at current use, because the current use of the property as an asset encompasses more than its function for agricultural or open space purposes. The property also functions as a financial asset available for the owner to draw on in the future. The owner of farmland in the urban fringe would not be a willing seller at the agricultural value even if the purchaser intended to use the land only for that purpose, and the owner would not be satisfied with an award based upon the agricultural value if the property were taken in eminent domain.

Attempts to limit these benefits to bona-fide farmers and to deny them to speculators have generally failed, because these two categories are not necessarily mutually exclusive. Nor do income-based assessments of this sort preserve open space from development in the long term. They may encourage speculation by making landholding less expensive, and they may encourage urban sprawl through “leapfrog” development, as land ripe for development in the inner urban fringe is held off the market.

Average Property Tax Collections for Agricultural Land per \$100 Market Value²⁸		
	1981	1991
Connecticut	0.81	0.63
Delaware	0.10	0.09
New York	2.02	1.99
South Carolina	0.25	0.39

Current-Use Assessment in New Jersey:
<p>“To qualify as farmland, a property must be at least five acres and produce at least \$500 in revenue from agriculture or horticulture.According to the Whitmans’ tax returns, in 1992 they paid \$47.27 in taxes, or 93 cents an acre, on the Far Hills Property...real-estate records show that Mr. and Mrs. Whitman paid her sister-in-law,</p>

²⁸ Federation of Tax Administrators, *Tax Administrators News*, Vol. 57, No. 11 (November, 1993), p. 127.

Frances Todd, \$870,000, or roughly \$46,000 and acre, for 18.732 acres contiguous to the Far Hills farm in June, 1989.”²⁹

Uniformity versus Classification.

A 1978 report of the District of Columbia Tax Revision Commission summed up the arguments for and against classification of property - that is, applying different rates of property tax to different types of land and buildings:

There are generally two arguments in favor of replacing a uniform property tax with a classified property tax: (1) By explicitly treating specific property classes differently, the legislative body would legalize the de facto classification which results from imperfect assessment practices. (2) A classification scheme favoring residential property would redress some of the inequities resulting from the regressive nature of the property tax and shift the burden to business property owners who are perceived to be in a better position to absorb or pass on property taxes....

However, opponents of classification advance four general arguments against replacing a uniform property tax with a classified property tax: (1) The jurisdiction endorsing such discriminatory treatment of business property could get a reputation as being anti-business and thereby thwart future commercial growth. (2) There is no pervasive economic rationale for taxing various types of income-producing property (including personal property) at different rates. (3) Since there is no theoretical basis for singling out various classes of property for heavier taxes, there is no objective point at which further classification should stop, thereby opening up the potential of political bargaining by well-organized special interest groups. (4) Classification is cumbersome and time consuming and thereby more costly to administer than a uniform property tax.³⁰

The state of Minnesota provides a cautionary example of the potentially open-ended nature of the classification process. Because the state constitution requires uniformity only within classes or property, and not uniformity between different classes, classification has produced as many as seventy categories, each with its own effective tax rate.³¹

Dealing with Exemptions.

Efforts to stem the erosion of the property tax base by exemptions have taken a number of forms, from political pressure on educational institutions to increase voluntary in-lieu of tax

²⁹ J. Gray, “Whitman Sold Wood to Trim Farm Taxes,” *The New York Times*, August 15, 1993, p. 40.

³⁰ *Financing An Urban Government*, Final Report of the District of Columbia Tax Revision Commission, pp. 69-70 (1978).

³¹ American Bar Association, *Property Tax Deskbook*, 1994-1994 edition (W. Prugh, ed.), at 24-8.

payments³² to legal attacks on the technical construction of state statutes relieving charitable institutions from property tax obligations. The Oregon Tax Court has been particularly active in this latter area in recent years, finding a YMCA to function more as a private health club than as a charitable institution, refusing an exemption for local theater groups, and requiring hospitals to establish their individual claims to exemption on grounds of community contributions.³³ Innovative efforts have also been begun to institute fees for services such as police and fire protection that would reach organizations exempt from property taxes.³⁴ Of course, these efforts themselves must deal with potential legal challenges if they can be characterized as taxes in substance if not in form.³⁵

It is important to recognize that special tax provisions to benefit homeowners, the elderly, farmers, and owners of open space are a form of exemption, as much as are explicit provisions for charitable and educational institutions. The problems of tax base erosion cannot be addressed effectively by curtailing the latter while expanding the former.

Circuit Breakers.

Circuit breakers limit property taxes to a designated percentage of income. They generally are administered and financed by the state through an income tax credit, although some are designed as independent programs. As in the case of other programs administered through income tax credits, special efforts are required to reach potential recipients who do not file income tax returns.

A more serious problem concerns the identification of taxpayers in need of assistance. A 1975 report to Department of Housing and Urban Development stated: “the concern about regressive property tax burdens, on balance, is not well founded and that the formulas used in circuit breakers are poor indices of actual property tax burdens.”³⁶

Do Circuit-Breakers Rely on Assumptions About Regressivity?

“In the mistaken belief that the property tax is regressive, cash payments to low- and moderate-income homeowners and renters have been enacted in many states and are contemplated by others and by the federal government...Thus, families whose income are temporarily depressed and

³² See, e.g., “Ithaca’s Mayor Blocks Cornell Construction Projects,” *The New York Times*, May 3, 1995, p. B9.

³³ See *YMCA v. Dept. of Rev.*, 308 Or. 644, 784 P.2d 1086 (1989); *Theatre West of Lincoln City, Ltd. v. Department of Revenue* (Oregon Tax Court, TC 3317, 1994); and *Tosterud v. Druian* (Oregon Tax Court, No. 3891, 1996). Note that in 1992 the Oregon Tax Court upheld a decision by the state's Department of Revenue reinstating the property tax exemption of the Portland YMCA's downtown facility retroactive to 1989 (*Northwest Alliance for Market Equality v. Department of Revenue*, Oregon Tax Court, No. 3236, 1992).

³⁴ E.g., W. Glaberson, “In an Era of Fiscal Damage Control, Cities Fight Idea of ‘Tax Exempt,’” *The New York Times*, February 21, 1996, p. A1.

³⁵ E.g., *Emerson College v. City of Boston*, 391 Mass. 415; 462 N.E.2d 1098 (1984).

³⁶ *Property Tax Relief Programs for the Elderly: An Evaluation*, prepared by Abt Associates, Inc. for the U.S. Department of Housing and Urban Development, Contract Number H-2205-4, 1975, p. 4.

whose housing expenditures are based on their normally higher incomes will qualify for more relief than will households whose income are normally low and who base their housing expenditures on those levels.”³⁷

Homestead Exemptions.

Homestead exemptions or credits reduce the tax on qualifying residential property, either by exempting a portion of its value or by extending a credit against the tax. They may be limited to property owned by certain groups of taxpayers, such as low-income, elderly or disabled homeowners, or they may apply to all owner-occupied residences. Provisions such as these reflect a political judgment that homeownership benefits the community. However, attempts to reward or discourage specific property-related behavior can be at odds with the concept of a value-based tax. Well maintained property will have a higher market value than a deteriorated or contaminated site. Moreover, the political motivation for such tax relief (which would seek to spread its benefits as widely as possible) must contend with equity and efficiency considerations (which would limit these benefits to the needy). The economist Mason Gaffney has remarked, “Those that become welfare cases should be treated by the welfare system on an impartial basis, without special favor to property owners. To use property tax relief as a substitute for welfare is to distribute welfare in proportion to wealth, surely an odd notion.”³⁸

What about Deferral?

In theory, the problem of “cash-poor” taxpayers could be solved with appropriate financial devices, such as home-equity loans and reverse mortgages. However, the low participation rates in programs offering tax-deferral programs to senior citizens demonstrates their intense concern for preserving family property unencumbered for the next generation.

Robert Ebel and James Ortbal wrote in 1989:

In 1979, only eight states and D.C. had deferral programs, and all were limited to elderly homeowners. Now...the number of deferral states has more than doubled and the range of those qualifying has expanded. Despite these merits, deferral programs generally have few participants. Two factors may explain this. First, many states have not publicized their programs aggressively. One reason for this is that some tax administrators are not eager to be placed in a situation of having to take foreclosure action if the amount of a deferral approaches or exceeds the amount of equity in a home. Second, homeowners simply are reluctant to place liens on

³⁷ Henry Aaron, *Who Pays the Property Tax: A New View* (Brookings Institution, 1973), pp. 71, 76

³⁸ Quoted in Henry Aaron, *Who Pays the Property Tax: A New View*, at p. 76.

their homes. This suggests that one of the original justifications for tax relief - the threat to homeownership - may not outweigh the costs of taking out a loan on one's home to pay the property tax.³⁹

Acquisition Value as a Tax Base.

Under "Proposition 13," California generally bases its tax on the acquisition value of property (or the 1975-76 assessment, for property that has not changed hands since that time) with only a 2% maximum annual inflation adjustment. This allows homeowners to calculate their future tax obligations with great accuracy, and eliminates the problem of dramatically rising property tax assessments that gave rise to the California tax revolt. This certainty, however, is purchased at a heavy price in tax equity. Justice Stevens pointed this out in his dissenting opinion in the Supreme Court case that refused to overturn Proposition 13 on federal constitutional grounds. He characterized Proposition 13 as a windfall to those who invested in California real estate in the 1970s, whom he termed "the Squires", as opposed to those who purchased later, at much higher prices, and now had to pay much higher taxes as well. The plaintiff in this case, Stephanie Nordlinger, purchased a condominium for \$170,000 in 1988 and received a tax bill "only a few dollars short of that paid by a pre-1976 owner of a \$2.1 million Malibu beachfront home."

As a direct result of this windfall for the Squires, later purchasers must pay far more than their fair share of property taxes.

The specific disparity that prompted petitioner to challenge the constitutionality of Proposition 13 is the fact that her annual property tax bill is almost 5 times as large as that of her neighbors who own comparable homes: While her neighbors' 1989 taxes averaged less than \$400, petitioner was taxed \$1,700. This disparity is not unusual under Proposition 13. Indeed, some homeowners pay 17 times as much in taxes as their neighbors with comparable property. For vacant land, the disparities may be as great as 500 to 1. Moreover, as Proposition 13 controls the taxation of commercial property as well as residential property, the regime greatly favors the commercial enterprises of the Squires, placing new businesses at a substantial disadvantage.

As a result of Proposition 13, the Squires, who own 44% of the owner-occupied residences, paid only 25% of the total taxes collected from homeowners in 1989. Report of Senate Commission on Property Tax Equity and Revenue to the California State Senate (1991) (Commission Report). These disparities are aggravated by section 2 of Proposition 13, which exempts from reappraisal a property owner's home and up to \$1 million of other real property when that property is transferred to a child of the owner. This exemption can be invoked repeatedly and indefinitely, allowing the Proposition 13 windfall to be passed from generation to generation. As the California

³⁹ Robert D. Ebel and James Ortbal, "Property Tax Relief: Current Status, Future Issues," *Tax Notes*, July 10, 1989, pp. 223-227.

Senate Commission on Property Tax Equity and Revenue observed, "The inequity is clear. One young family buys a new home and is assessed at full market value. Another young family inherits its home, but pays taxes based on their parents' date of acquisition even though both homes are of identical value. Not only does this constitutional provision offend a policy of equal tax treatment for taxpayers in similar situations, it appears to favor the housing needs of children with homeowner-parents over children with non-homeowner-parents. With the repeal of the state's gift and inheritance tax in 1982, the rationale for this exemption is negligible." Commission Report, at 9-10. The Commission was too generous. To my mind, the rationale for such disparity is not merely "negligible," it is nonexistent. Such a law establishes a privilege of a medieval character: Two families with equal needs and equal resources are treated differently solely because of their different heritage.⁴⁰

Postscript: Alternate Revenue Sources Compared

Any consideration of alternative tax bases raises a question as to how such an analysis might systematically compare the benefits and drawbacks of each. Particularly because the income tax and sales taxes are the primary means of replacing revenue lost by property tax reductions, it is instructive to note the approach taken by the eminent economist Carl Shoup in 1983, when he compared these taxes (distinguishing the property tax on housing and the tax on business real estate) according to a number of different criteria.⁴¹ Some of his conclusions are summarized in the following chart. While a detailed consideration of his approach is beyond the scope of this paper, his ranking is thought-provoking and suggestive of the way in which other criteria might be used to compare alternative tax reform proposals.

Ranking of the Four Taxes				
(highest, 1; lowest, 4)				
	Housing	Business Real Estate	Income	Retail Sales
Equal treatment of equals, broad aspect	4	3	1	2
Excess burden	4	2	3	1
Reduction of inequality	2	4	1	3
Taking into accounting family circumstances	2	4	1	3
Aid to depressed areas	4	2	3	1

⁴⁰ *Nordlinger v. Hahn*, 112 S. Ct. 23326, 120 L.Ed.2d 1 (1992) (dissenting opinion).

⁴¹ Carl Shoup, "The Property Tax versus Sales and Income Taxes," in *The Property Tax and Local Finance*, C. Lowell Harriss, ed. (New York: The Academy of Political Science, 1983).

Tax consciousness	3	4	1	2
Promotion of economic growth	4	3	1	2
Neutrality in foreign trade	2	3	4	1