Challenging the Conventional Wisdom on the Property Tax

EDITED BY

Roy Bahl, Jorge Martinez-Vazquez, and Joan Youngman

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Foreword

The chapters in this volume appraise the strengths and weaknesses of the property tax for both high-income and developing countries. This appraisal revisits what people think they know about the property tax itself—the conventional wisdom—and begins to compare the performance of the property tax with that of other revenue sources that are commonly used by local governments.

The timeliness of this review is reflected in the slow decline in the share of local revenue raised by the property tax in the United States, from 76 percent of own-source revenue for local governments in 1970 to 65 percent in 2006. This decline accompanies the spread of popular initiatives to curtail the growth of property tax revenues. These initiatives have mainly occurred after the approval by California voters in 1978 of Proposition 13, which limited growth in property tax rates and assessed values. These initiatives, in turn, provide behavioral evidence supporting the opinion polls that frequently rank the property tax as the most unpopular tax in the United States.

Visibility is thought to be a virtue for taxes, especially at the local level, because it enables voters to weigh the cost against the benefits of the local services provided. Ironically, the property tax may have too much of this virtue. Many view the visibility of the property tax as a key to its unpopularity. Moreover, the limits that have been placed on property tax revenues suggest that voters really do not like surprises in their property taxes, as many of the limits restrict the size of annual changes in property tax bills.

The performance of a tax is often measured in terms of its efficiency and related economic distortions summarized in measures of excess burden—the extra cost to the economy of raising one dollar of revenue. In the "benefit" view, property taxes are payments for local services and the excess burden is rather small, reflecting mainly administrative costs that comprise a few percent of revenues. Another view holds that property taxes are mainly a tax on capital, and calculations indicate that their additional excess burden ranges from 6 to 16 percent and even larger under some parameter combinations. While these burdens are not small, they are likely to be less than the excess burdens associated with other sources of local revenue, such as local sales taxes. Local sales taxes are also likely to be more regressive relative to income than property taxes. While this volume address these issues of excess burden and income incidence for the property tax, it is clear that more analysis of these issues and careful comparisons of performance across different taxes is still needed.

In developing countries, property tax practice varies much more widely than in high-income countries in terms of what is taxed (land, buildings, both combined), the government level setting the tax rate (local, provincial, national), and how property value is assessed (market transactions, value bands, rents, land area, etc.). Administrative capacity in developing countries is often weak. Because developing countries' revenue from the property tax as a share of GDP is about 30 percent of that in high-income countries, their administrative costs are likely to be a larger share of tax revenue.

Several ideas for improvements in the design and implementation of property taxes in both high-income and developing countries are presented here. Suggestions for additional analysis are discussed, particularly studies that provide consistent comparisons of the performance of the property tax relative to other local tax alternatives. Several of these ideas are under consideration by the Lincoln Institute.

I am pleased to thank the editors for their work on this volume, and to give special thanks to the Andrew Young School of Policy Studies at Georgia State University, which helped organize the conference in April 2008 where these ideas were first presented.

Gregory K. Ingram
President and CEO
Lincoln Institute of Land Policy

1 Whither the Property Tax

New Perspectives on a Fiscal Mainstay

Roy Bahl, Jorge Martinez-Vazquez, and Joan Youngman

The future role of the property tax in government finance systems around the world is anything but clear. While assessment limits, rollbacks, and even elimination of the property tax are the focus of the U.S. policy discussion, property tax collections in Organisation for Economic Co-operation and Development (OECD) countries rarely rise above 3 percent of gross domestic product (GDP), and the property tax is a very weak revenue source in developing and transition countries (for reviews, see Bahl and Martinez-Vazquez 2008). The chapters in this book address the reasons for this state of affairs and ask whether the property tax will play a reduced fiscal role in the future or if new reform paradigms might reverse this pattern.

The Conventional Wisdom: A "Good" Tax

Academics, particularly economists, are longtime fans of the property tax. Their arguments in favor of it as a mainstay of local government finance have become the conventional wisdom. This rationale for using the property tax to finance local government services is well known and is taught in virtually all public finance courses. Daphne Kenyon, in the commentary to chapter 9, says it well: "My hypothesis is that support for property taxation can be generated by linking the tax to local government. The argument, in a nutshell, is this: If you like local government, you had better appreciate the property tax." In this view, the property tax is an appropriate and feasible source of local revenue: generally not used by higher levels of government, able to be administered locally, and related to local services that benefit property or improve its value. Given the suitability of the property tax to local governments, believers in decentralization appreciate the existence of the property tax. If one accepts the benefit view that the property tax is a charge for local government services, as laid out in the famous Tiebout (1956) model, an efficiency case can be made (see chapter 2 in this volume). A charge for services can also be seen as an equitable means of distributing the costs of their provision. If one accepts the view that it is a tax on capital, then the property tax burden will fall more heavily on higher income residents (owners of capital), and therefore it might be argued that the property tax is progressive in its distribution of burdens.

The property tax is also seen by many to be fair, or horizontally equitable, because those owning property of the same value or paying the same property rent, and presumably of similar income levels, are subjected to the same tax. Moreover, the land tax portion of the property tax, falling on an immobile factor, avoids the distortion of economic signals that accompanies most other taxes.

The property tax has both the advantage and the burden of transparency. Taxpayers whose tax is not collected with their monthly mortgage payments are painfully aware of their annual tax bill. Because they recognize that certain local services are financed by the property tax (e.g., education), they can make fiscal decisions based on their evaluation of what the property tax buys for them.

The property tax also has significant revenue potential. Note that revenues average about 3 percent of GDP in OECD countries, are nearly 4 percent of GDP in Canada, and account for a significant share of local government spending in the United States. Moreover, this revenue is relatively stable. Until very recent times, the property tax has not fluctuated with the business cycle as much as income or sales taxes.

Finally, there is, at least in theory, some science to the administration of the property tax. There are acceptable methods for determining value, checking disparities among taxpayers, and disputing inaccurate assessments. Revaluation is not inexpensive, but the consequences of failure to revalue, at least periodically, can be even more costly.

Challenges: Industrialized Countries

The chapters in this volume are careful reviews of this conventional wisdom and conclude that it calls for a rethinking.

The underpinnings of the efficiency and equity arguments are not convincing. In chapter 8, Steven Sheffrin points out that the long debate about whether the property tax is a benefit tax or a tax on capital remains unsettled. The Tiebout model assumes a mobile population and jurisdictions with tax–public service packages that match voter preferences. But it is based on restrictive assumptions and is seriously incomplete as a model of local public finance (Fischel 2006). Leading students of this subject have questioned the relevance of the "gated community" approach, and indeed the original Tiebout article had little to say about the property tax. In chapter 2, Athiphat Muthitacharoen and George Zodrow show that the effects of the capitalization of property taxes and local government expenditures into house values, which are often taken to support the benefits view, are also consistent with the capital tax view.

The alternative to the benefits-received approach treats the equity question in terms of ability to pay. The new view of the tax concludes with the notion that the uniform national portion falls on owners of capital, and so it could be argued to be progressive. Even here, however, there are challenges. Sheffrin argues that the link between current income and property wealth is not tight, largely because of a significant number of low-income households with considerable property wealth. This is one reason for investigation of longer-term income patterns as part of tax incidence studies.

The horizontal equity or fairness dimension of the property tax also can be questioned. Sheffrin reviews the arguments that horizontal equity is not a robust theory of tax fairness because the pretax distribution of income and property values cannot always or necessarily be taken as a norm. In his commentary to chapter 8, C. Kurt Zorn acknowledges the issue surrounding the pretax distribution of income, but argues that on pragmatic grounds we should accept the horizontal equity maxim for fairness. Problems with horizontal equity may also arise from the assessment process. Alan Dornfest (in chapter 4) notes that assessment equity has been seriously compromised by the property tax limitation movement. He argues that this confounds the horizontal equity goals of the property tax.

The revenue productivity and lack of volatility of the property tax also can be questioned. The same assessment limitations, rate rollbacks, and targeted exemptions that have reduced the horizontal equity of the tax have also diminished its elasticity. And although recent years have not seen great increases in effective tax rates, there has been increased volatility in the assessment *shares* of individual taxpayers. This is often due to macro factors, and individuals have little voice in determining how these external factors affect their own tax liability (see chapter 8).

Although it is true that there is a science to the assessment of property, there is resistance to following good assessment practices. In fact, the heart of the problem with the property tax lies in the assessment of taxable values. Good assessment practices, particularly frequent reappraisals, do not necessarily mean higher taxes. A revenue-neutral response to higher values would reduce tax rates, and value shifts across the jurisdiction would reduce some relative values while raising others. But it is inevitable that those facing sharply higher taxes will object, sometimes strenuously. The success of tax limitation movements tells us that the promise of lower taxes often trumps the equity that reassessment brings.

The science of good assessment may be in place, but its implementation comes at a cost. Dornfest argues that the costs of reappraisal are especially high if assessed values are out of date, but that continued failure to reappraise results in a badly distorted distribution of tax burdens and an erosion of confidence in the tax. However, he cannot find a strong statistical relationship between the amounts spent on reassessment and the equity of the assessed base. He surveys the assessment cost literature in the United States and finds an average of about $20 per parcel—an amount that might surprise some. The average cost of assessment, compared to revenue collections, for the sample of jurisdictions he examines is around 2 percent.

Muthitacharoen and Zodrow question the conventional view that the property tax is an efficient tax. They develop a numerical simulation model to estimate the efficiency costs associated with the three main distortions usually attributed to the property tax:

- The locally variable portion of the property tax, as a capital excise, will drive capital out of the taxing jurisdiction.
- The property tax will cause a number of consumption- and production-based distortions because of the effect on the price of capital, and because capital and noncapital inputs are substitutes.
- The property tax can create a bias in the direction of underprovision of public services as communities attempt to hold down the property tax rate to avoid the loss of investment to the local area.

Their model is internally comprehensive, and its numerical solution relies on the existing literature to provide estimates of the key parameters. Most important, of course, are the elasticities of substitution in consumption and production. Their results show that the average efficiency cost of the property tax is between 5.8 and 15.9 percent of property tax collections, depending on the particular assumptions made about the parameters in the model. The lower the tax rate, the lower the efficiency costs. But the essential question is how the tax compares to its alternatives.

Muthitacharoen and Zodrow, and also James Alm (in the commentary to chapter 2), question whether the efficiency costs of other local government taxes (which also tend to be characterized by distortions because of base exclusions) are also this large. Muthitacharoen and Zodrow argue that it is not proper to compare their estimates of the efficiency cost of the property tax with estimates for state sales taxes because of differences in the underlying models used to make the estimates. Still, they speculate from the available evidence that the property tax may not be especially distortionary. This would be true if one believes in the benefit view of the property tax, as opposed to the capital tax view as assumed by Muthitacharoen and Zodrow. If so, there may be nowhere to hide, and the property tax may be less the villain than it has been painted by state legislators in recent years.

John Deskins and William Fox (chapter 3) are interested in the various behavioral effects of the property tax on economic decisions. Some of these are a result of simply levying a tax on land and improvements, and others are due to preferential treatment of certain types of property. Deskins and Fox do not try to estimate the welfare cost of tax-induced distortions. Rather, they survey the literature on the magnitude of these distortions, usually by reporting an elasticity with respect to the level of the effective rate of property taxation. This review gives striking evidence of the complexity of this issue and how little empirical work has been built on recent data. The following are areas where there is some agreement in the literature:

- Higher property taxes increase the rate of outmigration from an area.
- Property tax limitations have significant effects on housing tenure decisions.
- Property tax rates have small effects on business location decisions, except within a single metropolitan area.
- The property tax can have an important effect on new housing starts and abandonments.
- Preferential treatment of land in agricultural use significantly reduces urban development.

In the commentary to chapter 3, David Sjoquist reviews the Deskins and Fox results and finds the issue to be even more complex. He points out that even their comprehensive review missed some issues, such as the impact of the tax on inventories, motor vehicles, intangible property, and nonprofit organizations. He also is struck by the paucity of research to estimate the elasticities and points to the absence of current data as one reason for that lack. Because the property tax varies so much from state to state, this research requires either (1) a national database (census); (2) state Web sites with comparable data; or (3) case studies whose authors have access to the necessary data and institutional detail.

It is interesting to compare the impacts of property taxes and property transfer taxes. Terri Sexton's careful review and analysis of the use of the property transfer tax (chapter 7) shows that it exerts some offsetting and some reinforcing effects compared to the annual property tax. She finds the transfer tax to be progressive, but with lock-in effects on land sales that lead to excess burdens. Transfer tax rates would need to be quite high to match the revenues from the annual property tax, and this would magnify the efficiency costs. The transfer tax is likely to be more volatile in its revenue flow than the annual property tax. Since it is based on reported sales values, its administration is less complicated than that of the annual property tax. Taxpayers have shown some hesitancy to approve new legislation for stronger property transfer taxes, and international experience has demonstrated that high transfer tax rates are a significant incentive for underreporting sales prices. This has the dual effect of reducing tax collections and degrading the quality of official sales data.

In the commentary to chapter 7, Robert Ebel extends the Sexton analysis of property transfer taxes by drawing on the Washington, DC, experience. He argues that while the administration of the tax might be relatively straightforward in the case of residential property where it draws on the deed recordation and transfer process, it can be very difficult in the case of portfolio sales. He also demonstrates the volatility of the revenue flow and the dangers of earmarking the tax for specified purposes without taking this volatility into account.

Challenges: Developing Countries

The conventional wisdom does not travel well to the developing country setting where property markets are not mature, there is a paucity of evidence on transaction values, and administrative capacity is limited. These constraints diminish many of the inherent advantages of the property tax. Moreover, as Andrey Timofeev notes in the commentary to chapter 5, transfer of international experience is complicated by the great variety of different tax bases that are used to levy the property tax. William McCluskey, Michael Bell, and Lay-Cheng Lim (chapter 5) give a comparative analysis of the most common bases: capital value, rental value, and land value systems.

The chapters by Roy Bahl and Sally Wallace (chapter 6) and by Jorge Martinez-Vazquez, Luc Noiset, and Mark Rider (chapter 10) point out the weak revenue performance of the property tax in low-income countries. Both chapters argue that an important underlying reason for this contrast to OECD countries is the low fiscal importance of local governments. Martinez-Vazquez, Noiset, and Rider empirically test the hypothesis that a decentralized property tax leads to a greater level of revenue effort (with decentralization measured in terms of rate-setting authority and claim on revenues by local governments). They can accept this hypothesis in high-income countries, but not in low-income, developing countries.

In the commentary to chapter 10, Andrew Reschovsky underlines the important point that low property tax effort may well be external to property tax practice in a country. It may be a result of higher level governments deciding to finance local governments with intergovernmental transfers. Local political leaders in developing countries (and everywhere else) are thrilled with the possibility of financing their budgets with someone else's money, although central revenues can be expected to come with a price in terms of local autonomy.

The evidence is mixed on property tax equity as applied in developing countries. On the one hand, the exemption of most low-income housing, the concentration of property ownership in the higher income brackets, and uniform national rates suggest a progressive distribution of tax burdens. However, both horizontal and vertical equity can be compromised by assessment practices, a subject discussed in some detail by McCluskey, Bell, and Lim. In an interesting comparative analysis based on micro-level data for Northern Ireland, they show that the vertical distribution of tax liabilities is relatively similar under a capital value and a rental value system.

Riël Franzsen (commentary to chapter 4) is skeptical about the horizontal equity of the property tax. The message is that the political rate-setting process cannot be ignored. He notes that even if assessments are uniform and well done, the jurisdiction may provide special tax relief to particular kinds of property and thus offset the equity efforts of the assessment process.

Weak administration is the most important constraint on property tax revenue mobilization in developing countries. There is a long-standing criticism that governments in developing countries simply are unable to administer a well-functioning property tax. Bahl and Wallace point to incomplete tax rolls, poor record keeping, and the absence of reliable comparative sales data as major constraints. Martinez-Vazquez, Noiset, and Rider point to the difficulty of raising property taxes in countries where subsistence agriculture supplies a significant share of GDP and property rights are weak. Gary Cornia (commentary to chapter 6) discusses the lack of developed educational mechanisms that could lead to a career in property tax policy and administration. He also notes that the on-the-job training approach may have worked when economies were agrarian, but the present-day property tax is complicated enough that formal training is required.

The Politics of the Property Tax

The property tax is unpopular with voters who pay it, and not surprisingly, it is unpopular with their elected political representatives. Zorn makes the not-so-outrageous point that state legislators in the United States treat the subject of property tax reform as though it were radioactive.

There is plenty of objective evidence on the continuing voter opposition to the property tax. In chapter 9, Michael Pagano and Benoy Jacob report on survey data identifying the property tax as the "worst" tax. About 38 percent of respondents expressed this view in 2003, and about 42 percent did so in 2005. Sheffrin discusses the very high marks that homeowners in California have given Proposition 13. Property tax constraints, rather than the academic version of a "good property tax," appear to be what voters want. The current financial crisis will test voter reaction to service cuts when other revenue sources are constrained and credit markets closed.

A number of reasons have been given to explain this negative voter reaction. First, even assessments based on good sales value evidence are thought to be subjective. Taxpayers who see their properties as being appraised above market value or at a different percent of market value than their neighbors will see the property tax as unfair.[1] Even if the appraisal is on the mark, the taxpayer may not agree. Homeowners are subject to psychological forces that determine their own perceptions of the value of their homes (see chapter 8). Dornfest analyzes long-delayed revaluation as especially problematic because of "sticker shock" when taxpayers who have been paying less than an equitable share are suddenly forced to catch up.

A second major source of discontent is that liability for the property tax is well known by those who pay it because they see the annual bill. Ironically, even though transparency promotes accountability and allows voters to weigh the costs and benefits of public spending, the more transparent a tax liability, the more objectionable it is. Third, the property tax is collected against accrued property wealth rather than against realized income from property sales.

Sheffrin adds a fourth reason—changes in tax shares that result from revaluation. A taxpayer's share of total taxable property value in the community may be influenced by decisions taken by others, such as the closure of a neighborhood shopping center or the granting of a tax exemption to an

[1] Dornfest characterizes an 11.5 percent average deviation for the ratio of appraised to market value as "good" horizontal equity. However, the taxpayer in such a sample who is appraised at 15 percent above market value is not likely to see it this way.

existing industry. If total property tax revenues must remain constant in order to finance government services, then a property owner's tax liability can rise even though the taxpayer had no voice in the decisions that led to this increase. This can violate voters' perception of "procedural justice" in property taxation.

Finally, Pagano and Jacob point out that because several local governments and special districts may be taxing the same property tax base, the taxpayer may not see the link between the tax paid and the service benefits received. The failure to recognize this relationship fuels discontent with the property tax. Even as transparency presents one political problem, its absence creates another.

Media influence is a significant yet insufficiently studied element of public reaction to the property tax. Pagano and Jacob analyze the way that the press "framed" the issues in four cases of property tax limitations and rate reduction proposals. Their argument is that the way in which the information is presented influences the way the issue is understood by voters. They study articles about major property tax reform proposals from four newspapers (*Pittsburgh Post-Gazette, Boston Globe, Bangor Daily News,* and *Miami Herald*) using a "network" approach to try and define the central ideas put forth by the media. They uncover patterns that show that the media does frame property tax issues with strong emphasis effects, factual effects, and personality effects. They stop short of concluding that this media framing shaped individual perceptions about the property tax and the eventual voter outcomes. Kenyon suggests two complementary approaches to the keyword approach used by Pagano and Jacob. She proposes a search for metaphors that recur in such news stories or a search for (loaded) phrases rather than individual words.

What Happens Now?

Almost no one would claim that we have it right in terms of property tax policy and administration. The essays in this volume demonstrate that there is much room for improvement, even in this uncertain time for property taxation, and offer a number of proposals.

The United States

These chapters challenge the conventional wisdom about the efficacy of the property tax as a local government revenue source. In fact, the tax is badly flawed. To make matters worse, policy makers have largely abandoned reforms other than limits and rollbacks. The result is that the tax has become more inefficient, less equitable, and less revenue productive. Zorn raises the question, “Where do we go from here?”

None of these chapters offers a magic reform program, but nearly all have ideas about how the tax could be made better in practice. Dornfest and Sheffrin both see the volatility of property tax shares to be a major source of taxpayer discontent. For revaluation to be politically acceptable, Dornfest argues that assessing offices need to better educate policy makers and the general public about the implications of valuation changes for the distribution of tax liability. Policy makers need to be concerned about this volatility in making their tax rate decisions. Unless the public can better understand (and accept) the reason for this volatility, the voter pressure for rollbacks and limits will continue.

Deskins and Fox conclude that there are behavioral effects induced by the property tax. Where economic decisions are driven by property tax policies, a welfare cost can be imposed on society, and the advice generally given is to avoid such preferential treatments. However, Deskins and Fox also point out that there can be benefits to such behavioral effects, and that the property tax might be used to engineer desired impacts such as reducing urban sprawl.

There are also suggestions here for more fundamental changes in the property tax. Zorn suggests consideration of a comprehensive wealth tax that would include property, gift, inheritance, and perhaps capital gains taxes. Sheffrin is skeptical that the public would support such a proposal and points out that public opinion research shows that Americans are ambivalent about taxing the wealthy. Worldwide the use of wealth taxes, including inheritance and gift, has been on a sharp decline over the past decade.

Some states have pushed for increased property transfer tax rates as a revenue measure. Sexton thinks this unwise and argues that the property transfer tax would be a poor replacement for the annual property tax.

Sheffrin thinks that a banded property tax, as used in the United Kingdom, could be a reasonable option. By placing property in assessment bands and fixing the relationship between the rates applied in each band, some certainty in the relative share of tax payments is guaranteed. Moreover, this approach offers a nice balance between concern for ability to pay and a benefits view of the property tax. He also discusses the reasons for the dissatisfaction with the banded system in the United Kingdom. In particular, the failure to revalue shows that the U.K. system is not immune to the political pressures faced by traditional taxes based on individual values.

Developing Countries

The possibility for sweeping reform might be stronger in the case of developing countries. In many low-income countries the property tax is not well entrenched or well understood by the public, and its burdens are very low. “Good” property taxation has not been an easy sell. Still, the existing institutions might be less resistant to major reforms than in industrialized countries. But, as Bahl and Wallace point out, major reforms are costly and can only be justified by a much higher revenue yield.

One reform direction backs away from a value base and taxes property according to land and building area. However, property values are still implicit in this approach, and reappraisals (or nominal rate increases) remain the principal obstacle to a productive property tax under an area-based system (see chapter 6).

There have been attempts to modernize the assessment process in some developing countries by introducing computerized mass appraisal techniques. But Cornia discusses how these have faltered, owing largely to the absence of reliable data on property sales.

Martinez-Vazquez, Noiset, and Rider also argue for simplification, but they are not ready to call for giving up on the traditional approach to property taxation. Instead, they make the case for a more gradual transition to a modern property tax. Although they are advocates of the property tax as a mainstay of local government financing, and of local government discretion in rate setting, they would keep administration and enforcement at the central (or state government) level until administrative capacity is better developed at the local government level.

Bahl and Wallace call for a new approach to property taxation and would replace the annual property tax with a single, comprehensive tax on land and structures. Their proposal would unify the annual property tax on urban and rural property, replace the property transfer tax with a tax on capital gains, make use of betterment levies or special assessments, and use agricultural land values to establish a presumptive tax on agricultural income. This family of taxes would be brought under a single administration at the local level and would feature local rate-setting autonomy. They estimate that a tax levied at a rate of about 1 percent of land wealth could generate annual revenues equivalent to about 3 percent of GDP.

Conclusions

The straw man in this set of chapters is the apparent divide between academics, who like the property tax as a local revenue source, and voters and politicians, who do not. But, as most of these authors have pointed out, bad practice has overtaken many of the potential advantages of taxing property. Voters have a point. The result is an unhappy one. In the United States, voter preferences in recent years appear to be to trade an equitable property tax for one whose revenue growth is restrained. In developing countries, the reaction against reform is also strong.

The chapters in this volume provide a basis for qualifying the conventional wisdom on the advantages of property taxation. The authors use this general critique to suggest policy and administrative reforms that might lead to recapturing voter confidence and developing workable reforms.

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